FARM INCOME TAX MANAGEMENT AND REPORTING

Reference Manual

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Federal Forms
1040 - U.S. Individual Income Tax Return (some line number revisions)
   Schedule A & B - Itemized Deductions and Dividend and Interest Income
   Schedule D - Capital Gains and Losses
   Schedule E - Supplemental Income Schedule
   Schedule EIC - Earned Income Credit
   Schedule F - Profit and Loss from Farming
   Schedule R - Credit for Elderly or the Disabled
   Schedule SE - Self-Employment Tax, short and long schedules
1040EZ - Income Tax Return for single and joint filers with no dependents, income
   under $50,000, interest under $400, other limitations
1040A - Nonitemizers, under $50,000 taxable income, other limitations
1040X - Amended U.S. Individual Income Tax Return
943 - Employer's Annual Tax Return for Agricultural Employees
1099's - Information returns to be filed by person who makes certain payments
1096 - Annual Summary and Transmittal of U.S. Information Returns
W-2 - Wage and Tax Statement; W-3 - Transmittal of Income and Tax Statement
W-5 - Earned Income Credit Advance Payment Certificate
W-9 - Request for Taxpayer Identification Number: used to provide TIN to
   individual filing 1099, use SS-4 to obtain employer ID
1065 - U.S. Partnership Return (see rules for filing Schds. L, M-1 and M-2.)
2119 - Sale of Your Home
3800 - General Business Credit
4136 - Credit for Federal Tax on Fuels
4562 - Depreciation and Amortization: used to report depreciation, cost
   recovery, Section 179 expense election, and listed property.
4684 - Casualties and Thefts
4797 - Sales of Business Property (also involuntary conversions and recapture
   amounts under Sections 179 and 280F).
4835 - Farm Rental Income and Expense [Crop and Livestock Shares (not cash)
   Received by Landowner]
6251 - Alternative Minimum Tax Computation - Individuals
6252 - Installment Sale Income
8606 - Nondeductible IRA Contributions, IRA Basis, and Nontaxable IRA
   Distributions
8582 - Passive Activity Loss Limitations
8582-CR - Passive Activity Credit Limitations
8615 - Tax for Children Under Age 14 Who Have Investment Income of More Than
   $1,100
8645 - Soil and Water Conservation Plan Certificate
8801 - Credit for Prior Year Minimum Tax -- Individuals and Fiduciaries
8824 - Like-Kind Exchanges
8829 - Expenses for Business Use of Your Home

New York State Forms
IT-201 - Resident Income Tax Return (long form)
IT-201ATT - Summary of Other Credits and Taxes
IT-201X - Amended Resident Income Tax Return (only acceptable method)
IT-204 - Partnership Return
IT-212 - Investment Credit (recapture or early disposition schedule included)
IT-215 - Earned Income Credit
IT-220 - Minimum Income Tax
IT-399 - New York State Depreciation (with instructions)
CT-4-S - Short Form for S Corporations
WT-4-A & B - Quarterly Combined Withholding and Wage Reporting Return
1994 TAX LEGISLATION AND FARM INCOME SITUATION

Federal Legislation

The 1994 Social Security Domestic Employment Reform Act, known as the "Nanny Tax Bill" was passed by Congress and will become law when signed by President Clinton. The bill increases the social security tax threshold on domestic employees from $50 per quarter to $1,000 a year for 1994 and 1995. Domestic employees include maids, housekeepers, day-care providers, baby-sitters, gardeners, maintenance workers and more. After 1995 the threshold will be indexed for inflation. There will be social security tax refunds in cases where 1994 deposits have been made but the worker will be paid less than $1,000. In 1995 through 1997, employers of domestic workers may report social security or unemployment tax obligations annually on their individual Form 1040 rather than on quarterly Form 942. Farmers may treat wages paid to domestic workers under the new $1,000 annual threshold rules rather than the $150 and $2,500 agricultural wage thresholds.

Congress will not pass the Health Security Act or any other major health care package in 1994. The self-employed individual's deduction for 25 percent of health insurance premiums expired at the end of 1993, and no deduction will be available until new legislation is passed. New health care legislation is likely to include major excise tax increases, but the potential change in income tax rates and deductions is unclear.

New York Approves LLCs

New York State passed legislation (Ch. 576, Laws 1994) approving the limited liability company (LLC) as an alternative form of entity structure, effective October 24, 1994. To offset potential long-term tax revenue loss, the state has imposed an annual fee on each member of an LLC taxed as a partnership. The fee for LLCs with New York income is $50 per member up to $10,000 with a minimum fee of $325 per LLC. In addition, a foreign LLC doing business in New York will be required to pay a one-time fee of $250. New York City has the authority to impose an annual fee on LLCs as well. See page 56 for more information on LLCs.

1994 Farm Income Situation

On average, New York dairy farmers will have somewhat higher taxable incomes in 1994 compared with 1993. Farm gate milk prices have averaged 5 percent above 1993 through the first three quarters of 1994. Livestock prices are lower, and farm production costs are up about 2 percent. Look for the average dairy farm net income to be up 2 to 3 percent in 1994.

Cash crop and fruit producers may have higher 1994 taxable incomes. Estimated New York grain production is up 11 percent. Production estimates call for a 48 percent larger grape crop and an 18 percent increase in the New York State apple crop.

Year-end tax management options and strategies will be important for many farm taxpayers in 1994. Estimate 1994 taxable income before the end of the year so receipts and expenses can be managed to reduce a large, unexpected tax liability. Or use tax management options to increase a small AGI in order to use up deductions and exemptions. Examine the tax consequences of all potential farm property sales, and make tax planning part of the farm business's strategic plan.
FEDERAL TAX PROVISIONS AFFECTING INDIVIDUALS

Standard Deduction

The standard deduction is indexed to inflation and is adjusted annually. The 1994 standard deduction is 2.5 to 3.0 percent higher than the 1993 standard deduction. The inflationary adjustment was 3 percent in 1994 and will be 2.6 percent for 1995. Look for a joint standard deduction of $6,550 for 1995.

Basic Federal Standard Deduction for 1993 and 1994

<table>
<thead>
<tr>
<th>Filing Status</th>
<th>1993</th>
<th>1994</th>
</tr>
</thead>
<tbody>
<tr>
<td>Married filing jointly; or qualifying widow(er)</td>
<td>$6,200</td>
<td>$6,350</td>
</tr>
<tr>
<td>Head of household</td>
<td>5,400</td>
<td>5,600</td>
</tr>
<tr>
<td>Single individuals</td>
<td>3,700</td>
<td>3,800</td>
</tr>
<tr>
<td>Married filing separately</td>
<td>3,100</td>
<td>3,175</td>
</tr>
</tbody>
</table>

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 $750 deduction if married and filing a joint or separate return. The additional deduction is $950 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 1994 personal exemption is $2,450, up $100 from 1993, and is expected to increase to $2,500 in 1995.

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 1994, the benefit of the personal exemption is phased out for taxpayers with the following specific high levels of adjusted gross income:

$167,700 if married filing jointly or qualifying widow(er) with dependent child;
$139,750 if head of household;
$111,800 if single;
$83,850 if married filing separately.

These threshold amounts are up 3 percent from 1993 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 $83,850.
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. It is called the Deduction for Exemptions Worksheet.

