

# 2010 FEDERAL REFERENCE MANUAL FOR REGIONAL SCHOOLS



## Income Tax Management and Reporting for Small Businesses and Farms

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## TAX LEGISLATION

### 2010 LEGISLATION

Calendar year 2010 has thus far produced a variety of income tax legislation items but failed to extend many of the popular deductions and credits that have been the focus of legislation in previous years.

Legislation passed from December 2009 through September 2010 that contained income tax provisions includes the following:

- Defense Appropriations Act (Defense Act) enacted December 19, 2009
- Haiti Earthquake Relief Act (Haiti Relief Act) enacted January 22, 2010
- Hiring Incentives to Restore Employment Act (HIRE Act) enacted March 18, 2010
- Patient Protection and Affordable Care Act of 2010 (Affordable Care Act) enacted March 23, 2010
- The Health Care and Education Reconciliation Act of 2010 (Reconciliation Act) enacted March 30, 2010
- Haiti Economic Lift Program Act of 2010 (HELP Act) enacted May 24, 2010
- Preservation of Access to Care for Medicare Beneficiaries and Pension Relief Act of 2010 (Medicare Act) enacted June 25, 2010
- Homebuyer Assistance and Improvement Act of 2010 (Homebuyer Act) enacted July 2, 2010
- Education Jobs and Medicaid Assistance Act of 2010 (EJA) enacted August 10, 2010
- U.S. Manufacturing Enhancement Act of 2010 (MEA) enacted August 11, 2010
- Firearms Excise Tax Improvement Act of 2010 (FETA) enacted August 16, 2010
- The Small Business Job Creation and Access to Capital Act of 2010 (Jobs Act) enacted September 27, 2010

### Defense Appropriations Act (Defense Act)

#### COBRA Subsidy for Unemployed Workers

The COBRA premium subsidy period for unemployed workers was extended to 15 months, and employees terminated through February 28, 2010, were eligible individuals. The COBRA premium subsidy period now terminates no later than 15 months after the first day of the first month for which the premium reduction applies to the individual. Additionally, the eligibility period based on termination of employment was extended through February 28, 2010.

## **The Haiti Earthquake Relief Act (Haiti Relief Act)**

### **Charitable Contributions for Haiti Relief**

Cash contributions made after January 11, 2010, and before March 1, 2010, to provide relief for victims of the January 12, 2010, earthquake in Haiti could be treated as charitable contributions made on December 31, 2009. For calendar-year taxpayers who made contributions for Haitian earthquake relief victims, this act allows them to take a deduction on their 2009 tax returns.

## **Hiring Incentives to Restore Employment Act (HIRE Act)**

### **I.R.C. 179 Expensing**

The new law extends the \$250,000 and \$800,000 thresholds for tax years beginning in 2010. (See the Jobs Act that enhanced the deduction.)

### **Payroll Tax Exemption for Hiring Unemployed Workers**

Employers who hire previously unemployed workers after February 3, 2010, and before January 1, 2011, can qualify for a 6.2% payroll tax incentive that exempts them from the employer's share of social security tax on wages paid to the qualifying workers after March 18, 2010. Effective March 19, 2010, through December 31, 2010.

### **New Hire Retention Credit**

A new general business credit to encourage retention of the new employees will be available on income tax returns for tax years ending in 2011. The employer may claim the credit for each employee who is a qualified employee for purposes of the payroll tax exemption and who remains an employee for 52 consecutive weeks, as long as the employee's pay does not decrease significantly during the second half of the year. The employee's wages (as defined for income tax withholding purposes) for the last 26 weeks of employment must equal at least 80% of the employee's wages for the first 26 weeks of employment. The credit is limited to the lesser of \$1,000 or 6.2% of the wages paid by the employer to the employee during the 52-consecutive-week period. There is no provision for the credit to be carried back, but it may be carried forward. Effective for tax years ending in 2011.

### **Disclosure of Foreign Financial Assets**

Individuals with more than \$50,000 in foreign financial accounts will be required to identify their foreign accounts on their federal income tax returns. Effective for tax years beginning after March 18, 2010.

### **Statute of Limitations on Foreign Asset Reporting**

A 6-year statute of limitations for assessment of tax applies to understatements that are related to foreign assets. Effective for returns filed after March 18, 2010, and for earlier returns where the 3-year statute is still open.



## Foreign Trusts

More foreign trusts may be treated as grantor trusts, and new reporting requirements apply to U.S. owners of foreign trusts. Generally effective March 18, 2010.

## Reporting by Foreign Financial Institutions

Payments to foreign financial institutions will be subject to a 30% U.S. income tax withholding unless the financial institution agrees to comply with new reporting requirements. Effective for payments made after December 31, 2012.

