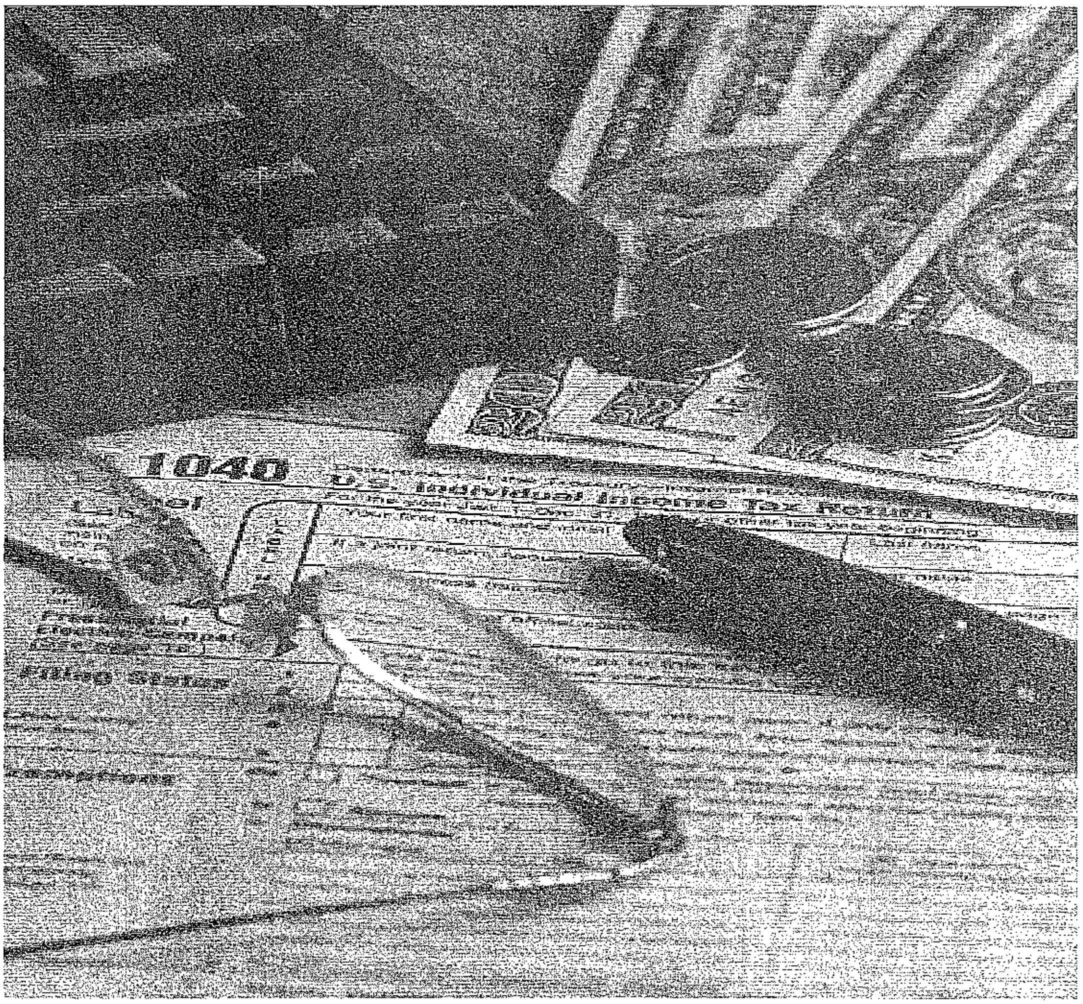
October 2004 E.B. 2004-17

INCOME TAX MANAGEMENT AND REPORTING FOR SMALL BUSINESSES AND FARMS



2004 Reference Manual for Regional Schools

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Publication Price Per Copy: $20.00

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What's New in Federal Legislation

On September 23rd, 2004, Congress passed the *Working Families Tax Relief Act of 2004* and sent it to the president for his signature. (This act is hereafter referred to as the 2004 Act.) Some of the benefits to small businesses, farmers and individuals are the following:

- The child tax credit will continue at $1,000 credit per eligible child through the end of 2010 rather than reverting to $700 in 2005.
- The 2004 Act increased the refundability in the Child Tax Credit. For 2004 the child credit was to be refundable to the extent of 10% of the taxpayer's earned income above $10,750, but the 2004 Act accelerated the increase to 15% for 2004.
- Marriage penalty relief was provided in the 2003 Act by increasing the standard deduction for married couples to twice the single bracket for 2004. Furthermore, the 15% bracket for married taxpayers filing jointly was expanded to 200% of the amount for unmarried taxpayers for 2004. Because of the 2004 Act extension the marriage tax penalty will continue as accelerated in the 2003 Act through the increased standard deduction and a 15% bracket for married couples that is double that of single filers through the end of 2010.
- The 2003 Act accelerated the increase in income thresholds for the 10% bracket for only 2003 and 2004, but the 2004 Act allows the 10% bracket to continue its inflation adjustments through the end of 2010.
- The 2003 Act increased the alternative minimum tax (AMT) exemption amount from $49,000 to $58,000 for married filing jointly and surviving spouses, increased from $24,500 to $29,000 for married filing separately, and increased the amount for other individuals from $35,750 to $40,250 only through the 2004 tax year. The 2004 Act extended the current exemption amounts through 2005.
- The 2004 Act extends the ability to offset AMT by nonrefundable personal credits through the 2005 tax year. This includes the dependent care credit, credit for the elderly and permanently and totally disabled, mortgage credit, child tax credit, education credits, adoption credit, and saver's credit.
- The 2004 Act provides the benefit of the child credit and earned income credit (EIC) to military families by expanding the definition of earned income to include combat pay. The EIC provision for military families is only for years 2004 and 2005.
- The 2004 Act reduced the complexity through reconciliation of the five definitions of a child in the tax code into a single definition for a qualifying child.
- The 2004 Act provided extensions of certain expiring provisions including the Research and Development Tax Credit, Work Opportunity Tax Credit, Welfare-to-Work Tax Credit, the Deduction for Certain Expenses of School Teachers, Credit for Qualified Electric Vehicles (phaseout) and the deduction for Clean-fuel Vehicle Property (no phaseout). The bonus depreciation on new equipment was not extended.

Let's review what the Jobs and Growth Tax Relief Reconciliation Act of 2003 provided. It was called the "administration's economic stimulus plan." Many of the provisions accelerated (temporarily) tax cuts previously planned for 2006 and later. Many of the changes and benefits of the last 3 years are phased in over the next 7 years and then, unless changed, the provisions revert to the pre–2001 Act rules and regulations. This *sunset clause*, which repeals the entire 2001 Act at the end of 2010, has added a lot of uncertainty to tax planning in the next 7 years. The combined benefits and law changes of the three acts will be discussed and explained in this manual. Some of the highlights and benefits from the 2003 Act that are updated and revised for 2004 for small businesses, farmers, and individuals are the following:

- The Act reduced the four top marginal tax rates (to 25%, 28%, 33%, and 35%, starting on January 1, 2003) and expanded the two lower tax brackets. The 10% bracket in 2004 was increased to $7,150 for singles and married-filing-separately taxpayers, whereas the married joint filers 10% bracket was increased to $14,300. The 15% tax bracket extends to $29,050 for single filers and $58,100 for married filing jointly in 2004.
- The child tax credit was modified and increased from $600 per eligible child to $1,000 for 2003 and 2004. There was no advance payment in 2004 as was experienced in 2003.
- The 2003 Act lowered capital gains rates on adjusted net capital gain to 5% and 15% on most net capital gains recorded after May 5, 2003. This special capital gains rate does not apply to the 28% rate on collectibles, the unrecaptured I.R.C. §1250 gain rate of 25%, and the I.R.C. §1202 qualified small business stock gain of 28%. Beginning in tax year 2008, the 5% capital gains rate is lowered to 0%. A similar reduction in maximum adjusted net capital gains rates will be used for AMT.
- Qualified dividend income received by noncorporate taxpayers is taxed at favorable adjusted net capital gains rates rather than ordinary income rates.
- I.R.C. §179, the expense election, has increased from $100,000 to $102,000 for tax year 2004. In addition, the phaseout limit was increased to $410,000. The definition of I.R.C. §179 property now includes off-the-shelf computer software. Furthermore, taxpayers may revoke or change their I.R.C. §179 election for 2004 without IRS consent, but revocation is irrevocable.

The 2003 Act increased the special first-year bonus depreciation from 30% to 50% for certain tangible property and computer software acquired after May 5, 2003, and before January 1, 2005. In the 2002 Act, taxpayers had the choice to elect out of a special 30% first-year additional bonus depreciation. Under the 2003 Act, an additional option is to elect 30% rather than 50%. To accommodate the 50% special depreciation allowance, the first-year depreciation limit on passenger vehicles in 2004 is increased to a maximum of $10,610 ($10,910 for trucks and vans) if the vehicle is qualified property and 50% bonus depreciation is claimed.

2004 Farm Income Tax Situation and Outlook

Following 3 out of 4 preceding years of poor milk prices, dairy farmers enjoyed record high milk prices for several months during 2004 and an annual average price that will be among the highest ever, rivaling the record high annual average of 1998. It is anticipated that this long overdue surge in income will be used by many farmers to simply pay bills and catch up on loan repayment. Although many producers, especially the better-run large-scale producers, were able to maintain profitability over the last 4years, for most producers the high milk prices of 2004 will simply give them a chance to catch up. For the time being, it is not expected to stimulate much new production.

Since the record high prices of the past spring, milk prices quickly moderated, but prices have remained above average and are expected to be strong through much of 2005. Supply factors led to the run up in prices, because monthly milk production was below the previous year's levels. There were several reasons for the decline in production, including 1) the accumulated effects of several years of low prices, 2) the reduced availability of replacement cattle due to the ban on cattle shipments from Canada, 3) reduced supplies of BST, and 4) poor returns over feed costs. Although there have been indications of precautionary buying patterns earlier in 2004 and building inventories in later 2004, for the most part demand has been fairly persistent despite the very high prices for dairy products at both wholesale and retail levels.

Looking toward 2005, the primary questions are both how long will demand hold and when will milk supplies show significant recovery. As of fall 2004, markets are unsettled, with some indicators suggesting continuing price strength and others suggesting decline. On the demand side, it is likely that ample to higher-than-normal and desirable inventories held by buyers will eventually result in some softness in markets, but demand-side factors may not play a major role in price swings as a general rule. Keep in mind that the holiday season demand for butter and cheese tends to boost prices in the fall, but could quickly lead to a downturn in December. Prices are far more likely to be vulnerable to supply-side effects as the generally strong prices this winter begin to have a more stimulative effect. Equally important will be an abundance of feed at reasonable prices. Corn prices are expected to be quite low, following a huge crop. Protein prices are also weak. The availability and cost of protein will vary considerably depending on an individual producer's circumstance with respect to high-quality forages versus other sources of protein. Highly variable rainfall and temperature patterns across the United States have made homegrown alfalfa relatively poor in many parts of the northern dairy states but adequate to excellent in other areas.

Farm incomes may be quite high in 2004, becasue of the record milk prices. Returns over feed cost seem on track to be strong in 2005. For many producers, this will likely be a good year to explore tax management strategies in general and income averaging in particular. To follow the forecast and other developments in the dairy situation, visit the Cornell Program on Dairy Markets and Policy at www.dairy.cornell.edu.

Harvested acreage for four major New York fresh vegetables in 2004 is estimated to be down 5% from 2003. Long periods of rain, saturated fields and cool weather during planting season caused this decrease. Sweet corn, snap beans, and cabbage all experienced this decrease because of rainy spring. Tomatoes acreage remained the same as last year. New York onion growers planted 13,400 acres in 2004, up 11% from 2003. Growers were able to get into muck fields early and plant onions. Total New York processed vegetable acreage is up 12% in 2004.

There was quite a bit of winter damage for grapes, especially wine grapes. So this year production will be lower. Moreover, because of the damage to the vines, the production for next year will decrease as well. Apple production is experiencing a good year. Production is up, and the fruit quality is good.

Tax Suggestions for Farmers

Here are some tax management suggestions for farmers with 2004 net farm profits:

- Purchase quantities of feed and supplies before the year end. These prepaid expenses may be claimed if they do not exceed 50% of other expenses on 1040 Schedule F.
- Buy needed machinery now. Take advantage of the I.R.C. §179 deduction as well as rapid depreciation.
- Pay additional wages to family members who actually work on the farm. Consider paying holiday bonuses to regular employees.
- Purchase IRAs or other tax-deferred retirement plans.

FEDERAL TAX PROVISIONS AFFECTING INDIVIDUALS

Standard Deduction

The standard deduction is indexed to inflation and is adjusted annually, as shown in Table 1. The 2003 Act increased the basic standard deduction amount for married taxpayers filing jointly to twice the basic standard deduction amount for single taxpayers, effective for 2003 until 2010.

Table 1. Basic Federal Standard Deduction for 2003, 2004, and 2005

Filing Status	2003	2004	2005*
Married filing jointly or qualifying widow(er)	$9,500	$9,700	$10,000
Head of household	7,000	7,150	7,300
Single individuals	4,750	4,850	5,000
Married filing separately	4,750	4,850	5,000

*Projected

Each taxpayer over age 65 or blind receives the regular standard deduction plus an additional $950 deduction if married and filing a joint or separate return ($1,000 in 2005). The additional deduction is $1,200 if the taxpayer is single or is the head of the household ($1,250 in 2005). The additional deductions are subject to the inflationary adjustment. A taxpayer that 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 2004 personal exemption allowed on the federal return is $3,100 for the taxpayer, his or her spouse, and his or her dependents. The projected amount for 2005 is $3,200. Taxpayers may not claim an exemption for themselves or for any other person who can be claimed as a dependent on someone else's tax return.

There is a phaseout of the personal exemption for certain high-income individuals. For 2004 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 adjusted for inflation annually:

- $214,050 if married filing jointly or qualifying widow(er) with a dependent child (exemptions completely lost at $336,550 AGI)
- $178,350 if head of household (exemptions completely lost at $300,850 AGI)
- $142,700 if single (exemptions completely lost at $265,200 AGI)
- $107,025 if married filing separately (exemptions completely lost at $168,275 AGI)

The phaseout in personal exemptions is 2% of the exemption amount for each $2,500 increment (or any fraction thereof) by which AGI exceeds the appropriate threshold amount. A married taxpayer filing separately will lose 2% of his or her exemption for each $1,250 increment above $107,025. The personal exemption phaseout or reduction is calculated on a nine-line worksheet called the "Deduction for Exemptions Worksheet," included in the Form 1040 instructions. If AGI exceeds the threshold, complete the worksheet before claiming the personal exemption deduction on line 41 of Form 1040.

Full personal exemption is scheduled to be restored after the year 2009. The above phaseout will gradually be reduced after 2005.

Example 1. Mr. and Mrs. Dairy file jointly, have two children, and their 2004 AGI is $274,150. They claim four personal exemptions and the standard deduction. Their reduction and net exemption are calculated as follows:

- AGI $274,150 − $214,050 threshold = $60,100 excess.
- The $60,100 excess ÷ $2,500 = 24.04, or 25 excess increments.
- Their reduction is 25 × .02 (2%) = .50 × $12,400 (4 @ $3,100) = $6,200.
- Their net personal exemption is $12,400 − 6,200 = $6,200.

A way to evaluate the cost of the personal exemption phaseout to the taxpayer is to calculate the additional tax liability. In Example 1, Mr. and Mrs. Dairy are in the 33% taxable income bracket, where the $6,200 of phased-out personal exemption will cost $2,046 in additional taxes. In other words, their $60,100 of excess AGI caused an additional tax liability of $2,046 or added 2.4% to their tax liability.

Dependents

Taxpayers must report the social security numbers of all dependents. 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, or file online from www.ssa.gov.

Taxpayers may not claim an exemption for a dependent that has gross income of $3,100 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 5 calendar months. Individuals who can be claimed as dependents on another taxpayer's return may not claim a personal exemption on their own return.

The qualified child, student, or other qualified dependent's basic standard deduction allowable is limited to the smaller of the basic standard deduction or the larger of (1) $800 or (2) the individual's earned income plus $250, as shown in Table 2.

Table 2. Examples of Single Taxpayer's Standard Deduction

	Base Amount	Earned Income	Earned Income + $250	Larger of the Two	Standard Deduction	Smaller of the Two
Case #1	$800	$0	$250	$800	$4,850	$800
Case #2	$800	$3,000	$3,250	$3,250	$4,850	$3,250
Case #3	$800	$5,000	$5,250	$5,250	$4,850	$4,850

Investment or unearned income in excess of $1,600 that is 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 $1,600, where the excess over $1,600 will be taxed at the parent's marginal rate, and unearned income greater than $800 but less than $1,600 will be taxed at 10%.

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 available, and the base amount is $1,600 with an $800 tax exemption. This election cannot be made if the child has income other than interest and dividends, if estimated tax payments were made in the child's name, or the child's income is more than $7,999.

Practitioner Note—The federal income tax on your child's income, including qualified dividends and capital gain distributions, may be less if you file a separate return for the child rather than making the election.

2004 Tax Rates

All the tax brackets have been adjusted for inflation this year. Each of the top four tax brackets has been moved up approximately 2.2% from 2003, which results in many taxpayers with constant taxable incomes paying somewhat less for income taxes in 2004. The 10% bracket increased by $150 for single taxpayers and married taxpayers filing separately and twice that for married taxpayers filing jointly. For example, for a married taxpayer filing jointly, the increase of $300 in the 10% bracket rather than the 15% bracket is a savings of $15 in income tax liability. After 2010 the 10% rate bracket reverts to the levels under the prior act, unless changed. There is not a 10% bracket for estates and trusts. The 15% bracket for those married taxpayers filing jointly is twice the single bracket. The 2004 tax rate schedules are shown in Table 3.

Table 3. Section 1(a)—Married Individuals Filing Joint Returns and Surviving Spouses

If Taxable Income Is:	The Tax Is:
Not over $14,300	10% of the taxable income
Over $14,300 but not over $58,100	$1,430 plus 15% of the excess over $14,300
Over $58,100 but not over $117,250	$8,000 plus 25% of the excess over $58,100
Over $117,250 but not over $178,650	$22,787.50 plus 28% of the excess over $117,250
Over $178,650 but not over $319,100	$39,979.50 plus 33% of the excess over $178,650
Over $319,100	$86,328.00 plus 35% of the excess over $319,100

Table 3. Section 1(b)—Heads of Households

If Taxable Income Is:	The Tax Is:
Not over $10,200	10% of the taxable income
Over $10,200 but not over $38,900	$1,020 plus 15% of the excess over $10,200
Over $38,900 but not over $100,500	$5,325 plus 25% of the excess over $38,900
Over $100,500 but not over $162,700	$20,725 plus 28% of the excess over$100,500
Over $162,700 but not over $319,100	$38,141 plus 33% of the excess over $162,700
Over $319,100	$89,753 plus 35% of the excess over $319,100

Table 3. Section 1(c)—Single Individuals (Other than Surviving Spouses and Heads of Households)

If Taxable Income Is:	The Tax Is:
Not over $7,150	10% of the taxable income
Over $7,150 but not over $29,050	$715 plus 15% of the excess over $7,150
Over $29,050 but not over $70,350	$4,000 plus 25% of the excess over $29,050
Over $70,350 but not over $146,750	$14,325 plus 28% of the excess over $70,350
Over $146,750 but not over $319,100	$35,717 plus 33% of the excess over $146,750
Over $319,100	$92,592.50 plus 35% of the excess over $319,100

Table 3. Section 1(d)—Married Individuals Filing Separate Returns

If Taxable Income Is:	The Tax Is:
Not over $7,150	10% of the taxable income
Over $7,150 but not over $29,050	$715 plus 15% of the excess over $7,150
Over $29,050 but not over $58,625	$4,000 plus 25% of the excess over $29,050
Over $58,625 but not over $89,325	$11,393.75 plus 28% of the excess over $58,625
Over $89,325 but not over $159,550	$19,989.75 plus 33% of the excess over $89,325
Over $159,550	$43,194 plus 35% of the excess over $159,550

Table 3. Section 1(e)—Estates and Trusts

If Taxable Income Is:	The Tax Is:
Not over $1,950	15% of the taxable income
Over $1,950 but not over $4,600	$292.50 plus 25% of the excess over $1,950
Over $4,600 but not over $7,000	$955 plus 28% of the excess over $4,600
Over $7,000 but not over $9,550	$1,627 plus 33% of the excess over $7,000
Over $9,550	$2,468.50 plus 35%ofthe excess over $9,550

Table 3. Section 1(h)—Capital Gains Rates (Non-Corporate Taxpayers)

Category of Gain	Tax Rate
Gain on collectibles	28%
I.R.C. §1202 gain	28%
Unrecaptured I.R.C. §1250 gain	25%
Net long-term capital gain	15%
Reduced long-term capital gains rate if ordinary tax rate is 10% or 15%	5%

The rates for heads of households are more favorable than for filing single. Single taxpayers who are maintaining a home for themselves and a dependent should qualify. A married taxpayer not living in the same household as his or her spouse for the last 6 months of the year is treated as married filing separately but may qualify as head of household if he or she has a qualified dependent.

The 2003 Act reduced the percentage on the four highest brackets, but these did not change from 2003 to 2004 and will remain at 25%, 28%, 33%, and 35%.

Marriage Tax Penalty

The 15% bracket for married taxpayers filing jointly increased to twice the single bracket for 2003 and 2004, which eliminated the marriage penalty in that bracket. The 2004 Act made this increase permanent until the end of 2010.

Practitioner Note—Notice that the 2003 act only fixed the 15% bracket and not other brackets. So, actually, the acts have not completely eliminated the marriage tax penalty.

The other part of the marriage tax penalty has to do with the comparison of standard deduction between singles and married filing jointly. Two singles were afforded a larger standard deduction than a married couple filing jointly. The 2003 Act changed this deduction starting in the year 2003 so that the deduction for married filing jointly moved to 200% of the single taxpayer amount. Thus, married taxpayers filing jointly will benefit from the $4,850 times 2, or $9,700 standard deduction in 2004. Inflationary adjustments will continue to be made until the end of the year 2010. The projected 2005 standard deductions are: $10,000 married filing jointly, $5,000 single or married filing singly and $7,300 for heads of households.

Increasing the credit phaseout amounts for joint filers will provide marriage tax penalty relief for EIC calculations. The 2001 Act increased by $1,000 in 2002, $2,000 in 2005, and $3,000 in 2008, both the beginning and ending of the EIC phaseout ranges. Married individuals must file a joint return in order to claim the EIC. The calculation of the couple's combined income previously penalized some couples that had a smaller EIC when married compared to unmarried.

Itemized Deductions Form 1040 (Schedule A)

Medical Expenses

Medical expenses that exceed 7.5% of AGI are itemized deductions. 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 including auto mileage deduction for 2004, which is $.14 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 general 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.

Qualified long-term care (LTC) insurance contracts are generally treated as an accident and health insurance contract. Contract benefits are generally excludable from taxation like money received for personal injury and sickness. The 2004 excludable per diem benefit limit is $230 per day or $83,950 annually. Benefits are reported to taxpayers on 1099-LTC and shown on Form 8853 Section C. This exclusion limit is ignored if the actual cost of the LTC is more than the per diem payment or if the taxpayer has been certified by a physician as terminally ill and death is expected within 24 months of certification.

For purposes of the itemized medical expense deduction, the cost of over-the-counter drugs is nondeductible. In September 2003, Rev. Rul. 2003-102 allows over-the-counter drugs to be covered by health care Flexible Spending Accounts. This ruling allows reimbursements for nonprescription drugs by an employer health plan to be excluded from income if substantiated by the employee.

Long-Term Health Care

Long-term health care premiums are deductible for 2004 by itemizers when combined with other premiums and medical expenses that exceed 7.5% of AGI. 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 $3,250 per year per person subject to the 7.5% exclusion. Those aged 61 to 70 years may include $2,600 per person; 51 to 60 years, $980 per person; 41 to 50 years, $490 per person; and 40 years and under, $260 per person–all subject to the 7.5% exclusion.

Disabled Taxpayers

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

Itemized Deductions

Itemized deductions not subject to the 2% AGI limit include state income and property taxes, personal casualty losses, and others.

Home Mortgage Interest

Home mortgage interest (qualified residence interest) on the taxpayer's principal and second home is an itemized deduction on Form 1040 Schedule A, providing that the mortgage satisfies the following limitations:

- Home Acquisition Loan–The mortgage was obtained after October 13, 1987, to buy, build, or improve a main home or a second home, but only if throughout 2004 the total mortgage debt was $1 million or less ($500,000 or less if married filing separately). Note: This limit applies to the total debt on mortgages obtained after October 13, 1987, plus any prior "grandfathered debt."
- Home Equity Loan–The mortgage was obtained after October 13, 1987, other than to buy, build, or improve a home, but only if throughout 2004 this debt was $100,000 or less ($50,000 or less if married filing separately).

To be deductible, both types of mortgages must be secured debt, and the mortgage must be recorded with the county recorder or otherwise perfected under state law.

Mortgage interest that exceeds these limits is nondeductible. However, an exception applies if the disallowed mortgage interest is deductible under another I.R.C. section.

Practitioner Note—There is 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 deduction.

Investment Interest Expense

Investment interest expense is deductible but 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). Because of the 2003 Act, dividends are treated as investment income for purposes of deductible investment interest **only** if the taxpayer elects not to take the reduced tax rates on the dividend. 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 long-term capital gain tax rate. By electing to treat net capital gain and/or dividend income as investment income to the extent of excess investment expense, any capital gain or dividend income can effectively be transformed into "tax-free" income by offset (T.D. 9147, 8/4/04 retroactive to 1/1/03).

Example 2. In 2004 Charlie has $6,000 of investment expenses but only $5,000 of investment income. Thus, Charlie can deduct only $5,000 of his expenses and must carry forward the other $1,000 to the next tax year. But, Charlie has $2,200 of dividend income during 2004. Charlie can elect to have $1,000 of that dividend income treated as investment income. By this election Charlie can deduct the full $6,000 of investment expenses in 2004. The remaining $1,200 ($2,200 – $1,000) of dividend income is subject to 15% tax rate (5% if in the 10% or 15% brackets).

Practitioner Note—If the dividend has been taxed at the lower rate given to dividends and capital gains, then it is not eligible to be used in determining the amount of deductible investment interest.

Investment Interest Expense Deduction

Form 4952, Investment Interest Expense Deduction, is designed to calculate the amount of investment interest expense that may be deducted in the current tax year and the amount you can carry forward to future years. The carryover interest deduction is limited to the excess of the 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

Personal interest is not deductible.

Charitable Contributions

Charitable contributions are subject to substantiation and disclosure rules. One set of rules applies to separate contributions of less than $250. For separate cash contributions of $250 or more, a taxpayer cannot rely solely on a canceled check but needs substantiation from the charity showing the amount and date the contribution was made. 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.

The standard mileage rate for a passenger car used for charitable causes is $.14 per mile for 2004.

Moving Expenses

Moving expenses are no longer itemized deductions. Report qualified moving expenses on Form 3903 and deduct them on line 29 of Form 1040.

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 a passenger car used for moving is $.14 per mile. Meal expenses are no longer included. The new place of work must be at least 50 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 premove 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 that they meet the requirements of qualified moving-expense reimbursement.

Deductions Subject to the 2% AGI Limit

Miscellaneous Deductions

The following deductions are subject to the 2% AGI limit:

- Unreimbursed employee business expenses subject to the 2% AGI limit include employment-related educational expenses; expenses for travel, meals, and entertainment (subject to 50% rule); and expenses for lodging, work clothes, dues, fees, and small tools and supplies.
- Employee business expenses reimbursed under a nonaccountable plan are subject to the 2% AGI limit.
- Investment expenses subject to the 2% AGI limit include legal, accounting, and tax counsel fees; clerical help and office rental; and custodial fees.
- Job-hunting expenses may be deductible if one is looking for employment. Job hunters' expenses are deductible if the expenses are incurred in looking for a new job in one's present occupation. The job-searching expenses are not deductible if one is looking for a job in a new occupation or looking for a first job. Factors to determine whether 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
  - Travel or transportation expenses

Other deductions include professional dues, books, journals, 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

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 proceeding 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%. Self-employed individuals claim this deduction on either Form 1040 Schedule C or F, whereas employees deduct 50% of any unreimbursed business meal on Form 1040 Schedule A. The deductible percentage of the cost of meals consumed by employees subject to the Department of Transportation (DOT) will gradually increase from 70% in 2004 to 80% in 2008. DOT employees include Federal Aviation Administration (FAA) employees (pilots, crews, etc.), railroad employees, and interstate truck and bus drivers under DOT regulations.

