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FARM INCOME TAX MANAGEMENT AND REPORTING

Reference Manual

1996 Farm Tax Schools

Stuart F. Smith
Charles H. Cuykendall

Department of Agricultural, Resource, and Managerial Economics
College of Agriculture and Life Sciences
Cornell University, Ithaca, New York 14853-7801

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1996 TAX LEGISLATION AND FARM INCOME SITUATION

Federal Legislation

President Clinton and congress have posted new tax legislation which will be effective in 1997. Here are the highlights of what's new:

- Deductibility of health insurance for self-employed individuals increases from the current 30% to 40% in 1997 and up to 80% after 2005.
- Cost of long term health care insurance (nursing home) will be a deduction on Schedule A subject to limitations.
- IRA deductions will rise to $4,000 for a couple regardless of whether the spouse is employed and has earned income.
- Experimental medical savings accounts will be available to certain employees and self-employed individuals who waive basic health care coverage and use the medical savings accounts for health care expenses.
- Savings Incentive Match Plan for Employees (SIMPLE) will be a new simplified employee pension plan for firms with less than 100 employees. This plan will allow an employee to defer up to $6,000 of salary, similar to a 401K plan with employer matching options.
- Section 179 deduction will increase from $17,500 to $18,000 for 1997 and further increase gradually to $25,000 after year 2002. Air or heating units will not qualify for Section 179 deduction.
- Voluntary tax withholding will be available on social security benefits, crop disaster payments, CCC loans and unemployment pay.

1996 Farm Income Situation

Dairy farm net incomes have been on a roller coaster in 1996. Feed costs reached near record highs during the first half of the year and uniform milk prices established new third quarter highs. Average 1996 milk prices will be up approximately 14 percent, but Sch. F net income may increase less than 12 percent on the average dairy farm. Annual feed costs have increased 25 percent or more for many farms and Sch. F expenses may be up 15 percent. Average dairy farm expenses are expected to increase 10 to 12 percent in 1996. Although average 1996 dairy farm net farm profits will only be marginally improved over 1995, there will be a major increase in income variability. A substantial number of dairy farmers will need innovative tax management strategies to avoid large income tax liabilities.

Increased variability describes the net income situation in most other NY farming enterprises. Cattle producers will very likely realize negative margins in 1996 while some cash crop producers may realize very high net incomes. Many apple growers had poor crops but grape production was above average.

Tax management consideration for high income farmers:

- Maximize use of Sec. 179 deductions and pre-paid expenses.
- Defer income with installment sales and deferred payment contacts.
- Increase the use of qualified retirement plans.
- Pay all operating accounts before the end of year.
- Double up itemized deductions and claim them every other year.
- Maximize after tax income over several years, don't minimize taxes paid in one year.

FEDERAL TAX PROVISIONS AFFECTING INDIVIDUALS

Standard Deduction

The standard deduction is indexed to inflation and is adjusted annually. The 1996 standard deduction is about 2.3 percent higher than the 1995 standard deduction. The inflationary adjustment will be around 3 percent for 1997.

Basic Federal Standard Deduction for 1995, 1996 and projected 1997

Filing Status	1995	1996	1997[1]
Married filing jointly; or qualifying widow(er)	$6,550	$6,700	$6,900
Head of household	5,750	5,900	6,050
Single individuals	3,900	4,000	4,150
Married filing separately	3,275	3,350	3,450

[1] projected

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 $800 (up $50 from 1995) deduction if married and filing a joint or separate return. The additional deduction is $1,000 (up $50 from 1995) 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 1996 personal exemption is $2,550, up $50 from 1995, and is expected to increase to $2,650 in 1997.

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 1996, the benefit of the personal exemption is phased out for taxpayers with the following specific high levels of adjusted gross income (AGI). These threshold amounts are up 2.8 percent from 1995 and are adjusted for inflation annually:

$176,950 if married filing jointly or qualifying widow(er) with dependent child; (exemptions completely lost at $299,450 AGI)
$147,450 if head of household; (exemptions completely lost at $269,950 AGI)
$117,950 if single (exemptions completely lost at $240,450 AGI)
$ 88,475 if married filing separately; (exemptions completely lost at $149,725 AGI)

The phaseout in personal exemptions 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 $88,475.

The personal exemption phaseout or reduction is calculated on an eight-line worksheet called the **Deduction for Exemptions Worksheet** included in the 1040 instructions. If adjusted gross income exceed the threshold, complete the worksheet before claiming the personal exemption deduction on line 36 of Form 1040.

Example: Mr. and Mrs. Dairy file jointly, have two children, and their 1996 AGI is $198,000. They claim four personal exemptions. Their reduction and net exemption are calculated as follows:

> AGI $198,000 - $176,950 threshold = $21,050 excess. $21,050 excess ÷ $2,500 = 8.4 or 9 excess increments. Their reduction is 9 x .02 (2 percent) = .18 x $10,200 (4 @ $2,550) = $1,836. Their net personal exemption is $10,200 - 1,836 = $8,364.

A 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. Dairy are in the 36 percent taxable income bracket, where the $1,836 of phased-out personal exemption will cost $661 in additional taxes. In other words, their $21,050 of excess AGI caused an additional tax liability of $661 or added 1.27 percent to their tax liability and effectively increased their marginal rate to 38.9 percent.

Dependents

Taxpayers must report the social security numbers of all dependents one month 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 $2,550 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 $650 or the individual's earned income up to his or her standard deduction. The $650 rule limits the basic standard deduction but not additional deductions for blind and elderly taxpayers.

Investment or unearned income in excess of $1,300 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 $1,300**, where the excess over $1,300 will be taxed at the parent's marginal rate and unearned income greater than $650 but less than $1,300 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, and an adjusted $1,300 base amount and $650 tax exemption are now indexed for inflation starting on 1996 returns 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.

1996 Tax Rates

All the tax brackets have been adjusted for inflation this year. Each tax bracket has been moved up approximately 2.8 percent from 1995, which results in many taxpayers with constant taxable incomes paying somewhat less income taxes in 1996. Married taxpayers filing jointly with $40,100 of taxable income in 1995 and 1996 will gain $143 in tax savings from the adjustments in tax rates.

1996 Tax Rate Schedules

Single Taxpayer		Married Filing Joint Return & Qualifying Widow(er)	
Taxable Income	Tax	Taxable Income	Tax
$0-$24,000	15%	$0-$40,100	15%
$24,000-58,150	$3,600.00 + 28% on excess*	$40,100-96,900	$6,015.00 + 28% on excess*
$58,150-121,300	$13,162.00 + 31% "	$96,900-147,700	$21,919.00 + 31% "
$121,300-263,750	$32,738.50 + 36% "	$147,700-263,750	$37,667.00 + 36% "
> $263,750	$84,020.50 + 39.6% "	> $263,750	$79,445.00 + 39.6% "

Head of Household		Married Filing Separate Returns	
Taxable Income	Tax	Taxable Income	Tax
$0-$32,150	15%	$0-$20,050	15%
$32,150-83,050	$4,822.50 + 28% on excess*	$20,050-48,450	$3,007.50 + 28% on excess*
$83,050-134,500	$19,074.50 + 31% "	$48,450-73,850	$10,959.50 + 31% "
$134,500-263,750	$35,024.00 + 36% "	$73,850-131,875	$18,833.50 + 36% "
> $263,750	$81,554.00 + 39.6% "	> $131,875	$39,722.50 + 39.6% "

* on excess over first number in bracket

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 $55,000 of taxable income will pay $1,420 more federal income taxes in 1996 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 $121,300, but a married taxpayer reaches the 36 percent tax rate when taxable income exceeds $73,850 per person.

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. The itemized deduction limitation for 1996 for married filing separately is $58,975 and the 1996 limit for all other taxpayers is $117,950.

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. Also there's a tax trap if you pay the mortgage on an ex-spouse's home, where only the ex-spouse resides after the divorce, there is no interest deductibility.

Investment interest expense is deductible on the 1996 return and is limited to the amount of net investment income. Investment interest expense 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 (auto mileage deduction for 1996 is $.10 per mile) 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.

Long-term Health Care premiums will be deductible by itemizers when combined with other premiums and medical expenses that exceed 7.5 percent of adjusted gross income. However, there are annual limits on the deductible premiums tied to age. Filers over 70 years old can include long term health care premiums of up to $2,500 per year per person subject to the 7.5 percent exclusion. Those between 60 and 70 years may include $2,000 per person; 50 to 60 years $750 per person; 40 to 50 years $375 per person, 40 years and under only $200 per person.

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 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. For 1996 returns, acknowledgment must be obtained from the charity by the earlier of the filing date or the due date of the return, including extensions. 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. 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. The standard mileage rate for passenger car use for charitable causes remains at $.12 per mile for 1996.

Moving expenses are no longer itemized deductions. Report qualified moving expenses 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. The standard mileage rate for passenger car use for moving has increased to $.10 per mile for 1996. 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: 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. Job hunting expenses may be deductible if one is looking for employment. Job hunters expenses are deductible if incurred in looking for a new job in their present occupation. The job searching expenses are not deductible if looking for a job in a new occupation or looking for a first job. Factors to determine if the employment is in the same occupation include: job classification, job responsibility, and nature of employment. The following are expenses that may be deductible: cost of typing, printing and mailing resumes; long distance phone calls and mailing; career counseling and agency fees; and travel or transportation expenses.

4. Other deductions: professional dues, books, journals and safe deposit box rental, 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. The deductible portion of meal and entertainment expenses paid in connection with a trade or business is 50 percent.

Limitation for High-Income Taxpayers

Taxpayers with a 1996 AGI in excess of $117,950 ($58,975 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: Fred and Ann Veryrich's 1996 AGI is $140,950. 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:

> $140,950 AGI - $117,950 maximum = $23,000 excess x .03 = $690. $690 is less than $4,000 (.80 x $5,000 of applicable itemized deductions). They reduce itemized deductions by $690; $17,000 - $690 = $16,310 adjusted itemized deductions.