## Payments to Other Foreign Entities

Payments to other foreign entities will also be subject to the 30% withholding requirement. Effective for payments made after December 31, 2012.

## U.S. Source Dividends

Payments to foreign persons that are equivalent to dividends will be treated as dividends. Effective for payments made on or after September 14, 2010.

## Worldwide Allocation of Income

The worldwide interest allocation rules for affiliated groups, which were initially set to take effect in 2009 and then delayed until 2017, have been postponed until 2021.

### Patient Protection and Affordable Care Act of 2010 (Affordable Care Act) and The Health Care and Education Reconciliation Act of 2010 (Reconciliation Act)

## Small Business Health Care Credit

Small businesses may qualify for an income tax credit equal to 35% of the health care premiums they pay for their employees. Both small businesses and tax-exempt organizations qualify for this credit.

**Employers need to meet specific requirements in order to qualify:**

- **Providing health care coverage.** A qualifying employer must cover at least 50 percent of the cost of health care coverage for some of its workers based on the single rate.
- **Firm size.** A qualifying employer must have less than the equivalent of 25 full-time workers (for example, an employer with fewer than 50 half-time workers may be eligible).
- **Average annual wage.** A qualifying employer must pay average annual wages less than \$50,000.
- **Maximum Amount.** The credit is worth up to 35% of a small business' premium costs in 2010. On Jan. 1, 2014, this rate increases to 50% (35% for tax-exempt employers).
- **Phase-out.** The credit phases out gradually for firms with average wages between \$25,000 and \$50,000 and for firms with the equivalent of between 10 and 25 full-time workers.

Both small businesses and tax-exempt organizations will use the new Form 8941 to calculate the small business health care tax credit. The credit reduces the premium amount that is deductible as a business expense. Effective for tax years beginning after December 31, 2009.

### **Additional Student Loan Forgiveness**

The gross income exclusion now extends to amounts received under either the National Health Service Corps loan repayment, state loan repayment, or loan forgiveness programs that are intended to increase the availability of health care services in areas that the state determines are underserved or health professional shortage areas. Effective for tax years beginning after December 31, 2009.

### **Therapeutic Discovery Projects**

Businesses with 250 or fewer employees will be eligible to compete for \$1 billion in nonrefundable investment tax credits or tax-exempt grants for qualified investments in new therapies relating to diseases. Effective for expenditures paid or incurred in 2009 and 2010.

### **Adoption Credit Changes**

The adoption credit is now refundable. The maximum amount of both the credit and the exclusion for employer-provided adoption assistance has increased. Effective for tax years beginning after December 31, 2009.

### **Charitable Hospitals**

To continue to qualify for tax exemption under I.R.C. § 501(c)(3), a charitable hospital organization must meet new requirements related to community health needs assessments; a financial assistance policy; and limitations on charges, billing, and collection. Generally effective March 23, 2010.

### **Medical Expenses for Older Children**

Health coverage provided for an employee's children under 27 years of age is now generally tax-free to the employee. The expanded benefit applies to both workplace and retiree health plans, as well as to self-employed individuals who qualify for the self-employed health insurance deduction on their federal income tax return. Employers with cafeteria plans can permit employees to make pre-tax contributions to pay for this benefit. Effective as of March 30, 2010.

### **Indoor Tanning Services Tax**

An individual who receives indoor tanning services is subject to a 10% excise tax on the amount paid for the tanning services. Effective for services performed on or after July 1, 2010.

### **Nonprescription Drugs**

The cost of over-the-counter medications will no longer qualify as an expense for flexible spending arrangements (FSAs), health savings accounts (HSAs), Archer medical savings accounts (MSAs), and health reimbursement accounts (HRAs). Effective for tax years beginning after December 31, 2010.

### **Nonqualified Medical Account Distributions**

The penalty for nonqualifying distributions from HSAs, and Archer MSAs increases to 20%. Effective for distributions made after December 31, 2010.

## **Simple Cafeteria Plans**

The law includes a provision for simple cafeteria plans. Eligible small employers offering these plans will be treated as meeting the nondiscrimination requirements. The employer will be required to make contributions for all qualified employees, whether or not the employee makes a salary reduction contribution. To qualify, employers must average 100 or fewer employees on business days during either of the 2 preceding years. Effective for tax years beginning after December 31, 2010.

## **Health Insurance Reporting**

Employers will be required to disclose the aggregate cost of the employee's health insurance coverage sponsored by the employer. Effective for tax years beginning after December 31, 2010.

## **1099 Reporting**

Businesses will be required to file an information return for all payments aggregating \$600 or more in a calendar year to a single payee, unless the payee is a tax-exempt corporation. Reporting must include gross proceeds paid for property or services payments. Effective for payments made after December 31, 2011.