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 3%/80% reduction rule for married filing separately in 2004 begins at $71,350 (AGI), and the limit for all other taxpayers starts at $142,700 (AGI).

Taxpayers with a 2004 AGI in excess of the limits previously mentioned 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% of excess AGI or 80% 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 the taxpayer has significant applicable itemized deductions. The 7.5% of AGI medical expense adjustment and 2% floor on miscellaneous itemized deductions must be applied before the high-income deduction.

Example 3. Fred and Ann Veryrich's 2004 AGI is $162,700. Their itemized deductions total $17,000, including $12,000 of deductible medical expenses (after the 7.5% AGI deduction) and investment interest. They claim no casualty or wagering losses. They must reduce their itemized deductions as follows:

- $162,700 AGI − $142,700 maximum = $20,000 excess; $20,000 excess × .03 = $600.
- $600 is less than $4,000 (.80 × $5,000 of applicable itemized deductions).
- They reduce itemized deductions by $600; $17,000 − $600 = $16,400 adjusted itemized deductions.

The previously given limitation on itemized deductions will be phased out starting in 2006 and completely eliminated after 2009. Starting in 2006, the otherwise applicable phaseout is reduced by one-third. Similarly, in 2008, the phaseout is reduced by two-thirds.

Planning Pointer—In 2011, there is no phaseout of itemized deductions. This is another tax-planning management area for those who are subject to deduction phaseouts. If they can delay their itemized deductions from 2005 to 2006, from 2007 to 2008, and from 2009 to 2010, they will pay less tax.

Interest and Ordinary Dividends (Form 1040 Schedule B)

Most taxpayers do not have to file a separate schedule if they have interest or *ordinary* dividend income of $1,500 or less. Form 1040 filers with over $1,500 are required to use 1040 Schedule B to list the names and amounts of those who paid them; Form 1040A filers use Schedule 1. In addition to having one less form to file (for many), this enables many taxpayers to use the shorter Form 1040EZ or use TeleFile to file by telephone. This $1,500 threshold replaced the old reporting threshold of $400. This does not affect filers with foreign bank accounts, because they must continue to report any foreign interest or dividends on 1040 Schedule B.

Qualified Dividend Income

Noncorporate taxpayers who have qualified dividend income will be taxed at reduced adjusted capital gains rates of 5% or 15% rather than at ordinary income rates of 10% to 35%. Under the 2003 Act, qualified dividends received from domestic and qualified foreign corporations generally will be taxed at the same rates that apply to capital gains. Qualified dividends under this provision will be taxed at rates of 5% (zero in 2008) and 15%. The act increases the amount of net capital gain (determined separately) by the amount of the taxpayer's eligible qualified dividend income. The act does not change the definition of net capital gain. Qualified dividend income is taxed at the same rates as net capital gain. This applies for purposes of both regular tax and the alternative minimum tax.

Requirements for qualified dividends for tax years beginning after December 31, 2002, are as follows:

- The definition of a dividend is a distribution of property, including money, by a corporation to its shareholders where it is paid out of current or accumulated profits and earnings.
- Payments that are called dividends that do not meet the preceding definition are not eligible for qualified dividend income treatment–for example, dividends paid by cooperatives to their patrons, dividends paid to policyholders by their insurance companies, and distributions from money market funds (even though they are called dividends). Regulated investment companies (RIC; i.e., most mutual funds) can generally distribute qualified dividend income only to the extent that the RIC received qualifying dividend income. RICs will notify shareholders of the amount of any qualified dividend income distributed.
- Any dividend received from a real estate investment trust (REIT) is subject to limitations of I.R.C. §854 and I.R.C. §857. The 2003 Act provides pass-through of qualified dividend income for RICs and REITs for any taxable year that the aggregate qualifying dividends received by the company or trust are less than 95% of its gross income and may not exceed the amount of the aggregate qualifying dividends received by the company or trust.
- The act provides that the reduced rates do not apply to dividends received from any organization that is exempt under I.R.C. §501 or was a tax-exempt farmers' cooperative in either the taxable year of the distribution or in the preceding year.
- Dividends received from a mutual savings bank that received a deduction under I.R.C. §591 or deductible dividends paid on employer securities are not qualified dividends.
- Dividends must be received by individual taxpayers (noncorporate).
- A shareholder must hold the dividend-paying stock for at least 61 days during a121-day period (a technical correction from 120 days) beginning 60 days before the stock trades without its dividend (the ex-dividend date) and the 60 days after the ex-dividend date [I.R.C. §246(c)]. In February 2004 the IRS said they would follow the technical corrections on qualified dividends even though the Corrections Bill of 2003 had not passed (IR News Release 2004-22). The holding period changed so that under the new law, a stock bought on the last day before the ex-dividend date could still meet the holding period test because there are 61 days left in the 121-day period. Likewise, a stock sold on the ex-dividend date could meet the test because that is the 61st day in the period.
- A similar, but longer, holding period exists for preferred stock dividends attributable to a period exceeding 366 days. This holding period is at least 91 days during a 181-day period beginning 90 days before the ex-divided date.
- Mutual funds, regulated investment companies, and real estate investment trusts that pass through dividend income to a shareholder must meet the holding period test in order to report qualified dividends on Form 1099-DIV.
- Taxpayers cannot offset or reduce qualified dividend income by other types of capital losses. Capital gains and losses are calculated separately from qualified dividend income.
- Individuals will have to add qualified dividend income to net capital gain in computing their tax on Form 1040 line 43 from the Dividend and Capital Gain Tax Worksheet.
- Qualified dividend income will be reported on 1099-DIV and totaled on Form 1040 line 9b.
- Any dividend on a share of stock to the extent that the taxpayer is under an obligation to make related payments with respect to positions in similar or related property is not qualified dividend income.
- Payments in lieu of dividends are not qualified dividend income.
- Dividends paid in tax years beginning after 2008 do not qualify as the code reverts to previous provisions.

Practitioner Note—Dividends declared and made payable by mutual funds in October, November, or December are considered received by shareholders on December 31 of the same years, even if actually paid during January of the following year.

Practitioner Note—On many 2003 Form1040 returns, there were errors in reporting dividends. Taxpayers were concerned about double accounting and did not report on 1040 line 9a the *total* dividends (qualified and nonqualified) and did not list on line 9b the qualified dividend amount previously included on line 9a.

Electronic Information Returns

Forms such as 1098, 1099, and 5498 can be furnished to the taxpayer electronically if the recipient consents. Electronic furnishing of Form W-2 was previously authorized, and Treas. Reg. §31.6051-1T has the details.

Foster Care Payments

Foster care payments made by qualified tax-exempt agencies and government agencies can qualify for exclusion from income under I.R.C. §131. The definition of a qualified individual was previously expanded and may include individuals over age 18.

Uniform Method on Determining a Child's Age

The IRS has had several rules for determining a child's age for many of the income tax credits. Rev. Rul. 2003-72 had cleared up and made a more uniform determination of the age threshold for various sections of the tax code. A child born on January 1, 1988, is 17 on January 1, 2005. This same child on December 31, 2004, is considered 16 years old. This rule holds for dependent-care credit, child tax credit, EIC, dependent-care assistance programs, foster care payments, adoption credit, adoption assistance programs, and dependency exemptions.

The same uniform method does not apply to senior citizens. They attain an age on the day before their birthday for most income tax benefits. A person who was born on January 1, 1940, is considered to be 65 on December 31, 2004, and may claim the additional deduction in addition to the standard deduction. It looks like age has its benefits.

Title II of the 2004 Act reduces the complexity by reconciliation of the five definitions of a child in the tax code into a single definition for a "qualifying child."

Earned Income Credit (EIC)

Basic EIC rates have been gradually increasing, and some low-income workers without qualifying children are eligible for EIC. Earned income includes wages, salaries, tips, and net self-employment earnings but does not include interest, dividends, alimony, and social security benefits.

Taxpayers in 2004 will use AGI to determine if they qualify for EIC subject to disqualified income, number of children and phaseouts.

Use Table 4 to see whether the taxpayer's earned income and number of qualified children meet the requirement for the credit, and refer to the IRS tables for the 2004 credit amount.

Table 4. EIC Rates, Income Ranges, and Phaseouts*

Earned Income or AGI Range for Taxpayers Not Filing as "Married Filing Jointly" (for 2004)

Qualifying Children	Credit Rate (%)	Maximum Credit	Phaseout	Phaseout Rate (%)	Maximum Credit
None	7.65	$ 5,100–6,399	$6,400–11,490	7.65	$390
One	34.00	7,650–14,049	14,050–30,338	15.98	2,604
Two or more	40.00	10,750–14,049	14,050–34,458	21.06	4,300

Earned Income or AGI Range for Married Filing Jointly (for 2004)

Qualifying Children	Credit Rate (%)	Maximum Credit	Phaseout	Phaseout Rate (%)	Maximum Credit
None	7.65	$ 5,100–7,399	$7,400–12,490	7.65	$390
One	34.00	7,660–15,049	15,050–31,338	15.98	2,604
Two or more	40.00	10,750–15,049	15,050–35,458	21.06	4,300

*This is not an official table. Do not use these figures in tax preparation because numbers are adjusted annually for inflation, and the amount of credit is normally determined by using EIC tables, within $50 ranges, released by the IRS.

It is possible for a low-income taxpayer to be eligible for EIC even though that taxpayer does not 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 that 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 the following: he or she cannot be claimed as a dependent or a "qualified child" on another person's tax return; his or her principal residence must be in the United States 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 the taxpayer cannot file Form 2555 or Form 2555-EZ. The credit percentage is much smaller (7.65%) for taxpayers with no qualifying children, and the credit is phased out over a lower income range.

To be eligible for EIC, any taxpayer must have all of the following:

- Earned income
- Earned income and AGI, each below the maximum earned income allowed
- A return that covers 12 months (unless a short-year return is filed because of death)
- A joint return if married (usually)
- Included income earned in foreign countries and not deducted or excluded a foreign housing amount
- Not be used as a qualifying child who is making another person eligible for the EIC

The 1996 Act expanded *disqualified income* to include (among other income items) *capital gain net income.* To disqualify more taxpayers, the law that said gains from the sale of passive investments should be included as disqualified income. The IRS *originally* said this included gain from sale of assets used in a trade or business. This interpretation included assets that met the holding-period requirements of I.R.C. §1231; these assets are not subject to recapture rules of I.R.C. §§1245, 1250, 1252, and so on. In Rev. Rul. 98-56 (November 1998), the IRS announced that they were reversing their position retroactively as follows:

> Section 32 of the Internal Revenue Code allows an EIC to eligible individuals whose income does not exceed certain limits. Section 32(i) denies the earned income credit to an otherwise eligible individual if the individual's "disqualified income" exceeds a specified level for the taxable year for which the credit is claimed. Disqualified income is income specified in §32(i)(2). Gain that is treated as long-term capital gain under §1231(a)(1) is not disqualified income for purposes of §32(i).

Therefore, gain from the sale of equipment and livestock (sows, boars, beef cattle, horses, cull dairy cows) that are I.R.C. §1231 property is not disqualified income.

In 2004 the EIC is denied to all taxpayers with an excess of $2,650 of taxable and nontaxable interest income, dividends, net capital gains (excluding those from I.R.C. §1231 assets), and net income from rents and royalties not derived in the ordinary course of business. All gains from the sale of business assets including ordinary gains (Form 4797, Part II) and gains recaptured as ordinary income (Form 4797, Part III) are not included in disqualified income.

There are three tests for a qualifying child: relationship, residency, and age. Any child who meets all three of the following conditions is a qualifying child:

1. The child is your
   - Son, daughter, adopted child, stepchild, grandchild, or foster child
   - Brother, sister, stepbrother, stepsister, or a descendant (such as a child, including an adopted child) of any such individual, but only if you cared for that person as your own child

> **Practitioner Note**—An **adopted child** is any child placed with you by an authorized placement agency for legal adoption, even if the adoption is not final. An authorized placement agency includes any person authorized by state law to place children for legal adoption. A **grandchild** is any descendant of your son, daughter, stepchild, or adopted child. A **foster child** is any child you cared for as your own child **and** who is placed with you by an authorized placement agency.

2. The child lives with you in the United States for over half of 2004.
3. The child is under age 19 at the end of 2004, under age 24 at the end of 2004, and a full-time student, or any age at the end of 2004 and permanently and totally disabled.

Individuals with qualifying children will not be allowed EIC if they fail to identify those children by name, age, and TIN on their returns.

The following are previous changes to the EIC:

- The EIC phaseout ranges (both beginning and ending) for married joint filers will increase by another $1,000 starting in 2005, and another $1,000 increase in 2008.

- In cases where a child may be claimed by two taxpayers, the tiebreaker rule was changed in 2002. Rather than the taxpayer with the highest modified AGI claiming the child, the claim will go to (1) the child's parent, or (2) if (1) does not apply, then the taxpayer with the highest AGI.
- The definition of earned income for purposes of calculating the credit will include only compensation included in gross income and net self-employment (SE) income. Previously, it included compensation excluded from income.
- In 2004 Earned Income Tax Credit will not be reduced by AMT.
- The residency requirement for a foster child is that the child "has to live with the taxpayer for more than 6 months rather than for the entire year."
- The 2004 Act provides the additional benefit of EIC to military families by expanding the definition of earned income to include combat pay. This provision is only for 2 years.

EIC Reminders for Farmers

If earned income is negative, there is no credit. Therefore, a farmer with a negative Form 1040 Schedule F net farm profit would not get a credit unless there were wage and Form 1040 Schedule C income more than enough to offset the loss on Form 1040 Schedule F, or the optional method of reporting SE income is used. A farmer with a negative net farm profit may use the optional method of reporting up to $1,600 of SE income to collect an EIC that would partially or wholly cover the SE tax and also provide **one** quarter of social security coverage, providing disqualified income (such as interest and dividends), earned income, and AGI are all less than the maximums allowed.

If AGI is greater than the maximum allowed, there would be no credit even if earned income is below the maximum. Many dairy farmers could have a Form 1040 Schedule F profit in the EIC range but not get a credit (or at least it is limited) because of gains from cattle sales shown on Form 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 SE income to result in an EIC with which to pay the SE tax and provide social security coverage, 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) may be used by any employee eligible for EIC to elect advanced payments from his or her employer. The EIC payments made by an employer to his or her employee offset the employer's liability for federal payroll taxes. Use the IRS tables to determine advanced payments of EIC. Advanced payments are limited to 60% of the credit amount for one qualifying child. The maximum that a taxpayer can receive throughout the year with his or her pay is $1,562, regardless of the total number of children a taxpayer may have. A taxpayer may be able to claim a larger credit but must file his or her 2004 tax return to claim more. 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 EIC payments to farm workers paid on a daily basis (IRS Publication 225, *Farmer's Tax Guide*).

Child Tax Credits

The child tax credit allows taxpayers to claim a credit for each qualifying child under 17 years of age. Generally, a qualifying child is one whom the taxpayer can claim a dependency and prove is a son or daughter (or descendent of either), a stepson or stepdaughter (or descendent of either), or an eligible foster child. For the taxable years starting in 2003 until the end of 2010 (2004 Act extender) the tax credit in increased from $600 to $1,000. For taxpayers with AGI in excess of the applicable threshold amount, the credit is phased out. The phaseout rate is $50 for each $1,000 of modified AGI (AGI plus certain foreign source income), or fraction thereof, in excess of the following thresholds: $75,000 for single individuals or heads of households, $110,000 for married individuals filing jointly, and $55,000 for married individuals filing separate returns. See Table 5 for an example of various filers with one child.

Table 5. One Eligible Child, Tax Credit Phaseout Based on MAGI

	Threshold Starting	Completely Gone
Married joint return	$110,001	$129,001
Single or head of household	75,001	94,001
Married separate return	55,001	74,001

For 2004 the child tax credit is refundable to the extent of the greater of: 15% (increased by a statutory change in the 2004 Act from 10%) of earned income above $10,750, or for taxpayers with three or more qualifying children, the excess of the taxpayer's social security taxes for the tax year over his EIC for the year. Furthermore, the 2004 Act provides the additional benefit of child tax credit to military families by expanding the definition of earned income to include combat pay. This latter provision is only for 2 years.

Child- and Dependent-Care Credits

The 2002 Job Creation and Worker Assistance Act increased this credit. An individual taxpayer maintaining a household in 2004 for a dependent under 13 or a dependent or spouse who is physically or mentally incapable of caring for themselves may get a child- and dependent-care credit of up to 35% of qualified employment-related expenses. Those care expenses cannot exceed $3,000 for one qualifying individual ($6,000 for two or more). This credit is decreased by 1% for each $2,000 (or fraction thereof) of AGI over $15,000, but the percentage never goes below 20%. This means that the credit rate is reduced to 20% for eligible taxpayers with AGIs over $43,000. The maximum credit for individuals with AGIs under $15,001 would be $1,050 for one and $2,100 for two qualifying individuals. To calculate the credit for a married couple filing jointly, treat the spouse as having a minimum earned income for any month that he or she is a full-time student or not able to care for himself or herself. Currently, in 2004, this amount is $250 per month with one qualifying person and $500 a month if there are two or more persons receiving care.

Example 4. Charlie Care has a 2004 AGI of $44,000, and employment-related dependent-care expenses of $3,500 with one qualifying dependent. Because his AGI exceeds the limit of $43,000, his percentage rate will be 20%. But his care expenses also exceed the limit of $3,000, thus his credit is only $600 ($3,000 × 20%).

There are six tests, the requirements of which must all be met, to claim the child- and dependent-care credits. These requirements involve having a qualifying person, keeping up a home, meeting the earned income test, having work-related expenses, meeting a particular filing status, and having provider identification.

Adoption Tax Benefits

A $10,390 credit ($10,630 in 2005) per child (including special-needs children) is allowed for qualified adoption expenses paid or incurred by a taxpayer. This credit is phased out ratably for taxpayers with modified AGI (MAGI) between $155,860 and $195,860. Eligible children are under 18 or are incapable of caring for themselves. There are several special rules on the timing of the credit in I.R.C. §§23 and 137. For special-needs children, the credit is allowed only for the year in which the adoption becomes final. The adoption credit is allowed against regular tax and AMT, less other nonrefundable credits and foreign tax credits.

In addition to the adoption credit, employer-paid or -reimbursed funds under an adoption assistance program are excludable. An employee may be eligible for both the credit and exclusion, provided they are not for the same expenses. The exclusion from gross income of employer adoption assistance cannot happen until the year in which a special-needs adoption becomes final.

Education Incentive Opportunities

Table 6 presents the benefits, restrictions, and limitations on several tax incentives for participants in higher education.

Table 6. Education Incentive Programs

	Hope Credit	Lifetime Learning Credit
Tax incentives	Per student: 100% of first $1,000 and 50% of second $1,000 used for tuition and fees for higher education for at least half-time students incurring expenses the tax year	Per taxpayer: 20% of first $10,000 for tuition and fees for any higher education, including upgrading skills, paid on behalf of taxpayer, spouse, or dependent to whom taxpayer is allowed an exemption
Restrictions	▪ Only for first 2 postsecondary years ▪ May not be claimed using any expenses paid by a Coverdell education savings account (ESA) distribution ▪ Maximum of 2 tax years ▪ Nonrefundable ▪ Not allowed for persons claimed as dependents on another taxpayer's return	▪ May not be claimed in the same tax year for the same person as claimed for the Hope Credit ▪ May not be claimed using any expenses paid by a Coverdell ESA distribution ▪ Nonrefundable
MAGI limits	Phaseout range starts at $42,000 and ends at $52,000 for singles; the range is $85,000 to $105,000 for joint returns; and the credit is not available to married filing separately.	Phaseout range starts at $42,000 and ends at $52,000 for singles; the range is $85,000 to $105,000 for joint returns; and the credit is not available to married taxpayers filing separately.

Table 6. Education Incentive Programs (continued)

	Coverdell ESA
Tax incentives	▪ Up to $2,000 of nondeductible contribution (from all contributors) per beneficiary as a trust account or custodial account for qualified higher education expenses for the withdrawal year of a designated beneficiary ▪ Liberalized expense items including elementary, secondary, special needs, and technology purchases Caution: Any balance remaining after the beneficiary reaches 30 or dies is deemed distributed within 30 days. The age 30 distribution rule does not apply to special-needs beneficiaries.
Restrictions	▪ 10% penalty plus tax on unqualified withdrawals ▪ Cash contributions only ▪ No contributions after account holder attains age 18 (The age 18 contribution rule does not apply to special-needs beneficiaries.)
MAGI limits	Phaseout range starts at $95,000 and ends at $110,000 for singles; the range is $190,000 to $220,000 for joint returns; and the credit is not available to married taxpayers filing separately. Only individuals have phaseouts; corporations and other entities may contribute regardless of AGI.
Deadline for contribution	Contribution deadline is April 15 (not including extensions) of the following year, and distributions will not be subject to additional tax if made on or before June 1 of the year following contribution.

	Student Loan Interest Deduction
Tax incentives	An above-the-line adjustment to gross income rather than an itemized Schedule A deduction: up to $2,500 for 2004 for interest paid on loans for higher education expenses while at least half-time student. Deduction is with respect to interest paid over any period of time. (See later.)
Restrictions on a qualifying loan	▪ No deduction if student is allowed as dependent on another taxpayer's return ▪ No double benefits, as with home equity loans ▪ See Final Regulations TD 9125, 5/6/04, summary following Table 6.
MAGI limits	Phaseout range starts at $50,000 and ends at $65,000 for singles; the range is $105,000 to $135,000 for joint returns; and the deduction is not available to married taxpayers filing separately.

Table 6. Education Incentive Programs (continued)

Qualified Tuition Program	
Qualified tuition program	Sponsored by a state to purchase tuition credits or save for payment of higher education expenses. (Must be state-sponsored or an educational institution meeting requirements.)
Taxation of earnings used for higher education in state-sponsored program	Distributee excludes earnings from taxation. If not used for qualified expense, the distributee is taxed on earnings and there is a 10% penalty (some exceptions).
Beneficiary	The definition of family members includes first cousins.
Coordination with Lifetime Learning and Hope Educational Credits.	Taxpayers can claim credits and exclude from income earnings distributed from this program as long as the expenses claimed are not the same as those for which a credit was claimed.

2004 Deduction of Higher Education Expenses (Above-the-Line Benefits)	
Deductible expenses	Qualified higher education expenses are tuition and related expenses of taxpayer, spouse, or dependents.
Deductible maximum	For 2004, $4,000 is the maximum amount deductible for single taxpayers or heads of households whose modified AGI doesn't exceed $65,000 ($130,000 for joint returns). **New for 2004** $2,000 is the maximum amount deductible for single taxpayers or HOHs whose modified AGI exceeds $65,000 but doesn't exceed $80,000 ($160,000 for joint returns).
AGI limits (once exceeded the deduction is eliminated)	Limits are $80,000 for single taxpayers or HOHs and $160,000 for married taxpayers filing jointly.
Ineligible taxpayers	▪ Married taxpayers filing separately and taxpayers that **may** be claimed by someone else ▪ Taxpayers whose modified AGI exceeds the applicable dollar limits shown above ▪ Taxpayers that have claimed a Hope or Lifetime Learning Credit for the year for the same student
Eligible taxpayers	Taxpayers under the above-AGI limits are eligible. Taxpayers may claim an exclusion of distributions from a tuition plan, an educational IRA, or interest on educational savings bonds as long as not claimed using the same expenses.

The Hope and Lifetime Credits generally may be claimed against a taxpayer's AMT liability for taxable years beginning before 2006, as extended in the 2004 Act.

The final regulations in T.D. 9125, 5-6-04 clarity the student loan interest deduction.

- Capitalized interest is deductible as qualified educational loan interest. Loan origination fees or late fees are considered interest if they are a charge for the use of money rather than for specific services
- Interest payments made by someone other than the taxpayer/borrower are treated as first paid to the taxpayer, then paid by the taxpayer to the lender. If the third party pays interest on the taxpayer's behalf as a gift, the taxpayer many deduct the interest.
- Although the 1997 Act (EGTRRA) eliminated the 60-month limitation period, it continues to apply to interest on qualified educational loans due and paid after December 31, 1997, but before January 1, 2002. The regulations clarify that the 60-month period begins on the first day of the month the interest payment is required.

Estimated Tax Rules

The minimum threshold after subtracting income tax withholding and credits for estimated tax payments is $1,000. 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% of last year's tax, or (2) 90% of the current year's tax liability. However, for individuals who exceed the $150,000 ($75,000 if married filing separately) prior year's AGI amount, the safe harbor is 110%. Similar rules apply to trusts and estates.

Example 5. Susan Ford, a salesperson, has the financial situation depicted in Table 7.

Table 7. Susan Ford's Taxes on AGI

Expected AGI for 2004	$62,150
AGI for 2003	59,975
Tax shown on 2003 return	11,000
Projected tax on 2004 return	12,000
Projected tax to be withheld in 2004	10,900

Susan expects to owe at least $1,000 ($12,000 − $10,900 = $1,100), so she should make an estimated tax payment; however she expects her income tax withholding ($10,900) to be at least 90% of the tax to be shown on her 2004 return ($12,000 × 90% = $10,800). Therefore, Susan does not need to pay estimated tax.

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.

Retirement Plan Contributions

In the tax year 2004, taxpayers have both opportunities and rewards for contributing to retirement plans. Table 8 gives some increased limits in the plans over last year's limitations.

The upper and lower limits of the phaseout range for deductible IRA's has increased by $5,000 for all filing statuses other than married filing separately. The deductible IRA phaseout AGI limits for employee's covered at work are as follows (dependent upon filing status):

Single, head of household	$45,000–$55,000
Married filing jointly	$65,000–$75,000
Married filing separately	$0–$10,000

The phaseout ranges for contribution to a Roth IRA are

Single, head of household	$95,000–$110,000
Married filing jointly	$150,000–$160,000
Married filing separately	$0–$10,000

Table 8. Limitations on Contributions

	Year		
	2003	2004	2005
IRAs, traditional & Roth	$ 3,000	$ 3,000	$ 4,000
Simple	8,000	9,000	10,000
401(k), 403(b), 457 and SEP	12,000	13,000	14,000
Defined contribution	40,000	41,000	COLA[1]
Defined-benefit plan[2]	160,000	165,000	COLA[1]
Compensation limit	200,000	205,000	COLA[1]
Stock bonus & profit share	25%	25%	25%

[1]Cost-of-living adjustment.
[2]Maximum annual benefit to be funded.

Additional Contributions

Catch-up or additional contributions to certain retirement plans are made possible by the 2001 Act for individuals aged 50 and over. These contributions are additions to the above limits, but total contributions still cannot exceed his or her earnings. The IRA contributions are still subject to AGI phaseout limits. The catch-up contribution provision does not apply to after-tax employee contributions of I.R.C. §457 plan participants in their last 3 years before retirement. Limits for catch-up contributions of certain retirement plans are given in Table 9.

Table 9. Catch-up Contribution Limits

Year	IRA	SIMPLE	401(k), 403(b), 457, and SEP
2003	$ 500	$1,000	$2,000
2004	500	1,500	3,000
2005	500	2,000	4,000
2006+	1,000	2,500	5,000

Nonrefundable Credit Allowed for Elective Deferrals and IRA Contributions

Contributions to some IRAs and employer-sponsored retirement plans are deductible or excludable from income. Started for the first in year 2002, the 2001 Act provides a nonrefundable tax credit for contributions made to qualified plans by eligible taxpayers. The amount of the credit depends on the taxpayer's MAGI, and the maximum annual contribution eligible for the credit is $2,000. There are limits on MAGI, dependent upon the taxpayer's filing status. The MAGI is determined without adjustments to AGI for I.R.C. §§911, 931, and 933 ("foreign" income adjustments). Eligible individuals include those over 17, but not if they are full-time students or claimed as dependents on someone else's return. The credit is available on elective contributions to I.R.C. §401(k) plans, I.R.C. §403(b) annuities, I.R.C. §457 plans (eligible deferred-compensation arrangement of a state or local government), SEPs or SIMPLEs, contributions to a traditional or Roth IRA, and voluntary after-tax employee contributions to a qualified retirement plan. The credit is reduced by amounts received over a previous period, as defined in the 2001 Act, by taxable distributions from any qualified retirement plan or savings arrangement listed in Table 9. There is an exception that excludes distributions from a Roth IRA. The MAGI-based credit rates for 2004 to 2006 are given in Table 10.