Earned Income Credit

Basic earned income credit rates were increased in 1994, the supplemental young child credit and the health insurance credit were eliminated, and some low-income workers without qualifying children became eligible for earned income credit. Earned income includes wages, salaries, tips and net self-employment earnings but does not include interest, dividends, alimony and social security benefits.

For taxpayers with one qualifying child, the 1996 EIC is 34.0 percent of the first $6,330 of earned income. The maximum credit is $2,152 and is reduced by 15.98 percent of earned income (or modified AGI, if greater) exceeding $11,610. For taxpayers with two or more qualifying children, the EIC is 40 percent of the first $8,890 of earned income. The maximum credit is $3,556 and is reduced by 21.06 percent of earned income (or modified AGI, if greater) exceeding $11,610.

Earned Income Credit Rates, Income Ranges, and Phaseout*

Qualifying Children	Credit rate	Earned income range: Maximum credit	Earned income range: Phaseout	Phaseout rate	Maximum credit
		For 1995			
None	7.65%	$4,105-5,125	$5,125-9,230	7.65%	$314
One	34.00%	6,159-11,292	11,292-24,396	15.98%	2,094
Two or more	36.00%	8,639-11,292	11,292-26,673	20.22%	3,110
		After 1995			
None	7.65%	$4,220-5,280	$5,280-9,500	7.65%	$323
One	34.00%	6,330-11,610	11,610-25,078	15.98%	2,152
Two or more	40.00%	8,890-11,610	11,610-28,495	21.06%	3,556

*This is not an official IRS table. Do not use these figures in tax preparation as numbers are adjusted annually for inflation.

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 smaller (7.65 percent)for taxpayers with no qualifying children, and the credit is phased out over a lower income range.

To be eligible for the Earned Income Credit, any taxpayer must have all of the following: (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 deducted or exclude a foreign housing amount; (6) not be used as a qualifying child making another person eligible for the earned income credit.

Beginning in 1996 this credit is denied to taxpayers with an excess of $2,220 of taxable and nontaxable interest income, dividends and net income from rents and royalties not derived in the ordinary course of business. The 1996 act expands disqualified income to include the excess of capital gains over capital losses.

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 1996 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 1996 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 or disqualified income 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.

The **Earned Income Credit Advance Payment Certificate (Form W-5)**, 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 1996

The estimated tax rules have not changed from 1994 when the 100 percent of last year's tax safe harbor rule was reinstated. 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 officially follows the federal definition of gross income from farming for tax years after 1992.

Limitation on Compensation for Retirement Plan Calculations

The maximum amount of compensation that can be taken into account under qualified retirement plans, SEPs, etc., was lowered to $150,000 by the '93 tax act. This amount is adjusted annually for inflation, but only in increments of $10,000. If the annual adjustment calculates to less than $10,000, no adjustment will be made. The 1996 maximum amount remains at $150,000. Transition rules apply to governmental plans and plans maintained under a collective bargaining agreement.

Employer-Provided Education Assistance

The exclusion for up to $5,250 of employer-provided educational assistance for undergraduates has been extended and is available for courses beginning before July 1, 1997 (not June 1 as intended, unless amended) and is retroactive for tax years beginning after December 31, 1994. The exclusion date for graduate-level education expenses up to $5,250 is for any course beginning before July 1, 1996. IRS has established a procedure for both employee and employer refunds for employer-provided education assistance in 1995 and 1996.

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. The amount of tax-free employer-paid parking is $165 a month for 1996 and tax-free transit passes cannot exceed $65 per month.

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, public charity or operating private foundation (land trust) may result in a deduction as a "qualified conservation contribution" under Sec. 170(h). The contribution must consist of the donor's entire interest in the property, a remainder interest, or a restriction into perpetuity on the use of the property. The purpose must be limited to conservation and historic preservation.

The donation of such an easement normally would reduce the value of the property. The value of conservation easements must be determined on a case-by-case basis and may be determined with reference to amounts paid for comparable easements. If comparable easements are not available, the decrease in fair market value of the property encumbered by the easement must be determined.

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**. If the donation of the easement does not decrease the value of the property, the contribution is zero. If the conservation easement causes other property owned by the donor to increase in value, the qualified charitable contribution must be reduced accordingly.

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 carry forward 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. 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 land is excluded), an allocation of part of the basis to the land not included would still be required.

USDA Wetland Reserve Program

The USDA is authorized to enter into permanent easement agreements with farmland owners to restore certain cropland to wetland. New York is a pilot state, 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.

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 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 business 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 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.

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. 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.

Form 8829, Expenses for Business Use of Your Home, is not filed with Schedule F, but 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 claimed.

Farmers who reside off the farm, crop consultants and sales representatives will be allowed home office deductions only if they meet two additional new rules. Home office activities must be equal to or of greater importance to their trade or business, than are non-office activities and time spent at the home office must be greater than that devoted to non-office activities.

Schedule C filers who claim expenses for business use of the home must file Form 8829. 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 is 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.

Transportation Expenses

When a taxpayer has two established places of business, the cost of traveling between them is deductible as an ordinary and necessary business expense under Sec. 162, because the taxpayer generally travels between them for business reasons. However, when one business is located at or near the taxpayer's residence, the reason for travel can be questioned. In Rev. Rul. 94-47 IRS takes the position that transportation expenses incurred in travel from the residence are only deductible if the travel is undertaken in the same trade or business as the one that qualifies the taxpayer for a deductible home office.

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.

Self-employed Health Insurance Premiums

The provision that allows self-employed taxpayers to deduct a percentage of health insurance premiums paid as an adjustment to income on 1040 was retroactively restored on April 11, 1995. The deduction was 30 percent for 1995 and likewise for 1996, with the balance subject to the 7.5 percent rule for itemizers. In 1997 the deduction moves to 40 percent, followed by several annual increases until reaching a maximum of 80 percent after 2005. Self-employed taxpayers include sole proprietors, partners and more than two percent S corporation shareholders.

Many self-employed taxpayers filed amended returns to claim the deduction for 1994. Taxpayers may file the 1994 amended return with their timely filed 1996 or 1997 returns. If a self-employed taxpayer included the full amount of health insurance premiums paid in 1994, as a medical deduction on Schedule A, they should file an amended return to claim the 25% deduction on 1040 and omit that part of the deduction from Schedule A.

Qualified health insurance premiums are limited to health insurance coverage of the taxpayer and/or the taxpayers spouse and dependents. The deduction may not exceed earned income. It does not reduce income subject to self-employment tax and that part 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 taxpayers spouse that is the employee.

Employee Health and Accidental Insurance Plans

An employer can claim premiums paid on employee health and accident insurance plans as a business expense on Schedules F or C. The payments are not included in employee income (I.R.C. Sec. 105 (b)). Plans purchased from a third party (an insured plan) as well as self-insured plans qualify but the latter are subject to nondiscrimination rules.

Health insurance purchased for an employee's family qualifies, even if a member of that family is the employer. A taxpayer operating a business as a sole proprietorship can employ his or her spouse, provide health insurance that covers the spouse-employee and the family of the spouse-employee (including the employer), and deduct the cost as a business expense (Rev. Rul. 71-588).

A written plan is not required if it is purchased through a third-party insurer. Self-insured plans must have a written plan document that describes the expenses and benefits paid by the employer. A plan that reimburses an employee for health insurance premiums paid by the employee can work but direct payment of premiums by the employer is less complicated and is recommended.

The following rules apply when the taxpayer employs his or her spouse, pays the family health insurance premiums as a nontaxable employee benefit, and deducts them as a business expense:

1. The spouse must be a *bona fide* employee with specific duties and the salary and benefits received must be proportionate to the duties.

2. The employer must file all payroll reports, withhold income and FICA taxes and furnish a Form W-2 to the employee.

The advantages of paying the family health insurance premiums this way are a reduction of Schedule F or C net income, a reduction of combined taxable income, a potential reduction in self-employment income and a potential net tax savings. The disadvantages are additional record keeping, payroll tax deposits, a possible increase in social security taxes (if the employer's earnings are above the earnings base), and a potential reduction in social security benefits to the employer.

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 FAVR allowance is not available to self-employed individuals.

The 1996 standard mileage rate increased to 31 cents per mile for all business miles driven. The standard mileage rate may not be used when the automobile has been depreciated using a method other than straight line, the car is used for hire, two or more cars are used at once, or the car is leased. The use of Section 179, ACRS, or MACRS depreciation also 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 (46.5 cents for 1996). 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.

Clean Fuel Vehicles and Electric 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 between June 30,1993 and December 31, 2001.

Tax Preparation Fees

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" (Rev. Rul. 92-29). 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.

Withholding on Supplemental Wage Payments

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) is 28 percent.

Business Tax Credit for Social Security Tax on Tips

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. The 1996 law clarifies that this credit is available whether or not the employee reported the tips on which the employer FICA taxes were paid. To prevent a double benefit, no deduction is allowed for any amount used in determining the credit.

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.

Deductibility of Borrowed Funds To Satisfy Interest Due

Cash basis taxpayers are not entitled to interest deductions in cases where the funds used to pay the interest due are borrowed from the same lender to whom the interest is owed. Borrowing to satisfy the interest obligation has been ruled that the obligation was postponed rather than paid. If a taxpayer borrows to pay the interest from the same lender accurate records must be kept so when the note is paid the then deductible interest is not forgotten. Borrowing from a different lender or borrowing prior to payment due date and paying multi-obligations from the advance seems to meet the deductibility requirements.