## **Medical Expense Threshold**

The threshold for medical expenses used as itemized deductions will increase to 10%, unless the taxpayer or the taxpayer's spouse is at least age 65. Generally effective for tax years beginning in 2013.

## **Executive Compensation**

The deduction for compensation paid by a covered health insurance provider to officers, employees, directors, and other workers or service providers (such as consultants) performing services for or on behalf of a covered health insurance provider is limited to \$500,000. Generally effective for tax years beginning after December 31, 2012.

## **Medicare Part D Subsidy**

The tax-exempt subsidy for employers that maintain prescription drug coverage for retirees who are eligible for Medicare Part D will reduce the employer's deduction for its drug expense. Effective for tax years beginning after December 31, 2012.

## **Unearned Income Medicare Tax**

A 3.8% Medicare tax will be imposed on the net investment income for certain individuals, estates, and trusts. The tax applies when modified adjusted gross income (MAGI) exceeds \$250,000 for joint returns and surviving spouses, \$125,000 for a married filing separately return, and \$200,000 for other filing statuses. For estates and trusts, the tax applies when the income attains the highest tax bracket. Effective for tax years beginning after December 31, 2012.

## **Earned Income Medicare Tax**

An additional 0.9% employee-only Medicare tax will be imposed on wages and self-employment income exceeding \$250,000 for joint returns and surviving spouses, \$125,000 for a married filing separately return, and \$200,000 for other filing statuses. Effective for tax years beginning after December 31, 2012.

## **Health Insurance Requirement**

Most U.S. citizens and legal residents will be required to maintain minimum essential coverage of qualifying health insurance that provides essential health benefits and limits cost sharing. Effective for tax years beginning after December 31, 2013.

## **Premium Assistance Credit**

Individuals who are not covered through an employer health insurance plan may be eligible for a refundable tax credit to help pay for insurance premiums purchased on a state exchange. Effective for tax years ending after December 31, 2013.

## **Free Choice Vouchers**

Employers who subsidize health insurance coverage through an eligible employer-sponsored plan are required to provide qualified employees with a voucher to assist them with purchasing a health plan through a state exchange. Effective for vouchers provided after December 31, 2013.

## **Cafeteria Plan Use for Plans**

Certain small employers may purchase individual health insurance through an exchange using cafeteria plans. Effective for tax years beginning after December 31, 2013.

## **Employer (Penalty) Excise Tax**

Where a large employer does not offer minimum essential coverage for all its full-time employees, offers unaffordable coverage, or offers coverage with benefits that are less than a “bronze-level” plan, the employer will be required to pay an excise tax (a penalty) if any full-time employee is certified as purchasing health insurance through a state exchange and receiving a tax credit or cost-sharing reduction. Effective for months beginning after December 31, 2013.

## **Large Employer Reporting**

Applicable large employers subject to the employer shared responsibility rules and offering employers must report certain health insurance coverage information to both its fulltime employees and to the IRS. Effective for calendar years beginning after December 31, 2013.

## **High-Cost Coverage Tax**

Where the aggregate value of employer-sponsored health insurance coverage for an insured employee exceeds a threshold amount, insurers will be subject to an excise tax. Effective for tax years beginning after December 31, 2017.

### **Preservation of Access to Care for Medicare Beneficiaries and Pension Relief of 2010 (Medicare Act)**

Although the Medicare Act’s main purpose was to reverse a scheduled 21% percent reduction in Medicare reimbursements to doctors, it also includes a collection-related measure that allows the IRS to disclose to the Department of Health and Human Services any amount of delinquent tax debt owed by any applicant attempting to enroll or reenroll as a Medicare provider of services or Medicare supplier.

## **Homebuyer Assistance and Assistance of 2010 (Homebuyer Act)**

### **First-Time Homebuyer Credit**

The new law provided individuals with qualifying purchase contracts a 3-month extension of time, through September 30, 2010, to close on the purchase and still qualify for the credit; however the act did not extend the April 30, 2010 contract date requirement. Effective through September 30, 2010.

### **Prisoner Fraud**

The new law allows the IRS to also disclose information to the head of any state government agency that is responsible for administering prisons. As a fraud prevention measure, I.R.C. § 6103(k) was enacted in response to about 1,300 prisoners' claims for the First-Time Homebuyer Credit. Effective July 2, 2010.

### **Insufficient Funds**

The new law changes the wording of I.R.C. § 6657 from “any check or money order in payment of any amount” to “any instrument in payment, by any commercially acceptable means, of any amount,” thereby clarifying that it applies to electronic funds transfers and other electronic payments. Effective for instruments tendered after July 2, 2010.