Table 10. Credit Rates Based on MAGI 2004–2006

Joint Return		Head of Household		All Other Filers		Credit
Over	Not Over	Over	Not Over	Over	Not Over	Percentage
$0	$30,000	$0	$22,500	$0	$15,000	50%
30,000	32,500	22,500	24,375	15,000	16,250	20%
32,500	50,000	24,375	37,500	16,250	25,000	10%
50,000		37,500		25,000		0%

Employer-Provided Education Assistance

The exclusion for up to $5,250 of employer-paid educational assistance for undergraduates is available for courses beginning before January 1, 2011. The employer-paid education exclusion for graduate studies was effective for courses beginning in 2002 and remains until changed or until January 1, 2011. Be sure that this benefit is a written contract as an employee benefit, or the assistance might end up taxable to the employee. No more than 5% of the amounts paid by the employer during the year for educational assistance under a qualified plan can be provided to more than 5% owners of the employer and the spouses or dependents of such more than 5% owners.

Deduction for Teacher's Expenses

The deduction for teacher's expenses scheduled to expire at the end of the 2003 tax year was extended for the 2004 tax year by the 2004 Act. Eligible educators in public and private elementary and secondary schools who work at least 900 hours during the school year as a teacher, instructor, counselor, principal, or aide may claim a deduction for purchases of books and classroom supplies. They may deduct up to $250 in qualified expenses on the line 23 of the taxpayer's Form 1040. Qualified expenses are unreimbursed expenses for supplies, books, equipment, and other materials used in the classroom. Educators should maintain records and receipts of qualifying expenses, noting the date, amount, and purpose of each purchase.

IRS Helps Heirs Locate Estate's Assets

If someone dies without a will, the IRS will allow heirs to see the last tax return filed before that person's death per Rev. Rul. 2004-68. Heirs must qualify that they have a financial interest in the information to determine if they have located all the estate's assets.

User Fees Required for Offers-in-Compromise

The IRS adopted final regulations requiring a $150 user fee beginning November 1, 2003, for processing offers in compromise. The fees are not refundable if the offer is withdrawn, rejected, or returned unprocessed. There will be no user fee for offers based solely on doubt as to liability and no fees for low-income taxpayers (below poverty guidelines set by the Department of Health and Human Services).

Five-Year Carryback of Net Operating Losses (NOLs)

The 2002 Act temporarily extended the net operating cost (NOL) carryback period to 5 years for NOLs arising in taxable years ending in 2001 and 2002. This did not affect farm NOLs that already qualify for the 5-year carryback. For NOLs arising in 2003, the former 2-year carryback rule applies. Taxpayers are not forced to use the longer carryback period for 2001 and 2002 NOLs. Taxpayers may elect out of the 5-year period, but the election is irrevocable. Taxpayers had the choice of two elections: one to not have the 5-year carryback, and one to waive the carryback entirely. Farmers continue to have these choices regarding farm NOLs.

Form 1040 Line Comparisons from 2004 to 2003 Form 1040

2004 Line 24. New line, certain business expenses of reservists, performing artists, and fee-basis government officials, shifting IRA deductions and others down one line.

2004 Line 28. Health savings account deduction, shifting moving expenses and others down another line.

2004 Line 46. Changed from Child and Dependent Care to Foreign Tax

Net effect of line changes is two new lines on the front of Form 1040, thus just a little smaller font size.

The lines and labels on the back side of 2004 Form 1040 as of press time are in the same order as last year only two numerals higher.

The IRS simplified the signature requirements of tax return preparers. Notice 2004-54 says that income tax return preparers may sign original returns, amended returns, or requests for filing extensions by rubber stamp, mechanical device, or computer software program. But the taxpayer must still provide his or her true signature on the return sent to IRS.

New for 2005, Form 941 Quarterly Payroll Tax Return

The IRS has made major changes to Form 941 to be used in 2005. It is now a two page form and a number of lines and boxes have been changed or eliminated. Starting in 2006 employers that deposit less the $2,500 per quarter in payroll taxes per quarter can file Form 941 once a year if they have an on-time payment record for at least 2 years.

Renewal Schedule for Enrolled Agents

The IRS announced the renewal schedule for some enrolled agents in Announcement 2004-35 and Treasury Department Circular 230. Enrolled agents must apply for renewal of enrollment by submitting completed Form 8554 Application for Renewal of Enrollment to Practice Before the IRS to the IRS. The 2003 announced delay did not impact affected agents or the number of continuing professional education requirements.

Individuals enrolled to practice before the IRS who received their initial enrollment on or before November 1, 2003, and who have a social security number than ends with the numbers 0, 1, 2, or 3 should have applied for renewal of enrollment between June 1, 2004 and July 31, 2004. Individuals enrolled after November 1, 2003 are not required to renew at this time as your enrollment card should say effective through March 31, 2007.

Enrolled agents who have a social security number that ends with the numbers 4, 5, or 6 must apply for renewal between November 1, 2004 and January 31, 2005. To be eligible for renewal one must have completed 16 CPE credit hours in each of the years 2002, 2003, and 2004.

Renewal for the enrollment cycle beginning in April 2008 has more CPE requirements and ethics hour requirements.

Enrollment cards for Enrolled agents with Social Security numbers ending in 7, 8, or 9 set forth an expiration date of March 31, 2005. Subsequent to the issuance of these cards, the renewal schedule has changed. The IRS office plans to mail new enrollment cards to effected agents with a new expiration date of March 31, 2006, with no fee for this extension.

Enrolled agents who have a social security number that ends with the numbers 7, 8, or 9 must apply for renewal between November 1, 2005 and January 31, 2006. To be eligible for renewal one must have completed 16 CPE credit hours in each of the years 2002, 2003, 2004 and 2005.
Renewal for the enrollment cycle beginning in April 2009 has more CPE requirements and ethics hour requirements.

LONG-TERM CAPITAL GAINS RATES

The paperwork on capital gains for this year may again be a challenge with the additional lines on each of the following forms: 1040 Schedule D, the Schedule D Worksheet, Form 6251 (AMT), and Form 8801. Again, the IRS estimates that a few million individuals who could have filed on Form 1040A will have to report their capital gains distributions on Form 1040 and attach Schedule D. Remember the 2003 Act added two capital gains rates mid-year for the taxpayer challenge. The new rates were 5% and 15%, along with 10%, 20%, 25%, and 28% maximum rates depending upon taxpayer's income bracket and source of the gain. A taxpayer is potentially subject to more capital gains rates than brackets for ordinary income tax calculations. Capital gain when a taxpayer disposes of an asset is taxed at maximum capital gain rates, which are lower than ordinary income brackets. Net capital gain is calculated as the excess of the net long-term capital gain over the net short-term capital loss for the tax year. A taxpayer's gain or loss is treated as long-term only if the asset is held for more than 1 year, or 2 years in the case of certain classes of livestock covered later.

Under legislation prior to 2003, the maximum rate of tax on adjusted net capital gain of an individual was 20% or 10% if the taxpayer would have been taxed in the 15% rate on ordinary income. The 2003 Act reduced the 20% and 10% rates on net capital gains to 15% and 5% respectively, in 2004. These lower rates apply to both regular and alternative minimum tax.

For taxpayers in the 10% or 15% bracket, the holding period begins as normal with the day after acquisition. The 5-year holding period legislation was repealed as of May 6, 2003. So those taxpayers in the regular tax brackets above 15% planning to hold assets for 5 years to take advantage of the reduced 18% capital gains rate will get the new 15% on qualifying gains. Those taxpayers who elected to pay gains to date and restart the 5-year time clock have not only paid a higher rate than in effect today but also have incurred an implied interest cost of paying taxes in advance.

Planning Pointer—Taxpayers should also consider that capital gains rates could be reduced by future legislation and that their income tax bracket in the future years could be below the rates paid today; in addition, there is an implied interest cost of paying taxes in advance.

Some assets are excluded from adjusted net capital gains and are ineligible for the lowest long-term rates. Gain from the sale of I.R.C. §1250 property (general-purpose buildings and other depreciable real estate) that would be ordinary income under I.R.C. §1245 depreciation recapture rules and that has not already been taxed as ordinary gain under I.R.C. §1250 has a maximum tax rate of 25%. The maximum rate on net capital gain from the sale of collectibles and certain small business stock under I.R.C. §1202 remains at 28%.

Cattle (dairy or breeding) and horses (breeding, sport, work, or draft) must be held 24 months to qualify for the 5%/10% or 15%/20% capital gain rates. The holding period for other I.R.C. §1231 assets, as well as capital assets, to qualify for these rates remains at 12 months. Short-term gains are still taxed as ordinary income.

In 2004, taxpayers who are not required to file a Form1040 Schedule D can enter capital gain distributions from mutual funds directly on Form 1040 line 13, check the box, and calculate the tax on all taxable income on the "Qualified Dividends and Capital Gain Tax Worksheet –Line 43".

Installment sale payments are taxed under the ordinary or capital gain rates in effect for the year received and not those in effect in the year of the actual sale. Consequently, payments received in 2004 are eligible for the lower rates.

Adjusted Net Capital Gain Exclusions

Adjusted net capital gain (ANCG) excludes unrecaptured gain from the sale of I.R.C. §1250 assets (general-purpose buildings), gain on collectibles, and I.R.C. §1202 small business stock gain.

Computing Net Capital Gain

Remember that some or all of capital gain income can be taxed below its maximum rate if the taxpayer is in or **below** the 28% taxable income bracket. Noncorporate taxpayers will compute their net capital gains tax by applying capital gain income to the 10%, 15%, or 25% taxable income bracket in the following order:

1. If there is unused **10% or 15% taxable regular income rates** after applying the ordinary income to the 10% and 15% brackets, then
   a. Unrecaptured I.R.C. §1250 gain: The 25% maximum is reduced to the 10% or 15% ordinary tax rate, if the 10% bracket or 15% bracket is not fully used.
   b. Collectibles and other 28% rate gain assets: The 28% maximum is reduced to the 10% or 15% ordinary tax rate, if the 10% bracket or 15% bracket is not fully used.
   c. Adjusted net capital gain–remainder after (b): The 20% maximum is reduced to 5% if the 10% or 15% bracket is not fully used.
2. If there is unused **25% taxable regular income rates** after applying the ordinary income to the 25% brackets, then
   a. Unrecaptured I.R.C. §1250 gain: The 25% maximum is the maximum and taxed at the 25% rates anytime during the year in the 28% bracket or any higher bracket.
   b. Collectibles and other 28% rate gain assets: The 28% maximum is reduced to the 25% ordinary tax rate, if the 25% bracket is not fully used.
   c. Adjusted net capital gain–remainder after (c) (from list 1): The 15% maximum is not reduced, if the 25% bracket is not fully used.
3. If there is unused **28% taxable regular income rates** after applying the ordinary income to the 28% brackets, then
   a. Unrecaptured I.R.C. §1250 gain: The 25% maximum is the maximum and taxed at the 25% rates anytime during the year in the 28% bracket or any higher bracket.
   b. Collectibles and other 28% rate gain assets: The 28% maximum is not reduced at any time during the year and is taxed at 28% in the 28% bracket or any higher bracket.

c. Adjusted net capital gain–remainder after (c) (from list 2): The 15% maximum is not reduced, and is 15% if in the 28% bracket or any higher bracket.

Example 6. Mr. and Mrs. F. P. Milker file a joint return, and their 2004 15% taxable income tax bracket goes to $58,100. Their taxable income after personal exemptions and itemized deductions is $62,900, exceeding the 15% bracket by $4,800, as shown in Table 3. Their taxable income includes $6,000 unrecaptured I.R.C. §1250 gain from the sale of a farm building, $3,500 of capital gain from the sale of antiques, and $10,000 of ANCG from the sale of dairy cattle. All livestock sold were held over 24 months and sold at the dates in Table 11.

Table 11. Determination of Tax Rates with Various Income Sources

	Notes	Tax On	Tax Rate
Ordinary income		$14,300	10%
Ordinary income		29,100	15%
Gain on farm building sale February 2004 (unrecaptured I.R.C. §1250 gain)	25%	6,000	15%
Gain in sale of antiques September 2004	28%	3,500	15%
Gain on sale of dairy cattle (ANCG, $10,000 total)			
Held more than 2 years Aug. 2004	15%	5,200	5%
Subtotal		$58,100	
Amount in excess of 15% bracket sold Nov. 2004		4,800	15%
Total taxable income		$62,900	

Netting Capital Gains and Losses

The following rules apply to the netting of capital gains and losses for tax years ending after May 6, 1997:

1. Short-term capital losses, including carryovers, are combined with short-term capital gains. Any net short-term capital loss is used to reduce long-term capital gains in the following order: 28% sale gain, unrecaptured I.R.C. §1250 gain (25%), and adjusted net capital gain (15%)
2. Gains and losses are netted within the four long-term capital gain groups to determine a net capital gain or loss for each group. There can be no net loss in the 25% group, which is limited to gain to the extent of straight-line depreciation.
3. A net loss from the 28% group (including long-term capital loss carryovers) is used to reduce gain in the 25% group, and then any net loss balance is carried to the lower groups.
4. A net loss from the15% group is used to reduce gain from the 28% group, and any remaining net loss is carried to the 25% group.

Note that long-term capital loss carryovers are used to reduce gains or increase loss in the 28% group regardless of the source of that carryover.

Net Capital Losses

A net capital loss results for the year if a taxpayer's capital losses on Form 1040 Schedule D exceed capital gains. Only a maximum of $3,000 of any such net capital loss may be deducted in determining gross income of the current year (by transfer to page 1 of Form 1040). Any excess capital loss becomes a capital loss carryover to be used in future years (until used, there is no expiration). The capital loss carryover may be short-term, long-term, or a combination of the two depending on whether it arises from Form 1040 Schedule D Part I, Part II, or both. In the year to which the loss is carried, the short-term capital loss carryover is entered in Part I, Form 1040 Schedule D; the long-term is entered in Part II. In either event, they net against any other gains and losses arising in this carryover year. Again, if the net result is a loss, the loss deduction is limited to $3,000, and any excess becomes a carryover to the following year. Short-term capital losses are considered used first in the event that only a portion of the capital losses of the year is deductible.

Inherited Property Rules

Recent year's legislation did not change the step-up in basis rule that gives a decedent's property a new basis equal to its fair market value (FMV) on the date of death (or alternative valuation date). Only gain that occurs after that date will be subject to income tax. Inherited property (except for I.R.C. §1231 livestock) will automatically be considered held the required holding period for long-term capital gains treatment. For I.R.C. §1231 livestock, the date acquired by the decedent is used to determine the holding period.

Capital Gains and AMT, Flow-through Entities, and Small Business Stock

The new, lower long-term capital gains rates will be used to compute AMT (Form 6251, page 2). Entities such as S corporations, partnerships, estates, and trusts may pass through capital gains to their owners or beneficiaries and must make the determination of when a long-term capital gain is taken into account on its books.

> **Practitioner Note**—Taxpayers who make gifts of stock held over one year, to their children at least 14 years old and in the 10% bracket may be able to lower their overall tax liability. Parents may want to buy back the same securities in the open market, because wash-sales restrictions do not apply when capital gains are realized

On the sale or exchange of small business stock (I.R.C. §1202 stock) held for more than 5 years, 50% of the gain may be excluded from the taxpayer's gross income. The remaining capital gain is taxed at 28%. Gain eligible for the 50% exclusion may not exceed the greater of $10 million or 10 times the taxpayer's basis in the stock. If such small business stock is sold before meeting the 5-year holding requirement, there is no exclusion, and the gain will be taxed at the normal maximum capital gains tax rate (if the required holding period has been met). This 50% exclusion amount is a tax preference item for AMT purposes.

SALE OF TAXPAYER'S PRINCIPAL RESIDENCE

Currently there is an exclusion of gain from the sale of a principal residence amounting to $250,000 ($500,000 for joint filers) on sales and exchanges made after May 6, 1997. The old rollover of gain provision (I.R.C. §1034) and the $125,000 of gain exclusion, including the 55 years of age requirement (old I.R.C. §121), were repealed and replaced with this current exclusion under I.R.C. §121.

The new exclusion can be used by taxpayers of any age on each home they have owned and used as a principal residence for at least 2 years during the 5-year period ending on the sale date. Use of the exclusion is limited to once every 2 years. Use of the old exclusion prior to May 7, 1997, does not affect the availability of the new exclusion. Married taxpayers filing joint returns get a $500,000 exclusion if all of the following apply: either spouse has owned the residence for at least 2 years, both spouses have lived in it for at least 2 years, and neither spouse has used the new exclusion in the past 2 years.

Married spouses who qualify for the $500,000 exclusion may elect to exclude $250,000 of gain from the sale of each spouse's principal residence within a 2-year period. Those who are married and filing jointly but are living apart also get the $250,000 exclusion on the qualified sale of each spouse's principal residence. A recently married spouse does not lose eligibility for the $250,000 exclusion by marrying a taxpayer that has used the exclusion within 2 years.

A partial exclusion may be claimed by taxpayers who have excluded the gain on the sale of another home sold after May 6, 1997, and within 2 years of the current sale, if the current sale was due to a change in place of employment, change in health, or unforeseen circumstances. Regulations have been issued to provide safe-harbors for these reasons, including the following unforeseen circumstances:

1. Involuntary conversion of the residence
2. A natural or man-made disaster or act of war or terrorism resulting in a casualty to the residence
3. Death of a qualified individual
4. A qualified individual's cessation of employment, making him or her eligible for unemployment compensation
5. A qualified individual's change in employment or self-employment status that results in the taxpayer's inability to pay housing costs and reasonable basic living expenses for the taxpayer's household
6. A qualified individual's divorce or legal separation under a decree of divorce or separate maintenance
7. Multiple births resulting from the same pregnancy of a qualified individual

For this purpose, qualifying individuals are (1) the taxpayer, (2) the spouse, (3) the co-owner of the property in question, or (4) a person whose principal place of abode is the taxpayer's household.

Example 7. Mr. and Mrs. Mover sold and moved out of their first home March 1, 2004, because of a change in employment. They began renting and living in that home on June 28, 2002, but did not buy it until August 4, 2002. They lived in the home for 612 days but owned it for only 575 days. Their partial exclusion is based on the portion of the 2-year (730 days) ownership requirement that they lived in the house (575 days), the shorter of the two requirements. Their partial exclusion for 2004 is $393,850 (575 ÷ 730 = .7877; .7877 × $500,000 = $393,850), therefore Mr. and Mrs. Mover can exclude up to $393,850 of any gain realized on the sale of their residence.

Gains from insurance proceeds and other reimbursements for homes destroyed or condemned also qualify for the exclusion. The sale of a remainder interest in a home to a person related to or an entity owned by the taxpayer does not qualify. Gain equal to any depreciation allowed or allowable for the business use of a home after May 6, 1997, cannot be included in the exclusion but would be recognized as gain from the sale of I.R.C. §1250 property. However, if the structure with business use is not part of the dwelling unit, none of the gain from that structure qualifies for exclusion.

The final regulations state that the gain exclusion for the sale of residence applies to the sale of vacant land owned and used as part of the taxpayer's principal residence, provided that a qualifying sale of the dwelling unit occurs within 2 years before or after the sale of the related vacant land. The vacant land must be adjacent to land containing the dwelling unit. If the residence is not sold prior to filing the tax return for the year of the vacant land sale, the gain on the land must be reported and then an amended return filed when the qualifying residence is actually sold.

Other specific rules (1) affect transfers incident to a divorce, (2) define time of ownership for surviving spouses, and (3) define periods of use for taxpayer's transferred to nursing homes.

If any gain is to be recognized, the sale of residence is reported directly on Form 1040 Schedule D. On the line directly below that used to report the total gain, the exclusion amount (if any) is listed as a loss with a description of "Section 121 exclusion." If no gain is to be recognized, no reporting is required, unless you have received a Form 1099-S.

INCOME AVERAGING FOR FARMERS

Individual taxpayers with certain farm income may elect a 3-year method of income averaging. Elected farm income (EFI) is deducted from the current year's taxable income and, in effect, one-third of it is added to each of the 3 prior years' taxable income to be taxed at the rates of those prior years (referred to as *base years*). However, C corporations, estates, and trusts may not use the election. The IRS reports that this tax-saving method of calculating tax is being underutilized by taxpayers.

Elected Farm Income (EFI)

The EFI is taxable income attributed to any farming business and designated to be included in the election. This includes not only net farm profits from Form 1040, Schedule F, but also an owner's share of net farm income from an S corporation (including wages), partnership, or limited liability company (LLC). It does not include wages from either an S or a C corporation. Gains from the sale of farm business property (excluding land and timber) regularly used in farming for a substantial period may be included in EFI. Farm NOLs must also be included. A farming business includes nursery production, sod farming, the production of ornamental trees and plants, as well as the production of livestock, fruit, nuts, vegetables, livestock, horticultural products, and field crops. However, gain from the sale of trees that are more than 6 years old when cut is not eligible farm income, because these trees are no longer classified as ornamental trees. The income, gain, or loss from the sale of grazing and development rights or other similar rights classified as attributable to a farming business are not electable for farm income.

The terms *regularly used* and *substantial period* are not defined in the I.R.C. or committee reports. Regulations (§1.1301-1) have clarified that if a taxpayer ceases farming and later sells farm business property (other than land) within a reasonable time after the cessation, the gains or losses from the sale will be considered farm income. If the sale is within 1 year, it will be deemed to be within a reasonable time. For sales beyond 1 year, one will need to consider all facts and circumstances.

The tax imposed when income averaging is elected will be the current year's federal income tax liability without the EFI, plus the increase in the 3 prior years' tax liability caused by the addition of one-third of the EFI to each of the years. Farm income averaging does not affect SE tax. Update: Effective in 2004 farmers and fishermen are not affected by AMT when using income averaging.

Farm taxpayers who elect income averaging will be able to spread taxable farm income over a 4-year period and designate how much (in equal amounts in each of the 3 base years) and what type of farm income (ordinary or capital gains) to include in EFI. Form 1040 Schedule J is used to compute and report the tax from income averaging. The relevant tax rates for capital gains apply in the current year as well as in the base year calculations.

Example 8. Fruit growers Mr. and Mrs. B & B Goodyear have a substantial increase in farm income in 2004. Receipts are up and costs are down. Mrs. Goodyear works off-farm. When Form 1040 Schedule F profits of $58,000 are combined with nonfarm income and deductions, taxable income is $82,100. They file a joint return. Their taxable income for 2003 and the previous 3 years is as shown in Table 12.

Table 12. Goodyears' Taxable Income

Year	Taxable Income
2004	$82,100
2003	27,900
2002	40,750
2001	25,200

The Goodyears elect to income average in 2004. Their maximum EFI is $58,000 (taxable income attributed to farming). Their optimum EFI may be taxable income that exceeds their 15% tax bracket or $24,000 ($82,100 − 58,100). They decide to use $24,000 of their Schedule F profit as EFI and tax $8,000 at the tax rates in effect in each of the 3 base years.

Question 1. Will all of the EFI be taxed at 15%?

Answer 1. In 2002 their 15% tax bracket ended at $46,700, and their taxable income was $40,750, leaving $5,950 of the 15% rate bracket available for EFI from the current year. Therefore, $2,050 ($8,000 − $5,950) added to the 2002 base-year income will be taxed at 27%.

Question 2. Should the Goodyears reduce EFI to avoid the 27% tax bracket in 2002?

Answer 2. For each $1 of EFI subject to the 27% tax rate in 2002, $2 is taxed at 15% in the other base years. Therefore, the marginal tax rate for the Goodyear's EFI is .19% [(.15 + .15 + .27) ÷ 3]. If they put less than $24,000 in the 2004 EFI, their 2004 taxable income will exceed $58,100, and their marginal tax rate will be 25%.

Question 3. How much income tax will the Goodyears save by income averaging in 2004?

Answer 3. They will save 10% (25% rate minus 15% rate) on the first $17,850 (3 × $5,950) or $1,785, and 6% (25% − 19%) on the remaining $6,150 of EFI or $369, for a total tax reduction of $2,154.

Base-Year Losses

The IRS allows the use of negative taxable incomes in the base years when performing the income-averaging calculation. This, in effect, allows such taxpayers to income average using 0% tax rates for the base years with eligible losses. However, there can be no double benefit from the negative taxable incomes already reflected in the NOL arising from that year.

Example 9. Sam had a $45,000 Schedule F loss in 2001. He and his wife filed a joint return and claimed five exemptions (including three children). Taxable income was calculated as shown in Table 13.

Table 13. Sam's Taxable Income

Schedule F	($45,000)
Standard deduction	(7,600)
Exemptions	(14,500)
Taxable income	($67,100)

Sam's NOL for 2001 would be $45,000. This NOL must be removed from taxable income, leaving ($22,100) to be used as base-year income for 2001 on Sam's Schedule J.

Questions and Answers

Question 1. Which taxpayers qualify for farm income tax averaging?

Answer 1. I.R.C. §1301 says that "individuals engaged in a farming business" qualify, and it specifically excludes estates and trusts. The IRS instructions indicate that individual owners of partnerships, LLCs, and S corporations qualify (farm income flows through the business and retains its character in the hands of the individual owner taxpayer). C corporations and their owners do not qualify for farm income averaging.

Question 2. Does the EFI retain its character as unused brackets are carried forward, and may the taxpayer select the type of income to include in EFI?

Answer 2. Taxpayers will be allowed to carry forward the unused lower brackets as ordinary farm income and keep capital gains in current-year taxable income, or select the best combination of ordinary farm income and qualified capital gains to meet their tax management objectives. When a combination of ordinary farm income and capital gains is included in EFI, the IRS indicates that an equal portion of each type of income must be added to each base year. The taxpayer cannot add all of the capital gains to a single prior year.

Any capital gain that is added to base-year income will be treated at the capital gains tax rate in effect for that prior year. Therefore, 2004 farm business gains of a taxpayer in a 25% income tax bracket could be eligible for a 10% capital gains tax rate if the taxpayer has a base year in the 15% income tax bracket and includes these gains in elected farm income. Note: The effective rate on such capital gains would be 5% for the 2003 base year.

Question 3. Do farm owners who rent their farm or land for agricultural production qualify?

Answer 3. If the farm owner materially participates in the farming activity and properly reports the income on Form 1040 Schedule F, this income qualifies for income averaging. Final regulations also make this true if the farm owner does not materially participate but receives share rental income (properly reported on Form 4835). This is a change from prior interpretation. For crop-share rents received after January 1, 2003, the lessor needs to have a written crop-share lease agreement. Cash rental income reported on Form 1040 Schedule E is not income attributable to a farming business.

Question 4. How much farm use is required to meet the "regularly used in farming" rule that applies to gains from the sale of farm business property?

Answer 4. All sales reported on Form 1040 Schedule F are qualified. Sales of raised dairy and breeding livestock reported on Form 4797 qualify. Sales of farm property for which depreciation and I.R.C. §179 deductions are claimed also qualify. Therefore, it appears as if all sales of farm machinery, buildings, livestock, and other eligible I.R.C. §1231 property qualify as being "regularly used."

Question 5. If I.R.C. §1231 gain is part of EFI, is it subject to recapture because of unrecaptured I.R.C. §1231 losses in the base years?

Answer 5. Final regulations indicate that I.R.C. §1231 gains would be taxed as long-term capital gains rate for the prior year. The I.R.C. §1231 loss of that prior year remains fully deductible from ordinary income and the I.R.C. §1231 loss carryover to subsequent years is unchanged.

Question 6. Can the election to income average be made on an amended return?

Answer 6. Final regulations changed the answer to this question to "yes." The previous requirement that income averaging could only be amended if there is another change on the return was rescinded.

Question 7. If a prior-year return reflected an NOL carryover that was only partially applied, will an additional NOL carryover be used in that prior year when one-third of this year's EFI is "carried to a base year"?

Answer 7. No, the amount of the NOL applied is not refigured to offset the EFI added to that prior year. Similarly, base-year's income, deductions, and credits are not affected by the additional income allocated to that year (for example, the taxable portion of social security benefits or the allowable Form 1040 Schedule A Itemized Deductions). In essence, Form 1040 Schedule J uses the tax brackets of the base years without altering the tax returns originally filed for those base years.