CORPORATE PROVISIONS

Corporate Tax Rates

C or regular corporations are subject to federal income tax rates ranging from 15 to 39 percent. The favorable rates below 34 percent are phased out when taxable income ranges from $100,000 to $335,000. The marginal tax rate increases to 35 percent on taxable income exceeding $10 million. Capital gains are taxed at the regular corporate tax rates.

1996 Corporate Tax Rates

Taxable Income	Tax
$0 to $50,000	15%
50,001 to 75,000	$7,500+ 25% on excess*
75,001 to 100,000	13,750+ 34% " "
100,001 to 335,000	22,250+ 39% " "
335,001 to 10,000,000	113,900+ 34% " "
10,000,001 to 15,000,000	3,400,000+ 35% " "
15,000,001 to 18,333,333	5,150,000+ 38% " "
over 18,333,333	35%

* on excess over first number in taxable income bracket

Salaries and qualified benefits paid to corporate officers and employees are deducted in computing corporate taxable income, but dividends paid to stockholders come from corporate profits that are taxed in the C corporation. Corporate dividends are also included in the stockholders taxable income.

S Corporations have elected not to be a tax paying entity but must file Form 1120S. S corporation shareholders will include their share of business income, deductions, losses and credits on their individual returns.

Estimated Tax Payments

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. A corporation must make installment payments, if the estimated tax for the year is expected to be $500 or more.

Personal Service Corporations

A personal service corporation that provides services in the fields of accounting, actuarial services, architecture, consulting, engineering, health, law, performing arts, and more than 10% of the corporations stock is owned by the employees providing the services, is taxed at a flat rate of 35 percent.

Alternative Minimum Tax (AMT)

The C corporation alternative minimum tax rate is 20 percent applied to a tax base that includes tax preferences and adjustments similar to the AMT for individual taxpayers. The AMT tax liability is the amount of AMT tax that exceeds the regular corporate income tax. The AMT exemption base is $40,000 and is phased out at the rate of $0.25 for each $1 of taxable income in excess of $150,000 and is eliminated at $310,000. AMT incomes exceeding $2 million may be subject to a 0.12 percent environmental tax imposed whether or not the corporation is subject to AMT. Form 4626 is used in computing a corporation's AMT and environmental tax.

PARTNERSHIP ISSUES

Schedules L, M-1 and M-2 on Form 1065 are to be completed on all partnership returns unless all three of the following apply; the partnership's total receipts are less than $250,000, total partnership assets are less than $600,000, 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.

A partnership that fails to file a timely and complete return is subject to penalty unless it can show reasonable cause for not filing Form 1065. A family farm partnership with 10 or fewer partners will usually be considered to meet this requirement if it can show that all partners have fully reported their shares of all partnership items on their timely filed income tax returns. Each partner's proportionate share of each partnership item must be the same and there may be no foreign or corporate partners. IRS Pub. 225.

Distribution of Contributed Property

Final regulations under IRC Sec. 704(c)(1)(A) prevent the shifting of income and deductions from the contributing partner to other partners with respect to "built-in" gain or loss on property contributed to a partnership. Deductions and income with respect to contributed property must be allocated among partners to take account of the difference between the property's basis and FMV when contributed.

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.

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.

Self-employed Health Insurance

Premiums for health insurance paid by a partnership on behalf of a partner for services as a partner are treated as guaranteed payments. (Usually deductible on 1065 as a business expense, listed on Schedules K and K-1 and reported on Sch. E). A partner who qualifies can deduct 30 percent of the health insurance premiums paid by the partnership on his or her behalf as an adjustment to income on 1040.

LIKE-KIND TAX FREE (Deferred) EXCHANGES

Taxpayers may postpone recognition of gain on property they relinquish if they exchange that property for property that is "like-kind." The gain is postponed by not recognizing the gain realized on the relinquished property and reducing the basis in the acquired property. Both the relinquished property and the acquired property must be used in a trade or business or held for investment [I.R.C. Sec. 1031(a)(1)]. Here is a summary of the rules [Reg. Sec. 1.1031(k)-1].

Generally, in order to constitute a deferred exchange, the transaction must be an exchange of qualifying property. A sale of property followed by a purchase of a like-kind does not qualify for nonrecognition under Sec. 1031. Gain or loss is recognized if the taxpayer actually or constructively receives money or non-like-kind property before the taxpayer actually receives the like-kind replacement property. In a deferred exchange, property received by the taxpayer will be treated as property not of a like-kind to the relinquished property if it is not "identified" before the end of the "identification period" **or** the identified replacement of property is not received before the end of the "exchange period".

The identification period begins on the date the taxpayer transfers the relinquished property and ends at midnight **45 days** thereafter. The exchange period begins on the date the taxpayer transfers the relinquished property and ends on the earlier of **180 days** thereafter or the due date (including extensions) for the taxpayer's tax return for the taxable year in which the transfer of the relinquished property occurs. (If more than one property is relinquished, then the exchange period begins with the earliest transfer date.)

Replacement property is identified only if it is designated as such in a written document signed by the taxpayer and is properly delivered before the end of the identification period to a person obligated to transfer the property to the taxpayer or to any other qualified person involved in the exchange. Replacement property must be clearly described in a written document or agreement, (real property by legal description and street address, personal property by make, model, and year). In general, the taxpayer can identify from one to three properties as replacement property. However, there can be any number of properties identified as long as their aggregate FMV at the end of the identification period does not exceed 200% of the aggregate FMV of all the relinquished properties (the 200% rule). Identification of replacement property can be revoked in a signed written document properly delivered at any time before the end of the identification period.

Identified replacement property is received before the end of the exchange period if the taxpayer actually receives it before the end of the exchange period and the replacement property received is substantially the same property as that identified. A transfer of property in a deferred exchange will not fail to qualify for nonrecognition of gain merely because the replacement property is not in existence or is being produced at the time it is identified.

If the taxpayer is in actual or constructive receipt of money or other property before receiving the replacement property, the transaction is a <u>sale</u> and not a deferred exchange. The determination of whether the taxpayer is in actual or constructive receipt of money or replacement property is made without regard to certain arrangements made to ensure that the other party carries out its obligation to transfer the replacement property. These arrangements include replacement property secured or guaranteed by a mortgage, deed of trust, or other security interest in property; by a standby letter of credit as defined in the regulations; or a guarantee of a third party. It is also made without regard to the fact that the transferee is secured by cash, if the cash is held in a qualified escrow account or in a qualified trust.

A qualified escrow account or trust is one in which the escrow holder or trustee is not the taxpayer or a disqualified person, and the taxpayer's right to receive, pledge, borrow, or otherwise obtain the benefits of the cash are limited until the transaction is closed.

<u>A qualified intermediary</u> (Q/I) is a person who is not the taxpayer or a disqualified person and acts to facilitate the deferred exchange by entering into an agreement with the taxpayer for the exchange of properties. A Q/I enters into a written agreement with the taxpayer, acquires the relinquished property from the taxpayer, and transfers the relinquished property and the replacement property.

A disqualified person is a person who is the agent of the taxpayer at the time of the transaction. A person who has acted as the taxpayer's employee, attorney, accountant, investment banker or broker, or real-estate agent or broker within the two-year period ending on the date of the transfer of the first of the relinquished properties is treated as a agent of the taxpayer at the time of the transaction. A disqualified person includes related parties defined in Sec. 267(b) or Sec. 707(b), substituting 10% for 50% ownership.

Real Property

For real property, "like-kind" is interpreted very broadly. Any real estate can be exchanged for any other real estate and qualify for I.R.C. Sec. 1031 so long as the relinquished property was, and the acquired property is, used in a trade or business or held for investment. Consequently, a farm can be exchanged for city real estate and improved real estate can be exchanged for unimproved real estate.

Example: Alva Babcock plans to sell her farm real estate and wants to invest the proceeds in an apartment building. The farm real estate and apartment building are like-kind property. Therefore, if she exchanges the farm for an apartment building, she does not have to recognize the gain on her farm real estate.

Farm Business Personal Property

"Like-kind" is interpreted more narrowly for personal property than it is for real property. Regulations add some clarity to the murky issue of determining whether personal property is like-kind by providing safe harbors for determining what property is like-kind.

The safe harbor applicable to farm property includes all the four-digit product classes within Division D of the Standard Industrial Classification codes. Any two assets that are listed in the same four-digit product class (other than the miscellaneous classes) are like-kind property. Product classes are published in the 1987 Standard Industrial Classification Manual

Since most personal property used in a farm business is included in product class 3523 Farm Machinery and Equipment, farmers will generally qualify for I.R.C. Sec. 1031 treatment when they exchange farm equipment for farm equipment. Livestock of different sexes are not property of a like-kind but exchanges of same sex livestock have qualified as tax free exchanges.

Other Deferred Exchange Rules and Requirements

IRS Form 8824 is used as a supporting statement for like-kind exchanges reported on other forms, including Form 4797, Sale of Business Property, and Schedule D, Capital Gains and Losses. **A separate Form 8824 should be attached to Form 1040 for each exchange.** Form 8824 should be filed for the tax year in which the seller (exchanger) transferred property to the other party in the exchange.

If the relinquished property is subject to depreciation recapture under I.R.C. Sec. 1245, 1250, 1252, 1254, and or 1255; part or all of the recapture may have to be recognized in the year of the like-kind exchange.

Like-kind exchanges between related parties can result in recognition of gain if either party disposes of the property within two years after the exchange.

INDEPENDENT CONTRACTOR VS. EMPLOYEE

Section 530 of the Rev. Act of 1978 has been amended, effective January 1, 1997, to clarify the safe haven provisions that taxpayers may use to protect the status of workers treated as independent contractors. Section 530 currently 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 including 1099's are filed.

There is reasonable basis for not classifying a worker as an employee if the taxpayer can 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 a significant segment of the industry.

The 1996 Sec. 530 amendments clarify the definition of terms including "long-standing practice" and "significant segment" of an industry. The burden of proof has been shifted to IRS once the taxpayer established a *"prima facie"* case using one of the authorities above.