## **Education Jobs and Medicaid Assistance Act of 2010 (EJA)**

### **Earned Income Credit**

The new law specifies that, beginning in 2011, the advance payment option for the Earned Income Credit (EIC) will no longer be available. Effective January 1, 2011.

### **Foreign Income Matching Rule**

The new law creates a new matching rule which prevents the separation of creditable foreign taxes from the associated foreign income. Generally effective for foreign income taxes paid or accrued in tax years beginning after 2010.

### **Covered Asset Acquisitions**

The new law specifies that the disqualified portion of a foreign income tax paid or accrued in connection with a covered asset acquisition is ineligible for the Foreign Tax Credit. Generally effective for covered asset acquisitions after 2010.

### **Treaty Income**

The new law applies a separate Foreign Tax Credit limitation for each item that is treated as arising from foreign sources under a treaty obligation, matching the treatment of other entities to that of foreign corporations. Effective for tax years beginning after August 10, 2010.

## **I.R.C. § 956**

The new law states that the amount of foreign taxes that a 10% U.S. shareholder is deemed to pay with an I.R.C. § 956-deemed dividend inclusion is limited to the amount that would be paid on an actual dividend. Effective for acquisitions of U.S. property after December 31, 2010.

## **Foreign Corporation Redemptions**

The new law specifies that the earnings and profits (E&P) of a foreign acquiring corporation will not be reduced in some acquisitions treated as stock redemptions. Effective for acquisitions after August 10, 2010.

## **Interest Expense Allocation**

The new law states that a foreign corporation will be fully treated as a member of an affiliated group for allocating interest expense. Effective for tax years beginning after August 10, 2010.

## **Repeal of 80/20 Rule**

The new law repeals the 80/20 rule so that certain interest and dividend payments will now be subject to the 30% withholding tax on payments to nonresident aliens. Effective for tax years beginning after December 31, 2010.

## **The Small Business Job Creation and Access to Capital Act of 2010 (Jobs Act)**

Several tax provisions in this new legislation affect 2010 and 2011 federal income tax returns. The tax provisions are contained in Title II, the Creating Small Business Jobs Act of 2010 (Jobs Act). The enactment date was September 27, 2010.

The following provisions are among those included in the 2010 Jobs Act.

## **I.R.C. § 179 Deduction**

The maximum deduction for I.R.C. § 179 expensing is increased to \$500,000 for tax years beginning in 2010 and 2011, and the investment limit for beginning the phase-out is increased to \$2,000,000. Over-the-counter computer software continues to be eligible property. A taxpayer may elect to treat up to \$250,000 of the cost of qualified real property (certain leasehold improvement property, restaurant property, and retail improvement property) as qualifying I.R.C. § 179 property. The provision allowing taxpayers to change an election on an amended return is extended through tax years ending before 2012.

## **Additional First-Year Depreciation**

The 50% additional first-year depreciation under I.R.C. § 168(k) is extended (retroactive to January 1, 2010) to property placed in service through December 31, 2010. Furthermore, the I.R.C. § 280F limitation on depreciation of passenger automobiles for which the taxpayer did not elect out of additional first-year depreciation is increased by \$8,000 to \$11,160 for vans and trucks and \$11,060 for other passenger automobiles.

## Listed Property

Cellular telephones and similar equipment, such as personal digital assistants (PDAs), are removed from the I.R.C. § 280F definition of listed property, so that the strict record-keeping rules no longer apply for tax years beginning after December 31, 2009.

## Self-Employed Health Insurance

The I.R.C. § 162(l) income tax deduction for self-employed health insurance may be deducted in calculating self-employment tax for the taxpayer's first tax year beginning after December 31, 2009.

## Business Credit Carryback

The I.R.C. § 39 business credit carryback period for an eligible small business is 5 years for credits arising in the business's first tax year beginning after December 31, 2009. An eligible small business is a sole proprietorship, partnership, or non-publicly traded corporation that did not have more than \$50,000,000 in average annual gross receipts for the prior 3 tax years. Furthermore, these credits may also be used to offset alternative minimum tax.

## Startup Expense Deduction

The maximum deduction under I.R.C. § 195 for startup expenses is doubled to \$10,000, and the phase-out threshold is increased from \$50,000 to \$60,000 for tax years beginning in 2010.

## Roth Accounts

- Government 457(b) plans may establish Roth accounts for employee contributions, beginning in 2011.
- Certain employer plans [401(k), 403(b), and government 457(b) plans] may permit balances in those plans to be rolled over to Roth accounts within those plans, effective immediately upon enactment. Amounts rolled over in 2010 are included in the employee's income in equal amounts in 2011 and 2012, unless the employee elects otherwise.