Question 8. Must a taxpayer use the same filing status in each year?

Answer 8. No, the tax will be computed based on the filing status in effect for each base year and the election year.

Question 9. What tax rate will be used for the "Kiddie" Tax when income averaging has been used on the parents' tax return?

Answer 9. The tax rate is the parents' effective tax rate after farm income averaging has been applied.

Question 10. Can a taxpayer use income averaging even though it provides no current-year tax savings?

Answer 10. Yes, although you may have to override your tax preparation software in order to print the Form 1040 Schedule J. This technique may be used to shift income to the oldest base-period year, which will drop out of the calculations for the following year. This may allow the base-period incomes to even out (and marginal tax rates) in anticipation of income averaging in future years. Note that optimizing base-period income has become more difficult with tax brackets being reduced by 0.5% each year and by a full 2% reduction for all but the highest bracket for 2003 and 2004 (the highest bracket being reduced 3.6%).

Question 11. Can the use of income averaging create or increase AMT liability?

Answer 11. No, because lawmakers voted in October 2004 to permit income to be determined for the AMT comparative computation without regard to income averaging.

Planning Guidelines and Information

Implement economically sound income tax management practices throughout the year rather than use income averaging as the only tax management strategy. Use tax management practices that reduce taxable income before income averaging is elected.

> **Planning Pointer**—If the taxable income in a base year is less than the ANCG of that year, elected ordinary farm income carried to that year will be taxed at the net capital gains rate until adjusted taxable income of that base year equals that year's ANCG.

Income averaging should be used to transfer as much as possible of high-bracket income from the election year to low tax brackets in the base years. There will be cases in which the EFI used in a base year is not taxed in the lowest bracket, but income averaging will still save taxes. A farm taxpayer needs the following information to determine whether and how much 2004 farm income should be averaged:

- Taxable income for 2004 as well as ordinary income and capital gain attributed to farming
- Taxable income from his or her 2001, 2002, and 2003 tax returns
- Taxable income tax brackets for 2004 and the 3 prior years (see Table 14)

Priority of Goals

1. Elect farm income until the marginal rate of the current year is not greater than the average of the marginal rates at which the elected farm income is being taxed in the base years. Be sure to consider the effective rate if capital gains exist in the base year or are included in EFI.
2. Then, load the oldest base year followed by an equal amount in the other base years to the extent this can be done without increasing tax.

3. Finally, elect additional income attempting to level the income of the current and prior 2 base years to prepare these years to be base years for next year's income averaging, again, only to the extent this can be done without increasing tax.

Table 14. Top End of Taxable Income Tax Brackets

Bracket	Single	Married Filing Joint	Head of Household	Married Filing Separately
2004				
10%	$7,150	$14,300	$10,200	$7,150
15%	29,050	58,100	38,900	29,050
25%	70,350	117,250	100,500	58,625
28%	146,750	178,650	162,700	89,325
33%	319,100	319,100	319,100	159,550
2003				
10%	$7,000	$14,000	$10,000	$7,000
15%	28,400	56,800	38,050	28,400
25%	68,800	114,650	98,250	57,325
28%	143,500	174,700	159,100	87,350
33%	311,950	311,950	311,950	155,975
2002				
10%	$6,000	$12,000	$10,000	$6,000
15%	27,950	46,700	37,450	23,350
27%	67,700	112,850	96,700	56,425
30%	141,250	171,950	156,600	85,975
35%	307,050	307,050	307,050	153,525
2001				
15%	$27,050	$45,200	$36,250	$22,600
27.5%	65,550	109,250	93,650	54,625
30.5%	136,750	166,500	151,650	83,250
35.5%	297,350	297,350	297,350	148,675

CCC COMMODITY LOANS AND LOAN DEFICIENCY PAYMENTS

When market prices for commodities fall below the marketing assistance loan rates offered by the Commodity Credit Corporation (CCC), producers may realize more income by taking advantage of one or more of the government options. Those options and the income tax consequences are discussed in this section.

CCC Nonrecourse Marketing Assistance Loan

Instead of selling a commodity, producers can use the commodity as collateral for a nonrecourse loan from the CCC. This option puts cash in the producer's pocket at the time of harvest and lets the producer wait to see whether market prices improve.

I.R.C. §77 provides for an election to treat these loans as income in the year received. The election is made on Form 1040 Schedule F. If the producer has not made the I.R.C. §77 election, the CCC loan is treated the same as any other loan. Rev. Proc. 2002-9 provides procedures for an automatic change in accounting methods in the event that a taxpayer wishes to stop reporting loans as income.

If market prices subsequently rise above the loan rate, producers will choose to repay the loan, with interest, and then sell the commodity for more than the loan.

The income tax consequences of the sale depend upon whether or not the I.R.C. §77 election has been made. In any event, the interest expense is deductible on Form 1040 Schedule F.

Typically, the I.R.C. §77 election has not been made, so the producer has no basis in the commodity. Therefore, the full sale price must be reported as Form 1040 Schedule F income.

If the I.R.C. §77 election has been made, the producer has basis in the commodity equal to the amount of the loan. That basis is subtracted from the sale price to determine the gain on the sale (which is reported in the resale section of Form 1040 Schedule F).

If market prices do not rise above the loan rate, producers will choose to redeem the commodity by paying the posted county price (PCP) to the CCC. By making that payment, the producer is no longer obligated on the loan and can keep the difference between the original loan rate and the PCP. This option replaces the option of forfeiting the grain to the CCC under the old loan program.

A producer who redeems the commodity by paying the PCP will receive a Form CCC-1099-G from the CCC for the difference between the loan rate and the PCP. That amount must generally be reported as an Agricultural Program Payment on Form 1040 Schedule F. This is true even if the producer uses CCC certificates rather than cash to repay the loan and, as a result, does not receive a CCC-1099-G.

However, if the producer made an I.R.C. §77 election, the difference between the loan rate and the PCP is not reported as taxable, because the full loan amount has already been reported in taxable income in the year received. Instead, this difference is subtracted from the producer's basis in the commodity so that the producer now has basis in the commodity only equal to the PCP. The producer should still report the market gain on line 6a on Form 1040 Schedule F but not include it as taxable on line 6b.

Loan Deficiency Payment

If market prices are below loan rates, producers can simply claim a loan deficiency payment (LDP) for their crops rather than borrowing from CCC. That payment is equal to the difference between the loan rate and the PCP on the date the LDP is claimed. Producers get the same result as if they had taken the loan and paid the PCP rate on the date they claimed the LDP.

The LDP is reported as an Agricultural Program Payment.

Note that reconciling taxpayer records to the amounts reported on Form CCC-1099-G can be challenging:

- CCC loan activity is not reported on the Form 1099. Borrowings and program payments may be commingled in taxpayer records.
- Often, advance government payments are made. Then, if market conditions are better than expected, these advances must be repaid. Sometimes these payments are simply netted from subsequent government payments; at other times they are paid by taxpayer check and can be confused with PCP "purchase" payments or repayments of CCC loans.
- Program payments are typically direct deposited to the producer's bank account. Sometimes, these payments are applied directly to CCC loan payments.
- Interest paid to CCC on loans is not reported to the taxpayer on a Form 1099.

PROVISIONS APPLYING PRIMARILY TO BUSINESS ACTIVITY

Business Record Keeping

Record keeping is probably one of the tasks that farmers and small business operators enjoy least. However, as this reference manual indicates, it is very important to the business. The tax laws covering farming and small businesses are very complicated.

The advantage of a good set of records is that they will help the business do the following:

- Prepare a tax return
- Support receipts and deductible expenses on a tax return
- Prepare accurate financial statements
- Chart and monitor the progress of the business

The IRS indicates that you must keep these business records to prove the income or deductions on a tax return. The period of time varies dependent upon an individual business situation (Table 15). The period of retention is never less that 3 years from the due date of the return and can be for a lifetime. The taxpayer should always keep copies of their filed tax returns.

Table 15. Keeping Records for Income Tax Purposes

In This Situation	Keep for This Length of Time
A. You owe additional tax, and situations B, C, and D do not apply to you.	3 years
B. You do not report income that you should report, and it is more than 25% of the gross income shown on your return.	6 years
C. You file a fraudulent income tax return.	No limit
D. You do not file a return.	No limit
E. You file a claim for credit or refund after you file your return.	Later of: 3 years or 2 years after tax was paid
F. Your claim is due to a bad-debt deduction.	7 years
G. Your claim is due to a loss from worthless securities.	7 years
H. Keep records on an asset for the life of the asset or until you dispose of the asset and if by death or gift inform recipient of basis.	No limit

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 (IRS 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.

For tax years beginning after December 31, 1998, the home office rules are more relaxed. The definition of principal place of business was expanded. It allows a deduction for administration and management even though the work is performed elsewhere. I.R.C. §280A(c)(1) indicates that a home office will qualify as the principal place of business if (1) the office in the home is used for the administrative or management activities of the taxpayer's trade or business, and (2) there is no other fixed location where the taxpayer conducts substantial administrative or management activities of the trade or business. All other rules continue to apply. The space must be used exclusively and regularly for business. IRS Pub. 587, *Business Use of Your Home*, provides examples that describe four situations in which a taxpayer's home office will qualify even if the use before 1999 did not qualify for the deduction.

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

Form 1040 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 Form 8829.

Form 8829, Expenses for Business Use of Your Home, is not filed with Form 1040 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.

Caution—When a taxpayer sells a home on which expenses for business use have been claimed, tax consequences may occur. Final Treas. Regs. under I.R.C. §121 reflect a taxpayer-friendly change by the IRS. Previously, the IRS had indicated that any portion of the residence used for business could disqualify that portion from exclusion if that portion was not used as the taxpayer's principal residence for at least 2 out of the 5 years prior to sale. Under the final regulations, as long as the home office is part of the "dwelling unit" of the residence, then only the gain equal to the depreciation allowed or allowable after May 6, 1997, is treated as taxable gain. However, if the office is in a building separate from the dwelling unit, a portion of the gain must still be allocated to that office and reported on Form 4797 under the normal rules for the sale of business property.

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 I.R.C. §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, the IRS takes the position that transportation expenses incurred in travel from the residence are deductible only if the travel is undertaken in the same trade or business as the one that qualifies the taxpayer for a deductible home office. The expense of commuting from personal residence to place of business is not deductible.

Business trip expenses for a spouse, dependent, or other individual are not deductible unless the person is an employee of the person paying for 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.

Provisions for Health Insurance and Medical Expenses

Self-Employed Health Insurance Premiums

This tax provision allows self-employed taxpayers to deduct health insurance premiums paid as an adjustment to income on Form 1040. Also, if you pay premiums on a qualified long-term care contract for yourself, your spouse, or your dependents, you can include these premiums (subject to the annual limits stated previously). For tax years after 2002, the deduction is 100%. Self-employed taxpayers include sole proprietors, partners, and less-than-2% S corporation shareholders.

Qualified health insurance premiums are limited to health insurance coverage of the taxpayer and the taxpayer's spouse and dependents. The deduction may not exceed earned income. It does not reduce income subject to self-employment tax, and the amount deducted as an adjustment to gross income may not be included in medical expenses claimed as itemized deductions. A taxpayer eligible for coverage in an employer's subsidized health insurance plan may not deduct insurance premiums he or she pays, even if it is the taxpayer's spouse that is the employee. Eligibility is tested monthly.

Medical Saving Programs

Beginning in 2004 the Health Savings Account (HSA) has been introduced to take the place of the Archer Medical Savings Account (MSA). Contributions to an HSA may be made by the employer, the employee, or a member of the employee's family. The contributions are tax deductible and withdrawals are tax-free if used for qualifying medical expenses. To qualify for an HSA, the individual must be covered under a high-deductible health plan (HDHP) and no other general health insurance plan. These MSAs are tax-exempt accounts with a financial institution in which employees of a small employer or self-employed taxpayers save money for future medical expenses. With the introduction of HSAs, no new MSAs may be established after 2003 but contributions may continue to existing MSAs. For details on this program see IRS Publication 969, Health Savings Accounts and Other Tax-Favored Health Plans.

Employee Health and Accidental Insurance Plans

An employer can claim premiums paid on employee health and accident insurance plans as a business expense on Form 1040 Schedules F or C. As a qualified fringe benefit, the payments are not included in employee income [I.R.C. §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.

A written plan is not required if it is purchased through a third-party insurer. Self-insured plans must have a written 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.

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). With the increase in the deduction for self-employed health insurance premiums to 100%, there will be less incentive to have the spouse on payroll for this purpose. However, as a business deduction, the use of this fringe benefit deduction would reduce the employer's self-employment tax. Note that paying *cash* wages in addition to providing this fringe benefit may actually result in an increase in social security taxes for the couple (if the employer's earnings are above the earnings base), and a potential reduction in social security benefits to the employer.

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 taxpayer may question the value of this added bookkeeping and paperwork unless the business is already doing payroll reporting.

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. The 2004 standard mileage rate is 37.5 cents per mile for all business miles driven (leased as well as purchased vehicles). The standard mileage rate may not be used when the automobile has been depreciated using a method other than straight-line or the car is used for hire. Beginning in 2004, the standard mileage rate may be used on up to four vehicles (previously, the limit was one vehicle). The use of I.R.C. §179, accelerated cost recovery system (ACRS), or modified accelerated cost recovery system (MACRS) depreciation also causes disqualification from using the standard rate. 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 I.R.C. §179.

Cell Phones Used for Business

The IRS has some very strict rules on the deductibility of cell phone expenses. They require detailed records of business use, and deductions based on estimates are disallowed according to the Tax Court (T.C. Memo 2001-165). Businesses must have a logbook or similar documentation for substantiation.

Return Preparers Have to Issue Privacy Policy Statements

Under Regulation 16 CFR Part 313, effective July 1, 2001, all financial institutions, including accountants or other tax preparation services that are in the business of completing tax returns, must provide a privacy policy disclosure statement to customers. All existing customers must be provided with the notice, and it must be provided to all new customers. All customers must also be provided with a copy at least annually. See the regulation for the specific information to be provided in the disclosure statement.

CORPORATE AND PARTNERSHIP PROVISIONS

Corporations

C (regular) corporations are subject to federal income tax rates ranging from 15% to 39%. Capital gains are taxed at the regular corporate rates. A personal service corporation is taxed at a flat rate of 35%. The 2004 tax rates for small businesses are given in Table 16.

Table 16. 2004 Corporate Tax Rates for Small Businesses*

Taxable Income	Tax
$0 to $50,000	15%
$50,001 to $75,000	$7,500 + 25% on amount over $50,000
$75,001 to $10,000,000	$13,750 + 34% on amount over $75,000 plus 5% on taxable income from $100,000 to $335,000

*Tax rates for corporations with more than $10 million of taxable income average approximately 35%.

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.

If the estimated tax for the year is expected to be $500 or more, a corporation is required to make estimated tax payments equal to the lesser of 100% of the tax shown on its return for the current year or on 100% of last year's tax (the prior year's tax must be greater than $0).

Corporations that have elected S status are not tax-paying entities but must file Form 1120S. S corporation shareholders will include their share of business income, deductions, losses, and credits on their individual returns.

The AMT has been repealed, effective January 1, 1998, for small corporations (less than $15 million of total gross receipts from 1995 through 1997 and not more than $22.5 million in any succeeding 3-year period).

Farm family corporations (at least 50% of stock owned by members of the same family) with annual gross receipts exceeding $25 million in any year after 1985 must use accrual tax accounting. Non–family farm corporations with 3-year average annual gross receipts exceeding $1 million in any year after 1975 must use accrual tax accounting. Additional exceptions to accrual accounting are provided for S corporations and corporations engaged in operating a nursery or raising or harvesting trees (other than fruit or nut trees). When farm corporations become subject to the gross receipt rule and are required to change to accrual accounting, an adjustment (I.R.C. §481) resulting from the change is included in gross income over a 4-year period, beginning with the year of the change.

Schedules L, M-1, and M-2 on Form 1120

Starting with tax year 2002, small corporations–those with less than $250,000 in gross receipts and less than $250,000 in assets–no longer have to complete Schedules L, M-1, and M-2 of Form 1120; Parts III and IV of Form 1120-A; or Schedules L and M-1 of Form 1120S (IRB 2002-48). Even though the IRS does not require these records, the companies will still want to maintain records dealing with assets, liabilities, and equity, in addition to the reconciliation needed to arrive at taxable income.

Partnership Filing Rules and Issues

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.

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: (1) the partnership's total receipts are less than $250,000, (2) total partnership assets are less than $600,000, and (3) Schedules K-1 are filed and furnished to the partners on or before the due date of the partnership return, including extensions.

Limited liability companies with more than one member file Form 1065 unless they elect to be taxed as corporations.

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 Form 1065 as a business expense listed on Schedules K and K-1 and reported as partner income on Form 1040 Schedule E). For tax years after 2002, a partner who qualifies can deduct 100% of the health insurance premiums paid by the partnership on his or her behalf as an adjustment to income on Form 1040. According to IRS instructions, the health insurance may instead be treated as a distribution to the partner with the resulting effect on capital accounts.

Partnership tax returns may now be filed electronically. Paper Form 8453-P must still be filed by the partnership.

INCOME TAX IMPLICATIONS OF CONSERVATION AND ENVIRONMENTAL PAYMENTS AND GRANTS RECEIVED BY FARMERS

Farmers and participating landowners are receiving New York State or federal grants and payments for a number of different conservation and environmental programs. Here is a review of the income tax consequences associated with some of the programs.

Cost-Sharing Payments under I.R.C. §126

Cost-sharing payments that qualify under I.R.C. §126 may be excluded from income reported by farmers. Several federal and state programs have been certified under I.R.C. §126. On a federal level these include the Wetlands Reserve Program, the Soil and Water Conservation Assistance Program, the Agricultural Management Assistance Program, the Conservation Reserve Program, and the Forestland Enhancement Program. On a New York State level, eligible programs include the NYS Agricultural Non-Point Pollution Grant Program, the NYC Watershed Agricultural Program, and other watershed protection programs. To be excluded, the payment must be for capital expenditures such as concrete pads, storage tanks, tile drains, diversion ditches, and manure storage. Payments for items that can be expensed on Form 1040 Schedule F, including soil and water conservation expenses, may not be excluded. A portion of a payment that increases annual gross receipts from the improved property more than 10% or $2.50 times the number of affected acres may not be excludable. The depreciable basis of the improvement is reduced by the amount of payment excluded from gross income.

All excluded I.R.C. §126 payments are subject to recapture as ordinary income to the extent that there is gain upon sale of the property within 10 years of receiving the payment (I.R.C. §1255). If the property is sold in more than 10 and less than 20 years, a declining percentage of the excluded payment is recaptured.

Conservation Reserve Payments

Farmers enrolled in the Conservation Reserve Program (CRP) are compensated for converting erodible cropland to less intensive use. They receive annual CRP rental payments that are ordinary income. Whether the payments are Form 1040 Schedule F income subject to self-employment tax or are Form 1040 Schedule E or Form 4835 income not subject to self-employment tax depends on the following conditions:

- If the taxpayer receiving CRP payments is materially participating in a farming business that includes the enrolled land, the CRP payments are Form 1040 Schedule F income. The Sixth Circuit has reversed the Tax Court (*Wuebker*) case, which had treated the CRP payments as non–self-employment income to be reported on Form 1040 Schedule E.
- If the taxpayer is a nonparticipating landlord, and the taxpayer hires someone to manage the CRP acreage, the payments are Form 1040 Schedule E income.
- If the taxpayer was and is a nonmaterially participating crop-share lessor before and after entering the CRP, the payments are Form 4835 income.

Wetlands Reserve Program (WRP)

Farmers and other landowners may be receiving permanent or nonpermanent easement payments for enrolling land in the Wetlands Reserve Program (WRP) where its use is limited to hunting, fishing, periodic grazing, haying, and managed timber production. Permanent easements may be a lump-sum payment or range from 5 to 30 annual payments. Nonpermanent easement payments must be extended over 5 or more years. Landowners participating in the WRP are also eligible for cost-sharing payments to restore the land to a healthy wetland condition.

Granting a permanent easement results in the same tax consequence as selling development rights. The taxpayer is allowed to reduce the entire basis in the underlying property before reporting gain from the easement (Rev. Rul. 77-414). If the land has been held for more than 1 year, the gain is I.R.C. §1231 capital gain.

Example 10. True Wetland enrolls 100 acres under the WRP permanent easement option and receives $500 per acre or $50,000. The basis of the 100 acres, purchased in 1955, is $20,000. True reduces the basis to $0 and realizes a $30,000 capital gain.

Permanent easement payments spread over more than the first year should be reported as installment sales. Because interest is not included in any current WRP contract, it must be imputed, and a portion of each payment must be allocated to interest. The grantor of a discounted or bargain sale permanent easement may be able to claim a charitable deduction for the difference between its value and the price received.

Nonpermanent easement payments are ordinary income unless the taxpayer accepts the position taken by the American Farmland Trust and reports them in the same way as perpetual or permanent easement payments. The IRS and the Tax Court say the payments are ordinary income, and if the taxpayer continues to use the land in an associated farming or timber activity, they are included in self-employment income.

Cost-sharing payments under the WRP are eligible to be excluded under I.R.C. §126. Otherwise, these restoration payments are reported as Form 1040 Schedule F income, where they may be offset by the restoration costs. If the taxpayer continues to farm, some or all of the cost-sharing payments may be deducted as soil and water conservation expenses or depreciated as improvements. Income and expenses associated with managing and maintaining the WRP land are reported on Form 1040 Schedules F or C.

INCOME FROM CANCELLATION OF DEBT AND RECAPTURE AGREEMENTS

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, NOLs, and basis in assets, which may result in tax liability for the taxpayer in future years.

Bankrupt and Insolvent Debtor Rules

For bankrupt or insolvent debtors, if canceled debt exceeds total tax attributes, the excess canceled debt is not reported as taxable income. However, 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 the amount of solvency.

Solvent Farmer Rules (Debt Discharged after 4/9/86)

In order to qualify for the solvent farmer rules, discharged debt (DD) 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% or more of the aggregate gross receipts of the farmer for the 3 previous years must have been attributable to farming; and (2) the discharging creditor must (a) be in the business of lending money, (b) not be related to the farmer, (c) not have sold the property to the farmer, and (d) 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. The general rule that basis may not be reduced below the amount of the taxpayer's remaining debt does not apply under these special solvent farmer rules. The DII remaining after tax attributes have been reduced must be included in a solvent farmer's taxable income. If the DII exceeds the total 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 may cause a tax liability.

Solvent and insolvent farmers receive no relief from gain triggered on property transferred in settlement of debt. The difference between basis and FMV is gain. Only debt discharge in excess of the FMV of the relinquished property is considered 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 [I.R.C. §108(c)(5)].

Farm Service Agency Recapture of Previously Discharged Debt

Some farm owners were required to give the Farm Service Agency (FSA) a shared appreciation agreement or a recapture agreement in exchange for the discharge of debt. The agreement allows FSA (formerly FmHA) to recapture part of the debt that was previously discharged if the farm is sold for more than the appraised value at time of discharge. If the taxpayer treated the debt reduction as DII debt for tax purposes at the time of the workout, then an FSA recapture will trigger a tax consequence. A typical appreciation agreement would obligate the farmer to pay the FSA the lesser of (1) the excess of the amount received when the farm is sold over the amount paid to FSA under the agreement or (2) the difference between the FMV of the farm at buyout and the amount paid under the agreement. When DD is recaptured, the tax treatment of some DII may need to be changed. The DII originally recognized as ordinary income now becomes a deduction against ordinary income. The DD offset by a reduction in attributes is added back to the same attributes, and the DD not recognized under insolvency rules requires no adjustment.

LIKE-KIND 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. §1031(a)(1)]. This section provides a summary of the rules [Reg. §1.1031(k)-1].

Rules and Requirements

The first requirement is that the transaction must actually be an exchange of qualifying property. A sale of property followed by a purchase of a like kind does not qualify for nonrecognition under I.R.C. §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. Property received by the taxpayer will be treated as property not of a like kind 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 the day the taxpayer transfers the relinquished property and ends at midnight **45 days** later. The exchange period begins on the day the taxpayer transfers the relinquished property and ends on the earlier of **180 days** later or the due date (including extensions) for the taxpayer's tax return. (If more than one property is relinquished, then the exchange period begins with the earliest transfer date.)

Deferral of tax is also possible with *reverse* like-kind exchanges (in which the seller acquires replacement property *before* the original property is sold). Rev. Proc. 2000-37 outlines the very exacting requirements that must be met for such swaps to qualify as like-kind exchanges.

Replacement Property

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. Replacement property must be clearly described in a written document (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 *sale* 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 by 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 trust.

Qualified Escrow Account and Intermediary

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.

A qualified intermediary (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.

The taxpayer's agent at the time of the transaction is a disqualified person. An agent is a person who has acted as the taxpayer's employee, attorney, accountant, investment banker or broker, or real-estate agent or broker within the 2-year period ending on the date of the transfer of the first of the relinquished properties.

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. §1031 as 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. However, care must be exercised to ensure that any I.R.C. §1245 property included as part of the real estate given up is replaced with an equal amount of such property in the replacement real estate received. I.R.C. §1245 property includes single-purpose livestock and horticultural facilities, silos, grain bins, and drainage tile.

Farm Business Personal Property

Like-kind is interpreted to mean *like class* for personal property. Under proposed regulations issued August 12, 2004, *like class* means that both the relinquished and replaced properties are in the same product class under the North American Industry Classification System (NAICS). Prior to this date, property was classified under the Standard Industrial Classification (SIC) System. Generally, this will have no impact on the classifications previously used for farm property to qualify as like-kind.

Most equipment used in a farm business is included in product class 33311, which includes items such as combines, planters, tractors, plows, haying equipment, and milking machines. Farmers will generally qualify for I.R.C. §1031 treatment when they exchange farm equipment for farm equipment. However, automobiles, general-purpose trucks, heavy general-purpose trucks, information systems, and other office equipment are all assigned to separate product classes. Livestock of different sexes are not property of a like kind, but exchanges of same-sex livestock have qualified as tax-free exchanges.

LIKE-KIND EXCHANGE DEPRECIATION RULES

IRS Notice 2000-4 requires that for property placed in service after January 2, 2000, the basis of the traded item continues to be depreciated over the remaining recovery period of the old property, using the same method and convention. Accumulated depreciation of the old asset would carry over and potentially be subject to recapture upon the sale of the newly acquired asset under I.R.C. §1245 depreciation recapture rules. Any additional cost basis would be treated as newly acquired property. This provision applies to all MACRS property, but taxpayers that did not calculate depreciation in accordance with this announcement, prior to January 3, 2000, are not required to change depreciation calculations. If they wish to change prior depreciation calculations, the procedure described in the instructions for Form 3115 should be followed.

Practitioner Note—Temporary regulations under I.R.C. §168 issued on February 27, 2004, allow taxpayers to elect to not apply the principles of IRS Notice 2000-4 and go back to the prior procedure of combining the remaining basis of the traded item with the cash paid to boot and treating the asset as a single item on the depreciation schedule. The potential recapture under I.R.C. §1245 for the accumulated depreciation on the traded item still carries over to the newly acquired asset. Unless Form 4562 is revised, the election is made by noting at the top of Form 4562 "Election Made Under Section 1.168(i)-6T(i)". The election is available on an asset by asset basis.

Example 11. Under rules *prior* to Notice 2000-4 (including the election to not follow this Notice under the temporary regulations)

- Farmer Pat paid $100,000 for a combine in 1996.
- Pat depreciated it as 7-year property using MACRS 150% declining balance.
- In 1999 Pat traded the combine and $40,000 cash for a tractor.
- Calculation of the basis in the new tractor is as shown in Table 17.

Table 17. Calculation of Basis

Beginning combine basis		$100,000
1996 depreciation	$100,000 × 10.71%	(10,710)
1997 depreciation	$100,000 × 19.13%	(19,130)
1998 depreciation	$100,000 × 15.03%	(15,030)
1999 depreciation	$100,000 × 12.25% × 1/2	(6,125)
Ending basis		49,005
Boot cash for the tractor		40,000
Basis in new tractor		$ 89,005

- Calculation of Pat's total 1999 depreciation on these two assets is as shown in Table 18.