**Example:** Mr. and Mrs. Goodfarmer file jointly, have two children, and their 1994 AGI is $198,000. They claim four personal exemptions. Their reduction and net exemption are calculated as follows:

\[
\text{AGI} \quad \text{\$198,000} - \text{\$167,700 threshold} = \text{\$30,300 excess.} \quad \text{\$30,300 excess} + \text{\$2,500} = 12.1 \text{ or 13 excess increments. Their reduction is 13 x .02 (2 percent) = .26 x \$9,800 (4 @ \$2,450) = \$2,548. Their net personal exemption is \$9,800 - 2,548 = \$7,252.}
\]

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. Goodfarmer are in the 36 percent taxable income bracket, where the $2,548 of phased-out personal exemption will cost $917 in additional taxes. In other words, their $30,300 of excess AGI caused an additional tax liability of $917 or added 3.0 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 $2,450 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, Tax for Children Under Age 14 Who Have Investment Income of More than $1,200, 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, Parent's Election to Report Child's Interest and Dividends, 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.
The RRA of 1993 added 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 1993, which results in taxpayers with constant taxable incomes paying less income taxes in 1994. The new 36 and 39.6 percent brackets will be indexed for inflation for tax years beginning after 1994.

### 1994 Tax Rate Schedules

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<th>Single Taxpayers</th>
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<tr>
<td>Taxable Income</td>
<td>Taxable Tax</td>
<td></td>
<td>Taxable Income</td>
</tr>
<tr>
<td>$0-$22,750</td>
<td>15%</td>
<td>$0-$38,000</td>
<td>15%</td>
</tr>
<tr>
<td>$22,750-$55,100</td>
<td>$3,413 + 28% on excess</td>
<td>$38,000-$91,850</td>
<td>$5,700 + 28% on excess</td>
</tr>
<tr>
<td>$55,100-$115,000</td>
<td>$12,471 + 31%</td>
<td>$91,850-$140,000</td>
<td>$20,778 + 31%</td>
</tr>
<tr>
<td>$115,000-$250,000</td>
<td>$31,040 + 36%</td>
<td>$140,000-$250,000</td>
<td>$35,705 + 36%</td>
</tr>
<tr>
<td>$250,000+</td>
<td>$79,640 + 39.6%</td>
<td>$250,000</td>
<td>$75,305 + 39.6%</td>
</tr>
</tbody>
</table>

### Head of Household | Married Filing Separate Returns

<table>
<thead>
<tr>
<th></th>
<th>Taxable Income</th>
<th>Taxable Income</th>
<th>Taxable Tax</th>
<th>Taxable Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>$0-$30,500</td>
<td>15%</td>
<td>$0-$19,000</td>
<td>15%</td>
<td></td>
</tr>
<tr>
<td>$30,500-$78,700</td>
<td>$4,575 + 28% on excess</td>
<td>$19,000-$45,925</td>
<td>$2,850 + 28% on excess</td>
<td></td>
</tr>
<tr>
<td>$78,700-$127,500</td>
<td>$18,071 + 31%</td>
<td>$45,925-70,000</td>
<td>$10,389 + 31%</td>
<td></td>
</tr>
<tr>
<td>$127,500-$250,000</td>
<td>$33,199 + 36%</td>
<td>$70,000-125,000</td>
<td>$17,852 + 36%</td>
<td></td>
</tr>
<tr>
<td>&gt; $250,000</td>
<td>$77,299 + 39.6%</td>
<td>&gt; $125,000</td>
<td>$37,652 + 39.6%</td>
<td></td>
</tr>
</tbody>
</table>

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 $1,219 more federal income taxes in 1994 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 were 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 have elected to 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 have been paid on the due
date of the taxpayer's 1993 return without extensions. The second installment must
be paid on or before the due date of the 1994 return, and the third installment is
due with the 1995 tax return. Failure to make timely payment of any installment
terminates the election.

The installment option applied 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.

The election to use the installment option must have been made on the
individual taxpayer's original 1993 return, and Form 8841 must have been attached.
The installment election did not apply to estates and trusts. There is no
installment election for the additional high bracket income taxes paid in 1994.

**Itemized Deductions**

A taxpayer should itemize if total itemized deductions are greater than his or
her standard deduction. The election to itemize can be made or revoked on a
timely-filed, amended return. 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 1994 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 was 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. One set of rules applies to separate contributions of $250 or more. For noncash contributions, the taxpayer must obtain from the charity a receipt that describes the donated property, a good-faith estimate of its value, and whether anything was given to the taxpayer in exchange. For separate cash contributions exceeding $250, a taxpayer cannot rely solely on a canceled check but needs substantiation from the charity showing the amount and date the contribution was made. Taxpayers must use Form 8283 to report total noncash charitable contributions over $500.

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.

Penalties of $10 per contribution, not to exceed $5,000 per fundraising event, are imposed upon charities that fail to make the required disclosure.

Moving expenses are no longer itemized deductions. Report qualified moving expenses incurred after 1993 on Form 3903 and deduct them on line 24 of Form 1040.

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.

The following expenses, previously allowed as moving expenses, no longer qualify in 1994 and later tax years: 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 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).

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 50 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 1994 AGI in excess of $111,800 ($55,900 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 1994 AGI is $140,000. 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:

$140,000 AGI - $111,800 maximum = $28,200 excess x .03 = $846. $846 is less than $4,000 (.80 x $5,000 of applicable itemized deductions).

They reduce itemized deductions by $846; $17,000 - $846 = $16,154 adjusted itemized deductions.

Earned Income Credit Simplified and Expanded

Basic earned income credit rates have been increased, and low-income workers without qualifying children may be eligible for some 1994 earned income credit.
The supplemental young child credit and the health insurance credit were eliminated for tax years beginning after 1993.

For taxpayers with one qualifying child, the 1994 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 is now 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 must be age 25 or more, but under 65 years of age. A married taxpayer who does not meet the minimum age requirement may be eligible if his or her spouse meets the minimum age requirement. Other eligibility rules for the low-income taxpayer are: he or she cannot be claimed as a dependent or a "qualified child" on another person's tax return; his or her principal residence was in the USA for more than one-half of the tax year; the return must cover a 12-month period; the taxpayer cannot file a separate return if married, and cannot file Form 2555 or Form 2555-EZ. The credit percentage is much lower (7.65 percent), and no credit is earned when income exceeds $9,000.

<table>
<thead>
<tr>
<th>Year</th>
<th>Earned income range of earned income</th>
<th>Credit Rate</th>
<th>Maximum Credit</th>
<th>Phased Out Rate</th>
<th>Maximum Phaseout Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>1993</td>
<td>One Qualifying Child</td>
<td>18.5%</td>
<td>$7,750 - 12,200</td>
<td>13.21%</td>
<td>$1,434</td>
</tr>
<tr>
<td>1994</td>
<td>26.3%</td>
<td>$7,750 - 11,000</td>
<td>11,000 - 23,755</td>
<td>15.98%</td>
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<td>1995</td>
<td>34.0%</td>
<td>6,000 - 11,000</td>
<td>11,000 - 23,765</td>
<td>15.98%</td>
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<th>Year</th>
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<th>19.5%</th>
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<th>13.93%</th>
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<td>1993</td>
<td>19.5%</td>
<td>$7,750 - 12,200</td>
<td>$12,200-23,050</td>
<td>13.93%</td>
<td>$1,511</td>
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<td>1994</td>
<td>30.0%</td>
<td>8,425 - 11,000</td>
<td>11,000 - 25,296</td>
<td>17.68%</td>
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<td>1995</td>
<td>36.0%</td>
<td>8,425 - 11,000</td>
<td>11,000 - 23,425</td>
<td>20.20%</td>
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<table>
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<tr>
<th>Year</th>
<th>No Qualifying Children</th>
<th>0</th>
<th>$4,000 - 5,000</th>
<th>7.65%</th>
<th>$306</th>
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<tbody>
<tr>
<td>1994 &amp; later</td>
<td>7.65%</td>
<td>$4,000 - 5,000</td>
<td>$5,000 - 9,000</td>
<td>7.65%</td>
<td>$306</td>
</tr>
</tbody>
</table>

'This is not an official IRS table. Do not use these figures in tax preparation.