## Nonqualified Annuities

The holder of a nonqualified annuity (that is, one that is not part of a qualified employer plan) can elect to divide the annuity for purposes of annuitizing a portion of the contract, effective for tax years beginning after December 31, 2010. In applying I.R.C. § 72, a pro-rata share of the investment in the contract is assigned to each portion of the contract.

## S Corporation Built-In Gains

The holding period for S corporation built-in gains is reduced to 5 years for tax years beginning in 2011, if the fifth year in the recognition period precedes the 2011 tax year [I.R.C. § 1374].

## I.R.C. § 1202 Stock

The exclusion of gain on qualified small business (I.R.C. § 1202) stock will be 100% for stock acquired after enactment of the 2010 Jobs Act and before January 1, 2011. The stock must be held for 5 years to be qualifying stock.

## Information Returns (Form 1099)

- Rental property owners will be considered to be in the trade or business of renting property for information return purposes for payments made after December 31, 2010. Therefore, they must file information returns if they pay more than \$600 to a service provider for rental property expenses [I.R.C. § 6041].
- The \$15, \$30, and \$50 tiered penalties for failure to timely file information returns are doubled for returns required to be filed on or after January 1, 2011 [I.R.C. § 6721]. The maximum amounts increase to \$250,000, \$500,000, and \$1,500,000. The intentional failure-to-file penalty increases from \$100 to \$250. I.R.C. § 6722 now includes similar \$30, \$60, \$100, and \$250 per return penalties.

## Tax Shelter Reporting Penalty

The I.R.C. § 6707A penalties for failure to disclose certain tax shelter transactions are decreased, retroactive to January 1, 2007. In general, the penalty is 75% of the tax reduction shown on the return, limited to \$10,000 for an individual taxpayer failing to disclose a reportable transaction (\$50,000 for other taxpayers) and \$100,000 for an individual taxpayer failing to disclose a listed transaction (\$200,000 for other taxpayers). However, the minimum penalty for an individual is \$5,000, and the minimum penalty for other taxpayers is \$10,000.

## PRIOR LEGISLATION

### The American Recovery and Reinvestment Act of 2009

In an attempt to stimulate the economy, Congress passed—and President Obama signed into law on February 17, 2009—the American Recovery and Reinvestment Act (ARRA) of 2009 (Public Law No. 111-5). The major provisions include extensions of the 2008 additional first-year depreciation deduction and increased I.R.C. § 179 expensing, a 5-year net operating loss (NOL) carryback provision for small businesses, a new car sales tax deduction, a 2009 alternative minimum tax (AMT) patch, a new Making Work Pay credit, enhancements to the child tax credit and first-time homebuyer credit, taxpayer-friendly additions to many energy incentives, along with an increased exclusion on gain from the sale of qualified small business stock, and many other items of interest.

### \$250 Economic Recovery Payment

For 2009 only, a one-time payment of \$250 is provided under the new law to individuals on fixed incomes—primarily Social Security recipients, railroad retirees, and disabled veterans. Individuals who qualify for the recovery payment should receive the payment from their respective agency. Retired government workers, who generally are ineligible for Social Security, also will receive the \$250 one-time payment as a refundable credit. The new Making Work Pay credit will be reduced by any of these payments. There is no income cap that applies to this benefit.

### Delayed Recognition of Certain Cancellation of Debt Income

Under prior law, a taxpayer generally had reportable income if his or her debt was canceled or repurchased for an amount less than its adjusted issue price. The amount of cancellation of debt income (CODI) is the excess of the old debt's adjusted issue price over the repurchase price. Certain businesses



are allowed to apply CODI over 10 years (defer tax on CODI for the first 4 or 5 years and recognize this income ratably over the following 5 or 6 taxable years) for specified types of business debt repurchased by the business after December 31, 2008, and before January 1, 2011.

## **Unemployment Compensation**

The new law excludes up to \$2,400 of unemployment compensation from a recipient's gross income, regardless of total income, for 2009 only.

## **Parity for Transit Benefits**

Prior law provided a tax-free fringe benefit that employers could provide to employees for transit and parking. Those benefits were set at different dollar amounts. The new law sets the tax-free benefit employers can provide for transit equal to that allowed for parking. The act sets the limit for both benefits at \$230 per month for 2009, indexes them equally for 2010, and clarifies that certain transit benefits apply to federal employees.

## **Additional First-Year Depreciation**

The new law extends the 50% additional first-year depreciation allowed on qualifying property under the 2008 Economic Stimulus Act. This extension is retroactive to January 1, 2009, and applies to property placed in service through December 31, 2009. The provision regarding the dollar cap for new vehicles placed in service in 2009 continues to be \$8,000 higher for bonus depreciation purposes, effective January 1, 2009.