Table 18. Calculation of Depreciation

Combine from above		$ 6,125
Tractor	$89,005 × 10.71%	9,532
		$15,657

Example 12. Under Notice 2000-4, which requires Pat to continue depreciating the carried-over basis over the remaining life of the combine continuing with the same depreciation rate,

- Farmer Pat paid $100,000 for a combine in 2001.
- Pat depreciated it as 7-year property using MACRS 150% declining balance.
- In 2004 Pat traded the combine and $40,000 cash for a tractor.
- Calculation of the total 2004 depreciation on these two assets is as shown in Table 19.

Table 19. Calculation of Depreciation on Two Assets

2004 (fourth-year depreciation) on combine that was traded and has left the farm:		
Combine traded (left the farm)	$100,000 × 12.25%	$12,250
2004 (first-year depreciation) on tractor that is on the farm:		
Tractor on farm (boot only)	$40,000 × 10.71%	4,284
Total depreciation		$16,534

The result is a first-year greater depreciation for Pat than under pre-2000 rules ($16,534 versus $15,657). The advantage of this methodology is that, where the trade-in has not been depreciated to zero, the new method yields a faster recovery than would be available if the remaining basis was added to the basis of the new property and depreciated accordingly. Next year, if Pat trades that new tractor in for a baler, Pat will have a three-line calculation of depreciation, but only one piece of equipment left on the farm.

Bookkeeping

Pat's depreciation schedule will need some notes to keep track of what machinery is gone, what is remaining on the farm, and which was traded for which. Notice 2000-4 does not give any guidance in this area. Pat should keep the traded property on the depreciation schedule with a note as to which piece it was traded for, and the basis of the new equipment, which will be just the boot price. If Pat is a frequent trader, it may take several lines to support the depreciation and basis in the traded and acquired property. If Pat ultimately sells the piece of equipment, the remaining basis of all the traded items will be added to the basis of the item being sold to determine gain. The election under the temporary regulations starts to look attractive – even though it may result in less current depreciation expense!

Other Deferred-Exchange Rules and Requirements

IRS Form 8824 is used as a supporting statement for like-kind exchanges that either generate no taxable gain or reported on other forms, including Form 4797 (Sale of Business Property) and Form 1040 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. §§1245, 1250, 1252, 1254, or 1255, part or all of the recapture may have to be recognized in the year of the like-kind exchange. Any recapture potential not recognized in the year of the exchange will carry over as an attribute of the asset received in the exchange.

Like-kind exchanges between related parties can result in recognition of gain if either party disposes of the property within 2 years after the exchange.

DEPRECIATION AND COST RECOVERY

The Job Creation and Worker Assistance Act of 2002 made substantial changes to this area by allowing taxpayers to claim a 30% bonus depreciation on qualifying property placed in service under a binding contract after September 10, 2001 (even though enacted March 9, 2002). The Jobs and Growth Tax Relief Act of 2003 increased the bonus depreciation to 50% for purchases made under a binding contract after May 5, 2003, and placed in service prior to January 1, 2005. In addition, recent regulations indicate that total cost basis is eligible for bonus depreciation rather than just the new cash invested. The 2003 Act also increased the I.R.C. §179 deduction. Other than the bonus depreciation and I.R.C. §179 deduction (both discussed later) and Notice 2000-4 and subsequent temporary regulations regarding like-kind exchanges (see the previous section), the standard depreciation rules for regular income tax have not changed. The AMT depreciation rules were modified in 1998 and will reduce the depreciation adjustment for 1999 and years following. 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 using MACRS, ACRS, and the depreciation rules that apply to property acquired before 1981. This section 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,* IRS Pub. 225.

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. The taxpayer that owns the asset must claim depreciation. 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 has three opportunities to recover the lost depreciation. It may be recovered by filing an amended return in any of the following situations:

- An incorrect amount was claimed due to a mathematical error.
- An incorrect amount was claimed due to a posting error.
- A "method of accounting for the property" has not been adopted.

A method of accounting has been adopted if an incorrect amount of depreciation has been claimed on two or more consecutively filed tax returns for reasons other than a mathematical or posting error. In this case, Form 3115, Application for Change in Accounting Method, is filed to request a change in accounting method and to document the amount of adjustment being claimed on *subsequently filed* tax returns. Various Rev. Procs. have been issued (2002-9, 2002-19, 2002-33) to describe the process. If the adjustment is negative (due to previously understated depreciation), it may be taken in total on the next tax return filed. If the adjustment is positive and exceeds $25,000, it is reported equally on the next 4 years' returns. Form 3115 must be filed with the National Office of the IRS, and a signed copy must be attached to the taxpayer's return for the tax year that the correction in depreciation is made. There is no fee for filing Form 3115 under these automatic approval procedures.

Expensing the purchase of small assets is not an option according to the Tax Court (T.C. Memo 2001-149). If the item has a useful life greater than 1 year, it is to be depreciated. The only exception stated is that if the aggregate total of all such items for the tax year is less than 1% of operating expenses and net income, the expense would be allowed.

MACRS Classes

The MACRS class life depends on the asset depreciation range (ADR) midpoint life of the property, as shown in Table 20.

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 in Table 21.

Table 20. MACRS Class Life and ADR Midpoint Life

MACRS Class	ADR Midpoint Life
3-year	4 years or less
5-year	More than 4 years but less than 10
7-year	10 years or more but less than 16
10-year	16 years or more but less than 20
15-year	20 years or more but less than 25
20-year	25 years or more other than I.R.C. §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

Three-Year Property

- I.R.C. §1245 property with an ADR class life of 4 years or less is 3-year property. 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 4 years.

- I.R.C. §1245 property is considered 3-year property if it is used in connection with research and experimentation. Few farmers will have this type of property.
- Race horses more than 2 years old when placed in service and all other horses more than 12 years old when placed in service are considered 3-year property.

Five-Year Property

- All purchased dairy and breeding livestock (except hogs and horses included in the 3- or 7-year classes)
- Automobiles, light trucks (under 13,000 lbs unladen), and heavy-duty trucks
- Computers and peripheral equipment, typewriters, copiers, and adding machines
- Logging machinery and equipment

Seven-Year Property

- All farm machinery and equipment
- Silos, grain storage bins, fences, and paved barnyards
- Breeding or work horses (12 years old or less)

Ten-Year Property

- Single-purpose livestock and horticultural structures (7-year property if placed in service before 1989)
- Orchards and vineyards (15-year property if placed in service before 1989)

Fifteen-Year Property

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

MACRS Classes 20 Years and Higher

- Twenty-year property includes farm buildings such as general-purpose barns, machine sheds, and many storage buildings.
- Property that is 27.5-year includes residential rental property.
- Property that is 39-year (31.5 if acquired before May 13, 1993) includes nonresidential real property.

Table 21. ACRS, MACRS, and MACRS Alternative Depreciation System (ADS) Recovery Periods for Common Farm Assets

Asset	Recovery Period (Years)		
	ACRS	MACRS	ADS
Airplane	5	5	6
Auto (farm share)	3	5	5
Calculators, copiers, and typewriters	5	5	6
Cattle (dairy or breeding)	5	5	7
Communication equipment	5	7	10
Computer and peripheral equipment	5	5	5
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[a]	15
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 (for farm labor housing)	19	20	25
Office equipment (other than calculators, copiers, or typewriters) & furniture	5	7	10
Orchards	5	10[b]	20
Paved lots	5	15	20
Property with no class life	5	7	12
Rental property (nonresidential real estate)	19	39[c]	40
Rental property (residential)	19	27.5	40
Research property	5	5	12[d]
Sheep (breeding)	3	5	5
Silos	5	7	12[d]
Single-purpose livestock structure (housing, feeding, storage, and milking facilities)	5	10[a]	15
Single-purpose horticultural structure	5	10[a]	15
Solar property	5	5	12d
Storage (apple, onion, potato)	5	20	25
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
Vineyard	5	10[b]	20
Water well	5	15	20
Wind energy property	5	5	12[d]

[a] If placed in service before 1989, recovery period is 7 years.
[b] If placed in service before 1989, recovery period is 15 years.
[c] If placed in service before May 13, 1993, recovery period is 31.5 years.
[d] No class life specified; therefore, 12-year life assigned.

Cost Recovery Methods and Options

Accelerated cost recovery methods for MACRS property are shown in Table 22. Depreciation on farm property placed in service after 1988 is limited to 150% declining balance (DB) rather than the 200% available for nonfarm property (both with cross over to straight-line). There are two straight-line (SL) options for the classes eligible for rapid recovery. The SL option may be taken over the MACRS class life or the MACRS alternative depreciation system (ADS) life. A fourth option is 150% DB over the ADR midpoint life. The changes in depreciation required for AMT purposes are discussed in this section under "AMT Depreciation" and in the "Alternative Minimum Tax" section.

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

Table 22. Accelerated Cost Recovery Methods for MACRS

Class	Most Rapid MACRS Method Available
3-, 5-, 7-, and 10-year	
Farm assets	150% DB if placed in service after 1988[1]
	200% if placed in service 1987 through 1988[1]
Nonfarm assets	200% DB
15- and 20-year	150% DB
27.5- and 39(31.5)-year	Straight-line *only*

[1]See exception for orchards and vineyards above.

The MACRS law does not provide for standard percentage recovery figures for each year. However, the IRS and several of the tax services have made tables available, such as Table 23.

Table 23. Annual Recovery (Percentage of Original Depreciable Basis)*
(The 150% DB percentages are for 3-, 5-, 7-, and 10-year class farm property placed in service after 1988.)

	3-Year Class		5-Year Class		7-Year Class		10-Year Class		15-Yr Class	20-Yr Class*
Recovery Year	200% DB	150% DB	200% DB	150% DB	200% DB	150% DB	200% DB	150% DB	150% DB	150% DB
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	7.70	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	5.29
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							6.56	8.74	5.91	4.46
10							6.55	8.74	5.90	4.46
11							3.28	4.37	5.91	4.46
12–15									5.90†	4.46
16									2.95	4.46
17–20										4.46
21										2.24

*Rounded to two decimals, see IRS Pub. 946 for more precise 20-yr class rates.
† The percentage is 5.90 in years 12 and 14, 5.91 in years 13 and 15.

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 (reflected in Table 23). A half-year of recovery may be taken in the year of disposal (not reflected in the table unless disposal is in the final year of the cost recovery period). No depreciation is allowed on property acquired and disposed of in the same year. Property in the 27.5-year and 39-year classes is subject to a mid-month convention in the year placed in service.

Mid-Quarter Convention

If more than 40% 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 receive 87.5%, 62.5%, 37.5%, and 12.5% of the year's depreciation, respectively. The amount expensed under I.R.C. §179 is not considered in applying the 40% rule. In other words, the amount expensed under I.R.C. §179 can be taken on property acquired in the last quarter, which may help avoid the mid-quarter convention rule (see Example 13 in under the "Election to Expense Depreciable Property" section).

MACRS Alternative Depreciation

The MACRS ADS is required for some property and is an option for the rest. It is a straight-line system based on the alternative MACRS recovery period (ADR midpoint lives). Farmers who are subject to capitalization of preproductive expenses, discussed later, may elect to avoid capitalization; but if they do so, they must use the ADS life on all property. As noted later, any taxpayer required to use ADS is ineligible for bonus depreciation but may still use the I.R.C. §179 expense deduction.

Election to Expense Depreciable Propesrty

The I.R.C. §179 expense deduction is $102,000 for 2004 and will be indexed for inflation for 2005 before reverting to the pre-2003 Act level of $25,000 for 2008. The expense deduction is phased out dollar for dollar for any taxpayer that places over $410,000 (up from $400,000 in 2003 and $200,000 prior to 2003) of property in service in any year, with a complete phaseout at $512,000. Eligible property is defined as I.R.C. §1245 property to which I.R.C. §168 (accelerated cost recovery) applies. In addition, off-the-shelf computer software is eligible property. Property must be used more than 50% of the time in the business to qualify. General-purpose buildings, property acquired from a related person, and certain property leased by noncorporate lessors do not qualify. Excluded is property used outside the United States, property used by tax-exempt organizations, property used with furnished lodging, property used by governments and foreigners, and air conditioning and heating units. When property is acquired by trade, I.R.C. §179 deductions may not be claimed on the basis of the trade-in.

In the case of partnerships, the $102,000 limit applies to the partnership and also to each partner as an individual taxpayer. A partner who has I.R.C. §179 allocations from several sources could be in a situation where only $102,000 may be expensed because of the $102,000 limitation. Any allocations in excess of $102,000 are lost forever, which is a different result from the limitation discussed below. The same concept applies to S corporations.

The amount of the I.R.C. §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 I.R.C. §179 deduction. Any disallowed I.R.C. §179 deductions due to this taxable income limitation are carried forward to succeeding years. The deduction of current plus carryover amounts is then limited to the taxable business income of that carryover year.

I.R.C. §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 Form 1040 Schedules C or F in determining income from the "active conduct of a trade or business" when calculating the allowable deduction. I.R.C. §1231 gains and losses from a business actively conducted by the taxpayer, as well as ordinary gains and losses from business assets reported on Form 4797, are also included.

Gains from the sale of I.R.C. §179 assets are treated like I.R.C. §1245 gains. The amounts expensed are recaptured as ordinary income in the year of sale. The I.R.C. §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% or less, I.R.C. §179 expense recapture is invoked no matter how long the property was held for business use. The amount recaptured is the excess of the I.R.C. §179 deduction over the amount that would have been deducted as depreciation. The recapture is reported on Part IV of Form 4797 and then on Form 1040 Schedule F.

Every business owner who has purchased MACRS property should consider the I.R.C. §179 expense deduction because only New York investment tax credit will be lost when it is used. It should not be used to reduce AGI below standard (or itemized) deductions plus exemptions, unless an additional reduction in self-employment tax is worth more than depreciation in a future tax year. Also, the taxpayer must be sure not to use more I.R.C. §179 deduction than the amount of taxable income from the "active conduct of a trade or business."

The 2003 Act allows taxpayers to make or revoke an I.R.C. §179 expensing election on an amended return for tax years beginning after 2002 and before 2006 without consent of the commissioner.

> **Practitioner Note**—Previous guidance was that taxpayers should not rely on unused I.R.C. §179 deduction to bail them out upon audit, because this election to expense was only allowed on a timely filed tax return. The 2003 Act would allow any unused I.R.C. §179 deduction to be claimed if, for example, it is determined that certain parts, supplies, or repairs should have been capitalized rather than expensed.

The I.R.C. §179 deduction can also be used to manage the triggering of the mid-quarter convention in order to maximize depreciation deductions.

Example 13. V. Sharp placed $182,000 worth of 7-year MACRS property in service. He could expense $102,000 and claim $8,568 of depreciation ($182,000 − 102,000 = $80,000 × .1071 = $8,568) under the half-year convention. If $132,000 of Sharp's property was placed in service in the last quarter and the $102,000 I.R.C. §179 election is applied to this $132,000, $30,000 is left to be used in the 40% test. Thus, $30,000 ÷ ($182,000 − 102,000) = .375, which is less than 40%, so Sharp avoids the mid-quarter rules. However, if his depreciable items had totaled $175,000, and $132,000 was placed in service in the last quarter, he would be caught by the 40% rule, even if he applied the $102,000 I.R.C. §179 to the items placed in service in the last quarter. That is, $30,000 ÷ ($175,000 − 102,000) = .41, and all the depreciation items would be subject to the mid-quarter convention.

If the 40% 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 I.R.C. §179 could work to the advantage of a taxpayer that wanted to become subject to the rules. If third-quarter property could be expensed and thereby have the 40% 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 14. A farmer purchased a tractor, harvester, and combine in 2004. All belong in the 7-year property class. The farmer may not recover the tractor over 7 years with rapid recovery (150% DB) and the other items over 7 or 10 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 2002 (7-year property), 150% DB for 7 years for equipment purchased in 2003, and could now select SL 7-year recovery for all machinery purchased in 2004.

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, SL over 7 years on 7-year property, and SL over 15 years on most 10-year property.

Some Special Rules on Autos and Listed Property

There are special rules for depreciation on vehicles and other listed property. If used less than 100% in the business, the maximum allowance is reduced, and if used 50% or less, the I.R.C. §179 deduction is not allowed and depreciation is limited to SL. The maximum depreciation and I.R.C. §179 expense allowance for four-wheeled vehicles called luxury cars (6000 lbs or less) placed in service in 2004 were reduced for 2004 to $2,960 for the first year (but see the later section on bonus depreciation, if such is claimed), $4,800 for the second year, $2,850 for the third year, and $1,675 for each succeeding year (see Table 24). If the business-use percentage is less than 100%, these limits are reduced accordingly. Cellular telephones acquired after 1989 are listed property. Computers are listed property unless they are used only for business. Starting in the year 2003, pickups and vans have depreciation caps that are different from other automobiles as shown in Table 24.

Table 24. Depreciation Limitations for Passenger Autos, Pickups, and Vans

Year Placed in Service	1st Year	2nd Year	3rd Year	Later Years
1998	$3,160	$5,000	$2,950	$1,775
1999	$3,060	$5,000	$2,950	$1,775
2000	$3,060	$4,900	$2,950	$1,775
2001–2002 regular	$3,060	$4,900	$2,950	$1,775
2001–2002 with 30% bonus starting 9/11/01	$7,660	$4,900	$2,950	$1,775
2003 regular for cars	$3,060	$4,900	$2,950	$1,775
2003 regular for pickups and vans	$3,360	$5,400	$3,250	$1,975
2003 additional for 30% bonus	$4,600			
2003 additional for 50% bonus starting 5/6/03	$7,650			
2004 regular for cars	$2,960	$4,800	$2,850	$1,675
2004 regular for pickups and vans	$3,260	$5,300	$3,150	$1,875
2004 additional for 50% bonus*	$7,650			

*Note: This limitation applies even if the tax payer elects 30% bonus depreciaton.

AMT Depreciation

For I.R.C. §1245 property placed in service after 1998, if the 200% DB MACRS method is used for regular tax purposes, depreciation must be recalculated for AMT purposes using 150% DB MACRS. The difference between regular depreciation and this redetermined amount is an income adjustment subject to inclusion in alternative minimum taxable income. For all other property placed in service after 1998, the depreciation method is the same for regular tax and AMT purposes. Therefore, farm property placed in service after 1998 is depreciated using the same method for AMT purposes. (Note: There could still be an AMT adjustment on such property if it was acquired using a trade-in that has a different basis for AMT purposed due to prior-year rules discussed later.) An adjustment remains for nonfarm property depreciated using 200% DB MACRS as well as for other property placed in service prior to 1999.

For I.R.C. §1245 property placed in service after 1986 and before 1999, depreciation must be recalculated for AMT purposes by using Table 25.

Table 25. I.R.C. §1245 Property Placed in Service Prior to 1999

Used for Regular Tax Purposes	Must Use for AMT Purposes
150 DB MACRS	150 DB, ADS life
200 DB MACRS	150 DB, ADS life
SL MACRS	SL, ADS life
ADS	ADS

The AMT depreciation adjustment for I.R.C. §1250 property placed in service after 1986 and before 1999 is the difference between what was claimed for regular income tax and that allowed under MACRS ADS SL depreciation.

Bonus Depreciation

As a result of the Job Creation and Worker Assistance Act of 2002 there is an opportunity to claim a front-end additional depreciation deduction (equal to 30% of original cost) on any *new* asset placed in service on or after September 11, 2001. This is being referred to as the *bonus depreciation.* The 2003 Act provides a 50% bonus depreciation for similarly qualified property placed in service after May 5, 2003. In both cases, a binding written contract prior to the stated dates disqualifies the asset from the additional depreciation. This special depreciation allowance is in addition to the I.R.C. §179 direct expense deduction. Of course, these deduction possibilities do not increase the total amount of depreciation to be claimed over the life of the asset, but they do speed up the deduction into the year of acquisition (essentially accelerating deductions from future years).

Qualified Property

- The following qualifications are used to determine whether assets are eligible for bonus depreciation under regulations issued September 5, 2003, the *total cost (including adjusted basis of any traded item)* is eligible for this bonus depreciation.
- The property must be placed in service prior to January 1, 2005.

- The asset has a depreciable life of 20 years or less. This means that fixtures, vehicles, machinery, and equipment are all eligible, as well as farm buildings and barns. However, commercial buildings and residential rental property do not qualify. Property that is water utility property [as defined in I.R.C. §168(e)(5)], computer software other than computer software covered by I.R.C. §197, or qualified leasehold improvement property also qualifies.
- The original use of the asset must commence with the taxpayer after September 10, 2001, for 30% bonus depreciation or after May 5, 2003, for 50% Bonus Depreciation (i.e., the asset must be new rather than used). See additional detail the under the "What Constitutes New?" section.)
- The property must be used over 50% for the business (especially a consideration for vehicles, snowmobiles, ATVs, etc.).

What Constitutes New?

For equipment and buildings, the determination is not too difficult. There is the issue of reconditioned or rebuilt property–it is considered used property and therefore ineligible. However, if the taxpayer makes capital improvements to existing property (i.e., does the reconditioning) those capital improvement expenditures are eligible for bonus depreciation.

What about cattle? If the animal has been used for its dairy or breeding purpose, it is no longer new. Thus, milk cows purchased from another farmer's herd would not qualify, but the purchase of heifers from one in the business of raising dairy replacements would qualify.

Mandatory Use or Election Out

The use of bonus depreciation is mandatory on eligible purchases. If not claimed, basis will still be reduced under the allowed or allowable rules.

The taxpayer is allowed to elect out of the use of bonus depreciation on qualifying purchases. The taxpayer may elect out of 50% bonus depreciation and claim 30% or out of bonus depreciation entirely. However, this election is made on a class by class basis. As with other elections, the election out of bonus depreciation may be made on an amended return filed within 6 months of the original due date of the return. After 6 months of the original due date of the return, a taxpayer can revoke an election out of bonus depreciation only with the prior written consent of the commissioner.

Impact of Use of ADS Depreciation

If the taxpayer is a fruit grower or vineyardist who is required to use ADS depreciation because they have elected out of uniform capitalization rule (discussed in a later section), they are ineligible for the Bonus Depreciation. However, if a taxpayer simply elects to use ADS to stretch the useful life (rather than being required to do so), he or she could still claim bonus depreciation on otherwise qualifying property. In addition, there are certain nonfarm situations where the use of ADS is required, and in these situations bonus depreciation is not available.

Luxury Car Limits Modified

To accommodate 50% bonus depreciation on eligible lightweight vehicles, the amount of first-year depreciation allowed on passenger vehicles was increased from $2,960 to $10,610, trucks and vans $3,260 to $10,910 (you must pro-rate for business-use percentage; see Table 24). However, this increased limit is only available if bonus depreciation is used. If the taxpayer elects out of bonus depreciation for this class of property, or the vehicle is used, the previous limit of $2,960 (lightweight pickups and vans $3,260) still applies. In either event, the depreciation limitation is reduced by multiplying it by the vehicle's business-use percentage. The higher limits continue to apply even if the taxpayer elects 30% bonus depreciation.

Interaction with I.R.C. §179

Bonus depreciation is in addition to the I.R.C. §179 deduction on qualifying property. I.R.C. §179 is deducted first, and then the remaining basis is eligible for bonus depreciation, as shown in Table 26.

Sam purchased a new tractor for $163,000 on July 15, 2004, and wishes to maximize depreciation deductions. The calculations are shown in Tables 26 and 27.

Table 26. MACRS Depreciation

Original cost	$163,000
Less: I.R.C. §179	102,000
Balance	$61,000
	× 50%
Bonus depreciation	$30,500
Balance for MACRS ($161,000 − $100,000 − $30,500)	$30,500
7-year MACRS factor	× 10.71%
MACRS depreciation	$3,267

Table 27. Total Depreciation for 2004

I.R.C. §179	$102,000
Bonus depreciation	30,500
MACRS	3,267
Total depreciation	$135,767

Alternative Minimum Tax

Bonus depreciation is also allowed in the calculation of alternative minimum taxable income (AMTI), so there will be no additional depreciation adjustment for AMT as a result of using bonus depreciation.

Temporary Regulations Issued 9/5/03

The temporary regulations issued September 5, 2003, clarified that bonus depreciation may be claimed on the full adjusted tax basis of new property, not just the cash paid to boot. These regulations apply retroactively, and therefore bonus depreciation claimed during the prior 2 tax years may have been understated. However, under these regulations, it is not necessary to amend the prior-year return just to protect against the allowed or allowable rule. As a matter of convenience, the IRS is allowing the original interpretation as a permissible method of accounting.

Additional Depreciation Rules

MACRS rules allow half a year's depreciation in the year of disposition if using the half-year convention. If the mid-quarter convention applies, depreciation is allowed for the quarters held in the year of disposition. For 27.5- and 39-year property, depreciation is claimed in the year of disposition based on the months held in that year.

When assets are sold, gain to the extent of all prior depreciation on all I.R.C. §1245 as well as on 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 SL recovery is used (see the section, "A Review of Farm Business Property Sales").

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 IRS Pub. 946, *How to Depreciate Property.*

Choosing Recovery Options

Taxpayers will maximize after-tax income by using I.R.C. §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. The taxpayer that will not be able to use all the deductions in the early years may want to consider one of the SL options. A taxpayer in a low tax bracket may wish to forgo the I.R.C. §179 deduction to save tax deductions for future years if higher tax brackets are expected. Also, the loss of NYS investment tax credit (ITC) on any amount expensed under I.R.C. §179 should be considered.

Using SL rather than 150% DB on 20-year property will preserve capital gain treatment (at a 25% maximum rate) at the time of disposal because the amount of depreciation in excess of SL is treated as ordinary income at the time such I.R.C. §1250 property is sold. However, the tax savings will not be realized until many years from now, and if the asset is fully depreciated at the time of sale, there is no *excess* depreciation to be recaptured as ordinary income. 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–that is, using 150% DB MACRS. The time value of money makes current-year depreciation more valuable than that used in later years. However, depreciation claimed to reduce taxable income below zero is wasted.

Reporting Depreciation and Cost Recovery

Form 4562 is used to report the I.R.C. §179 expense election, bonus depreciation, depreciation of recovery property, depreciation of nonrecovery property, amortization, and specific information concerning automobiles and other listed property. Depreciation, cost recovery, and I.R.C. §179 expenses are combined on Form 4562 and entered on Form 1040 Schedule F. However, partnerships and S corporations will transfer the I.R.C. §179 expense election to Schedule K (Form 1065 or 1120S), rather than combining it with other items on Form 4562. Furthermore, I.R.C. §179 is excluded when calculating net earnings for self-employment at the partnership level on Schedules K and K-1, Therefore, I.R.C. §179 must be included as an adjustment on the partner's Form 1040 Schedule SE if the partner meets the test for the I.R.C. §179 deduction to be taken (i.e., business income limitation and overall $102,000 limit).

Uniform Capitalization Rules for Fruit Growers and Nurserymen

Plants subject to uniform capitalization rules 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 that is more than 6 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 nondepreciable costs of replacing trees and vines do not have to be capitalized.

In Notice 2000-45, the IRS has now provided the following list of commercially grown plants with nationwide weighted average preproductive periods in excess of 2 years: almonds, apples, apricots, avocados, blackberries, blueberries, cherries, chestnuts, coffee beans, currants, dates, figs, grapefruit, grapes, guavas, kiwifruit, kumquats, lemons, limes, macadamia nuts, mangoes, nectarines, olives, oranges, papayas, peaches, pears, pecans, persimmons, pistachio nuts, plums, pomegranates, prunes, raspberries, tangelos, tangerines, tangors, and walnuts. This is not an all-inclusive list. For other plants grown in commercial quantities in the United States, the nationwide weighted average preproductive period must be determined based on available statistical data.

Fruit growers who choose to capitalize will need to establish reasonable estimates of the preproductive costs of trees and vines. Nurserymen could use the farm-price method to establish their preproductive costs of growing trees, vines, and ornamentals. Capitalization requires the recovery of orchards, vineyard, and ornamental tree preproductive period expenses over 10 years, SL.

If growers elect not to capitalize, they must use ADS to recover the costs of trees and vines (20-year SL) and all other depreciable assets placed in service. Only the preproductive period growing costs may be expensed. As discussed earlier, this required use of ADS also prevents the taxpayer from claiming the 30% or 50% bonus depreciation.

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 file the complete list of items included in the taxpayer's depreciation and cost recovery schedules.