To be eligible for the Earned Income Credit, any taxpayer must have (1) earned income; (2) earned income and adjusted gross income, each below the maximum earned income allowed; (3) a return that covers 12 months (unless a short-year return is filed because of death); (4) a joint return if married (usually); (5) included income earned in foreign countries and not deduct or exclude a foreign housing...
amount; (6) 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 1994 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 1994 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 the maximum allowed.

If AGI is greater than the maximum allowed, there will be no credit even if earned income is below the maximum. 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 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 1994**

The '93 Tax Act reinstated 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 ($75,000 if married, filing separately) 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.

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 an employee's gross income of up to $5,250 of employer-provided education assistance that qualifies under Code Sec. 127 continues only 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.

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 on interest, dividends and other reportable payments is 31 percent, rather than 20 percent.

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.
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 interest that is sold and the interest retained. The gain would be the difference between the sale price of the interest sold and its basis.

If it is impossible to allocate the basis, the taxpayer is allowed to reduce the basis on the entire property covered by the development rights agreement 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 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 have been accepted. 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 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.

In determining whether a farm or other enterprise is organized and managed with the intent to make a profit, the following factors are among those normally considered:

a. The farm resources are organized and managed in a business-like manner. Evidence may include: a business plan, annual goals, complete business and financial records, business summary and analysis, business agreements and budgets.

b. The amount of time and effort spent managing and operating the farm or business.

c. The taxpayer, or the taxpayer's advisors, have the knowledge needed to manage the activity or enterprise as a successful business.

d. The current or future income derived from the activity is or will be needed for the taxpayer's livelihood.

e. Losses are due to circumstances beyond the taxpayer's control or are normal in the start-up phase of this activity (e.g., Christmas tree farming).

f. Technology has been improved and management methods have been changed in an attempt to improve profitability.

g. There are records to show that the activity has been profitable in past years and/or the taxpayer has made a profit in similar activities.

h. The activity or enterprise is not owned and operated for personal pleasure or recreation.

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. For more information on the use of the presumption, 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 principal 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.

The Supreme Court ruled in the Soliman case that the "principal place of business" was the place where the taxpayer performed the most important or significant business activities. This has a major impact on sales representatives and service providers who have their office at home and spend most of their working hours on the road. But the ruling on the Soliman case should not affect most farmers.

Because a farmer's principal place of business is the entire farm, and most farmers live in homes that are on the farm, an office in their home would be at their principal place of business (Pub. 225). A self-employed farmer who lives on the farm must still use the home office exclusively and regularly for farm business in order to deduct the applicable business use of home expenses.

"Exclusive use" means only for business. If a farmer uses the family den, dining room or his bedroom as an office, it does not qualify. "Regular use" means on a continuing basis, and a regular pattern of use should be established. "Regular use" does not mean constant use. The office should be used regularly in the normal course of the taxpayer's business.

Although Form 8829, *Expenses for Business Use of Your Home*, is not filed with Schedule F, it may be used as a worksheet to help farmers determine the appropriate expenses to claim. Applicable expenses for business use of the home include a percentage of the interest, taxes, insurance, repairs, utilities and depreciation paid.

Schedule C filers who claim expenses for business use of the home must file Form 4562. 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.

Caution: When a taxpayer sells a home on which expenses for business use have been claimed, tax consequences may occur. If the taxpayer were entitled to deduct business use of the home expenses in the year of sale, the sale proceeds must be divided between the sale of a residence (Form 2119) and the sale of business property (Form 4797). The gain reported on 4797 is not eligible for the rollover provision or the one-time exclusion.

**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.

**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.
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.

No Deduction for Most Club Dues

Prior to 1994, taxpayers could deduct club dues if they established that the use of the club was primarily for the furtherance of the taxpayer's trade or business and the specific expense was directly related to the active conduct of that trade or business [IRC §274(a)]. For 1994 and later years, qualified club dues may be deducted only if they are for membership in professional organizations (e.g., bar associations and teachers associations), or civic and public service organizations (e.g., Kiwanis, Lions, Rotary, Sertoma and similar organizations).

Health Insurance Premiums

The provision that allowed self-employed taxpayers to deduct 25 percent of health insurance premiums paid as an adjustment to income on 1040 expired on Dec. 31, 1993. If the provision is extended by late 1994 or 1995 legislation, it will probably be retroactive to Jan. 1, 1994 and the following rules will apply. The payments will be limited to health insurance coverage of the taxpayer and/or the spouse and dependents. The deduction may not exceed earned income. 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.

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 1994 standard mileage rate increased to 29 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.

The standard mileage rate may not be used when the automobile has been depreciated using a method other than straight line. The use of Section 179 or ACRS causes disqualification. When a taxpayer uses the standard rate on a vehicle in the first year it is used in the business, the taxpayer is making an election not to use MACRS depreciation or Section 179.

Rural mail carriers are allowed a special mileage rate equal to 150 percent of the basic standard mileage rate (43.5 cents for 1994). The special mileage rate applies to all business uses 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.
**Electric and Clean Fuel Vehicles**

Clean fuel vehicles placed in service after June 30, 1993 are eligible for a limited deduction, regardless of whether the use is business or personal. The deduction is limited to (a) $50,000 for trucks or vans with a gross vehicle weight of more than 26,000 pounds, and buses with a seating capacity greater than 20; (b) $5,000 for trucks and vans with GVW of 5,000-26,000 pounds; and (c) $2,000 for other vehicles not included in (a) or (b). There also is a deduction of up to $100,000 for clean vehicle refueling property. There are lots of rules and fine print. The clean fuel definition is very restrictive.

There is a 10 percent credit (maximum $4,000) for either business or personal electric vehicles (with at least four wheels) placed in service after June 30, 1993.

**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.

**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.

**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.

**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.

**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.

**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.

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.

**CORPORATION PROVISIONS**

**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.
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 version of the 1993 RRA bill. The Conference Agreement did not include this provision in the final bill but directed OMB to recommend ways of improving information reporting by federal agencies.

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.

INVESTMENT INCENTIVES IN THE REVENUE RECONCILIATION ACT OF 1993

Capital Gain 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.
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.