## **I.R.C. § 179 Expensing**

The 2008 Economic Stimulus Act increased the amount of I.R.C. § 179 expensing for 2008 to \$250,000 and increased the threshold for reducing the deduction to \$800,000. The new law extends the increased 2008 I.R.C. § 179 expensing amounts for tax years beginning in 2009 to those same thresholds. The \$25,000 limit imposed on sport utility vehicles was not affected by this legislation.

## **NOL Carryback**

The NOL carryback period of 2 years for all businesses has been modified for NOLs that were incurred in 2008. The new law allows qualified small businesses (those with average gross receipts of \$15 million or less) the opportunity to extend the maximum carryback period for 2008 NOLs to 3, 4, or 5 years. Fiscal-year taxpayers can apply the extended carryback either to NOLs generated in tax years beginning or ending in 2008. NOLs incurred in 2009 will revert to the carryback period of 2 years, 3 years for a casualty NOL, and 5 years for a farm NOL.

## **Small Business Capital Gains**

Under prior law, I.R.C. § 1202 provided a 50% exclusion for the gain from the sale of certain small business stock held for more than 5 years. The amount of gain eligible for the exclusion is limited to the greater of 10 times the taxpayer's basis in the stock or \$10 million gain from stock in that small business corporation. This provision is limited to individual investments and not the investments of a corporation. The non-excluded portion of I.R.C. § 1202 gain is taxed at the lesser of ordinary income rates or 28%, instead of the lower capital gains rates for individuals. The provision under the new law allows a 75% exclusion for individuals on the gain from the sale of certain small business stock held for more than 5 years. This change is for stock issued after the date of enactment and before January 1, 2011.

## **Sales Tax Deduction**

Eligible purchasers of new vehicles can deduct state and local sales or excise taxes on purchases made between February 16, 2009, and January 1, 2010. Purchases before February 17, 2009, are not eligible for this special deduction. Deductible sales or excise taxes cannot exceed the portion of the tax attributable to the first \$49,500 of the purchase price on any one vehicle. This limit applies to each vehicle individually, where a taxpayer acquires more than one qualifying vehicle. Any newly purchased automobile, whether domestic or foreign made, including cars, light trucks, SUVs, and motorcycles, first used by the taxpayer and weighing no more than 8,500 gross pounds, generally qualifies. Motorhomes also qualify. The deduction is claimed as an addition to the standard deduction or as an itemized deduction. Income phase-outs apply for modified adjusted gross income (MAGI) of \$125,000 for individuals and \$250,000 for married couples with full phase-out at \$135,000 for individuals and \$260,000 for married couples.

## **Extension of AMT Relief**

The new law includes an AMT patch for 2009. The AMT patch for 2008 exemption amounts has been raised slightly for 2009. The 2009 AMT exemption amounts are \$46,700 for singles and heads of households (up from \$46,200 in 2008) and \$70,950 for joint filers and surviving spouses (up from \$69,950 in 2008). In addition, the use of nonrefundable personal tax credits against an individual's regular tax and AMT liability is extended to tax years beginning in 2009.

## **Eliminate Costs Imposed on State and Local Governments by the AMT**

AMT can increase the costs of issuing tax-exempt private activity bonds imposed on state and local governments. Under prior law, interest on tax-exempt private activity bonds was generally subject to AMT. This limits the marketability of these bonds and, therefore, forces state and local governments to issue these bonds at higher interest rates. Last year, Congress excluded one category of private activity bonds (i.e., tax-exempt housing bonds) from the AMT. The act excludes the remaining categories of private activity bonds from the AMT if the bond is issued in 2009 or 2010. The bill also allows AMT relief for current refunding of private activity bonds issued after 2003 and refunded during 2009 and 2010.

## **Making Work Pay Credit**

For tax years beginning in 2009 and 2010, eligible individuals are allowed a refundable credit against income tax in an amount equal to the lower of 6.2% of the individual's earned income or \$400 (\$800 for married couples filing jointly). Earnings from self-employment also qualify to the extent they are taken into account in computing taxable income. The credit will phase out at a rate of 2% for individuals with MAGI that exceed \$75,000 (\$150,000 for married couples) and will be completely phased out for individuals with MAGI of \$95,000 (\$190,000 for married couples). Nonresident aliens, individuals who can be claimed as another taxpayer's dependent, individuals who do not provide a social security number on their returns, and estates and trusts are ineligible for the credit. A reduction in wage withholding went into effect in March 2009 so that eligible taxpayers would receive the benefit of the credit through their paycheck. The credit will be claimed on a new form, Schedule M.