GENERAL BUSINESS CREDIT

The general business credit (GBC) is a combination of investment tax credit, work opportunity credit, welfare-to-work credit, research credit, low-income housing credit, disabled access credit, and others (see the following page). Form 3800 is used to claim the credit for the current year, to apply carryforward from prior years, and claim carryback from later years. The credit allowable cannot reduce regular tax below tentative AMT. It is also limited to $25,000 plus 75% of net regular tax liability above $25,000. Special limits apply to married persons filing separate returns, controlled corporate groups, estates and trusts, and certain investment companies and institutions [I.R.C. §46(e)(i)]. The Taxpayer Relief Act of 1997 (TRA 97) changed the carryback period to 1 year and the carryforward period to 20 years beginning in 1998. The 3-year carryback and 15-year carryforward rules remain for all credits earned before 1998.

Review of Federal Investment Credit

Federal ITC was repealed for most property placed in service after December 31, 1985. The ITC may still be earned on rehabilitated buildings, qualified reforestation expenses, and certain business energy investments. ITC [I.R.C. §45(a)(1)] is 10% of the amount of qualified investment with more liberal allowances for some rehabilitated historic buildings. The ITC 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 ITC claimed is fully earned, the credit must be recomputed to determine the amount to recapture. Recapture rules apply when there is early disposition of rehabilitated buildings, business energy property, or reforested land for which investment credit has been claimed. The amount of recapture is 100% during the first year of service and declines to zero after 5 full years of service. Form 3468 is used for computing ITC; Form 4255 is used to recapture ITC.

Rehabilitated Buildings

The rehabilitated buildings (expenditures) credit is 10% for a qualified rehabilitated building and 20% 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 a business. Buildings that are used for residential purposes qualify only if they are certified historic structures that are 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% of the investment credit claimed. Expenditures must exceed the greater of the adjusted basis of the property or $5,000. Qualifying investment is reduced by any I.R.C. §179 expense claimed on the building.

Reforestation

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% of ITC claimed.

Energy

Business energy investment credit is equal to 10% 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. The basis of any qualifying equipment must be reduced by 50% of ITC claimed.

Other General Business Credits (GBCs)

Tax Credit for Child-Care Expenses Provided by Businesses for Employees' Children

The 2001 Act provides that after December 31, 2001, business taxpayers may receive a credit equal to 25% of qualified expenses for employee child care plus 10% of child-care referral and resource services up to a maximum of $150,000 credit per year. Employer's expenditures are deductible as ordinary and necessary business expenses. Qualified child-care expenses include costs to acquire, build, rehabilitate, or expand nonprincipal residence (within meaning of I.R.C. §121) depreciable property. The fact that a child-care facility is in a residence will not prevent it from being qualified if it meets all the other requirements in I.R.C. §45F. To be qualified, the facility must meet open enrollment, nondiscrimination, and other regulations contained in I.R.C. §45F as well as applicable state and local laws. Credits taken for costs of building, purchasing, or rehabilitating a facility are subject to recapture for the first 10 years after it is placed in service. The basis of the facility is reduced by the credit claimed.

Pension Plan Credit for Start Up Costs for Small Businesses

Starting in 2002, the 2001 Act offers a nonrefundable income tax credit for 50% of the first $1,000 in administrative and retirement education costs for any small business that sets up a new qualified defined-benefit or defined-contribution plan. Eligible plans would also include an I.R.C. §401(k) plan, SIMPLE plan, or SEP plan. A small business is one that employed in the preceding year 100 or fewer employees with compensation of at least $5,000. Credit is for only the first 3 plan years and must include at least one non–highly compensated employee. Although part of the GBC, any unused credit may *not* be carried back to years prior to 2002.

Work Opportunity Credit

The work opportunity credit (which now applies to qualifying individuals who start to work no later than December 31, 2005) is available to employers on first-year employee wages paid (Form 5884). First-year wages paid to targeted group employees with 120 to 400 hours of service earn 25% credit. The credit increases to 40% when an eligible employee reaches or exceeds 400 hours. There are eight targeted groups, including qualified SSI recipients, recipients of aid to families with dependent children (IV-A recipients), certain food stamp recipients, high-risk youth living in empowerment zones, economically disadvantaged ex-felons, and certain disabled workers and veterans. Qualification rules were modified for IV-A recipients and veterans.

Welfare-to-Work Credit

The welfare-to-work credit (Form 8861) is available to employers on qualified wages paid to long-term family assistance recipients who start to work no later than December 31, 2005. The credit is 35% on qualified first-year wages and 50% on qualified second-year wages. The credit applies to the first $10,000 of an eligible employee's wage each year for a maximum credit of $8,500 over 2 years. Wages include the value of benefits, health insurance benefits, and employer contributions, including educational assistance and dependent-care expenses.

In general, to qualify as long-term family assistance recipients, members of a family must have been receiving family assistance for at least 18 months before the hiring date. The recipient must be certified by a designated local agency as being a member of a family receiving assistance under a IV-A program. Employers cannot get work opportunity credit and welfare-to-work credit on the same employee.

Credit for Increased Research Expenditures

The credit for increased research expenditures (formerly the research and development credit) has an extension to December 31, 2005, and amounts to 20% of qualified research expenditures. This credit is claimed on Form 6765.

Disabled Access Credit

The disabled access credit may be claimed on Form 8826 by an eligible small business that incurs expenses for providing access to persons with disabilities. The credit is 50% 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.

Miscellaneous Credits

Other GBCs include those for new markets tax, low-income housing, alcohol fuels, enhanced oil recovery, renewable electricity production, empowerment zones, American Indian employment, and employer FICA tax on tips.

A REVIEW OF FARM BUSINESS PROPERTY SALES

Because farm taxpayers are affected by preferential capital gains tax rates, income averaging, and the complexities of installment sale reporting rules, tax planning for farm property sales has increased in importance. The first step in tax planning is making the distinction among gains from sales of property used in the farm business that are eligible for capital gains treatment, gains subject to recapture of depreciation, and Form 1040 Schedule F income.

IRS Property Classifications

The reporting of gains and losses on the disposition of property held for use in the farm business continues to be a complicated, but important, phase of farm tax reporting. Form 4797 must be used to report gains and losses on sales of farm business property. Form 1040 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.

I.R.C. §1231 Property

I.R.C. §1231 includes gains and losses on the sale or exchange of business assets meeting a holding-period requirement. (See the discussion later explaining that livestock must be held for dairy, breeding, sport, or draft to qualify as I.R.C. §1231 property.) The required holding period is 24 months for cattle and horses and 12 months for all other business assets, including unharvested crops sold with farmland that was held at least 1 year. There are instances, however, when gain on livestock, equipment, land, buildings, and other improvements is treated specifically under I.R.C. §§1245, 1250, 1252, and 1255 (resulting in a portion of these gains being treated as ordinary income).

Under I.R.C. §1231, net gains are treated as long-term capital gains, but net losses are fully deductible ordinary losses.

Practitioner Note—Net I.R.C. §1231 gains are treated as ordinary income to the extent of unrecaptured net I.R.C. §1231 losses for the 5 most recent prior years. A taxpayer that claimed a net I.R.C. §1231 loss on the 2000, 2001, 2002, or 2003 return and has a net I.R.C. §1231 gain for 2004 must recapture the losses on the 2004 return (if they have not already been used against I.R.C. §1231 gains in earlier years). Losses are to be recaptured in the order in which they occurred. Any current-year I.R.C. §1231 gains in excess of these prior year losses would still receive long-term capital gains treatment. Total gain is unaffected—this provision simply converts gain from capital gains to ordinary income.

I.R.C. §1245 Property

I.R.C. §1245 is one of the depreciation recapture sections. Farm machinery and purchased dairy, breeding, sport, and draft livestock held for the required period and sold at a gain are reported under this section. Gain will be ordinary income to the extent of depreciation and I.R.C. §179 expense deductions. Gain to the extent of depreciation claimed on capitalized preproduction costs is also reported here. Even if a taxpayer elects out of uniform capitalization rules (UCR) and instead uses the ADS method of depreciation, the preproduction costs that would have otherwise been capitalized must be recaptured as ordinary income.

Single-purpose livestock and horticultural structures (placed in service after 1980) are I.R.C. §1245 property. Nonresidential 15-, 18-, and 19-year ACRS property becomes I.R.C. §1245 property if fast recovery (regular ACRS) has been used. Other tangible real property, including silos, storage structures, fences, paved barnyards, orchards, and vineyards, is I.R.C. §1245 property.

I.R.C. §1250 Property

Farm buildings and other depreciable real property held over 1 year and sold at a gain are reported in I.R.C. §1250 unless the assets are I.R.C. §1245 property. If a method other than SL depreciation was used, the gain to the extent of depreciation claimed after 1969 that exceeds what would have been allowed under SL depreciation is recaptured as ordinary income. No recapture takes place when only SL depreciation has been used. A taxpayer may shift such real property to SL depreciation without special consent. In addition, gain to the extent of SL depreciation on I.R.C. §1250 assets sold after May 6, 1997, is called unrecaptured I.R.C. §1250 gain and is taxed at a maximum rate of 25%.

General-purpose farm buildings (including a house provided rent-free to employees) placed in service after 1986 are MACRS 20-year property eligible for 150% DB depreciation. Depreciation claimed that exceeds SL must be recaptured as ordinary income when the buildings are sold. A different MACRS option may be used on a substantial improvement to the original building. If fast recovery has been used on either the building or a substantial improvement to it, gain will be recaptured on the entire building to the extent of fast recovery. Any remaining gain will be capital gain. For residential rental real estate, gain will be recaptured only to the extent that fast-recovery deductions exceed SL on ACRS 15-, 18-, and 19-year property.

Example 15. A general-purpose farm building was purchased in 2002 for $20,000. Regular MACRS was used until the building was sold for $23,000 in 2004. Accumulated depreciation totaled $2,861. Total gain was therefore $5,861, as shown in Table 28. SL depreciation would have been $2,000, so an excess depreciation of $861 would be recaptured as ordinary income. The gain from SL depreciation would be taxed at a maximum rate of 25%. The $3,000 of gain resulting from the sale price exceeding the original cost would be subject to long-term capital gains rates (5% or 15%).

Table 28. Calculation of Total Gain and Tax on Gain

Purchase price	$20,000
Selling price	23,000
Basis ($2,861 accumulated depreciation)	17,139
Gain	5,861
Tax on Gain	
SL depreciation (taxed at maximum rate of 25%)	2,000
Excess depreciation (recaptured at ordinary income rates)	861
Sales price in excess of cost (taxed at long-term capital gains rates)	3,000
	$ 5,861

Note that for corporations, I.R.C. §291(a) increases the ordinary income recapture by 20% of the additional amount that would be treated as ordinary income if the property were subject to the recapture rules for I.R.C. §1245 property. Although corporations do not receive reduced tax rates on capital gain, this provision may impact the tax consequences of an installment sale of I.R.C. §1250 property by a corporation.

I.R.C. §1252 Property

Gain on the sale of land held less than 10 years will be part ordinary and part capital gain when soil and water conservation expenditures have been expensed. If the land was held 5 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 5 years and less than 10, part of the soil and water expenses will be recaptured. The percentages of soil and water conservation expenses subject to recapture during this time period are as follows: sixth year after acquisition of the land, 80%; seventh year, 60%; eighth year, 40%; and ninth year, 20%. Table 29 gives an illustration.

Table 29. Example of Recaptured Gain

Cost of farmland acquired April 1, 1998	$100,000
Soil and water expenses deducted on 1999 tax return	8,000
Price land was sold for on May 15, 2004	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 6 years, so the gain is divided; $8,000 × .80 = $6,400 is ordinary gain, and $30,000 − $6,400 = $23,600 qualifies for capital gains treatment.

I.R.C. §1255 Property

If government cost-sharing payments for conservation have been excluded from gross income under the provisions of I.R.C. §126, the land improved with the payments will come under I.R.C. §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% for each additional year the land is held. There is no recapture after 20 years.

Use of Form 4797 and Form 1040 Schedule D by Farmers

All sales of farm business properties are reported on Form 4797 to separate I.R.C. §1231 gain and loss from ordinary gain and loss. Casualty and theft gains and losses are reported on Form 4684 and transferred to Form 4797. Part III is used to apply the recapture provisions to any business asset held the required holding period and sold at a gain. The ordinary gain is transferred to Part II. The remaining capital gain is transferred to Part I.

If the I.R.C §1231 gains and losses reported on Form 4797 result in a *net gain*, net I.R.C. §1231 losses reported in the prior 5 years must be recaptured as ordinary income by transferring I.R.C. §1231 gain equal to the nonrecaptured losses to Part II. Any remaining gain is transferred to Form 1040 Schedule D and combined with capital gain or loss, if any, from disposition of capital assets. If the I.R.C. §1231 items result in a *net loss*, the loss is combined with ordinary gains and losses on Form 4797 Part II and then transferred to Form 1040.

Livestock Sales

The majority of livestock sales from Northeast farms 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 held 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 Form 1040 Schedule F. Receipts from the sale of "bob" veal calves, feeder livestock, slaughter livestock, and dairy heifers *raised for sale* are entered on Form 1040 Schedule F, line 4. Sales of livestock purchased for resale are entered on line 1 of Form 1040 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 whether sales should be reported on Form 4797 or Form 1040 Schedule F.

Dairy, Breeding, Sport, or Draft Livestock

Dairy cattle raised or purchased to replace or add to the taxpayer's 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 dairy, breeding, sport, or draft purposes are classified into two groups according to length of holding periods:

1. *Cattle and horses held 2 years or more, and other breeding livestock held 1 year or more.* Animals in this group are I.R.C. §1231 livestock, and recent acts did not change these holding periods. Emus and ostriches are currently excluded from the IRS definition of I.R.C. §1231.
2. *Cattle and horses held less than 2 years and other breeding livestock held less than 1 year.* These sales do not meet holding-period requirements.

Most dairy animals will meet the 2-year holding period requirement. Major exceptions are raised young stock sold with a herd dispersal and the sale of cows that were purchased less than 2 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 I.R.C. §1231 Livestock

Sales of I.R.C. §1231 livestock are entered in Part I or Part III of Form 4797. Because Part III is for recapture, purchased I.R.C. §1231 livestock that produce a gain when sold are to be entered in Part III where they are taxed as I.R.C. §1245 property. Sales of raised I.R.C. §1231 livestock that are held for dairy, breeding, sport, or draft purposes are entered in Part I. All purchased I.R.C. §1231 livestock (held the required holding period) that result in a *loss* when sold is also entered in Part I.

Reporting Sales of Livestock Not Meeting Holding-Period Requirements

Dairy, breeding, sport, or draft livestock that are *not held for the required* period, whether sold for a gain or loss, will be entered in Part II of Form 4797. This will include raised cattle that are held for dairy or breeding but sold before they reach 2 years of age and purchased cattle held for dairy or breeding but held for less than 2 years. Tax forms for reporting common farm business property sales are shown in Table 30.

Table 30. Summary of Reporting Most Common Farm Business Property Sales

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

Gifts and Below-Market Sales

If a taxpayer sells an asset at below market value, they in essence have a sale and a gift. A taxpayer should always determine FMV and file the appropriate sale and or gift tax returns. If an individual sells to a family member and the value may be questioned or discounts were used to arrive at the value of the gift or sale, they should file a gift tax return. This is true even if the amount of the gift is below the 2004 annual gift tax exclusion of $11,000 per person. This filing is important because it starts the statute of limitations running. If a gift tax return (with adequate disclosure) is filed, the IRS has only 3 years to challenge the value of the gift. If the taxpayer does not disclose certain gifts in a manner to apprise the IRS of the nature and amount of the gift, the period of limitations is held open indefinitely, and the gift amount may even be added back into an estate tax calculation.

INSTALLMENT SALES

The installment method of reporting may be used by taxpayers (who are nondealers) for the sale of real property or personal property (except for the gain caused by depreciation recapture). Installment sales continue 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. This election is made by simply reporting the total proceeds in the year of sale.

Taxable income from installment sales is computed by multiplying the amount of principal received in any year by the gross profit ratio. The gross profit ratio is gross profit (selling price minus the total of adjusted tax basis, expenses of sale, and recapture gains ineligible for installment reporting) divided by contract price (selling price minus mortgage assumed by buyer, plus any mortgage assumed in excess of adjusted tax basis). Form 6252 is used to report installment sales income. Interest must be charged on the outstanding balance at the published applicable federal rate (AFR), or higher; otherwise, it will be imputed by the IRS. IRS Pub. 225 contains a chapter on installment sales.

Depreciation Recapture

Recaptured depreciation does not qualify for installment sale reporting. That portion of the gain attributed to recaptured depreciation of I.R.C. §§1245 and 1250 property (or ordinary income recapture under I.R.C. §§1252 or 1255) must be excluded from installment sale reporting. I.R.C. §179 expenses also are subject to I.R.C. §1245 recapture. The full amount of recapture is reported as ordinary income in the year of sale regardless of when the payments are received.

Example 16. Frank Farmer sells his raised dairy cows, machinery, and equipment to his son, Hank for $180,000. The cows are valued at $80,000, and the machinery is valued at $100,000. Hank will pay $30,000 down and $30,000 plus interest for 5 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 because prior 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 sales gain on the installment method.

When the sale of I.R.C. §§1245 and 1250 property produces gain in addition to the amount 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 the recapture amount as payments are received.

Related-Party Rules (I.R.C. §453)

The installment sale and 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 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 2 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 2-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.

The resale rule will not 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), and (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% 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 [I.R.C. §§453(g) and 1239].

AMT Issues

Farmers may use the installment method of accounting for AMTI from the disposition of property used or produced in farming. However, other individuals who regularly sell tangible personal property are not able to use the installment method to report income from sales in tax years beginning after August 5, 1998.

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.

The capital gains rules in effect at the time an installment payment is received and reported determine how the gain is taxed. However, a change in the capital gain holding-period requirement after the year of sale would not change a long-term gain to a short-term gain or vice versa.

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 FMV 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 that gain or loss is calculated as the difference between the FMV and the basis of the obligation if the parties are unrelated [I.R.C. §§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, and it no longer requires an AMT adjustment in the year of sale.

Unstated and Imputed Interest Rules

If the installment sale contract interest rate does not provide at least the AFR, part of the principal payment must be treated as 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. See Table 31 for a list of recent AFRs, based on length of term.

Imputed interest rules applicable to certain debt instruments, including installment sales, are covered under I.R.C. §§1274 and 483. There are several special rules and numerous exceptions that complicate the understanding and application of imputed interest rules. Of special interest are the following:

1. All sales and exchanges in which the seller financing does not exceed $4,217,500 (in 2002, indexed thereafter) must have an interest rate of the lesser of 100% of the AFR or 9% (compounded semiannually).
2. All sale-leaseback transactions are subject to rates equal to 110% of AFR.
3. The sale or exchange of the first $500,000 of land between related persons, (brothers, sisters, spouse, ancestors, or lineal descendants) in 1 calendar year, must have the lesser of a stated rate of 6% compounded semiannually or the AFR.
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.
6. The AFR can be the current month's rate or the lower of the 2 preceding months' rates.

Table 31. Recent Applicable Federal Rates (AFR)

Term	Compounding Period	Sept. 2004	Oct. 2004	Nov. 2004
Short-term (<3 yrs)	Annual	2.34%	2.26%	2.37%
	Monthly	2.32%	2.24%	2.35%
Mid-term (3–9 yrs)	Annual	3.84%	3.62%	3.55%
	Monthly	3.77%	3.56%	3.49%
Long-term (>9 yrs)	Annual	5.03%	4.84%	4.70%
	Monthly	4.92%	4.73%	4.61%

Source: `http://www.irs.gov/taxpros/lists/0,,id=98042,00.html`

LEASING OF LAND AND OTHER FARM ASSETS

Production Flexibility Contract (PFC) Payments on Leased Land

The 1996 Farm Bill provides production flexibility contract (PFC) payments to landowners and tenants based on the crop acreage base for the leased land. In general, these PFC payments are divided between the landowner and the lessee according to their respective share of the crop produced. This may induce landowners to shift from a cash rent arrangement to a share lease, to be able to share in the government payments. If the landowner begins to materially participate, then it will affect the landowner's self-employment taxes and social security benefits, because the income would be reported on Form 1040 Schedule F. If the landowner does not meet any one of the material participation tests (*Farmer's Tax Guide*, IRS Pub. 225), then they can report their share of the crop on Form 4835 rather than as cash rent on Form 1040 Schedule E and still not be subject to SE taxes.

Rental Income and Deductions [I.R.C. §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 Form 1040 Schedule E and not included in net earnings from self-employment. Crop and livestock share rents are reported on Form 4835 and flow through to Form 1040 Schedule E. However, there are two exceptions (the second of which is very important to farm operators):

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 the following apply:
   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.
   b. There is material participation by the taxpayer with respect to the agricultural or horticultural commodity.

The IRS (with support from the Tax Court) has taken the position that rent received by a taxpayer for land rented to a partnership or corporation in which the taxpayer materially participates is subject to SE tax (i.e., the material participation of the entity arrangement is wrapped into the lease arrangement). Working for wages as an employee of the farm operation has also been considered as part of the overall arrangement, making the rental payments paid to the employee or landowner subject to SE tax. However, in December 2000, the Eighth Circuit Court of Appeals indicated that fair rental amounts would not be subject to SE tax because there would then be no indication that what would otherwise be compensation was being shifted to rental income. For taxpayers outside the Eighth Circuit, the IRS is not bound by this decision. However, the Eighth Circuit decision could be cited as substantial authority, permitting taxpayers to avoid the imposition of the 20% penalty for the intentional disregard of IRS rules. (Note: In October 2003, The IRS commissioner issued a nonacquiescence notice regarding this court decision.)

The language of I.R.C. §1402 appears to exclude rents paid on farm buildings and improvements from SE tax even if there is an overall arrangement found to be providing for material participation.

Income and expenses from the rental of personal property (not leased with real estate) is reported on Form 1040 Schedule C or C-EZ. Net profit from Form 1040 Schedule C is included in SE income. Material participation is not a factor in classifying income from the rental of personal property that is 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 one to operate the farm as the sole proprietor and to pay SE tax on the entire farm net profit. Paying rent to a spouse for use of the property he or she owns might reduce SE tax.

Although Rev. Rul. 74-209, 1974-1 allows an operator to deduct rent paid to a spouse as a joint owner of business property equal to one-half its fair rental value, more recent IRS rulings and opinions have qualified that ruling. The 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. Note also the issue discussed earlier, which could cause the rental income to be subject of SE tax if the spouse is an employee of the farm and the arrangement can be construed collectively as providing for material participation.

Strategy

If a sole proprietor deducts rental payments made to a spouse for use of his or her jointly owned property, or a farm entity pays land rent to one of its owners, the following precautions are suggested:

1. Make sure there is a formal written and signed rental agreement and an FMV rental rate for buildings separate from farm land, with at least annual payments.
2. Deduct the taxes, interest, and insurance on the rented property on the owner's Form 1040 Schedule E.
3. If payments are made to a spouse, the spouse should deposit the rental income in a separate account and pay his or her tax and interest payments from the account.
4. The farm operator must file Form 1099 for all rent payments made in excess of $600.
5. The landowner must avoid material participation.

Practitioner Note—An IRS determination that land rent is SE income because of material participation from an overall arrangement would not only cause additional SE tax to be paid but could also affect eligibility for social security benefits of those landowners collecting benefits prior to age 65.

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. Therefore any "self-rental" profits cannot be used to allow the deduction of passive losses from other sources.

Valid Tax Lease or Conditional Sales Contract

To determine whether an agreement is a lease or a sales contract, one needs to look at the intent, based upon the facts and circumstances in the agreement. This issue frequently arises when acquiring equipment. Generally, an agreement will be a conditional sales contract rather than a lease for tax purposes if any of the following are true:

1. The agreement applies part of each payment toward an equity interest.
2. The lessee gets title to the property upon payment of a stated amount under the contract.
3. The amount the lessee pays for a short period of time is nearly the amount that would have to be paid to buy the property.
4. The lessee pays much more than the current fair rental value of the property.
5. The lessee can purchase the property at a nominal price compared to the value of the property at the time of purchase.
6. The lessee has the option to buy the property at a nominal price compared to the total amount the lessee has to pay under the lease.
7. The lease designates part of the payments as interest or part of the payments is easy to recognize as interest.

The most common lease arrangement today is the leveraged lease of newly purchased equipment, where a large portion of the purchase price is financed with a loan that is fully amortized by lease payments from the lessee. These leases are used for automobiles, trucks, computers, equipment, and so forth. The IRS will accept these transactions as a valid lease if all the following conditions are met:

1. When the lessee places the property in use, the investment of the lessor must be at least 20% of the cost of the property.
2. The lease term includes all renewal or extension periods at fair rental value at the time of the renewal or extension.
3. No lessee may purchase the property at a price less than its FMV when exercised.
4. Lessee may furnish none of the cost of the property.
5. The lessee may not lend to the lessor any of the money or guarantee indebtedness to acquire the property.
6. The lessor must expect to receive a profit from the transaction.

For cash method taxpayers, the allowable deduction for prepaid lease payments, as a general rule, is limited to the taxable year for the months expired. In the case of *Zaninovich v. Commissioner,* the Court of Appeals ruled that if an expenditure results in the creation of an asset having a useful life that extends substantially beyond the close of the tax year, then that expenditure may not be deductible or may be deductible only in part, for the taxable year made. The Court of Appeals adopted the *1-year rule,* which treats an expenditure as a capital expenditure (buildings, machinery, and equipment) if it creates an asset or secures a like advantage to the taxpayer and has a useful life in excess of 1 year. On the other hand, an expenditure can be deducted in full if the benefit of the payment does not exceed 1 year (e.g., cash rent).

ALTERNATIVE MINIMUM TAX (AMT)

The AMT is a separate but parallel tax system. Its purpose is to impose a minimum tax on high-income taxpayers with so many deductions, exemptions, and credits that their regular income tax is very low or zero. However, more taxpayers may be subject to AMT as personal deductions and nonrefundable credits increase. AMT may be created by adding back certain deductions and exemptions used to compute the regular tax and by disallowing most tax credits.

It is estimated that in 2004, 3.5% of all taxpayers will owe AMT, especially middle-incomers. If the AMT regulations are not changed by 2008, it is estimated that over 25% of taxpayers will be paying AMT.

Corporations with 3-year average annual gross receipts of less than $7.5 million are currently exempt from AMT.

AMT depreciation for pollution control facilities placed in service after December 31, 1998, may be computed using MACRS class lives and the SL method (for regular tax purposes these facilities qualify for 5-year amortization). Prior to TRA 97, longer ADS lives were required.

AMT Rate and Exemption Phaseout

The AMT has a two-tiered 26% and 28% rate system for noncorporate taxpayers. The 26% rate applies to the first $175,000 of AMTI ($87,500 for married filing separately) in excess of the exemption. The 28% rate begins at $175,000 of AMTI. The lower capital gain rates used when computing regular taxes are also used to compute AMT on net capital gains. The exemptions are not indexed. However, the 2003 Act increased the exemption amount for 2003 and 2004. The exemption is phased out at a rate of 25% of AMTI exceeding specific levels, as shown in Table 32. 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.

Table 32. AMT Exemption and Phaseout

Filing Status	Maximum Exemption	AMTI Exemption Phaseout Threshold	Complete Phaseout At
Joint & qualifying widow(er)	$58,000	$150,000	$382,000
Single & heads of household	40,250	112,500	273,500
Married filing separately	29,000	75,000	191,000
Trusts and estates	22,500	75,000	165,000

The AMT exemption for children under age 14 has been increased to the child's earned income plus $5,750 for 2004. This amount is indexed for inflation. The annual exemption cannot exceed $40,250

Alternative Minimum Taxable Income (AMTI)

AMTI is calculated on Form 6251 by starting with Form 1040 taxable income before subtracting personal exemptions. Any NOL carryforward used in calculating the regular tax is added, and itemized deductions disallowed on Form 1040 Schedule A for higher-income taxpayers are now allowed.

Adjustments and Preferences

The first category below contains adjustments treated as exclusions. The AMT from *exclusion* items is not eligible for a credit against the following year's regular tax. The remaining adjustments are *deferral* items and are used in computing AMT credit in future years.