The following rules continue to be important and enforcement efforts will continue to focus on serious deficiencies like independent contractors who are not issued 1099's.

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. They are divided into two groups below. "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.

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

PROVISIONS SPECIFIC TO AGRICULTURE

Certain Conservation Payments Excluded From Income (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 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 educational events. Payments for items that would be expensed on Sch. 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. Determination is made on a case-by-case basis. Refer to *Income Tax Implications for Farmers Receiving New York City Watershed Agricultural Program Payments*, E.B. 95-22, Department of Agricultural, Resource, and Managerial Economics, Cornell University, for more details.

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 Natural Resources Conservation Service or by a comparable state agency. Landowners must be materially participating in farm production to expense soil and water conservation costs. Report soil and water conservation expenses directly on Sch. F, line H. Form 8645 has been eliminated.

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. A Temporary Treasury Regulation (1.451-6T) 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.

Hedging of Non-Inventory Supplies

The IRS has issued final regulations concerning the determination of the character of gain or loss from hedging transactions (TD 8555, I.R.B. 1994-28) and for accounting for business hedging transactions (TD 8554, I.R.B. 1994-28). The final regulations define a hedge as a transaction that a taxpayer enters into in the normal course of business, primarily to reduce the risk of interest rate or price changes or of currency fluctuations. Crop producers normally hedge the risk of price changes with regard to anticipated crops, crops under production or stored crops. For livestock producers the objective is to lock in a price for the animals they will sell, replacement animals, or feed to be purchased.

The regulations retain the rule that a hedge of property or of an obligation is a hedging transaction only if a sale or exchange of the property, or termination of the obligation, could not produce capital gain or loss. However, a special rule has been added for non-inventory supplies. Under this rule, if a taxpayer sells only a negligible amount of a non-inventory supply, then the non-inventory supply is treated as ordinary property (but only for the purposes of determining whether a hedge of the purchase of that supply is a hedging transaction).

Income from Cancellation of Debt

Some farmers are likely to have debt canceled by their lenders. 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 taxable income. In return for not reporting the income, the taxpayer must reduce "tax attributes," such as investment credit, net operating losses and basis in assets which may result in tax liability for the taxpayer in future years.

Two sets of rules control the reporting of canceled debt. One applies to **bankrupt and insolvent debtors**, including farmers, and the other set applies to **solvent farmers**.

Bankrupt and insolvent debtor rules: If canceled debt exceeds total tax attributes, the excess canceled debt is not reported as taxable income. If cancellation of debt outside of bankruptcy causes a taxpayer to become solvent, the solvent debtor rules must be applied to the DII equal to solvency.

Solvent farmer rules (debt discharged after 4-9-86): Discharged debt must be "qualified farm indebtedness" which is debt incurred directly in connection with the operation of the farm business. Additional "qualified farm indebtedness" rules are: (1) 50 percent or more of the aggregate gross receipts of the farmer for the three previous years must have been attributable to farming and (2) 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.

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 farming and (3) other property. Basis may be reduced below the remaining debt. 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.

Solvent and insolvent farmers receive little relief from gain triggered on property transferred in settlement of debt. The difference between basis and FMV is gain regardless of the amount of DII. The FMV is ignored for nonrecourse debt and the entire difference between the basis of property transferred and the debt canceled is gain or loss. Discharge of indebtedness is not includable in income if the transaction is a purchase price reduction (IRC Sec. 108 (c) (5)).

Other Agricultural Provisions

- Initial land clearing expenses are not deductible as operating expenses but are added to the land's basis. Routine brush clearing expenses on land already farmed are deductible on Schedule F.

- The limitation on deducting qualified prepaid expenses has not changed. Cash basis farm taxpayers may claim prepaid expenses up to 50 percent of all other Schedule F expenses for the current tax year. There are two exceptions that may help qualified farm-related taxpayers claim additional prepaid expenses.

DEPRECIATION AND COST RECOVERY

The standard depreciation rules have not changed for 1996. Here is a valuable reference for practitioners and taxpayers who want to apply depreciation rules to maximize after tax income. The modified accelerated cost recovery system (MACRS) provides for eight classes of recovery property, two of which may be depreciated only with straight line. MACRS applies to property placed in service after 1986. Pre-MACRS property continues to be depreciated under the ACRS or pre-ACRS rules. Most taxpayers will be dealing with MACRS, ACRS, and the depreciation rules that apply to property acquired before 1981. This manual concentrates on the MACRS rules but some ACRS information is included. Additional information on ACRS and pre-ACRS rules can be found in the *Farmer's 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. A lessor cannot depreciate improvements made by the lessee.

Depreciation or cost recovery is not optional. It should be claimed each year on all depreciable property including temporarily idle assets. An owner who neglects to take depreciation when it is due now has two opportunities to recover the lost depreciation. It may be recovered by filing an amended return or by following a new procedure for automatic change to a permissible accounting method for depreciable property, Rev. Proc. 96-31. The new procedure was effective May 13, 1996 and is available to taxpayers whose depreciation or amortization deduction claimed is less than the allowable amount. Form 3115 must be filed with the commissioner of IRS and a copy attached to the taxpayers timely filed return for the tax year. Procedure 96-31 carries detailed, line-by-line instructions on how to complete Form 3115.

MACRS Classes

The MACRS class life depends on the ADR midpoint life of the property.

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

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

Three-year property:

1. Section 1245 property with an ADR class life of four years or less. This includes over-the-road tractors and hogs held for breeding purposes. It does not include 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. Silos, grain storage bins, fences, and paved barnyards.

3. Breeding or work horses.

Ten-year property includes single purpose livestock and horticultural structures (seven year property if placed in service before 1989) and orchards and vineyards (15 year property if placed in service before 1989).

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.

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

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

*No class life specified. Therefore, 12-year life assigned.
**7 if placed in service before 1989.
***15 if placed in service before 1989.
****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 are two straight line (SL) options for the classes eligible for rapid recovery. SL may be taken over the MACRS class life or, using alternative MACRS depreciation system, over the ADR midpoint life. A fourth option is 150 percent DB over the ADR midpoint life, the depreciation method required for alternative minimum tax purposes discussed under Alternative Minimum Tax.

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

Class	Most Rapid MACRS Method Available
3, 5, 7 and 10-year	Farm assets: 150 percent DB if placed in service after 1988. 200 percent if placed in service 1987 through 1988. (See exception for orchards and vineyards above.)
	Nonfarm assets: 200 percent DB with switch-over to SL.
15 and 20-year	150 percent declining balance with switch-over to SL.
27.5 and 39(31.5)-year	Straight line only.

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

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

Recovery Year	3-Year Class 200% d.b.	3-Year Class 150% d.b.	5-Year Class 200% d.b.	5-Year Class 150% d.b.	7-Year Class 200% d.b.	7-Year Class 150% d.b.	10-Year Class 200% d.b.	10-Year Class 150% d.b.	15-Yr. Class 150% d.b.	20-Yr. Class 150% d.b.
1	33.33	25.00	20.00	15.00	14.29	10.71	10.00	7.50	5.00	3.75
2	44.45	37.50	32.00	25.50	24.49	19.13	18.00	13.88	9.50	7.22
3	14.81	25.00	19.20	17.85	17.49	15.03	14.40	11.79	8.55	6.68
4	7.41	12.50	11.52	16.66	12.49	12.25	11.52	10.02	7.69	6.18
5			11.52	16.66	8.93	12.25	9.22	8.74	6.93	5.71
6			5.76	8.33	8.92	12.25	7.37	8.74	6.23	5.28
7					8.93	12.25	6.55	8.74	5.90	4.89
8					4.46	6.13	6.55	8.74	5.90	4.52
9							6.55	8.74	5.90	4.46
10							6.55	8.74	5.90	4.46
11							3.29	4.37	5.90	4.46
12-15									5.90	4.46
16									3.00	4.46
17-20										4.46
21										2.25

Half-Year and Mid-Month Conventions

MACRS provides for a half-year convention in the year placed in service regardless of the recovery option chosen. Unlike ACRS, a half-year of recovery may be taken in the year of disposal. No depreciation is allowed on property acquired and disposed of in the same year. Property in the 27.5 and 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 is $17,500 for property placed in service in tax years beginning after 1992 and before 1997. It increases to $18,000 for 1997, $18,500 for 1998, $19,000 for 1999, $20,000 for 2000, $24,000 in 2001 and $25,000 in 2003. 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. Eligible property is defined as Sec. 1245 property to which Sec. 168 (accelerated cost recovery) applies. Prior to 1991 only Sec. 38 property qualified. Property must be used more than 50 percent of the time in the business to qualify. General purpose buildings, property acquired from a related person, and certain property leased by non-corporate lessors does not qualify. 1996 legislation excludes property used outside the U.S., property used by tax exempt organizations, property used with furnished lodging, property used by governments and foreigners, and air conditioning and heating units (effective January 1, 1991). When property is acquired by trade, Sec. 179 deductions may not be claimed on the basis of the trade-in.

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 allocations from several sources could be in a situation where not all of it may be used because of the $17,500 limitation. The same concept applies to S corporations.

The amount of the Sec. 179 expense deduction 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 excluding 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 per year.

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 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 Sec. 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 Sec. 179 deduction over the amount that would have been deducted as depreciation.

Every business owner who has purchased MACRS property in 1996 should consider the $17,500 expense deduction because only New York investment tax credit will be lost when Sec. 179 is used. It should not be used to reduce AGI below standard (or itemized) deductions plus exemptions, unless an additional reduction in 1996 self-employment tax is worth more than depreciation in a future tax year. Also, the taxpayer must be sure not to use more Sec. 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. 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.