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

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 exceed 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 Schedule K that cannot be claimed as partnership expenses, such as a Sec. 179 deduction, 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 |
| 3. Guaranteed pymts. (not health insurance) |
| 4. Exp. recorded on books this year not included on Sch. K, lines 1-12a, 17e, and 18a (itemize): |
| a. Depreciation |
| b. Travel & entertainment |
| 5. Total, lines 1-4 $______ |
| 7. Deductions included on Sch. K, lines 1-12a, 17e, and 18a, not charged against book income this year |
| a. Depreciation |
| b. Travel & entertainment |
| 8. Total, lines 5 and 6 $______ |
| 9. Income (loss) (Schedule K, line 23a). Line 8 - line 5 $______ |

SCHEDULE M-2, Analysis of Partners' Capital Accounts, is the reconciliation schedule. The entries on lines 1 and 9 must be the same as line 21, Sch. L. Line 3 is the net income per books, which will include 4797 income on many farms. Line 4 includes capital gains. The Sec. 179 deduction goes on line 7. Use other entries on lines 4 and 7 to balance.

**Schedule M-2, Analysis of Partners' Capital Accounts**

| 2. Capital contributed |
| 3. Net income (loss) per books |
| 4. Other increases: |
| 5. Total lines 1-4 $______ |
| 7. Other decreases: |
| 8. Total lines 6 and 7 $______ |
| 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 1993 disaster payments from the federal government in 1994.
Income from Cancellation of Debt

Some New York farmers are likely to have debt cancelled by their lenders during 1994 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 moved them from the 3-year ACRS to the 5-year MACRS class.

<table>
<thead>
<tr>
<th>MACRS Class</th>
<th>ADR Midpoint Life</th>
</tr>
</thead>
<tbody>
<tr>
<td>3-year</td>
<td>4 years or less</td>
</tr>
<tr>
<td>5-year</td>
<td>More than 4 but less than 10</td>
</tr>
<tr>
<td>7-year</td>
<td>10 or more but less than 16</td>
</tr>
<tr>
<td>10-year</td>
<td>16 or more but less than 20</td>
</tr>
<tr>
<td>15-year</td>
<td>20 or more but less than 25</td>
</tr>
<tr>
<td>20-year</td>
<td>25 or more other than 1250 property with an ADR life of 27.5 or more</td>
</tr>
<tr>
<td>27.5-year</td>
<td>Residential rental property</td>
</tr>
<tr>
<td>39-year (31.5 if acquired before 5/13/93)</td>
<td>Nonresidential real property</td>
</tr>
</tbody>
</table>
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.

39-year (31.5 if acquired before 5/13/93) property includes nonresidential real property.
<table>
<thead>
<tr>
<th>Asset</th>
<th>ACRS</th>
<th>MACRS</th>
<th>Alternative</th>
</tr>
</thead>
<tbody>
<tr>
<td>Airplane</td>
<td>5</td>
<td>5</td>
<td>6</td>
</tr>
<tr>
<td>Auto (farm share)</td>
<td>3</td>
<td>5</td>
<td>5</td>
</tr>
<tr>
<td>Calculators and copiers</td>
<td>5</td>
<td>5</td>
<td>6</td>
</tr>
<tr>
<td>Cattle (dairy or breeding)</td>
<td>5</td>
<td>5</td>
<td>7</td>
</tr>
<tr>
<td>Citrus groves</td>
<td>5</td>
<td>15</td>
<td>20</td>
</tr>
<tr>
<td>Communication Equipment</td>
<td>5</td>
<td>7</td>
<td>10</td>
</tr>
<tr>
<td>Computer and peripheral equipment</td>
<td>5</td>
<td>5</td>
<td>5</td>
</tr>
<tr>
<td>Computer software</td>
<td>5</td>
<td>7</td>
<td>12*</td>
</tr>
<tr>
<td>Copiers</td>
<td>5</td>
<td>5</td>
<td>6</td>
</tr>
<tr>
<td>Cotton ginning assets</td>
<td>5</td>
<td>7</td>
<td>12</td>
</tr>
<tr>
<td>Farm buildings (general purpose)</td>
<td>19</td>
<td>20</td>
<td>25</td>
</tr>
<tr>
<td>Farm equipment and machinery</td>
<td>5</td>
<td>7</td>
<td>10</td>
</tr>
<tr>
<td>Fences (agricultural)</td>
<td>5</td>
<td>7</td>
<td>10</td>
</tr>
<tr>
<td>Goats (breeding or milk)</td>
<td>3</td>
<td>5</td>
<td>5</td>
</tr>
<tr>
<td>Grain bin</td>
<td>5</td>
<td>7</td>
<td>10</td>
</tr>
<tr>
<td>Greenhouse (single purpose structure)</td>
<td>5</td>
<td>10**</td>
<td>15</td>
</tr>
<tr>
<td>Helicopter (agricultural use)</td>
<td>5</td>
<td>5</td>
<td>6</td>
</tr>
<tr>
<td>Hogs (breeding)</td>
<td>3</td>
<td>3</td>
<td>3</td>
</tr>
<tr>
<td>Horses (nonrace, less than 12 years of age)</td>
<td>5</td>
<td>7</td>
<td>10</td>
</tr>
<tr>
<td>Horses (nonrace, 12 years of age or older)</td>
<td>3</td>
<td>3</td>
<td>10</td>
</tr>
<tr>
<td>Logging equipment</td>
<td>5</td>
<td>5</td>
<td>6</td>
</tr>
<tr>
<td>Machinery (farm)</td>
<td>5</td>
<td>7</td>
<td>10</td>
</tr>
<tr>
<td>Mobile homes on permanent foundations</td>
<td>10</td>
<td>15</td>
<td>20</td>
</tr>
<tr>
<td>Office equipment (other than calculators, copiers or typewriters)</td>
<td>5</td>
<td>7</td>
<td>10</td>
</tr>
<tr>
<td>Office furniture &amp; fixtures</td>
<td>5</td>
<td>7</td>
<td>10</td>
</tr>
<tr>
<td>Orchards</td>
<td>5</td>
<td>10***</td>
<td>20</td>
</tr>
<tr>
<td>Paved lots</td>
<td>5</td>
<td>15</td>
<td>20</td>
</tr>
<tr>
<td>Property with no class life</td>
<td>5</td>
<td>7</td>
<td>12</td>
</tr>
<tr>
<td>Rental property (nonresidential real estate)</td>
<td>19</td>
<td>39****</td>
<td>40</td>
</tr>
<tr>
<td>Rental property (residential)</td>
<td>19</td>
<td>27.5</td>
<td>40</td>
</tr>
<tr>
<td>Research property</td>
<td>5</td>
<td>5</td>
<td>12*</td>
</tr>
<tr>
<td>Sheep (breeding)</td>
<td>3</td>
<td>5</td>
<td>5</td>
</tr>
<tr>
<td>Silos</td>
<td>5</td>
<td>7</td>
<td>12*</td>
</tr>
<tr>
<td>Single purpose agricultural structure</td>
<td>5</td>
<td>10**</td>
<td>15</td>
</tr>
<tr>
<td>Single purpose horticultural structure</td>
<td>5</td>
<td>10**</td>
<td>15</td>
</tr>
<tr>
<td>Solar property</td>
<td>5</td>
<td>5</td>
<td>12*</td>
</tr>
<tr>
<td>Tile (drainage)</td>
<td>5</td>
<td>15</td>
<td>20</td>
</tr>
<tr>
<td>Tractor units for use over-the-road</td>
<td>3</td>
<td>3</td>
<td>4</td>
</tr>
<tr>
<td>Trailer for use over-the-road</td>
<td>5</td>
<td>5</td>
<td>6</td>
</tr>
<tr>
<td>Truck (heavy duty, general purpose)</td>
<td>5</td>
<td>5</td>
<td>6</td>
</tr>
<tr>
<td>Truck (light, less the 13,000 lbs.)</td>
<td>3</td>
<td>5</td>
<td>5</td>
</tr>
<tr>
<td>Typewriter</td>
<td>5</td>
<td>5</td>
<td>6</td>
</tr>
<tr>
<td>Vineyard</td>
<td>5</td>
<td>10***</td>
<td>20</td>
</tr>
<tr>
<td>Wind energy property</td>
<td>5</td>
<td>5</td>
<td>12*</td>
</tr>
</tbody>
</table>

*No class life specified. Therefore, 12-year life assigned.
****7 if placed in service before 1989.
***15 if placed in service before 1989.
****31.5 if placed in service before 5/13/93.
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.