1. Exclusion items are standard deductions or certain itemized deductions from Form 1040 Schedule A, including most medical deductions, miscellaneous deductions subject to the 2% 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 that could be either positive or negative. Preferences treated as exclusion items include certain carryovers of charitable contributions, tax-exempt interest from specified private activity bonds, and excess tax-depletion allowances.
2. The depreciation adjustment is the net difference between accelerated MACRS depreciation and that allowed for AMT. This continues to be a major adjustment item on farm tax returns. However, both the I.R.C. §179 deduction and bonus depreciation are allowed in calculating AMTI. (See a discussion of this topic in the "Reporting Depreciation and Cost Recovery" section.)
3. Adjusted gain or loss from dispositions reported in Form 4797 or Form 1040 Schedule D and Form 4684 that have a different basis for AMT than for regular tax (because of the accumulated depreciation adjustment).
4. Incentive stock option adjustments, passive activity adjustments, AMTI from estates and trusts, tax-exempt interest from private activity bonds.
5. Accelerated depreciation on real and leased property and amortization of certified pollution control facilities placed in service before 1987.
6. Other adjustments may be required for intangible drilling costs, long-term contracts, certain loss limitations, mining costs, patron's distributions, pollution control facilities, research and experimental costs, and tax shelter farm activities.

Related Adjustments

Any item of income or deduction for a regular tax purpose that is based on income (e.g., earned income, AGI, MAGI, or taxable income from a business) must be recalculated based on alternative tax AGI.

Alternative Tax Net Operating Loss Deduction (ATNOLD)

The alternative tax net operating loss deduction (ATNOLD) is the last step in calculating AMTI. The alternate tax NOL is generally limited to 90% of AMTI and is calculated and deducted after all adjustments and preferences have been added in. For an ATNOLD generated or taken as carryforwards in tax years ending in 2001 or 2002, 100% may be deducted against AMTI. The ATNOLD 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 ATNOLD is reduced by the preference items that increased the regular tax NOL.

Form 1045, Application for Tentative Refund can be used to calculate the ATNOLD, providing the adjustments from the preceding list are made.

Tentative Minimum Tax

The minimum tax exemption reduced by the 25% phaseout is subtracted from AMTI before the 26% and 28% rates are applied. Taxpayers with net capital gains from Form 1040 Schedule D apply the appropriate capital gains rates by completing Part IV of Form 6251. However, be aware that the existence of capital gains may trigger AMT on ordinary income by causing the phaseout of the AMT exemption amount. 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 (Foreign Tax Credit).

Example 17. Taxpayer with a Large Net Capital Gain in 2003. Mary and Tom Worker file a joint return in 2004. Their W-2 wage income was $67,800. The stock market had rebounded and on July 1, 2004, they liquidated a large portion of their holdings and have a $316,100 long-term capital gain. Their total income was $382,400. They claimed a $9,700 standard deduction and would have claimed $6,200 of personal exemptions, but they were completely phased out because of income levels. The result was $374,200 of taxable income. See Table 33 for the calculation of their 2004 income tax liability.

Table 33. Regular Tax Calculation

$14,300 × 10% ordinary	$ 1,430
$43,800 × 15% ordinary	6,570
$316,100 × 15% (capital gains rate)	47,415
Total regular tax liability	$55,415

But with the lower tax rates and expanded brackets are Mary and Tom subject to AMT? See Table 34 for the AMT calculation.

Table 34. AMT Calculation

Taxable income before personal exemptions	$374,200
Standard deduction	+9,700
Tentative AMT income	383,900
Less AMT exemption amount	0*
AMT income	383,900
$67,800 × 26% ordinary	17,628
$316,100 × 15% (capital gains rate)	47,415
Total AMT tax liability	$ 65,043

*The $58,000 exemption is completely phased out at this level of total income.

Mary and Tom pay the larger of the two calculations $65,043, which is $9,628 more than the regular tax liability.

Practitioner Note—Even though the long-term capital gains are taxed at the same rate for regular and AMT tax calculations, the benefits of the lower and wider regular income tax brackets of the 2003 Act for ordinary income as well as the standard deduction and personal exemptions are lost when taxpayers are subject to AMT.

The Working Families Relief Act of 2004 provides a technical correction to The Taxpayer Relief Act of 1997. The correction allows AMTI in excess of regular taxable income to be taxed at capital gains rates to the extent capital gains were included in regular taxable income. Tax returns for open years should be reviewed for possible amendment if AMT was paid and capital gains existed. This correction may save tax dollars under somewhat unique fact patterns.

AMT 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 Form 6251.

The limitation on the use of the GBC is calculated on Form 3800, not on Form 6251. The GBC can only be used to reduce regular income tax to the amount of the tentative AMT.

The foreign tax credit is allowed in the calculation of AMT. The 2004 Act extends the relief provisions of the 2002 Act to taxpayers for tax years through 2005 by permitting the personal nonrefundable credits (such as the education credits, dependent-care credit, and saver's credit) to offset both the regular tax and the minimum tax. The 2001 Tax Relief Act made permanent the ability to offset AMT by both the child tax credit and the earned income credit.

The other credits, including investment credit, can be carried forward to the extent that they do not provide a current-year 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 tax on AMTI reduced by the exemption amount exceeds the taxpayer's regular tax. 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. Also, if any credits are limited by tentative AMT, Form 6251 must be filed.

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 because of AMT. The credit means that the taxpayer, in the long run, will not pay AMT on the deferral items.

Part I of Form 8801, Credit for Prior Year Minimum Tax 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 NOL deduction, which is calculated like the ATNOLD except that only the exclusion adjustments and preferences are included. It also requires computation of the minimum foreign tax credit on the exclusion items.

Part II of Form 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, the orphan drug credit, and the electric vehicle credit.

INFORMATIONAL RETURNS

Informational Forms (Often Issued or Received by Small Businesses)

Form 1099-MISC

Form 1099-MISC must be filed by any person engaged in a trade or business, on each nonemployee paid $600 or more for services performed during the year. Rental payments, prizes, awards, and fish purchases for cash must also be reported when one individual receives $600 or more and royalties at $10 or more. Payments made for nonbusiness services are excluded. Payments made to corporations are excluded unless the payment is for legal services of any dollar amount (no $600 threshold). When payments of $600 or more are made to the same individual for services and merchandise, payments for the merchandise can be excluded only if the contract and bill show that a determinable amount was for the merchandise.

Form 1099-INT

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

Form 8300

Form 8300 is filed by the recipient of cash in excess of $10,000 received in the course of a trade or business, within 1 year, in one lump sum or in separate payments, from the same buyer or agent, and in a single or related transaction. Cash includes all currency and specific monetary instruments with a value of less than $10,000 (cashier's checks, bank drafts, traveler's checks, and money orders). The report must be filed within 15 days after receiving $10,000.

Filing Dates and Penalties

The Forms 1099 must be furnished to the person named on the return on or before January 31 and to the IRS with Form 1096, Annual Summary and Transmittal, on or before February 28. There is a single penalty of $15 per information return for failure to file timely returns if filed by March 30 (30 days late), with a $25,000 cap for small businesses. This penalty increases to $30 per return if filed between March 30 and August 1, with a $50,000 cap for small businesses. Returns filed after August 1 or never filed have a $50 penalty per return and a $100,000 cap for small businesses. The penalties are waived if the taxpayer can demonstrate that the Form 1099 error or late filing was due to reasonable cause, and not to willful neglect.

There is a mandatory requirement to use magnetic media or electronic filing if the client has 250 or more informational returns. Taxpayers who ignore this requirement face a $50 penalty per informational return. Waivers for this requirement must be requested on Form 8508, 45 days in advance of the due date of the return. The due date for filing information returns with the IRS is extended to March 31 for returns filed electronically.

SOCIAL SECURITY TAX AND MANAGEMENT SITUATION, AND OTHER PAYROLL TAXES

Planning Pointer—Annual increases in the earnings subject to social security (FICA) and SE taxes continue to place a high priority on exploring opportunities to reduce the burden of these taxes through wise tax management.

The Current Social Security Tax

The social security earnings base increased to $87,900 for 2004. There is no cap on the amount of earnings subject to Medicare tax. FICA and SE-tax percentage rates remain the same as in 2003. The total rate is divided into two components representing the social security and Medicare tax. The maximum 2004 social security tax is $5,449.80 (employer's share), up $55.80 from 2003. See Table 35 for the 2003 through 2005 social security and Medicare tax rates.

Table 35. Social Security Tax Table

Year	Soc. Sec.	Medicare	Soc. Sec.	Medicare	Soc. Sec.	Medicare
2003	87,000	Unlimited	6.20	1.45	12.40	2.90
2004	87,900	Unlimited	6.20	1.45	12.40	2.90
2005	90,000	Unlimited	6.20	1.45	12.40	2.90

[1]Paid by both employer and employee.

Employers use separate social security and Medicare tax withholding tables. Forms 941 and 943 require social security and Medicare taxes to be reported separately. The self-employment tax is calculated on Form 1040, Schedule SE. The SE tax is separated into a social security tax of 12.4% and a Medicare tax of 2.9% for a total tax of 15.3%.

Two Deductions for Self-Employed

1. Self-employed taxpayers receive an adjustment to gross income equal to one-half of SE taxes. 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% from SE income when computing net earnings from self-employment. This is achieved by multiplying total profit from Form 1040 Schedules C 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 $87,900 of SE 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

The optional method allows taxpayers to pay SE tax on two-thirds of gross farm income if gross is below $2,400. Taxpayers with gross farm income in excess of $2,400 may use this optional method and report $1,600 of SE 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 who is 31 or older, to be fully insured, must have 40 quarters of coverage or be currently insured with 20 quarters in the 10 years immediately before disability or death. The earnings required to receive one quarter of credit increased to $900 in 2004 ($920 in 2005). Thus, the optional method will yield only *one* quarter of coverage. This is an important negative change in the coverage for farmers trying to be currently insured under the social security system. Earning $3,600 any time during 2004 will provide four quarters of coverage.

Example 18. Ima Cow has $2,800 of 2003 gross farm income netting only $1,300 of net farm income. He would pay SE tax of $1,300 × .9235 × .153 = $184.00. The optional method would result in $1,600 × .153 = $245 of SE tax and still earn only one quarter of coverage. Ima may realize an additional benefit by using this method and paying the SE tax–that benefit would be an increase of reportable income for the EIC.

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 piecework 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 piecework labor is subject to the $150 rule. The $150 test is applied separately on 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 that hire their children who are less than 18 years old need not pay social security tax or FUTA for children under 21. Wages paid by a parent to a child for domestic service in the home are not covered until the child reaches 21.

Taxation of Social Security Benefits

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% of social security benefits have been in effect for several years. The rules that tax up to 85% of social security benefits for higher-income taxpayers became effective in 1994. Under an agreement between the United States and Canada, signed in 1997 and retroactive to January 1, 1996, the United States or Canadian social security benefits are taxed exclusively in the country where the recipient resides.

The 85% rules apply to single taxpayers, heads of household, married taxpayers filing separately with provisional incomes above $34,000, and married taxpayers filing jointly with provisional incomes above $44,000. Provisional income is MAGI plus 50% of social security benefits. The MAGI 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. Eighty-five percent of the taxpayer's social security benefit
2. The sum of 85% of the excess of the taxpayer's provisional income above the applicable threshold amount plus the lesser of
   - **a.** The amount of social security benefit included under previous law *or*
   - **b.** The amount of $4,500 ($6,000 for married taxpayers filing jointly)

For married taxpayers filing separately, gross income will include the lesser of 85% of social security benefits or 85% of provisional income (i.e., the threshold is $0).

The 50% rules apply to single taxpayers with provisional incomes between $25,000 and $34,000 and to 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 AGI, 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.

Reduction of Benefits

When a person's wage and self-employment earnings exceed the statutory earnings limit, social security benefits of the working beneficiary and dependents are reduced by a percentage of the excess earnings. In 2004 the annual earnings limit for those less than full retirement age is $11,640 ($12,000 for 2005), and for those who have attained full retirement age earnings are now unlimited. The reduction of benefits is one-half of excess earnings when the taxpayer is less than full retirement age. Full retirement age for those born in 1938 is 65 and 2 months, but for those born in 1939 it is 65 and 4 months (see the Social Security Administration Web site for those born in later years).The 2004 cost-of-living increase in benefits was 2.1% (2.7% for 2005).

Retirement Planning Considerations

Although the earnings cap for those workers over full retirement age who are getting social security benefits has eliminated, those under full retirement age still have to stay under $11,640 in earnings in 2004 to avoid a reduction of benefits because of earnings. Usually work done prior to drawing benefits but paid later does not affect benefits. Commissions, sick pay, vacation pay, bonuses, and carryover crops might fall in to the category not to be counted in earned income for social security, but they are taxable for federal tax purposes. Carryover grain sales made by retiring farmers are excluded from reducing social security benefits if both (1) the grain was produced and in storage before or during the first month of benefits, and (2) the grain is sold in the first year after beginning to draw benefits. Remember that this carryover grain sale must be reported on Schedule F and Schedule SE.

The retirement earning test for the year the individual reaches full retirement age is $31,080 per year or $2,590 per month. This test applies only to earnings prior to attaining full retirement age. If the retiree fails the test, $1 in benefits will be withheld for every $3 in earnings above the limit. There is no limit on earnings beginning the month an individual attains full retirement age.

"Nanny Tax" Social Security Domestic Employment Act

This act allows the payment of employment taxes for domestic workers (baby-sitters, yard workers, house cleaners) to be reported on the employer's income tax return. The 2004 wage threshold for reporting and paying social security taxes is $1,400 annually. During 2004, you may exclude from wages up to $100 a month in transit passes given to your employee to commute to your home by public transportation or up to $190 a month in employer provided qualified parking.

Household employers use Schedule H (Form 1040) to report and pay social security, Medicare, FUTA (threshold still $1,000), and withheld income taxes Farmers may treat wages paid to domestic workers under the new $1,400 annually threshold rules rather than the $150 and $2,500 agricultural wage thresholds, by filing Form 1040 Schedule H.

Household employers must include an employer identification number (EIN) on forms they file for their employees, such as Forms W-2 and Form 1040 Schedule H. An EIN can be obtained by completing and filing Form SS-4, Application for Employer Identification Number. Order Form SS-4 by calling (800) TAX-FORM or online at `www.irs.gov`.

The 1995 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.

Preparers' Election for Alternative Identification Numbers

As an alternative to preparers including their own social security number on prepared returns, they may use a preparer ID number (PTIN), obtained by filing Form W-7P. The number, when issued, will begin with a "P" followed by 8 digits with no dashes. New York State also allows use of the PTIN.

Small Firms Will Pay FUTA Less Often

Beginning in 2004 firms can skip quarterly deposit of FUTA until accumulated liability and FICA tax exceed $2,500, the quarterly trigger. Previously, quarterly FUTA deposits were required if FUTA liability exceeds $100 in the quarter, even if other payroll tax thresholds were not met.

NEW YORK STATE INCOME TAX

The New York State 2004 to 2005 Budget Bill was passed in August 2004. The bill included some very minor income tax changes for individuals and businesses compared to the previous year:

- Extension of the alternative fuels credit (Form IT-253) that expired 12/31/03.
- Long term care credit (Form IT-249) increased from10% of the cost of premiums paid to 20% in 2004.
- Nonresidents who sell shares of stock in a cooperative housing corporation in 2004 may have to adjust their 2004 estimated income tax payments.
- Some changes in the New York City earned income credit.
- Empire State film production credit with regulations still pending (application necessary).
- Voluntary (check-off) box for prostrate cancer contributions.
- Postponed reinstatement of the sales tax exemption on clothing under $110 continues through May 31, 2005.
- The designation of empire zones is extended until March 31, 2005.

As a reminder these were the changes in the 2003-2004 budget bill that were covered last year:

- For tax years 2003–2005, the bill *temporarily* added two new personal income tax rates and brackets. The top rate increased from 6.85% in 2002 to 7.7% through 2005. With a one-eight of a percentage decrease in the 7.5% bracket in tax year 2004.
- New personal income tax estimated tax requirements were created for flow-through entities with nonresident members, and for nonresident individuals with sales of real property.
- Increased fees for LLCs expands them to single-member LLCs and accelerates the due date from April 15 to January 30.
- The state sales tax rate was temporarily increased from 4.0% to 4.25% effective June 1, 2003 to May 31, 2005.
- The year-round sales tax exemption was suspended for clothing and footwear for 1 year, and two 1-week exemption periods were given.
- For tax years beginning after 2002 and for property placed in service on or after June 1, 2003, the New York State personal income tax (and corporate franchise tax) is partially decoupled from federal SDA provisions. An exception exists with respect to qualified Resurgence Zone property and qualified New York Liberty Zone property.
- For tax years beginning after 2002, an additional modification is required for sport utility vehicle expensing. The amount deducted on the federal return by a taxpayer (except an eligible farmer) under I.R.C. §179 with a vehicle weight over 6000 pounds will be modified both in the first year and for any recapture amount in federal AGI.

Decouple from Federal Expensing of SUVs

For tax years beginning on or after January 1, 2003, in determining New York AGI, taxpayers, except for eligible farmers, must add to federal adjusted gross income the amount deducted under I.R.C. §179 for a sport utility vehicle that weighs in excess of 6,000 pounds. I.R.C. §179 relates to an election to expense certain depreciable assets used in an active trade or business. An eligible farmer is a taxpayer who qualifies as an eligible farmer for purposes of the New York State farmers' school tax credit.

A modification has been added to allow a subtraction for any recapture amount included in federal AGI pursuant to I.R.C. §179(d) attributable to the federal deduction for a sport utility vehicle as described earlier. The modification may be made only for a vehicle for which the addition modification described above was made in the current year or a prior tax year.

Because the tax law does not contain a provision for depreciation for a sport utility vehicle in lieu of I.R.C. §179, amounts required to be added to federal AGI are not allowed as a deduction in computing New York AGI in subsequent years. As such, the I.R.C. §179 **expense benefit is permanently lost** in computing New York AGI.

Additionally, no modification was made to the Tax Law to adjust any gain or loss for federal income tax purposes upon the subsequent sale or disposition of the property subject to the addition modification. As such, no adjustment is made to the federal gain or loss in computing New York AGI.

Decouple from Federal Bonus Depreciation

Modifications to federal AGI are required for property placed in service on or after June 1, 2003, that qualified for the special bonus depreciation allowance created by the federal *Job Creation and Worker Assistance Act of 2002,* and enhanced by the federal *Jobs and Growth Tax Relief Reconciliation Act of 2003,* and for which this allowance was claimed for federal income tax purposes. These modifications apply to qualified property other than (1) qualified resurgence zone property, and (2) qualified New York Liberty Zone property described in I.R.C. §1400L(b)(2).

For tax years beginning on or after January 1, 2003, for property placed in service on or after June 1, 2003, in computing New York AGI, a taxpayer must add to federal AGI the amount of the depreciation deduction for qualified property allowable under I.R.C. §167. Also, a taxpayer must subtract from federal AGI the depreciation deduction for qualified property allowable under I.R.C. §167 as if the property did not qualify for federal bonus depreciation provisions under I.R.C. §168(k)(2) (i.e., the amount of depreciation that would have been allowed for federal income tax purposes if the property had been acquired on September 10, 2001).

For tax years beginning on or after January 1, 2003, upon disposition of property to which the I.R.C. §612(k) subtraction modification applies, a subtraction modification must be made to reflect the difference in depreciation allowable for federal and New York purposes.

Use Tax Collection Line on New York Tax Forms

The New York State personal and other income tax forms starting in 2003 have a line (56) for taxpayers to report unpaid state and local compensating use tax on purchases made inside or outside New

York State. If you are an individual, estate, or trust that is a **New York resident** for sales and use tax purposes and **you are filing a New York State personal income tax return or fiduciary income tax return,** your sales tax is due on the due date of your income tax return, without regard to any extension of time to file your return. In the instructions, the taxpayers are informed of their legal requirements to remit such use taxes when they have made purchases outside of the state, in person, or through remote means. New York estimates they are losing $1 billion in unrealized tax revenue from the Internet and estimate they can generate approximately $25 million the "Internet use tax" line to these tax forms.

Most tangible personal property is subject to sales or compensating use tax. Some examples are tobacco products, alcohol, candy, clothing, books, electronic equipment, furniture, collectibles, gasoline when purchased without paying the tax, and other items purchased in and out of state. You also may owe additional local tax if you bring property to your locality that you purchased in another locality that has a lower tax rate.

Individual, estate or trust taxpayers that are a New York resident may report and pay their sales or use tax liability on their income tax return for

- Personal purchases;
- Purchases related to royalty activities or rental real estate activities reported in Part I of Federal 1040 Schedule E, and;
- Purchases related to 1040 Schedule C, C-EZ, or F business (not otherwise eligible for exemption) unless the business is registered, or is required to be registered for sales tax purposes.

If you are an individual, estate, or trust that is a New York resident for sales and use tax purposes and **you are not filing a New York State personal income tax return or fiduciary income tax return**, you must pay any sales or use tax you owe by filing Form ST-140, *Individual Purchaser's Report of Sales and Use Tax*, for the period covered by your tax year for federal income tax purposes. Form ST-140 is due on the date your federal income tax return is due, without regard to extensions of time to file. If no federal income tax return is required to be filed, Form ST-140 is due on the date your federal return would have been due, without regard to extensions of time to file. You must report and pay your sales or use tax liability on your ST-140, Individual Purchaser's Report of Sales and Use Tax, on the same items listed above for New York residents.

Practitioner Note—All businesses that are registered, or required to be registered, with the Tax Department for sales tax purposes, must pay their sales and use taxes on their sales tax returns for purchases made by the businesses.

A corporation, partnership, LLC, or limited liability partnership (LLP) operating in New York State that is not registered, or required to be registered for sales tax purposes, must report its sales and use tax liability by filing Form ST-130, *Business Purchaser's Report of Sales and Use Tax.* The tax is due within 20 days of the date of the first taxable use in New York of the tangible personal property or taxable service.

For further questions and answers see New York State Department of Taxation and Finance Pub. 774 (1/04), *Purchaser's Obligations to Pay Sales and Use Taxes Directly to the Tax Department*, and instructions for the specific income tax return of the taxpayer.

Farm Property School Tax Credit

This credit has been extensively taught and included in this manual for the last 7 years. Refer to previous manuals, and for more information on the Farm Property School Tax Credit, see New York State Publications 51 and 51.1 for questions and answers.

A change, in September 2003–a bill was passed in relation to the use of income averaging to determine the income eligibility of growers for the agricultural property tax credit. In their tax year, growers can average their income over a 3-year period to satisfy the two-thirds of income from farming requirement that is needed for the farmer's school tax credit. This will benefit crop farmers whose income declines severely because of adverse weather conditions.

New York State School Tax Relief (STAR)

The New York State school tax relief (STAR) program provides a partial exemption from school property taxes for owner-occupied primary residences. Senior citizen property owners must be 65 years of age or older, as of December 31, 2004, and must provide their 2003 federal or state income tax return, not to exceed $64,650 AGI, reduced by any "taxable amount" from an IRA, or individual retirement annuity (2003 Form 1040 line 34 minus line 15b).

A separate budget bill, Chapter 83 of the Laws of 2002, provides for a cost-of-living adjustment to the maximum income allowed under the enhanced STAR exemption for persons age 65 and over. For applications on the 2005 assessment rolls the maximum 2003 income tax year income limit of $64,650. This amount is indexed annually based on the rate of inflation used to index social security benefits. The taxable status data related to assessment rolls to be completed in 2005 is the applicable income tax year of 2003.

The enhanced STAR senior citizen exemption is a $50,000 exemption from the full value of their property. The eligible senior citizen must apply with the local assessor for the enhanced STAR exemption by March 1, 2005, in most towns. (This is the taxable status date, but deadlines vary, so most taxpayers should apply earlier. In counties where the sales price differential factor is greater than one, the exemption amounts will be adjusted upward.

The basic STAR program is available to all primary residence homeowners, regardless of age. The full value assessment exemption is $30,000 in the school year 2004 to 2005. To be eligible, an owner must own and live in a one-, two-, or three-family residence, mobile home, condominium, cooperative apartment, or farmhouse. Under recent legislation, the exemption for persons with disabilities and limited incomes is subtracted from assessed value before subtracting the STAR exemption.

Income Verification Program

To simplify the application process for seniors eligible for enhanced STAR, an optional Income Verification Program was established. Seniors who are reapplying for enhanced STAR may authorize the assessor to verify their incomes in subsequent years with the state by providing their social security number. To apply for this program this year, eligible seniors will need to submit the STAR Income Verification Program application in addition to their STAR application. Applicants will not have to reapply or submit tax returns thereafter, assuming their income eligibility continues to be verified each year by the state.

New York Tuition Savings Program

A taxpayer may contribute up to $5,000 per year exempt from New York personal income tax to an I.R.C. §529 account to be used for higher education expenses at qualified institutions. Married individuals can each contribute up to $5,000 each year. These contributions are subtracted from a taxpayer's federal AGI in calculating the New York AGI. The interest earned receives tax-free treatment until withdrawn. Nonqualified withdrawals are subject to income tax. New York State contributions to all accounts for any beneficiary are subject to a maximum account balance, which is established annually to reflect the cost of a four-year undergraduate education.

Standard Deductions and Exemptions

The standard deductions and exemptions for 2004, based on tax status, are shown in Table 36.

Table 36. New York State Standard Deductions and Exemptions for 2004

Standard Deduction		2004
Tax status:	Joint (surviving spouse)	$14,600
	Head of household	10,500
	Single	7,500
	Married filing separately	6,500
	Dependent filers	3,000
Exemption		1,000

A New York State exemption is not available for either the taxpayer or the spouse.

Itemized Deductions

Taxpayers who file joint federal returns and separate New York returns must divide itemized deductions 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 New York State returns. Itemized deductions of higher-income taxpayers are subject to limitations and are reduced by the sum of two percentages. The first percentage becomes effective at New York adjusted gross income (NYAGI) levels dependent on the taxpayer's filing status, and the second becomes effective at NYAGI levels above $475,000.

Supplemental Tax for Taxpayers with NYAGI Exceeding $100,000

Taxpayers with NYAGI 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*). The supplemental tax is determined by multiplying the resident's tax table benefit by a fraction. The tax table benefit is the difference between

1. The amount of taxable income in the taxpayer's tax table that is not subject to the highest rate of tax or the second highest rate of tax, multiplied by such rate, and
2. The highest dollar denominator tax of the second highest dollar denominated tax set forth in the tax table

New York Personal Income Tax Rates

There are three separate rate tables for (1) married filing jointly and qualifying widow(er); (2) heads of households and (3) single, married filing separately, and estates and trusts (Table 37). Filing status conforms to federal status except that when the New York resident status of spouses differs, separate returns must be filed.

Starting in the tax year 2003 there were two new upper tax brackets for all taxpayers. After the 6.85% bracket there was a 7.5% and a 7.7% bracket. In 2004, the 7.5% bracket was lowered by 1/8%. These rate increases are scheduled to be eliminated in 2006.

Table 37. New York State Income Tax Table

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	150,000	1,946 plus 6.85% " " " "	40,000
150,000	500,000	9,481 plus 7.375% " " " "	150,000
500,000		35,293.50 plus 7.70% " " " "	500,000

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	125,000	1,492 plus 6.85% " " " "	30,000
125,000	500,000	8,000 plus 7.375% " " " "	125,000
500,000		35,656.25 plus 7.70% " " " "	500,000

Table 37. New York State Income Tax Table (continued)

Single or Married Filing Separately

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	100,000	973 plus 6.85% " " " "	20,000
100,000	500,000	6,453 plus 7.375% " " " "	100,000
500,000		35,953 plus 7.70% " " " "	500,000

New York Sales and Use Tax

Effective June 1, 2003, the New York Sales and Use Tax Rate was increased to 4.25%. This change affected tax collections and payment of taxable sales or deliveries to customers, or if one made taxable uses, within New York State. This increase was applied to all taxable sales and uses in New York State. Please remember that local jurisdictions have their own additional sales and use taxes.

The New York State and local sales and use tax exemption on clothing and footwear for items under $110 was eliminated, and vendors must collect New York State and local sales and compensating use taxes on sales of clothing, footwear, and items used to make or repair such clothing or footwear regardless of the price. Due to legislation enacted in August 2004 these vendors must continue to collect and remit New York State and local sales tax on these items until June 1, 2005. Two 7-day exemption periods were enacted for items under $110. The first was from August 31, 2004, and ended September 6, 2004. The next will be from January 31, 2005, and ending on February 6, 2005. Local jurisdictions have the choice as to tax or not to tax for their respective percentage on clothing and footwear during the year and during these specified tax-free weeks.