Example: Newt placed $100,000 worth of 7-year MACRS property in service during 1996. He could expense $17,500 and claim $8,836 of depreciation in 1996 ($100,000 - 17,500 = $82,500 x .1071 = $8,836) under the half-year convention. If $50,000 of Newt'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 test. Thus, $32,500 ÷ ($100,000 - 17,500) = .39, which is less than 40 percent, so Newt avoids the mid-quarter rules. However, if his 1996 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 1996 items would be subject to the mid-quarter convention.

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 Sec. 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.

Example: A farmer purchased a tractor, harvester and combine in 1996, 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, a 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 equipment purchased in 1994 (7-year property), 150 percent DB for seven years for equipment purchased in 1995, and could now select SL 7-year recovery for all machinery purchased in 1996.

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 15 years on most 10-year property.

Some Special Rules on Autos and Listed Property

There are special rules for depreciation on automobiles and other "listed property." If 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 $3,060 on cars placed in service in 1996. The maximum second year depreciation allowance is $4,900 for 1996 listed property. Cellular telephones acquired after 1989 are listed property. Computers are listed property unless they are used only for business.

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.

When assets are sold, gain to the extent of all prior depreciation 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 1996 depreciation more valuable than that used in later years. However, depreciation claimed to reduce taxable income below zero is depreciation wasted.

Reporting Depreciation and Cost Recovery

Form 4562 is used to report the Section 179 expense election, depreciation of recovery property, depreciation of nonrecovery property, amortization, and specific information concerning automobiles and other listed property. Depreciation, cost recovery, and Section 179 expenses are combined on 4562 and entered on Schedule F. However, partnerships will transfer the 179 expense election to Sch. K, Form 1065 rather than combining it with other items on 4562. Since it is excluded when calculating net earnings for self-employment on Sch. K and K-1, include it as an adjustment to net farm profit on Sch. SE.

ACRS Recovery Percentages

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

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

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

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

Accurate Records Needed

Accurate and complete depreciation records are basic to reliable farm income tax reporting and good tax management. Depreciation and cost recovery must be reported on Form 4562. A complete depreciation and cost recovery record is needed to supplement Form 4562. It is not necessary to submit the complete list of items included in the taxpayer's depreciation and cost recovery schedules.

REVIEW OF UNIFORM CAPITALIZATION RULES FOR FARMERS

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

Fruit Growers and Nurserymen

Plants subject to capitalization rules will include fruit trees, vines, ornamental trees and shrubs, and sod providing the preproductive period is 24 months or more. The preproductive period begins when the plant or seed is first planted or acquired by the taxpayer. It ends when the plant becomes productive in marketable quantities or when the plant is reasonably expected to be sold or otherwise disposed of. An evergreen tree which is more than six years old when harvested, (severed from the roots), is not an ornamental tree subject to capitalization rules. Timber is also exempt. If trees and vines bearing edible crops for human consumption are lost or damaged by natural causes, the costs of replacement trees and vines do not have to be capitalized.

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

See Publication 225, *Farmer's Tax Guide*, for other uniform capitalization rules.

REPORTING UTILITY EASEMENT PAYMENTS

In general, when a taxpayer sells part of an asset the basis in the asset must be allocated between the portion sold and the portion retained. However, when an easement is sold, the taxpayer is not required to apportion the basis between the interest that is sold and the interest that is retained (Rev. Rul. 77-414). When this rule is applied to the sale of a land easement, the entire basis may be used to reduce gain.

Example: In 1996 George sold a right-of-way for a gas pipeline through the center of his 10 acre field for $6,500. The pipeline right-of-way covers two acres. George retained the right to farm over the pipline. The basis in the land is $800 per acre. Since George's entire 10 acre field was affected and its basis of $8,000 is greater than the $6,500 received for the easement, there is no gain to report in 1996. George's basis is reduced to $1,500 or $150 per acre.

When part of the payment for the easement is compensation for a decrease in value of land that is not part of the easement, that amount should be used to reduce the basis of the land affected. When utility easement payments exceed basis, the excess should qualify as an involuntary conversion (IRC Sec. 1031). Payments received for crop damage caused by the utilities contractor is ordinary income reported on line 10 of Schedule F.

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 or 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 Conversions

Casualty gains, gains from forced sales due to condemnations, and 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 Conversions above) disposed of solely because of drought. 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 kind of livestock, including poultry, sold due to drought conditions. Only gains on those sold in excess of the number that would have normally been sold may be postponed, and the drought must have resulted in an area being designated as eligible for federal assistance. The election is made by attaching a statement to the tax return and should include a reference to IRC Sec. 451(e), evidence of the drought, the affect the drought had on livestock sales, the number sold, comparisons with normal sales years, and computation of income to be postponed. See Publication 225 for more details.

GENERAL BUSINESS CREDIT

General business credit (GBC) is a combination of investment tax credit (generally repealed 1/1/86), work opportunity credit (replaces targeted jobs credit), credit for research and experimentation, low-income housing credit, disabled access credit, plus others (see following page). 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. IC may still 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 with more liberal allowances for some rehabilitated buildings. IC 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 IC claimed is fully earned, it 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

Work opportunity tax credit (WOTC) has replaced targeted jobs credit. Between October 1, 1996 and September 30, 1997, employers may claim a 35% credit on the first $6,000 of first year wages paid to a qualifing individual ($2,100 maximum credit). Also for summer youth for work performed during any 90-day period between May 1 and September 15, employers may claim the same 35% credit on $3,000 of wages up to the maximum of $1,050. The employer must complete a prescreening notice before hiring, unless the worker has been pre-certified by an employment agency. To qualify for the credit the worker must have worked at least 180 days or 400 hours or in the case of summer youth, 20 days or 120 hours. In general, the following are qualifying individuals: Recipients of Aid to Families with Dependent Children; certain veterans and disabled workers; certain food stamp recipients; high risk youth living in empowerment zones and enterprise communities; and economically-disadvantaged ex-felons.

Credit for research and experimentation (R&E) replaced the credit for qualified research expenditures. The expanded R&E tax credit will be available from July 1, 1996 through May 31, 1997. The new law expands the "start up" firms eligibility to those with both qualified gross receipts and research expenses that began after 1983. See the 1996 Small Business Bill for the detailed qualifications of this credit.

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.

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 tax 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 a S corporation and its shareholders. To claim the credit, file Form 8826, Disabled Access Credit. For more information, see IRS Publication 907.

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, fuel from nonconventional sources and credit for qualified electric vehicles. The expired orphan drug credit was reinstated from July 1, 1996 to May 31, 1997. The credit for buyers of diesel powered cars, vans and light trucks was revoked effective August 20, 1996.

A REVIEW OF FARM BUSINESS PROPERTY SALES

The 28 percent maximum tax rate on capital gain has not changed. The spread between the maximum tax rate on capital gains (28 percent) and the higher 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 that are eligible for capital gain treatment, gains subject to recapture of depreciation, and Schedule F income is the first step in tax planning.

The reporting of gains and losses on the disposition of property held for use in the farm business continues to be a complicated but an 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: Net Sec. 1231 gains are treated as ordinary income to the extent of unrecaptured net Sec. 1231 losses for the five most recent prior years. In other words, a taxpayer that claimed a net Sec. 1231 loss on the 1991, 1992, 1993, 1994 or 1995 return and has a net Sec. 1231 gain for 1996, must recapture the losses on the 1996 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 Sec. 179 expense deductions.

   Tangible real property (except some Sec. 1250 buildings and their structural components) used as an integral part of farming is Sec. 1245 property. Single-purpose livestock and horticultural structures (placed in service after 1980) are Sec. 1245 property. Nonresidential 15, 18, and 19-year ACRS property becomes Sec. 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 Sec. 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 Sec. 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. <u>Section 1252</u> - 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, 1990 cost	$100,000
Soil and water expenses deducted on 1991 tax return	$8,000
Land was sold May 15, 1996 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 six years, so the gain is divided; $8,000 x .80 = $6,400 is ordinary gain and $30,000 - $6,400 = $23,600 qualifies as capital gain.

5. <u>Section 1255</u> - If government cost sharing payments for conservation have been excluded from gross income under the provisions of Sec. 126, the land improved with the payments will come under Sec. 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 Form 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. The intent of holding livestock is a key issue in determining if sales are reported on 4797 or Schedule F.

Breeding, Dairy, Draft or Sporting Livestock

Dairy cattle raised or purchased to replace or add to the taxpayers herd are held for dairy purposes. Dairy cattle that are raised or purchased and developed as breeding stock to be sold to other farmers are held for sale. 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. Emus and ostriches are curretnly excluded from the IRS definition of 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 subjected to the capitalization rules are entered in Part I which includes all raised cattle and horses two years of age and older that are held for breeding, dairy, draft or sporting purposes. All purchased 1231 livestock that result in a loss when sold are also entered in Part I.

Reporting Sales of Livestock Not Meeting Holding Period Requirements

Breeding, dairy, draft or sporting livestock that are not held for the required period whether sold for a gain or loss will be entered in Part II of 4797. This will include raised cattle that are held for dairy or breeding but sold before they reach two years of age and purchased cattle held for dairy or breeding but held for less than two years.

Use of 4797 and Schedule D by Farmers

All sales of farm business properties are reported on Form 4797 to separate 1231 gain and loss from recapture of depreciation, cost recovery, Section 179 expense deduction and basis reduction. Casualty and theft gains and losses are reported on 4684 and transferred to 4797.

If the 1231 gains and losses reported on 4797 result in a net gain, net 1231 losses reported in the prior five years must be recaptured as ordinary income by transferring 1231 gain equal to the nonrecaptured losses to Part II. Any remaining gain is transferred to Schedule D and combined with capital gain or loss, if any, from disposition of capital assets. If the 1231 items result in a net loss, the loss is combined with ordinary gains and losses on 4797 and then transferred to Form 1040.