<table>
<thead>
<tr>
<th>Class</th>
<th>Most Rapid MACRS Method Available</th>
</tr>
</thead>
<tbody>
<tr>
<td>3, 5, 7 and 10-year</td>
<td>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 39(31.5)-year Straight line only.</td>
</tr>
</tbody>
</table>

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.)

<table>
<thead>
<tr>
<th>Recovery Year</th>
<th>3-Year Class</th>
<th>5-Year Class</th>
<th>7-Year Class</th>
<th>10-Year Class</th>
<th>15-Yr.</th>
<th>20-Yr.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>200%</td>
<td>150%</td>
<td>200%</td>
<td>150%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1</td>
<td>33.33</td>
<td>25.00</td>
<td>14.29</td>
<td>10.71</td>
<td>10.00</td>
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<td>2</td>
<td>44.45</td>
<td>37.50</td>
<td>24.49</td>
<td>19.13</td>
<td>18.00</td>
<td>13.88</td>
</tr>
<tr>
<td>3</td>
<td>14.81</td>
<td>25.00</td>
<td>17.49</td>
<td>15.03</td>
<td>14.40</td>
<td>11.79</td>
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<td>4</td>
<td>7.41</td>
<td>12.50</td>
<td>11.52</td>
<td>12.25</td>
<td>11.52</td>
<td>10.02</td>
</tr>
<tr>
<td>5</td>
<td>11.52</td>
<td>16.66</td>
<td>12.49</td>
<td>12.25</td>
<td>11.52</td>
<td>10.02</td>
</tr>
<tr>
<td>6</td>
<td>5.76</td>
<td>8.33</td>
<td>8.93</td>
<td>12.25</td>
<td>8.93</td>
<td>8.74</td>
</tr>
<tr>
<td>7</td>
<td>4.46</td>
<td>6.13</td>
<td>6.55</td>
<td>8.74</td>
<td>6.55</td>
<td>8.74</td>
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<td>4.46</td>
<td>6.13</td>
<td>6.55</td>
<td>8.74</td>
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<td>8.74</td>
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<tr>
<td>12-15</td>
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<td>6.13</td>
<td>6.55</td>
<td>8.74</td>
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</table>

Annual Recovery Table: (Concluded)

<table>
<thead>
<tr>
<th>Recovery Year</th>
<th>3-Year Class</th>
<th>5-Year Class</th>
<th>7-Year Class</th>
<th>10-Year Class</th>
<th>15-Yr.</th>
<th>20-Yr.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>200%</td>
<td>150%</td>
<td>200%</td>
<td>150%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1</td>
<td>33.33</td>
<td>25.00</td>
<td>14.29</td>
<td>10.71</td>
<td>10.00</td>
<td>7.50</td>
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<tr>
<td>2</td>
<td>44.45</td>
<td>37.50</td>
<td>24.49</td>
<td>19.13</td>
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</tr>
<tr>
<td>3</td>
<td>14.81</td>
<td>25.00</td>
<td>17.49</td>
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<td>14.40</td>
<td>11.79</td>
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<tr>
<td>4</td>
<td>7.41</td>
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**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 39-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 pre-productive 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 IRC §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 1994 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 1994 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 39-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 1994, all 7-year MACRS property. He could expense $17,500 and claim $8,836 of depreciation in 1994 ($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 the $17,500 Sec. 179 election is applied to this $50,000, $32,500 is left to be used in the 40 percent calculation. Thus, $32,500 + ($100,000 - 17,500) = .39, which is less than 40 percent, so Pete avoids the mid-quarter rules. However, if his 1994 items had totaled $95,000 and $50,000 were placed in service in the last quarter, he would be caught by the 40 percent rule, even if he applied the $17,500 Sec. 179 to the items placed in service in the last quarter. That is, $32,500 + ($95,000 - 17,500) = .42, and all the 1994 items would be subject to the mid-quarter convention.

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 1994, 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 1993 (7-year property) but could choose 150 percent DB for seven years for a combine purchased in 1994. Keep in mind that 150 percent DB would be used on any other 7-year property purchased in 1994.
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 $2,960 on cars placed in service in 1994. 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 39-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 1994 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

<table>
<thead>
<tr>
<th>Straight Line Option</th>
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<th>Intermediate Years</th>
<th>Last Year</th>
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<tr>
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<td>1/12 in each of next 11 years</td>
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<td>25 years</td>
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<td>1/25 in each of next 24 years</td>
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<td><strong>10-year class options</strong></td>
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<td></td>
</tr>
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<td>1/20</td>
<td>1/10 in each of next 9 years</td>
<td>1/20</td>
</tr>
<tr>
<td>25 years</td>
<td>1/50</td>
<td>1/25 in each of next 24 years</td>
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<td>1/18 in each of next 17 years</td>
<td>balance</td>
</tr>
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<td>1/540 per mo.*</td>
<td>1/45 in each of next 44 years</td>
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*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 Nurseriesmen

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 nurseriesmen 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 as 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 effect 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, research credit, low-income housing credit, the disabled access credit, plus six others (page 33). 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 repealed for most property placed in service after 12/31/85. In 1994, 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 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. Units occupied by qualified full-time students and projects receiving assistance under the HOME Investment Partnership Act qualify for the credit.

**Credit for qualified research expenditures** made by a taxpayer carrying on a trade or business continues through 6/30/95. 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, the empowerment zone credit, the Indian employment credit and the employer social security 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.
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, 1994 would actually have less than 180 days in which to acquire the replacement property because the 1994 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 28 percent maximum tax rate on capital gain has not changed. 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 unrecovered 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 1989, 1990, 1991, 1992, or 1993 return and has a net Section 1231 gain for 1994, must recapture the losses on the 1994 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.