## **Increase in Earned Income Tax Credit**

The act temporarily increases the earned income tax credit (EITC) for working families with three or more children. Under prior law, working families with two or more children currently qualify for an EITC equal to 40% of the family's first \$12,570 of earned income. This credit is subject to a phase-out for working families with adjusted gross income (AGI) in excess of \$16,420 (\$19,540 for married couples filing jointly). The new law increases the EITC to 45% of the family's first \$12,570 of earned income for families with three or more children and would increase the beginning point of the phase-out range for all married couples filing a joint return (regardless of the number of children) by \$1,880.

## **Child Tax Credit**

The new law sets the income threshold at \$3,000 for the refundable portion of the child tax credit for 2009 and 2010, enabling more low-income families to claim the credit.

## **First-Time Homebuyer Tax Credit**

The new law raises the first-time homebuyer tax credit to a maximum of \$8,000 (up from \$7,500) and extends it through November 30, 2009. Furthermore, ARRA 2009 also eliminates any required repayment to the IRS if the taxpayer lives in the home for 36 months. These enhancements apply to purchases of a principal residence by a first-time homebuyer after December 31, 2008. The original first-time homebuyer credit, put into effect in 2008, still governs first-time homebuyer purchases on or after April 9, 2008, and before January 1, 2009. The credit phase-out, for taxpayers with MAGI in excess of \$75,000 and \$150,000 for joint filers, applies to both years.

## **“American Opportunity” Education Tax Credit**

For 2009 and 2010, the act will provide taxpayers with the “American Opportunity” tax credit of up to \$2,500 of the cost of tuition and related expenses paid during the taxable year. Under this enhanced Hope tax credit, taxpayers will receive a tax credit based on 100% of the first \$2,000 of tuition and related expenses (including books) paid during the taxable year and 25% of the next \$2,000 of tuition and related expenses paid during the taxable year. Forty percent of the credit would be refundable. This tax credit will be subject to a phase-out for taxpayers with AGI in excess of \$80,000 (\$160,000 for married couples filing jointly).

## **Computers as Qualified Education Expenses in I.R.C. § 529 Education Plans**

I.R.C. § 529 education plans are tax-advantaged savings plans that cover all qualified education expenses, including tuition, room and board, mandatory fees, and books. The act provides that computers and computer technology are qualified education expenses.

## **Tax Credits for Energy-Efficient Improvements to Existing Homes**

The new law extends the tax credits for improvements to energy-efficient existing homes through 2010. Under prior law, individuals were allowed a tax credit equal to 10% of the amount paid or incurred by the taxpayer for qualified energy-efficiency improvements installed during the taxable year. This tax credit was capped at \$50 for any advanced main air-circulating fan; \$150 for any qualified natural gas, propane, oil furnace, or hot water boiler; and \$300 for any item of energy-efficient building property. For 2009 and 2010, the bill increases the amount of the tax credit to 30% of the amount paid or incurred by the taxpayer for qualified energy-efficiency improvements during the taxable year. The act also eliminates the property-by-property dollar caps on this tax credit and provides an aggregate \$1,500 cap on all property qualifying for the credit. The bill would update the energy-efficiency standards of the property qualifying for the credit.

## **Tax Credits for Alternative Refueling Property**

The alternative refueling property credit provides a tax credit to businesses (e.g., gas stations) that install alternative fuel pumps, such as fuel pumps that dispense E85 fuel, electricity, hydrogen, and natural gas. For 2009 and 2010, the bill would increase the 30% alternative refueling property credit for businesses (capped at \$30,000) to 50% (capped at \$50,000). Hydrogen refueling pumps would remain at a 30% credit; however, the cap for hydrogen refueling pumps will be increased to \$200,000. In addition, the new law increased the 30% alternative refueling property credit for individuals (capped at \$1,000) to 50% (capped at \$2,000).

## **Plug-In Electric-Drive Vehicle Credit**

The act modified and increased a tax credit for each qualified plug-in electric-drive vehicle placed in service during the taxable year. The base amount of the credit is \$2,500. If the qualified vehicle draws propulsion from a battery with at least 5 kilowatt hours of capacity, the credit is increased by \$417, plus another \$417 for each kilowatt hour of battery capacity in excess of 5 kilowatt hours up to 16 kilowatt hours. Taxpayers may claim the full amount of the allowable credit up to the end of the first calendar quarter in which the manufacturer records its 200,000th sale of a plug-in electric-drive vehicle. The credit is reduced in following calendar quarters. The credit is allowed against AMT. The new law also restored and updated the electric-vehicle credit for plug-in electric vehicles that would not otherwise qualify for the larger plug-in electric-drive vehicle credit and provides a tax credit for plug-in electric-drive conversion kits.