Summary of Reporting Most Common Farm Business Property Sales

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

INSTALLMENT SALES

The installment method of reporting may still be used by nondealers for the sale of real property or personal property (except property subject to 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. That portion of the gain attributed to recaptured depreciation of Sec. 1245 and 1250 property must be excluded. Sec. 179 expenses and capitalized expenditures also are treated as Sec. 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 Sec. 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 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. (Closely related persons would include spouse, parent, children, and grandchildren, but not brothers and sisters.) 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.

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.

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).

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 sale proceeds for payment in a future year. Deposits into an irrevocable escrow account are 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 an installment sale. A partnership may use the installment sale method of reporting gain on the sale of partnership property even though an individual partner may have 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.

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.

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.

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 (other than "new" Sec. 38 property) where seller financing does not exceed $3,622,500 must have an imputed interest rate of the lesser of 100 percent of the applicable federal rate (AFR) or 9 percent (compounded semiannually).

2. Sales exceeding $3,622,500 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 compounded semiannually or interest will be imputed at 7 percent. This rule applies to the first $500,000 of land sold or exchanged 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 may be accounted for on the cash accounting method on sales of farms not exceeding $1 million and any other installment sale not exceeding $250,000.

The AFR 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 1996 monthly AFR was 5.91 percent (short term, not over three years), 6.52 percent (mid term, three to nine years), 6.91 percent (long term, over nine years). The monthly AFRs have increased slightly (.16 to .34 basis points) in the last year.

ALTERNATIVE MINIMUM TAX (AMT)

The AMT is 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 has a two-tiered 26 and 28 percent rate system for noncorporate taxpayers. The 26 percent rate applies to the first $175,000 of AMTI ($87,500 for marrieds filing separately) in excess of the exemption. The 28 percent rate begins at $175,000 of AMTI. The exemptions are not indexed and are phasedout 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.

Alternative Minimum Tax Exemption and Phaseout

Filing Status	Maximum Exemption	AMTI Phaseout Range	Phaseout Percent
Joint & qualifying widow(er)	$45,000	$150,000-330,000	25
Single & heads of household	33,750	112,500-247,500	25
Married filing separately	22,500	75,000-165,000	25

Alternative Minimum Taxable Income (AMTI)

AMTI is calculated on Form 6251 by starting with line 35 on 1040 (taxable income before subtracting personal exemptions) and is transferred to line 16 of Form 6251. Enter a negative amount 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. 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 interest 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 but not held for sale, 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.
4. Accelerated depreciation of real and leased personal property placed in service before 1987 and amortization of certified pollution control facilities placed in service before 1987.
5. Intangible drilling costs.

Related Adjustments. 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.

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

Tentative Minimum Tax

The minimum tax exemption reduced by the 25 percent phaseout is subtracted from AMTI before the 26 and 28 percent rates are applied. Then the AMT foreign tax credit is subtracted to arrive at tentative minimum tax. A taxpayer who has regular foreign tax credit will compute AMT foreign tax credit in much the same manner, using a separate Form 1116.

Alternative Minimum Tax and Credits

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

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

Who Must File Test

More taxpayers are required to file Form 6251 than have an AMT liability. Form 6251 must be filed if the taxpayer is liable for AMT (AMTI on line 21 is greater than the exemption on line 22), or if credits are limited by the tentative AMT amount on lines 24 or 26. If the total of preference items 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, 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

Taxpayers who sustain a net operating loss in 1996 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 1993 *Cornell Cooperative Extension 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.

Example: Hy Cost farmer has a 1996 Schedule F loss of $22,000 and net long term gain of $11,500 from cattle sales. Mrs. Cost has a wage income of $7,050, they file a joint return, claim the $6,700 standard deduction and four personal exemptions for $10,200. Total deductions $38,900 exceed income $18,550 by $20,350 but they cannot include the standard deduction and personal exemptions in their NOL. Their 1996 NOL is only $3,450 ($20,350 - $16,900).

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 1996 NOL would be first carried back to 1993, then to 1994, 1995, and then forward to 1997 and in order to 2011 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 NOL to be carried to the same year, the NOL from the earliest year is applied first. Reasons to forego the carryback period may include low income during the carryback period and recomputation of investment tax credit.

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.

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, applies to tax years ending after May 10, 1992 and uses a facts-and-circumstances approach to identifying a taxpayer's activities. The taxpayer may treat one or more trade or business activities or rental activities as a single activity if these activities form an **appropriate economic unit** for measuring gain or loss under the passive activity rules. Rental activities generally cannot be grouped with trade or business activities. The IRS has a right to redetermine a taxpayer's activities if any of the activities resulting from the taxpayer's grouping is not an appropriate economic unit and a principal purpose of the taxpayer's grouping is to circumvent the passive activity loss rules. Reg. 1.49-4 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 appropriate amounts of gross income, deductions and credits allocable to the activity disposed of.

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

Crop share lessors or landlords typically do not "materially participate" in the operation of the farm they own. However, they may actively participate in the rental real estate activity so that up to $25,000 of losses can be used to offset nonpassive income. The active participation test can be satisfied when the taxpayer participates in making management decisions, arranging for others to provide services (such as repairs) in a significant and *bona fide* sense. Such management decisions could include approving new tenants, deciding on rental terms, and approving repairs and capital improvements.

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.

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

The social security earnings base increased to $62,700 for 1996. There is no longer a cap on the amount of earnings subject to medicare tax. FICA and self-employment tax rates remain the same as in 1995. The total rate is divided into two components representing the social security and medicare tax. The maximum 1996 social security tax is $3,887.40 (employer's share), up $93.00 from 1995.

Social Security Tax Table

	Earnings Base		FICA Rate %[1]		Self-Employment Rate %	
Year	Soc. Sec.	Medicare	Soc. Sec.	Medicare	Soc. Sec.	Medicare
1995	$61,200	Unlimited	6.20	1.45	12.40	2.90
1996	$62,700	Unlimited	6.20	1.45	12.40	2.90
1997	$65,100[2]	Unlimited	6.20	1.45	12.40	2.90

[1] Paid by both employer and employee.
[2] Estimate

Separate social security and medicare tax withholding tables are used by employers. Forms 941 and 943 require 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 $61,200 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. The earnings required to receive one quarter of credit increased to $640 in 1996. Thus, the optional method will yield only two quarters of coverage. Earning $2,560 any time during 1996 will net four 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 employee.

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. Sole proprietors and husband-wife partnerships who hire their kids under 18 years old needn't pay social security tax on them nor FICA if under 21. Wages paid by a parent to a child for domestic service in the home are not covered until the child reaches 21.

New legislation requires employers to issue W-2 forms within 60 days of separation from service, unless there is reason to believe the employee will be rehired before the end of the tax year.

Payment of Agricultural Wages with Commodities

"In some instances" farmers and workers can reduce the amount of FICA taxes paid by paying wages in the form of grain, livestock or other commodities. It may not always be to the employee's advantage to reduce FICA taxes since social security benefits may also be reduced when disabled or retired.

In 1994, for the benefit of examiners, taxpayers and practitioners, IRS issued guidelines with a fairly narrow interpretation of I.R.C. Sec. 3121(a)(8)(A). The guidelines are just that, as there are many factors to determine a *bona fide* transfer of in-kind compensation. The guidelines may be followed, ignored or challenged and audits may result for those who do not follow them.

The two factors used to determine whether a *bona fide* transfer of in-kind compensation has occurred is Dominion and Control. The factors used by examiners to determine if the employer has parted with the control and the employee has exercised control over the commodity are:

- Documentation. This offers understanding of the arrangement and intent of the parties. The documentation should show both the employment relationship and the transfer of the commodities. Failure of the employer to get a release of security interests is also very important to prove dominion and control.

- Marketing of the commodity. After the commodity is transferred, the employee must market and dispose of the commodity, not in concert with the employer.

- Risk of gain or loss. The employee must assume the risk in quantity and quality. The greater the risk of the employee, the more likely it will be treated as a noncash payment of wages. The greatest risk is a fixed percentage of production, while the least risk is a fixed dollar value of a commodity.

- Employee's holding period. The length of time the commodity is held is indicative of the parties intent. A sale arranged before the transfer to the employee is considered equivalent to cash for employment tax purposes.

- Cost of ownership. The employee should be responsible for the cost to maintain, store and market the commodity received.

- Identification of noncash payment. The commodity should have evidence of a transfer of a specific identified commodity that is tagged, marked and separated to evidence recognition as a noncash wage.

The second component of intent involves whether the in-kind payment is equivalent to cash. In addition to the six components of dominion and control as they effect cash equivalency the following factors must be considered:

- Cash advances. If received and satisfied upon sale of the commodity then the cash advance is considered wages. Payment by warehouse receipts is considered negotiable and receipt of such by the employee might be considered the equivalent of cash.

- Immediate conversion. If employer knows the employee will immediately convert the in-kind payment to cash it will be considered wages.

- Sole source of income. When the transferred commodity is the workers only source of income, the transfer will be questioned since the employee will need cash to pay for family living expenses and would not be able to hold the commodity for a marketing period.

There are many other factors that are important to evaluate the payment in-kind transaction. The following recent letter rulings indicate that IRS will challenge transfers if they appear to be equivalent to cash (9428003, 9403001, 9322003, 9252003, 9202003 and 9136001.)

Remember even if the noncash wages are ruled exempt from FICA, FUTA and income tax withholding they are still subject to income taxes. 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 but not in box 3 and 5.

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. If the employee is a farmer or dealer, then they would use Schedule F or C respectively to report the commodities sold.

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. Disability benefits are treated the same way as other 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. Starting in 1996, U.S. residents receiving Canadian Social Security will not owe U.S. income tax on those benefits but will now be subject to Canadian tax rules on the benefits.