New York Earned Income Tax Credit (NY EIC)

An EIC is allowed against New York personal income tax. The New York earned income credit (NY EIC) is 30% of the allowable federal EIC for taxable years. 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. To claim this credit you must complete From IT-215, *Claim for Earned Income Credit.* For more information see Pub 310-NY.

Credit for Child and Dependent Care (NY CDC)

Taxpayers with NYAGI of $25,000 or less are allowed a New York child- and dependent-care (NY CDC) credit of 110% of the federal child- and dependent-care credit whether or not you actually claimed the federal credit. This refundable credit is gradually phased down from 110% to 20% of the federal CDC credit for taxpayers with NYAGIs between $25,000 and $65,000. At $65,000 and over NYAGI, the rate remains at 20% of the federal credit. To claim this credit you must complete Form IT-216, *Claim for Child and Dependent Care Credit.*

Gross Receipts Tax Credit

For tax years ending after January 1, 2000, owners, beneficiaries (estates and trusts) that are owners, partners, or New York S Corporation shareholders of an industrial or manufacturing business (IMB) are allowed a credit against the tax imposed under Article 22 of the tax law. The credit is equal to the sum of the taxes imposed under §§186-a, 186-c, 189, and 189-a of Article 9 of the tax law for gas, electricity, water, and refrigeration used or consumed in New York State, for which taxes were paid or passed through to the IMB during the year. New York State farmers can claim gross receipts taxes paid to their energy suppliers on the New York State DTF-623 tax form. This is a refundable tax credit on taxable years 2000 and thereafter until 2006. Farmers must contact their electric, natural gas, steam, water, or refrigeration suppliers to get the amount of New York gross receipts' tax paid over the current tax year. The business operator should contact their utility suppliers to get a statement of the amount of gross receipts tax paid. Farmers then can claim the IMB credit on their state return as a credit or refund. The credit cannot be carried over. The credit amount transfers from DTF-623 to the appropriate lines on their state return depending on the type of business entity filing. The tax credit is about 2.35% of the electricity expense paid and a little less for natural gas used on the farm. The one-page form and instructions can be downloaded at `http://www.tax.state.ny.us/pdf/2004/misc/dtf623_2004.pdf`. For further information, see New York State Office of Tax Policy Technical Services Division Bulletin TSB-M-00(3)I.

College Tuition Tax Credit/Deduction

For tax years beginning on or after January 1, 2001, full-year resident taxpayers may claim on Form IT-272 either a refundable tax credit or an itemized deduction for qualified college tuition expenses (not room, board, transportation, fees, books, etc.) paid on behalf of the taxpayer, the taxpayer's spouse, or the taxpayer's dependents. You must file Form IT-200 or Form IT-201 to get the credit from Form IT-272. You must file Form IT-201 to get the itemized deduction. The tax benefits are available for *undergraduate*-level study at any qualifying *in-state* or *out-of-state* institution of higher education. The student *does not* need to be enrolled in a degree program to claim either tax benefit.

The itemized deduction is also available to part-year residents and nonresidents. However, the refundable credit is limited to full-year New York State residents.

Qualified institutions of higher education include any institution of higher education as well as business, trade, technical, or other occupational schools that are recognized and approved by the Regents of the University of the State of New York or a nationally recognized accrediting agency or association accepted by the regents, and that provide a course of study leading to the granting of a post-secondary degree, certificate, or diploma.

For purposes of both the credit and deduction, *qualified college tuition expenses* are defined as tuition expenses less refunds, scholarships, or financial aid. It does not matter whether the expenses were paid by cash, by check, by credit card, with borrowed funds, or with funds from a qualified state tuition program. The maximum expense amount is $10,000 per student.

If an eligible student is claimed as a dependent on another person's tax return, only the person who can claim the student as a dependent may claim the credit. If an eligible student is *not* claimed as a dependent on another person's tax return, only the student may claim the credit. However, if you are married and filing separate returns, see the next section, "Spouses Filing Separately."

The maximum amount of qualified college tuition expenses allowed for each eligible student is $10,000, and there is no limit on the number of eligible students for whom you may claim a credit. Full-year New York State residents may claim a refund of any college tuition credit that is in excess of their New York State tax liability.

Spouses Filing Separately

If a taxpayer and spouse are filing separate returns, they can each claim their own credit on a separate Form IT-272. Or, one may claim the college tuition credit and the other may claim the itemized deduction. However, they must each claim their separately computed credit or deduction based only on the amount of qualified college tuition expenses *each has paid* (or was treated as having been paid) for the taxpayer, spouse, or person claimed as a dependent on their separate return. The taxpayer cannot claim a credit or deduction for qualified college tuition expenses that were paid for the spouse's dependent. (These expenses are treated as paid by the spouse for purposes of the credit.)

The refundable credit is calculated as follows:

- For taxpayers with expenses of $5,000 or more, the credit equals the applicable percentage 100% in 2004 of qualified tuition expenses times 4%.
- For taxpayers with expenses of less than $5,000, the credit equals the lesser of the amount spent for qualified tuition expenses multiplied by the applicable percentage or $200.

Applicable percentages of qualified tuition expenses are100% in 2004 and thereafter. In the tax year 2004 the credit will be as shown in Table 38.

Table 38. 2004 College Tuition Credit Ranges

Tuition Expense Range	Credit Range
$0 to $2,500	$ 0 to $100
$2,500 to $ 4,999	$ 100 to $200
$5,000 to $ 10,000	$ 200 to $400

In lieu of claiming the credit, a resident may elect to claim the New York college tuition itemized deduction if he or she itemized deductions on his or her federal return. The deduction is equal to the qualified tuition expense (limited to $10,000) multiplied by the applicable percentage (100% for 2004). Both the credit and the deduction should be calculated to determine which provides the greater tax benefit. Table 38 gives the deduction range for the $0 to $10,000 expense range. You cannot claim both the credit and the deduction. The college tuition itemized deduction is also available to nonresident and part-year resident taxpayers.

The college tuition itemized deduction for comparative purposes is determined by multiplying your tuition expense up to $10,000 by your marginal state income tax rate. Use the worksheet in the instructions to help determine if the college tuition itemized deduction or the college tuition credit offers the greater tax savings. Those who do not itemize will take the tuition credit option.

For more information see `Publication 10-W, FAQs: New York State College Tuition Credit and Itemized Deduction and FAQs: New York State College Tuition Credit and Itemized Deduction.`

Alternative Fuels Credit

You may be able to claim the alternative fuels credit if you or a business of which you are the sole proprietor purchases a new qualified electric, clean-fuel, or qualified hybrid vehicle, converts gasoline-powered or diesel-powered vehicles to alternative-fuel (clean-fuel) use; or invests in new clean-fuel vehicle refueling property. Except for qualified hybrid vehicles, which must have been placed in service in tax years beginning on or after January 1, 2000, this credit applies to property placed in service in tax years beginning after 1997 and before 2005.

The credit is available for both business and personal vehicles registered in New York State. The credit for refueling property is available only when the property is used in a trade or business located in New York State.

Clean-fuel means natural gas, liquified petroleum gas, hydrogen, and electricity. It also means any other fuel that is at least 85%, singly or in combination, methanol, ethanol, any other alcohol, or ether.

Qualified clean-fuel vehicle property is the same as federal qualified clean-fuel vehicle property as defined by I.R.C. §179A(c). This property includes the engine, exhaust components, and fuel storage and delivery components that enable the motor vehicle to use clean fuel, either in the retrofit of an existing vehicle or in a manufacturer's original equipment vehicle. The term *qualified clean-fuel vehicle property* does not include any qualified electric vehicle as defined in I.R.C. §30(c). The original use must commence with the taxpayer, and the vehicle must be acquired for use by the taxpayer and not for resale, although it may be rented or leased.

The maximum credit allowed for electric vehicles is $5,000 per vehicle. The credit for qualified hybrid vehicles is equal to $2,000 per vehicle registered in New York State provided, however, that the same vehicle may **not** qualify for both the qualified hybrid vehicle credit and the clean-fuel vehicle property credit. The maximum credit for clean-fuel vehicle property is $5,000 per vehicle for vehicles with a gross vehicle weight rating of 14,000 pounds or less, and $10,000 per vehicle for all other vehicles. The credit for clean-fuel vehicle refueling property is equal to 50% of the cost of such property. A technical amendment simplifies the sales tax exemption by providing that the "incremental cost" of a qualified hybrid vehicle is fixed at $3,000.

The alternative fuels credit is not refundable. However, any amount of credit or carryover of credit not deductible in the current tax year may be carried over to be deducted for the following year or years.

If you claim the alternative fuels credit on an electric vehicle, a clean-fuel vehicle, qualified hybrid vehicle, clean-fuel vehicle property, or clean-fuel vehicle refueling property, and that vehicle or property is disposed of, modified, or removed from qualified use, you may be required to recapture all or part of the credit you claimed.

To claim this credit, you must complete Form IT-253, *Alternative Fuels Credit.*

Empire Zone Credits

The Empire Zone Program was created to stimulate growth in New York State's economically distressed areas. New York has about 62 empire zones located throughout the state. The various acts provide certain new businesses with tax credits [see New York Tax Law §§14, 15, 16, 606(I)(1), 606(bb), and 606(cc) for additional details]. For information on the zone locations and boundaries, call (800) 782-8369, check the

Web at www.empire.state.ny.us, or look up the information in Publications 26 and 30. In addition, certain taxpayers may be eligible for the qualified empire zone enterprise (QEZE) sales and use tax exemption (see New York memo TSM-M-00(6)S). Some of the empire zone credits are

- **EZ investment tax credit.** A taxpayer is allowed a credit equal to 8% of the cost or other basis of tangible personal property, including buildings and structural components that is acquired, constructed, reconstructed or erected in a designated economic development zone. The credit must be claimed on Form IT-603 for the first taxable year in which the property becomes eligible.
- **EZ employment incentive credit.** This credit is allowed for 3 years following the tax year for which the economic development zone investment tax credit is allowed. The employment incentive credit is 30% of the economic zone investment tax credit. The credit requires that the average number of employees employed in the zone during the tax year is at least 101% of the average number employed during the tax year immediately preceding the year the investment credit was claimed. To claim this credit, you must complete Form IT-603.
- **EZ wage tax credit and zone equivalent area (ZEA) wage credit.** This is a credit for wages paid, other than to general executives for newly created full-time jobs in economic development zones. To claim the EZ credit, you must complete Form IT-601. To claim the ZEA credit, you must complete Form IT-601.1.
- **Economic development zone (EDZ) capital tax credit.** This credit is equal to 25% of the sum of (1) qualified investments or contributions made to one or more EDZ capital corporations established pursuant to §964 of General Municipal Law, and (2) qualified investments in certified zone businesses pursuant to the provisions of §210(19)(3) of the tax law. To claim this credit, you must complete Form IT-602.
- **QEZE credit for real property tax.** This is a credit allowed against personal or business income tax for real property taxes paid on property owned by a QEZE. See updated details in print or on the Web, in New York memo TSB-M-03(4)C and TSB-M-03(3)I Corporation Tax issued June 12, 2003, for details. To claim this credit, you must complete Form IT-604.
- **QEZE sales tax exemption.** QEZEs are granted a 10-year exemption from state sales tax on purchases of goods and services including utilities used predominantly in an empire zone.
- **QEZE tax reduction credit.** QEZEs are allowed a credit against business income tax equal to a percentage of taxes attributable to the zone enterprise. The credit is the product of the benefit period factor, the employment increase factor and the zone allocation factor multiplied by your tax factor. To claim this credit, you must complete Form IT-604.

Green Buildings Credit

This credit allows developers and building owners to deduct from state taxes eligible expenses associated with design, construction, rehabilitation, and maintenance of buildings with high energy efficiency and high environmental standards. Taxpayers must apply to the Department of Environmental Conservation for a credit certificate. The taxpayer will also have to obtain an eligibility certificate issued by a licensed architect or engineer certifying that the project meets certain green building standards. To claim this credit, you must complete Form DTF-630.

Residential Petroleum Tank Replacement Credit

This credit expired December 31, 2003.

Qualified Long-Term Care Insurance Credit

Effective for taxable years beginning on or after January 1, 2002, the long-term care insurance subtraction modification was repealed and replaced with a credit. The credit was increased in 2004 to 20% of the premiums paid during the year for qualified long-term insurance policies. This credit is not refundable for personal income taxpayers, but unused credit can be carried forward. If the amount of the credit allowable for any taxable year exceeds the tax liability for the year, the excess may be carried over to the following year or years and then deducted from the liability for such year or years. The credit is also available to employers who pay premiums for qualifying policies for their employees. Policies that qualified for the credit in the tax year 2001 also qualify for the new subtraction modification. To claim this credit, you must complete Form IT-249.

New York State Investment Credit (NYIC)

The New York State investment credit (NYIC) for individuals is 4% on qualified tangible personal property (and other tangible property used in production, including buildings and structural components) acquired, constructed, reconstructed, or erected on or after January 1, 1987. For corporations, the rate is 5% on the first $350,000,000 of investment credit base and 4% 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 3 years, it will earn 4% NYIC. Highway-use motor vehicles are ineligible for NYIC.

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 SL option is elected. The same is true of 7-, 10-, 15-, and 20-year MACRS property. Non-ACRS/MACRS properties that qualify for NYIC must still be held 12 years.

Excess or unused credit may be carried over to future tax years, but the carryforward period is limited to 10 years. In no event may the credit claimed prior to 1994 be carried over to taxable years beginning on or after 2004. The 1997 bill expanded general business corporations' carryforward period for unused investment tax credits from 10 to 15 years. 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 1 of the first 4 years. A business is new during its first 4 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 NYIC and retail enterprise credit as well as to report early disposition of qualified property.

Employment incentive tax credit (EITC) is available to regular corporations that qualify for NYIC and increases at least 1% during the year. The credit is 1.5% of the investment credit base if the employment increases less than 2%, 2% if the increase is between 2% and 3%, and 2.5% if the increase is 3% or more for each of the 2 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 to the next 7 taxable years.

The EITC and EDZ credit that applies to C corporations was expanded to sole proprietorships, partners of partnerships, shareholders of S corporations, and beneficiaries of estates and trusts. The credits are available to those entities that make investments eligible for the investment tax credit and in the years following the investment during which their number of employees increases.

Historic Barn Rehabilitation Credit

New York taxpayers are allowed a credit (as defined in I.R.C. §47) of 25% of their qualified rehabilitation expenses to restore barns originally constructed before 1936.

For newly constructed or reconstructed agricultural structures, New York's real property Tax Law §483 allows a 10-year property tax exemption from any increase in the property's assessed value resulting from the improvement. See the local assessor or board of assessors to determine eligibility and file an application for exemption. In addition, for those rehabilitated historic barns that do not qualify for the 10-year exemption, there is a district exemption that requires the approval of the local taxing authorities and school district. Again, contact the local assessor for qualification rules and application. The owner cannot receive both the 10-year exemption and this new assessment reduction. To claim this credit, you must complete Form IT-121AT and attach it to Form IT-212. For more information see TSB-M-97(1)I.

New York State Other Miscellaneous Credits

- New York State Household Credit. You can claim this credit right on Forms IT-200, IT-201, and IT-202. For more information see the instructions for your form.
- Resident Credit. If you are a full-year or part-year resident of New York State and part of your income was taxed by another state, Washington, D.C., or by a Canadian province you may claim this credit; to do so, you must complete Form IT-112-R and attach a copy of the other tax return. For more information see form instructions.
- Automated External Defibrillator Credit. To claim this credit, you must complete Form IT-249.
- Employment of Persons with Disabilities Credit. To claim this credit, you must complete Form IT-251. For more information see TSB-M-98(1)I.
- Financial Services Industry Investment Tax Credit. To claim this credit, you must complete Form IT-252. For more information see TSB-M-98(6)I.
- Financial Services Industry Employment Credit. To claim this credit, you must complete Form IT-252-ATT and attach it to your Form IT-252. For more information see TSB-M-98(6)I.

- Fuel Cell Electric Generating Equipment Credit. To claim this credit, you must complete Form IT-255.
- Solar Electric Generating Equipment. To claim this credit, you must complete Form IT-255. For more information see TSB-M-00(2)I and form instructions.
- Low-Income Housing Credit. To claim this credit, you must receive a housing credit allocation from Division of Housing and Community Renewal (DHCR) and complete Forms DTF-625 and DTF-625ATT and DTF-624. For more information see the form instructions or access the DHCR Web site.
- Qualified Emerging Technology Company Employment Credit. To claim this credit, you must complete Form DTF-621. For more information see TSB-M-00(2)I and form instructions.
- Qualified Emerging Technology Company Capital Tax Credit. To claim this credit, you must complete Form DTF-622. For more information see TSB-M-00(2)I and form instructions.
- Resident Credit Against Separate Tax on Lump-Sum Distributions. To claim this credit, you must complete Form IT-112.1 and attach a copy of federal Form 4972 and a copy of the other state tax return. For more information see form instructions.

Filing Fees for LLC and LLPs

Domestic and foreign LLCs that are treated as partnerships for federal income tax purposes, LLPs subject to Article 8-B of the Partnership Law and foreign LLPs that have any income derived from New York sources, are required to file returns with the department and pay a filing fee with the return. Effective for tax years beginning on or after January 1, 2003, the prescribed filing and payment is now due within 30 days of the last day of the tax year.

In addition, effective for tax years beginning in 2003 and 2004, the filing fees imposed have been increased. The amount of the filing fee has been increased to $100 multiplied by the total number of members or partners of the LLC, LLP, or foreign LLP. The minimum amount of the fee has been increased to $500 and the maximum amount of the fee has been increased to $25,000.

Also, effective for tax years beginning in 2003 and 2004, single-member LLCs that have income from New York State sources and are treated as disregarded entities for federal income tax purposes are subject to a return filing requirement and a filing fee. The fee is $100 for each entity. The return and payment are **due within 30 days of the last day of the tax year.**

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%. 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 NOLs are used to reduce minimum taxable income. The NYIC cannot be used to reduce the minimum income tax.

New-Hire Reporting

To facilitate the accurate and prompt determination of child-support obligations, Chapter 81 of the law requires all employers to report to New York State Department of Taxation and Finance identifying information about each newly hired or rehired employee in New York State. Employers have 20 calendar days from the hiring date to provide the employee and employer name, address, and ID numbers (see NYS Notice 97-10). The Immigration and Naturalization Service (INS) Form I-9 is available from (800) 870-3676 or www.ins.gov. Form W-4, for income tax withholding is also available from the IRS or online at www.irs.gov. When accepting a W-4 from a new employee, it is important for the employer to verify the employee's name and social security number. Employers can call SSA at (800) 772-6270 to verify up to five names and social security numbers (electronically up to 200 names).

Information Authorization Form

The New York State Tax Department has a form, similar to the federal Form 8821, Tax Information Authorization. If the taxpayers did not mark the "Yes" box on the filed return, authorizing the Tax Department to discuss their income tax return with the paid preparer who prepared it, the taxpayers may use the DTF-280 to authorize their paid preparer to represent them or receive confidential information relevant to their return. Taxpayers may also use this form to change or revoke the paid preparer's authorization on a previously filed return.

The department's Form DTF-280, Tax Information Authorization, is used to authorize the department to communicate orally or in writing with a designated person other than the taxpayer regarding confidential tax information. This form is not a power of attorney; it does not give the appointee authority to act on the taxpayer's behalf to obligate or bind him or her before the department. Taxpayers should use Form POA-1, Power of Attorney, to designate their legal representative.

Estimated Tax Rules

If you have taxable income from which no taxes are withheld during the year, you may have to pay estimated tax. However, you will not have to pay estimated tax if you meet any of the following qualifications:

- You expect your tax withheld during 2004 to be at least 90% of your total tax due for tax year 2004.
- You expect your tax withheld during 2004 to be at least 100% of your total tax for the 2003 tax year (110% of that amount if you are not a farmer or a fisherman and the New York AGI shown on that return is more than $150,000 or, if married filing separately for 2004, more than $75,000). However, if you did not file a 2003 tax return, or your 2003 tax return did not cover all 12 months, this item does not apply.
- You expect to owe less than $300 of New York State, city of New York, or city of Yonkers tax after deducting tax withheld and credits that you are entitled to claim. The $300 threshold is applied separately against each taxing jurisdiction.

Pass-Through Entity Estimated Payments

Effective for tax years ending after December 31, 2002, every partnership (other than a publicly traded partnership as defined in I.R.C. §7704), LLC that is treated as a partnership for federal income tax purposes, and New York S corporation, that has income from New York sources, is required to pay estimated taxes on behalf of its C corporation partners or members and nonresident individual partners, members, or shareholders on their distributive or pro rata share of the respective entity's income. Estimated tax for nonresident individual partners and shareholders means a partner's or shareholder's distributive share or pro rata share of the entity's income derived from New York sources for the year less the partner's or shareholder's share of certain partnership related deductions allocated to New York State, multiplied by the highest rate of tax under I.R.C. §601 of the tax law for the year (e.g., 7.7% for 2004). Estimated tax for corporate partners means a corporate partner's distributive share of the partnership's income derived from New York sources for the year multiplied by the highest rate of tax under I.R.C. 210.1(a) of the tax law for the year (e.g., 7.5% for 2004). This amount is reduced by the partner's distributive share or shareholder's pro rata share of any allowable credits from the partnership or New York S corporation. For a fiscal-year partnership or New York S corporation, estimated tax payments must be based on the partner's or shareholder's distributive share of partnership or S corporation income for the fiscal year that ends in the calendar year.

The tax law provides for an automatic exception from the estimated tax provisions for partners or shareholders as follows:

- Estimated tax payments are not required for any partner, member, or shareholder whose estimated tax required to be paid for the year by the partnership or New York S corporation is $300 or less; and
- Estimated tax payments are not required for any partner, member, or shareholder if the entity is authorized to file a group return, and the partner, member, or shareholder has elected to be included on the group return.

Additionally, the tax law authorizes the Commissioner of Taxation and Finance to waive the requirement that a partnership or New York S corporation make the estimated tax payments with respect to C corporations and nonresident individuals who meet certain conditions.

Partnerships must file Form CT-2658, Report of Estimated Tax for Corporate Partners, and Form CT-2658-ATT, Attachment to Report of Estimated Tax for Corporate Partners, to make estimated tax payments on behalf of partners that are C corporations. Partnerships and New York S corporations must file Form IT-2658, Report of Estimated Tax for Nonresident Individual Partners and Shareholders, and Form IT-2658-ATT, Attachment to Report of Estimated Tax for Nonresident Individual Partners and Shareholders, to make estimated tax payments on behalf of partners or shareholders who are nonresident individuals. These forms and their instructions have been printed in a packet, CT-2658/IT-2658-P, which can be downloaded at the New York State Web site rather than downloading each form separately.

Real Property Sold by a Nonresident

The personal income tax law has been amended to add a new §663, which requires nonresidents to pay estimated personal income tax on the gain, if any, from sales or transfers of real property located in New York State. The new law applies to transfers of real property occurring on or after September 1, 2003. Nonresidents (individuals, estates and trusts) must file Form IT-2663, Applications for Certification for Recording of Deed and Nonresident Estimated Income Tax Payment Voucher. This form must be filed regardless of whether a gain or loss is computed.

This estimation requires the taxpayer to use an estimated tax rate equal to the highest rate of tax for the taxable year. There are certain exceptions, such as the sale of the taxpayer's principal residence, which qualifies under I.R.C. §121. In the latter case, if the exclusion applies, the nonresident transferor must complete Schedule D on Form TP-584 to certify that they are not subject to the new §663. Also New York State resident individuals, estates, and trusts must also complete Schedule D on Form TP-584 to certify that they are not subject to the provisions of new §663 of the Tax Law. To get copies of the forms or read TSM-M-03(4)I, go to `www.nystax.gov`.

The county clerk is not allowed to record a deed unless the taxpayer has paid any estimated personal tax due, or certifies that such taxpayer is exempt from these requirements.

Payments for New York State Income Tax

The New York Tax Department is now accepting credit cards for payment of personal income tax liabilities and estimated tax payments, which can be made through certain plastic card vendors. The taxpayers pay the convenience fees for this service.

Cornell Income Tax Web Site

Check the Cornell Agricultural and Small Business Finance Web site (`http://agfinance.aem.cornell.edu`) for information on the following:

- Late-breaking tax legislation
- Problems encountered by other Cornell Tax School practitioners
- Tax issues affecting New York State filers
- Dates of next year's Cornell educational schools

HEADS UP ON THE CORPORATE TAX BILL PASSED IN OCTOBER 2004

(Too late to be detailed in this manual, but the bill has provisions that have retroactive dates, dates of enactment, and future year effective dates that affect many taxpayers.)

Benefits for small businesses and farmers:

- A tax deduction for business income from domestic manufacturing and production that includes farming and construction but not restaurants. This is a write-off that is phased in starting at 3% of such income in 2005 and 2006, increasing to 6% in 2007 through 2009 and 9% in years after 2009.
- The I.R.C. §179 increased limits are continued through the year 2007.
- Farm income averaging can be used when figuring the AMT starting in 2004.
- People who fish for a living can use income tax averaging.
- Farmers who sell livestock because of weather can have 4 years rather than 2 to buy replacements tax free, retroactive to the tax year 2002.
- Ethanol tax breaks are extended and there is a new credit for biodiesel fuel.
- Farmers will get money to stop growing tobacco.
- Starting in 2005 the 75-shareholder limit on S corporation goes to 100, and family members can elect to be treated as single owners.

Benefits and losses for individuals:

- During 2004 and 2005 income tax filers can elect to deduct state sales tax using the IRS table in lieu of claiming state income tax.
- Buyers of SUVs and certain vans will have the $102,000 expensing election capped at $25,000 for SUVs with loaded weights between 6,000 and 14,000 pounds. This is effective for property placed in service after the date of enactment.
- For vehicles donated to charity, the donor's deduction will be limited to the amount of the sale's price received by the charity starting January 1, 2005.
- The home-sale exclusion is less beneficial because any personal main residence acquired in a like-kind swap and sold within 5 years of the exchange will not be allowed any gain exclusion. This is effective upon the president signing the bill.

OTHER A.E.M. EXTENSION BULLETINS

EB No	Title	Fee (If applicable)	Author(s)
2004-16	Dairy Farm Business Summary, Southeastern New York Region, 2003	($12.00)	Knoblauch, W., Putnam, L., Kiraly, M., Walsh, J., Hadcock, S. and L. Hulle
2004-15	Dairy Farm Business Summary, Central Valleys Region, 2003	($12.00)	LaDue, E., Karszes, J., Balbian, D., Radick, C., Staehr, A., Maxwell, D. and L. Putnam
2004-14	Dairy Farm Business Summary, Intensive Grazing Farms, New York, 2003	($16.00)	Conneman, G., Grace, J., Karszes, J., Benson, A., Putnam, L., Staehr, A., and J. Degni
2004-13	A New Producer Milk Marketing Contract©: Costs, Risks, Benefits, and Feasibility of a Cooperative Financing Model	($12.00)	Richards, S.
2004-12	Using Crop Insurance: Profiles of 13 farmers who use crop insurance as a risk management tool	($12.00)	Richards, S., Sheils, C., Jacobs, E., Ashton, J., McGonigal, J., and J. Forrett
2004-11	Dairy Farm Business Summary, Western and Central Plain Region, 2003	($12.00)	Knoblauch, W., Putnam, L., Karszes, J., Hanchar, J., Murphy, J. and J. Barry
2004-10	Dairy Farm Business Summary, Northern Hudson Region, 2003	($12.00)	Conneman, G., Putnam, L., Wickswat, C., Buxton, S. and J. Karszes
2004-09	Dairy Farm Business Summary, New York Large Herd Farms, 300 Cows or Larger, 2003	($16.00)	Karszes, J., Knoblauch, W. and L. Putnam
2004-08	Starting An Ag Business? A Preplanning Guide	($7.00)	Richards, S.
2004-07	Doing Business in New York State: Structures and Strategies		Anderson, B., Henehan B. and C. Sullivan
2004-06	A Compilation of Smart Marketing Articles November 2001 - November 2003		Uva, W.
2004-05	Harvesting Change: A Planning Workbook for Apple Growers	($57.00)	Sheils, C. and A. DeMarree

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