   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, 1987 cost $100,000

Soil and water expenses deducted on 1988 tax return $8,000

Land was sold May 15, 1994 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

<table>
<thead>
<tr>
<th>Type of Farm Property</th>
<th>Tax Form and Section</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Cattle and horses held for breeding, dairy, draft or sporting purposes &amp; held for 2 years or more; plus other breeding or sporting livestock held for at least one year.</td>
<td></td>
</tr>
<tr>
<td>a) Raised, pre-productive costs not subject to capitalization rules (1231 Property)</td>
<td>4797, Part I</td>
</tr>
<tr>
<td>b) Purchased (and raised subject to capitalization rules), sale results in gain (1245 Property)</td>
<td>4797, Part III</td>
</tr>
<tr>
<td>c) Purchased (and raised subject to capitalization rules), sale results in loss (1231 Property)</td>
<td>4797, Part I</td>
</tr>
<tr>
<td>2. Livestock held for breeding, dairy, draft, &amp; sporting purposes but not held for the required period.</td>
<td>4797, Part II</td>
</tr>
<tr>
<td>3. Livestock held for sale.</td>
<td>Schedule F, Part I</td>
</tr>
<tr>
<td>4. Machinery held for one year or more</td>
<td></td>
</tr>
<tr>
<td>a) Sale results in gain</td>
<td>4797, Part III</td>
</tr>
<tr>
<td>b) Sale results in loss</td>
<td>4797, Part I</td>
</tr>
<tr>
<td>5. Buildings, structures &amp; other depreciable real property held for one year or more</td>
<td></td>
</tr>
<tr>
<td>a) Sale results in gain</td>
<td>4797, Part III</td>
</tr>
<tr>
<td>b) Sale results in loss</td>
<td>4797, Part I</td>
</tr>
<tr>
<td>6. Farmland, held for one year or more, sold at a gain</td>
<td></td>
</tr>
<tr>
<td>a) Soil &amp; water expenses were deducted or cost sharing payments excluded</td>
<td>4797, Part III</td>
</tr>
<tr>
<td>b) If 6a does not apply</td>
<td>4797, Part I</td>
</tr>
<tr>
<td>7. Machinery, buildings, &amp; farmland held for less than one year</td>
<td>4797, Part II</td>
</tr>
</tbody>
</table>
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 to compute the correct gross profit ratio. This adjustment must be made 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 (IRC §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.

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 an installment sales contract as security for a loan, the loan proceeds received are treated as installment payments received for tax purposes.

**Use of Escrow Accounts**

The installment method may be disallowed if the seller and buyer use an escrow account to hold all or part of the selling price for payment in a future year. Deposits into an irrevocable escrow account represent payment in full, unless a substantial restriction exists on the seller's ability to receive the funds (Rev. Rul's. 77-295 & 79-91). Tax courts have been more liberal and have allowed the use of escrow accounts where the arrangement is part of a bona fide, arms-length agreement between buyer and seller, no interest from the escrowed funds is received by the seller and the escrow agent does not act under the exclusive authority of the seller.

**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 cancellation 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 October 1994 monthly AFR was 5.84 percent (short term, not over three years), 6.88 percent (mid term, three to nine years), 7.43 percent (long term, over nine years). The monthly AFRs have risen approximately 2 points in the last year.
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 were 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. Regular tax is defined later.

<table>
<thead>
<tr>
<th>Filing Status</th>
<th>Maximum Exemption</th>
<th>AMTI Phaseout Range</th>
<th>Phaseout Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Joint &amp; qualifying widow(er)</td>
<td>$45,000</td>
<td>$150,000-310,000</td>
<td>25</td>
</tr>
<tr>
<td>Single &amp; heads of household</td>
<td>33,750</td>
<td>112,500-232,500</td>
<td>25</td>
</tr>
<tr>
<td>Married filing separately</td>
<td>22,500</td>
<td>75,000-155,000</td>
<td>25</td>
</tr>
</tbody>
</table>

Alternative Minimum Taxable Income

Form 6251 was revised in 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. Adjustments and preferences are no longer listed separately on 6251.

Adjustments. The first category below 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 - 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 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. Charitable contributions of appreciated real, personal, or intangible property no longer create a tax preference. However, there are situations where carryovers of contributions could still create a tax preference. Beginning in 1993, if charitable contributions are limited by a percentage of AGI (or ATAGI), the charitable deduction must be recomputed for AMT purposes.

2. Tax-exempt interest from private activity bonds.

3. The excess of the tax depletion allowance over the adjusted basis of the property.


5. Intangible drilling costs.

Related Adjustments. Beginning in 1993, any item of income or deduction for regular tax purposes that is based on income (e.g., earned income, AGI, modified AGI or taxable income from a business) must be recalculated based on alternative tax AGI.

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 AMT**

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 1994 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 (IRC 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 1994 NOL would be first carried back to 1991, then to 1992, 1993, and then forward to 1995 and in order to 2009 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 passive activity losses to shelter business and investment income as well as salary and wage income. In October 1994, the IRS finally issued final regulations that define the term "activity".

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 were 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 and taxpayers in the real property business).

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.

A significant participation activity is any trade or business activity in which the taxpayer participated for more than 100 hours but did not materially participate. A special set of rules may allow a taxpayer to separate these activities from passive activities, even though the material participation rules are not met.

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

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. It adopts a facts-and-circumstances approach to identifying a taxpayer's activities. The Reg. provides that the taxpayer may, for the tax year in which there is a disposition of substantially all of an activity, treat the part disposed of as a separate activity, if he can establish the following with reasonable certainty:
(a) the amount of deductions and credits allocable to that part of the activity for the tax year under the rules governing the carryover of disallowed deductions and credits from earlier years, and (b) the amount of gross income and any other deductions and credits allocable to that part of the activity for the tax year.

**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.

**Rental Real Estate Passive Losses (Taxpayers in the Real Property Business)**

Taxpayers in the real property business are not 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.

For 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.

**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.

**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.

8802 - 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 $60,600 for 1994. There is 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 1993. The total rate is divided into two components representing the social security and medicare tax. The maximum 1994 social security tax is $3,757.20 (employer's share), up $186 from 1993.

<table>
<thead>
<tr>
<th>Year</th>
<th>Earnings Base</th>
<th>FICA Rate %</th>
<th>Self-Employment Rate %</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Soc. Sec.</td>
<td>Medicare</td>
<td>Soc. Sec.</td>
</tr>
<tr>
<td>1993</td>
<td>$57,600</td>
<td>$135,000</td>
<td>6.20</td>
</tr>
<tr>
<td>1994</td>
<td>$60,600</td>
<td>Unlimited</td>
<td>6.20</td>
</tr>
<tr>
<td>1995</td>
<td>$61,200</td>
<td>Unlimited</td>
<td>6.20</td>
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</tbody>
</table>

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 $60,600 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 $620 in 1994. 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, but there has been much controversy over the exemption. The Indianapolis and Des Moines IRS districts are auditing farmers who paid more than de minimus noncash wages, and they argue that payments in commodities later converted to cash are subject to FICA taxes. The IRS national office is preparing a set of guidelines dealing with the issue. Here are the old (current) rules. 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 has been 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 must 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].

The new IRS guidelines are likely to make the payment-in-kind rules more restrictive. Any arrangement that looks or sounds like it is a substitute for cash may be disqualified if the new guidelines are adopted. The guidelines will probably say that the employee must bear the costs and the risk of loss associated with ownership of the commodity, and the employee must hold the commodity for some reasonable length of time after it is received from the employer.

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 social security wage on Form 943 or the employee's W-2. It is included as other compensation in box 1 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**

In 1994 and later, social security recipients are potentially subject to two sets of rules on taxation of social security benefits. The rules that tax 50 percent of social security benefits have been in effect for several years. The new rules that tax up to 85 percent of social security benefits for higher-income taxpayers became effective in 1994.