The 85 percent rules apply to single taxpayers with provisional incomes above $34,000 and married taxpayers filing jointly 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, <u>or</u>
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 <u>or</u>
   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.)

<u>Example 1</u>: U and I Taxpayers have the following 1996 income:

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

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; **<u>or</u>**
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 **<u>or</u>**
   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.

<u>Example 2</u>: 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, **<u>or</u>**
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 lessor of (1) one-half of the benefits received, or (2) one-half of the excess of the sum of the taxpayer's adjusted gross income, interest on tax-exempt obligations, and half of the social security benefits over the base amount. ($32,000 for persons filing jointly, $0 for married persons filing separately but living together, and $25,000 for all others.) Medicare payments are excluded from gross income.

Example: R. and U. Retiree received $15,200 in 1996 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. R. and U. 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 1996 the annual earnings limit for those less than age 65 is $8,280, and for those age 65 to 70 it is $12,500 (recently increased from $11,520). For those aged 70 and older there are no reductions. The corresponding 1997 earnings limits are $8,380 (projected) and $13,500. 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. The 1995 cost of living increase in benefits was 2.6 percent.

"Nanny Tax" Social Security Domestic Employment Act of 1994

This act allows the payment of employment taxes for domestic workers (babysitters, yard workers, house cleaners) to be reported on the employers tax returns. The wage threshold for reporting and paying social security taxes was raised from $50 per quarter to $1,000 annually, retroactive to January 1, 1994. Therefore, domestic workers and their employers who paid social security and medicare taxes on 1994 employee wages of less than $1,000 should file for refunds. Employers should use Form 843 and employees should request reimbursement from their employers for social security and medicare taxes withheld.

Beginning in tax year 1995 household employers used Schedule H (Form 1040) to report and pay social security, medicare, FUTA, and withheld income taxes. The quarterly return Form 942 is no longer used. Farmers may treat wages paid to domestic workers under the new $1,000 annually threshold rules rather than the $150 and $2,500 agricultural wage thresholds, by filing Schedule H.

Household employers must include an employer identification number (EIN) of forms they file for their employees, including Forms W-2 and Schedule H. EIN's can be obtained by completing and filing Form SS-4, Application for Employer Identification Number. Order Form SS-4 by calling 1-800-TAX-FORM.

Also effective in 1995, the law exempted household workers under the age of 18 from any social security and medicare taxes unless household employment is the worker's principal occupation.

Schedule H (Form 1040)

Taxpayers must file Schedule H if any of the following conditions apply:
(a) They paid any one household employee cash wages of $1,000 or more in 1996.
(b) They withheld Federal Income Tax during 1996 at the request of any household employee.

Rental Income and Deductions (IRC Sec. 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 Form 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. IRS indicated the deduction for spousal rent is allowable only if there is a *bona fide* landlord-tenant relationship and that substance rather than form governs. 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; and even a more desirable fact would be that the farm operator has no equity interest in the rented property

(2) make sure there is a formal, written, signed, rental agreement and a fair market value rental rate with at least annual payments;

(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 his or her tax and interest payments from the account;

(5) the operator must file Form 1099 for all rent payments made;

(6) the spouse should avoid material participation.

The farm operator's spouse cannot avoid material participation for purposes of the passive activity rules. The participation by a spouse (operator) is treated as participation by the taxpayer. Consequently, any income derived from the property in which he or she materially participates is not treated as passive activity income.

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 deposit rules for 1997 are as follows: Farm employers who reported $50,000 or less of federal payroll taxes in 1995 must make timely monthly deposits in 1997. 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 1995 must use the following semi-weekly deposit rules until June 30, 1996:

-- 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.

The 1996 Small Business Bill requires that if an employer's 1995 Federal tax deposits were more than $50,000, treasury deposits must be made by electronic funds transfer using the Electronic Federal Tax Payment System (EFTPS). All affected employers need to notify their bank to start the paperwork for either an "ACH debit" or "ACH credit" to forward payments to EFTPS. The effective date was delayed from January 1997 to July 1997 before penalties for non-compliance begin.

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 monthly deposit rule. Many farm employers with annual cash payrolls exceeding $150,000 will be subject to the Wednesday/Friday deposit rules.

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 (U.I.). 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 the day in each of twenty days, each day being in a different calendar week during the current or preceding calendar year.

The Federal Unemployment Tax Act exemption for alien agricultural workers has been made permanent for alien agricultural workers admitted to the U.S. to do agricultural work.

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 1996. The 1996 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 1996 "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 1996.

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. Exception: FUTA taxes withheld from household employees are deposited with FICA and income taxes on Schedule H (Form 1040).

LIMITED LIABILITY COMPANIES IN NEW YORK

Limited liability companies (LLCs), limited liability partnerships (LLPs), and professional limited liability companies (PLLCs) were authorized to operate in New York beginning October 24, 1994. Similar provisions apply to domestic (in state) as well as foreign (out of state) LLCs. New York allows the formation of an LLC with only one member. LLPs and PLLCs are intended for professionals such as doctors, lawyers, accountants and architects. It has not been clear if they have the same income tax characteristics as LLCs.

The basic concept of LLCs (including LLPs and PLLCs) is that they have the limited liability aspects of a corporation but are taxed like a partnership. The New York law allows an LLC formed in New York to qualify for partnership taxation. Whether an LLC qualifies to be taxed as a partnership for federal tax purposes depends on the presence or absence of certain corporate characteristics. If the LLC avoids at least two of these characteristics, it will be taxed as a corporation: (1) limited liability (2) continuity of life; (3) centralization of management; and (4) free transferability of interests. Since the LLC has the corporate characteristics of limited liability for all members, two of the remaining three characteristics must be avoided.

IRS Proposed Reg. Sec. 301.7701-3 provides simple election and default rules for unincorporated businesses. An unincorporated domestic organization (UDO) with two or more owners would receive a default classification as a partnership but could elect to be a corporation for tax purposes. A one member UDO would be taxed as a proprietorship. Proposed Regulations cannot be relied on as tax law.

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.)

A proposed amendment to IRS Reg. Sec. 1.1402 addresses the self-employment tax treatment of members of an LLC that is classified as a partnership for federal tax purposes. Generally, a member's net earnings from self-employment include the member's guaranteed payments and distributive share of business profit or loss. If a member of an LLC is treated as a limited partner under this proposed amendment, then the member's self-employment income will not include the distributive share of income or loss from the LLC. A member of an LLC may receive limited partner treatment only if not a manager of the LLC and if the business could have been formed as a limited partnership.

Establishing and maintaining an LLC will require paying money to NY State. In addition to the initial $200 fee required to file the articles of organization, 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

The 1996 New York State Budget Bill was passed on July 13, 1996. The income tax highlights of this year's bill are the following:

- Farm Property Tax Reform was passed effective beginning in the 1997 tax year. A qualified taxpayer may claim against school taxes paid on 100 acres of agricultural property and agricultural structures and buildings. There is an additional credit equal to 50 percent of school taxes paid on acreage above these limites. Credit is refundable and recaptured if property use changes within three years.

- Taxpayers are allowed a credit after 1996, of 25 percent of qualfied rehabilitation expenses in restoring of pre-1936 agricultural barns.

- Personal income tax credit for household and dependent care services necessary for gainful employment was increased to 20 percent of the federal credit. Additional credits for taxpayers with New York State adjusted gross incomes below $14,000 for 1996.

- A three month New York income tax amnesty began November 1, 1996 and ends January 31, 1997. Taxpayers who come forward to pay past due tax liabilities will be allowed a waiver of any penalties that may have been assessed.

Exemptions and Standard Deductions

The 1995 law gradually increases the standard deductions between 1994 and 1997 to the levels that NYTRRA 1987 intended.

	Year			
	1994	1995	1996	1997 and after
	-------- Standard Deduction ($) ---------			
Tax Status:				
Joint/(surviving spouse)	$9,500	$10,800	$12,350	$13,000
Head of household	7,000	8,150	10,000	10,500
Single	6,000	6,600	7,400	7,500
Married filing separately	4,750	5,400	6,175	6,500
Dependent filers	2,800	2,800	2,900	3,000
	------------ Exemption ($) ------------			
	1,000	1,000	1,000	1,000

Married persons filing separately each will receive one-half of the joint standard deduction. A New York State exemption is not counted for either the filer or the spouse.

Excess Deductions Credit (EDC) was allowed only for tax years beginning in 1995, for individual tax payers whose NY itemized deductions exceeded certain base amounts.

Itemized Deductions

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

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

1. The first percentage is 25 percent of a ratio which depends on the taxpayer's filing status:

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

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

   $25,000 ÷ $50,000 = .5; .5 x 25% = 12.5% reduction in itemized deductions.

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

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

   Example of second percentage: NYAGI = $550,000

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

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

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

Supplemental Tax for Taxpayers with NYAGI Exceeding $100,000

Taxpayers with New York adjusted gross incomes exceeding $100,000 pay a special tax computed on 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: New and York Taxpayer have a NY taxable income of $105,000 and a NYAGI of $120,000. Tax on $105,000 from the tax table is $6,958.75, but at the top rate of 7.125 percent is $7,481.25. The $20,000 that exceeds the NYAGI level of $100,000 is 40 percent of $50,000. The difference between $7,481.25 and $6,958.75 is $522.50; 40 percent of this is $209.00, which is added to the tax computed from the table to make the total tax $7,167.75.

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.

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 1995 law changed the rates and brackets for 1995 and beyond. The personal income tax rates are reduced over the next three years by a gradual phase-in. The top rate is lowered from 7.59375% in 1995, to 7.125% in 1996 then 6.85% in 1997.