The 85 percent rules apply to single taxpayers with provisional incomes above $34,000 and married taxpayers with provisional incomes above $44,000. Provisional income is modified AGI plus 50 percent of social security benefits. Modified AGI is AGI plus tax-exempt interest and certain foreign source income.

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

1. 85 percent of the taxpayer's social security 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 social security 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 social security benefits or 85 percent of provisional income. (In other words, the threshold is $0.)

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

<p>| | |</p>
<table>
<thead>
<tr>
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</thead>
<tbody>
<tr>
<td>Taxable interest and dividends</td>
<td>$9,000</td>
</tr>
<tr>
<td>Tax-exempt interest</td>
<td>6,000</td>
</tr>
<tr>
<td>Taxable pensions</td>
<td>30,000</td>
</tr>
<tr>
<td>Social security benefits</td>
<td>16,000</td>
</tr>
</tbody>
</table>

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

1. 85 percent of $16,000 social security 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 social security benefit included in gross income = $13,600, which is the smallest of 1, 2.a. or 2.b. In this example, 85 percent of social security benefits are included in income.

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 social security benefits is the lesser of:

1. 85 percent of $16,000 social security 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 social security benefit included in gross income = $8,550, which is the smallest of 1, 2.a. or 2.b. In this example, 53.4 percent of social security benefits are included in income.

The 50 percent rules apply to single taxpayers with provisional incomes between $25,000 and $34,000 and married persons filing jointly with provisional incomes between $32,000 and $44,000. For taxpayers in these ranges, the inclusion is still limited to the lesser 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 1994 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.

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 1994 the annual earnings limit for those less than age 65 is $8,040, and for those age 65 to 70 it is $11,160. 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 equity in the property; (2) make sure there is a written rental agreement and a fair market value rental rate; (3) deduct the taxes, interest, and insurance on the rented property on the spouse's Schedule E; (4) the spouse should deposit the rental income in a separate account and make his or her tax and interest payments from the account; (5) the spouse should avoid material participation; and (6) the operator must file Form 1099 for all rent payments made.

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.

Rules for Depositing FICA and Federal Income Taxes

The new deposit rules that took effect for wages paid after 12/31/92 will apply in 1995. Farm employers who reported $50,000 or less of federal payroll taxes in 1993 must make timely monthly deposits in 1995. 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 1993 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.

All employers who accumulate $100,000 or more in payroll taxes must make the deposit by the next banking day. 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.

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. 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 1994. The 1994 NYSUI rates range from 2.6 to 7.1 percent on the first $7,000 of each employee's total earnings. The standard and maximum basic rate is 5.4 percent. The 1994 "new employer" rate is 4.4 percent. Employers may receive a credit of up to 5.4 percent for NYSUI taxes paid on their FUTA liability even when their NYS experience rate is less than 5.4 percent. A farmer subject to the NYSUI may pay a FUTA rate as low as 0.8 percent in 1994.

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.
LIMITED LIABILITY COMPANIES IN NEW YORK

The governor signed legislation on July 26, 1994 that will allow limited liability companies (LLCs), limited liability partnerships (LLPs), and professional limited liability companies (PLLCs) to be formed and operate in New York beginning October 24, 1994. There are also provisions for "foreign" (i.e., out of state) versions of these entities to do business in New York.

The basic concept of LLCs (including LLPs and PLLCs) is that they have the limited liability aspects of a corporation but are taxed like partnerships. There is no U.S. tax code written by Congress that covers taxation of LLCs. Whether an LLC qualifies to be taxed as a partnership is entirely dependent on IRS rulings. An LLC legally formed in some states will automatically qualify to be taxed for federal purposes as a partnership, but in other states the taxation will depend on whether the LLC agreement is properly written to qualify as a partnership for IRS tax purposes. The New York law is written broadly enough that an LLC could be formed in New York that will not qualify for partnership taxation under IRS rules. Limited liability partnerships and professional limited liability companies appear to be unique to New York. They are intended for professionals such as doctors, lawyers, accountants and architects. It is not clear that they have the same liability and income tax characteristics as LLCs.

Whether an LLC qualifies to be taxed as a partnership (that is, no tax at the partnership level, but the income is allocated to the partners and is included in their taxable incomes) depends on whether it has a preponderance (that is, more than two) of the four corporate characteristics: (1) continuity of life; (2) centralization of management; (3) liability for corporate debts limited to corporate property; and (4) free transferability of interests. If the LLC has three or more of these characteristics, it will be taxed as a corporation.

LLCs have been characterized by some as limited partnerships with no general partner. A limited partnership must have a general partner who has personal liability for the debts of the limited partnership. In an LLC, none of the partners has personal liability for the debts of the LLC. (However, a prudent lender is not likely to lend much money to an LLC without the personal guarantees of the members of the LLC, so in fact, they will have personal liability for the debts.)

The other aspect of limited liability relates to personal liability of the members in case the LLC or one of its members is sued for allegations of wrongdoing. It is not clear to us that assets of a member of an LLC that are outside the LLC are necessarily beyond the reach of the plaintiff in such an action. It is our understanding that each member of an LLP is legally responsible for his/her own actions and the actions of those he or she directly supervises. The assets of the LLP are at risk in the case of lawsuits, and the personal assets of the offending member outside the LLP are at risk, but personal assets of nonoffending members outside the LLP are not at risk. (We are not attorneys, so if you have legal questions about LLCs, LLPs or PLLCs, consult your attorney.)

Establishing and maintaining an LLC will require paying money to NY State. In addition to the initial fees that must be paid to New York, there is an annual filing fee of $50 per member with a minimum of $325 and a maximum of $10,000.

General partnerships and limited partnerships which convert to LLCs will generally not have a taxable event. However, C and S corporations which convert to LLCs will have a taxable event. In general, the difference between the basis and fair market value of assets will be subject to tax if there is a conversion of either C or S to an LLC. In the case of a C corporation, there will be double taxation.
NEW YORK STATE INCOME TAX

New York passed a tax law in 1994 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 1997.

**Exemptions and Standard Deductions**


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<thead>
<tr>
<th>Year</th>
<th>1993</th>
<th>1994</th>
<th>1995</th>
<th>1996</th>
<th>after</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Standard Deduction ($)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tax Status:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Joint</td>
<td>$9,500</td>
<td>$9,500</td>
<td>$10,800</td>
<td>$12,350</td>
<td>$13,000</td>
</tr>
<tr>
<td>Head of household</td>
<td>7,000</td>
<td>7,000</td>
<td>8,150</td>
<td>10,000</td>
<td>10,500</td>
</tr>
<tr>
<td>Single</td>
<td>6,000</td>
<td>6,000</td>
<td>6,600</td>
<td>7,400</td>
<td>7,500</td>
</tr>
<tr>
<td>Married filing separately</td>
<td>4,750</td>
<td>4,750</td>
<td>5,400</td>
<td>6,175</td>
<td>6,500</td>
</tr>
<tr>
<td>Dependent filers</td>
<td>2,800</td>
<td>2,800</td>
<td>2,800</td>
<td>2,900</td>
<td>3,000</td>
</tr>
<tr>
<td>-----------</td>
<td>-------</td>
<td>-------</td>
<td>-------</td>
<td>-------</td>
<td>-------</td>
</tr>
<tr>
<td>Exemption ($)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
| 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 1991-95, $2,900 in 1996, and $3,000 in 1997 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:

<table>
<thead>
<tr>
<th>Filing Status</th>
<th>Numerator = Lesser of $50,000 or the excess of NYAGI over:</th>
<th>Denominator</th>
</tr>
</thead>
<tbody>
<tr>
<td>Married filing jointly</td>
<td>$200,000</td>
<td>$50,000</td>
</tr>
<tr>
<td>Single and married filing separately</td>
<td>$100,000</td>
<td>$50,000</td>
</tr>
<tr>
<td>Head of household</td>
<td>$150,000</td>
<td>$50,000</td>
</tr>
</tbody>
</table>
Example of first percentage (married, joint return): NYAGI = $225,000

\[ 25,000 + 50,000 = .5; \quad .5 \times 25\% = 12.5\% \]

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

\[ 550,000 - 475,000 = 75,000; \quad 50,000 \text{ is lesser.} \]

\[ 50,000 + 50,000 = 1.0; \quad 1.0 \times 25\% = 25\% \]

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**

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 1994 law delayed the implementation of the 1990 rates that were in the 1987 law until 1997. Rates for that year are:

**New York State Tax Rates, 1997 and Later**

<table>
<thead>
<tr>
<th>Filing Status</th>
<th>New York Taxable Income</th>
<th>Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Married filing jointly &amp; surviving spouse</td>
<td>Not over $27,000</td>
<td>5.5%</td>
</tr>
<tr>
<td></td>
<td>Over $27,000</td>
<td>7.0</td>
</tr>
<tr>
<td>Single, married filing separately, estates &amp; trusts</td>
<td>Not over $12,500</td>
<td>5.5</td>
</tr>
<tr>
<td></td>
<td>Over $12,500</td>
<td>7.0</td>
</tr>
<tr>
<td>Head of household</td>
<td>Not over $19,500</td>
<td>5.5</td>
</tr>
<tr>
<td></td>
<td>Over $19,500</td>
<td>7.0</td>
</tr>
</tbody>
</table>
There is a gradual phase-in. The rate schedules for 1994 follow. These are the same schedules that were in effect for 1990, 1991, 1992 and 1993. The 1995 and 1996 rates in the 1993 law were modified by the 1994 law but are not shown here.

Married Filing Jointly and Qualifying Widow(er)

If the 1994 New York taxable income is:

<table>
<thead>
<tr>
<th>Over</th>
<th>Not Over</th>
<th>Tax</th>
<th>4% of the excess over</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>$0</td>
<td>$11,000</td>
<td>4%</td>
<td>$440 plus 5%</td>
<td>11,000</td>
</tr>
<tr>
<td>11,000</td>
<td>16,000</td>
<td>$440</td>
<td>6%</td>
<td>16,000</td>
</tr>
<tr>
<td>16,000</td>
<td>22,000</td>
<td>$690</td>
<td>6%</td>
<td>22,000</td>
</tr>
<tr>
<td>22,000</td>
<td>26,000</td>
<td>$1,050</td>
<td>7%</td>
<td>26,000</td>
</tr>
<tr>
<td>26,000</td>
<td></td>
<td>$1,330</td>
<td>7.875%</td>
<td></td>
</tr>
</tbody>
</table>

Single, Married Filing Separately and Estates and Trusts

If the 1994 New York taxable income is:

<table>
<thead>
<tr>
<th>Over</th>
<th>Not Over</th>
<th>Tax</th>
<th>4% of the excess over</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>$0</td>
<td>$5,500</td>
<td>4%</td>
<td>$220 plus 5%</td>
<td>5,500</td>
</tr>
<tr>
<td>5,500</td>
<td>8,000</td>
<td>$220</td>
<td>6%</td>
<td>8,000</td>
</tr>
<tr>
<td>8,000</td>
<td>11,000</td>
<td>$345</td>
<td>6%</td>
<td>11,000</td>
</tr>
<tr>
<td>11,000</td>
<td>13,000</td>
<td>$525</td>
<td>7%</td>
<td>13,000</td>
</tr>
<tr>
<td>13,000</td>
<td></td>
<td>$665</td>
<td>7.875%</td>
<td></td>
</tr>
</tbody>
</table>

Head of Household

If the 1994 New York taxable income is:

<table>
<thead>
<tr>
<th>Over</th>
<th>Not Over</th>
<th>Tax</th>
<th>4% of the excess over</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>$0</td>
<td>$7,500</td>
<td>4%</td>
<td>$300 plus 5%</td>
<td>7,500</td>
</tr>
<tr>
<td>7,500</td>
<td>11,000</td>
<td>$300</td>
<td>6%</td>
<td>11,000</td>
</tr>
<tr>
<td>11,000</td>
<td>15,000</td>
<td>$475</td>
<td>6%</td>
<td>15,000</td>
</tr>
<tr>
<td>15,000</td>
<td>17,000</td>
<td>$715</td>
<td>7%</td>
<td>17,000</td>
</tr>
<tr>
<td>17,000</td>
<td></td>
<td>$855</td>
<td>7.875%</td>
<td></td>
</tr>
</tbody>
</table>

Household Credit

The 1994 law provided that the full amount of credit will be allowed for taxable years beginning in 1994 and 1995, and 50 percent of the credit will be allowed for 1996. For taxable years beginning after 1996, 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 1994, 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.
**Earned Income Tax Credit (EIC)**

An earned income credit (EIC) is allowed against New York personal income tax for taxable years beginning after 1993 (Sec. 606(d), Tax Law). The New York EIC is equal to 7.5 percent of the federal EIC for taxable years beginning in 1994, 10 percent of the federal EIC for taxable years beginning in 1995, 15 percent of the federal EIC for taxable years beginning in 1996, and 20 percent of the federal EIC for taxable years beginning after 1996.

**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.

<table>
<thead>
<tr>
<th>Household Gross Income</th>
<th>Applicable Rate</th>
<th>Maximum Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>$0 - $ 1,000</td>
<td>0.035</td>
<td>$75</td>
</tr>
<tr>
<td>5,001 - 6,000</td>
<td>0.045</td>
<td>65</td>
</tr>
<tr>
<td>10,001 - 11,000</td>
<td>0.055</td>
<td>55</td>
</tr>
<tr>
<td>15,001 - 16,000</td>
<td>0.065</td>
<td>45</td>
</tr>
<tr>
<td>17,001 - 18,000</td>
<td>0.065</td>
<td>41</td>
</tr>
</tbody>
</table>

**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

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 is 5 percent on the first $350,000,000 of investment credit base and 4 percent on any excess.

MACRS property placed in service after December 31, 1986 qualifies for NYIC. This means that farm property in the ACRS or MACRS 3-year class should qualify. There is no reduction in the amount of credit allowed for 3-year property, and if kept in use for three years it will earn 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 10 years (it was 7 years before the 1994 law extended it to 10). 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 increase is 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 1994 and Later

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 1993, individuals, estates and trusts (except farmers and fishermen) whose New York adjusted gross income in the prior year is more than $150,000 ($75,000 if married filing separately) must pay 110 percent of the prior year's state, and if applicable, city resident or nonresident tax, or 90 percent of the current year's tax, to avoid a penalty for underpayment of estimated tax.

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.
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Alan S. White
Stephen E. Hadcock
Larry R. Hulle

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