If the **1996 New York taxable income and filing status is**:

Married Filing Jointly and Qualifying Widow(er)

Over	Not Over	Tax	
$ 0	$11,000	4% of the excess over	$ 0
11,000	16,000	$ 440 plus 5% " " " "	11,000
16,000	22,000	690 plus 6% " " " "	16,000
22,000	26,000	1,050 plus 7% " " " "	22,000
26,000		1,330 plus 7.125% " " " "	26,000

Single, Married Filing Separately and Estates and Trusts

Over	Not Over	Tax	
$ 0	$ 5,500	4% of the excess over	$ 0
5,500	8,000	$ 220 plus 5% " " " "	5,500
8,000	11,000	345 plus 6% " " " "	8,000
11,000	13,000	525 plus 7%* " " " "	11,000
13,000		665 plus 7.125% " " " "	13,000

Head of Household

Over	Not Over	Tax	
$ 0	$ 7,500	4% of the excess over	$ 0
7,500	11,000	$ 300 plus 5% " " " "	7,500
11,000	15,000	475 plus 6% " " " "	11,000
15,000	17,000	715 plus 7% " " " "	15,000
17,000		855 plus 7.125% " " " "	17,000

*As amended.

If the **1997 New York taxable income and filing status is**:

Married Filing Jointly and Qualifying Widow(er)

Over	Not Over	Tax
$ 0	$16,000	4.00% of the excess over $ 0
16,000	22,000	$ 640 plus 4.50% " " " " 16,000
22,000	26,000	910 plus 5.25% " " " " 22,000
26,000	40,000	1,120 plus 5.90% " " " " 26,000
40,000		1,946 plus 6.85% " " " " 40,000

Single, Married Filing Separately and Estates and Trusts

Over	Not Over	Tax
$ 0	$ 8,000	4.00% of the excess over $ 0
8,000	11,000	$ 320 plus 4.50% " " " " 8,000
11,000	13,000	455 plus 5.25% " " " " 11,000
13,000	20,000	560 plus 5.90% " " " " 13,000
20,000		973 plus 6.85% " " " " 20,000

Head of Household

Over	Not Over	Tax
$ 0	$ 11,000	4.00% of the excess over $ 0
11,000	15,000	$ 440 plus 4.50% " " " " 11,000
15,000	17,000	620 plus 5.25% " " " " 15,000
17,000	30,000	725 plus 5.90% " " " " 17,000
30,000		1,492 plus 6.85% " " " " 30,000

Household Credit

The 1995 law provides that the full amount of credit will be allowed for taxable years beginning in 1995. Single taxpayers with household gross income (HGI) 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 filing separatly).

In 1996, the amount of household credit for single taxpayers ranges from $75 (taxpayers with 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, head of household, and surviving spouse, 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 (NY EIC)

An earned income credit is allowed against New York personal income tax for taxable years beginning after 1993 (Sec. 606(d), Tax Law). The NY EIC is 20 percent of the federal EIC for taxable years beginning in and after 1996 (up from 10% in 1995). For taxable years beginning after 1995, the EIC must be reduced by the taxpayer's household credit. Therefore, a taxpayer will not receive the benefits of both the NY EIC and the household credit.

Credit for Child and Dependent Care

A credit is allowed against New York State personal income tax for household and dependent care services necessary for gainful employment. The credit is a percentage of the federal EIC under IRC Sec. 21 for the same tax year. (Federal EIC does not have to be claimed.) The percentage is the sum of 20 percent and a multiplier which is 10 percent for 1996 multiplied by a fraction. The fraction is a numerator which is the lessor of $4,000 or $14,000, less the taxpayer's NYS AGI for the year. The increase is such that taxpayers with NY AGI below $10,000 get the full 30 percent while between $10,000 and $14,000 the credit is reduced and those over $14,000 receive only 20 percent of the federal credit. The numerator may not be less than zero and the denominator is $4,000. For taxable years after 1996 the multiplier will be 40 percent. For resident individuals, the credit is applied against all personal income tax after allowable credits and the excess, if any, may be refunded.

Example: Mr. and Mrs. Child Care has a 1996 NYS AGI of $12,000.

To determine multiplier $20\% + 10\% \times \frac{\$2,000}{\$4,000} = 25\%$

Resultant percentage times Federal EIC is the NY credit amount.

Real Property Tax Credit

The tax credit computations and limits are shown below for 1996. 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 an average of $450 a month. The taxpayer must occupy the same residence for six months or more to claim rent paid to qualify for the 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. This tax credit is reduced by any other personal income tax credit to which the taxpayer is entitled.

Partial Table for Computing Real Property Tax Credit, 1996

		Credit Allowed	
Household Gross Income	Applicable Rate	Under 65	65 & Over
$0 - $ 3,000	0.035	$75-71	$375-341
3,001 - 5,000	0.040	69-67	324-307
5,001 - 7,000	0.045	65-63	290-273
7,001 - 9,000	0.050	61-59	256-239
9,001 - 11,000	0.055	57-55	222-205
11,001 - 14,000	0.060	53-49	188-154
14,001 - 18,000	0.065	47-41	137- 86

Farm Property School Tax Credit

A very important tax relief program was included in the 1996 NY State Budget Bill. Effective for the 1997 tax year, NY taxpayers whose federal gross income from farming equals at least two-thirds of total federal gross income will be allowed a credit equal to school property taxes paid on certain agricultural property. The NY tax credit limitation is based on school taxes paid on qualified agricultural property plus 50 percent above the base acreage. The 1997 base average is 100 acres; 1998 base is 175 acres and there after 250 acres. If a taxpayer's farmland acreage exceeds the base acreage, the school taxes paid credit is scaled back in proportion to the sum of the base acreage and 50 percent of the acreage in excess of the base.

For example: 1997 school property tax paid on 300 acres of qualified land and buildings (residence excluded) was $15,000. The excess acreage is 300 - 100 = 200 acres and 50 percent of the excess is 100 acres. Therefore, the allowable percentage is 100 + 100 = 200/300 or 66.6 percent. Therefore credit is $10,000 ($15,000 x 66.6 percent). The credit is claimed against NY State personal income tax, corporate franchise tax, S corp or LLC income tax liabilities. Refunds can be claimed or carried over. Qualified agricultural property is land located in New York State which is used for agricultural production. The credit is not allowed for the lessee, as the operator, must be the owner of the leased land. The lessor of the land may or may not qualify dependent upon his qualifications as a farm taxpayer. The income limitation starts at $100,000 AGI and scales the credit back to zero at $150,000 AGI. If agricultural property is converted to nonqualified use, no credit is allowed that year and recapture is triggered for the previous two taxable years.

New York State Investment Credit (NYIC)

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 carry-forward period is limited to 10 years (but in no event may the credit be carried over to taxable years beginning on or after 1997). There is no provision for carryback of NYIC. Unused NYIC claimed by a **new business** is refundable. The election to claim a refund of unused credit can be made only once in one of the first four years. A business is new during its first four years in New York State. Only proprietorships and partnerships qualify. This refundable credit is not an additional credit for new businesses. A business that is substantially similar in operation and ownership to another business that has operated in the state will not qualify.

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

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

Employment incentive tax credit is available to regular corporations that qualify for NYIC and increase employees at least 1 percent during the year. The credit is 1.5 percent of the investment credit base if the employment increases less than 2 percent, 2 percent if the increase is between 2 and 3 percent, and 2.5 percent if the increase is 3 percent or more for each of the two years following the taxable year in which NYIC was allowed. The additional credit is available to newly formed as well as continuing corporations. The credit may not be used to reduce tax to less than the minimum taxable income base or the fixed dollar minimum, whichever is higher. Any remaining unused credit may be carried forward only to the 1996 taxable year.

Other Credits

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

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

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.

Estimated Tax Rules

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

For 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.

State Taxation of Pensions of Non-Residents

In January 1996, federal law banned the taxation by states of payouts from qualified pension, profit-sharing, 401(k) or government plans and IRA's, if the taxpayer was a non-resident. Income from non-qualified deferred-pay plans can be taxed by states unless payouts are made as a life annuity, for a 10 year or greater span, or the distributions are non-qualified excess-benefits plans.

Other Items of Importance From The 1996 New York State Budget Bill:

- Real property transfers tax was repealed for closing on or after June 15, 1996. This tax was 10 percent of the gain on New York State real property transfers for a consideration of $1 million or more.
- Effective on various dates between January 1, 1997 and April 1, 1999 there are changes in the petroleum business taxes on railroad diesel fuel, commercial gallonage, automotive-type diesel motor fuel, distillate fuel oil and fuel used to generate electricity.
- Sales tax on articles of closing costing less than $500 are exempt from State Sales Tax (county sales tax, local option) from January 18, 1997 to January 24, 1997.
- A four year period is allowed for claims for refunds of overpayment of highway use, truck mileage and fuel use taxes.
- The sales tax on motor vehicle damage insurance awards was postponed from September 1, 1996 to July 1, 1997.

OTHER A.R.M.E. EXTENSION BULLETINS

No. 96-11	Dairy Farm Business Summary Central Valleys Region 1995	Eddy L. LaDue Stuart F. Smith Karen Livingston James A. Hilson A.Edward Staehr Thomas Weeks Jacqueline M. Hilts Charles Z. Radick Linda D. Putnam
No. 96-12	Dairy Farm Business Summary Southeastern New York Region 1995	Robert A. Milligan Linda D. Putnam Colleen A. McKeon Stephen E. Hadcock Larry R. Hulle Paul Cerosaletti Mariane Kiraly
No. 96-13	Bibliography of Horticultural Product Marketing and Related Topic Papers Third Edition	Enrique E. Figueroa
No. 96-14	Trade Liberalization and the U.S. and Canadian Dairy Industries	Maurice A. Doyon Andrew M. Novakovic
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No. 96-16	Dairy Farm Business Summary Eastern New York Renter Summary 1996	Stuart F. Smith Linda D. Putnam
No. 96-17	Income Tax Myths, Truths, and Examples Concerning Farm Property Dispositions	Stuart Smith