## **Incentives to Hire Unemployed Veterans and Disconnected Youth**

Under prior law, businesses were allowed to claim a work opportunity tax credit equal to 40% of the first \$6,000 of wages paid to employees of one of nine targeted groups. The new law created two new targeted groups of prospective employees: (1) unemployed veterans and (2) disconnected youth. An individual would qualify as an unemployed veteran if they were discharged or released from active duty from the U.S. Armed Forces during the 5-year period prior to hiring and received unemployment compensation for more than 4 weeks during the year before being hired. An individual qualifies as a disconnected youth if they are between the ages of 16 and 25 and have not been regularly employed or attended school in the past 6 months.

## **Temporary Small Business Estimated Tax Payment Relief**

The bill reduces the 2009 required estimated tax payments for certain small businesses.

## **Temporary Reduction of S Corporation Built-In Gains Holding Period from 10 Years to 7 Years**

Under prior law, if a taxable corporation converts into an S corporation, the conversion is not a taxable event. However, following such a conversion, an S corporation must hold its assets for 10 years in order to avoid a tax on any built-in gains that existed at the time of the conversion. The act temporarily reduces this holding period from 10 years to 7 years for sales occurring in 2009 and 2010.

## **Advanced Energy Investment Credit**

The new law establishes a new 30% investment tax credit for facilities engaged in the manufacture of advanced energy property. Credits are available only for projects certified by the secretary of treasury, in consultation with the secretary of energy, through a competitive bidding process. The secretary of treasury must establish a certification program no later than 180 days after date of enactment, and may allocate up to \$2.3 billion in credits. Advanced energy property includes technology for the production of renewable energy, energy storage, energy conservation, efficient transmission and distribution of electricity, and carbon capture and sequestration.

## **Long-Term Extension and Modification of Renewable Energy Production Tax Credit**

The new law extends the placed-in-service date for wind facilities for 3 years (through December 31, 2012). The bill would also extend the placed-in-service date for 3 years (through December 31, 2013) for certain other qualifying facilities: closed-loop biomass, open-loop biomass, geothermal, small irrigation, hydropower, landfill gas, waste-to-energy, and marine renewable facilities.

## **Temporary Election to Claim the Investment Tax Credit in Lieu of the Production Tax Credit**

Under prior law, facilities that produce electricity from solar facilities are eligible to take a 30% investment tax credit in the year that the facility is placed in service. Facilities that produce electricity from wind, closed-loop biomass, open-loop biomass, geothermal, small irrigation, hydropower, landfill gas, waste-to-energy, and marine renewable facilities are eligible for a production tax credit. The production tax credit is payable over a 10-year period. Because of current market conditions, it is difficult for many renewable projects to find financing due to the uncertain future tax positions of potential investors in these projects. The act allows facilities to elect to claim the investment tax credit in lieu of the production tax credit.

## **Treasury Department Energy Grants in Lieu of Tax Credits**

Under prior law, taxpayers were allowed to claim a production tax credit for electricity produced by certain renewable energy facilities and an investment tax credit for certain renewable energy property. These tax credits help attract private capital to invest in renewable energy projects. Current economic conditions have severely undermined the effectiveness of these tax credits. As a result, the new law allows taxpayers to receive a grant from the Treasury Department in lieu of tax credits. This grant will operate like the current investment tax credit. The Treasury Department will issue a grant in an amount equal to 30% of the cost of the renewable energy facility within 60 days of the facility being placed in service or, if later, within 60 days of receiving an application for such grant.

## **Repeal Subsidized Energy Financing Limitation on the Investment Tax Credit**

Under prior law, the investment tax credit had to be reduced if the property qualifying for the investment tax credit was also financed with industrial development bonds or through any other federal, state, or local subsidized financing program. The new law repeals this subsidized energy financing limitation on the investment tax credit in order to allow businesses and individuals to qualify for the full amount of the investment tax credit—even if such property is financed with industrial development bonds or through any other subsidized energy financing.

## **Removal of Dollar Limitations on Certain Energy Credits**

Under prior law, businesses were allowed to claim a 30% tax credit for qualified small wind-energy property (capped at \$4,000). Individuals were allowed to claim a 30% tax credit for qualified solar water-heating property (capped at \$2,000), qualified small wind-energy property (capped at \$500 per kilowatt of capacity, up to \$4,000), and qualified geothermal heat pumps (capped at \$2,000). The act repeals the individual dollar caps. As a result, each of these properties would be eligible for an uncapped 30% credit.

## **Addition of Permanent Sequestration Requirement to CO<sub>2</sub> Capture Tax Credit**

In 2008, Congress provided a \$10 credit per ton for the first 75 million metric tons of carbon dioxide (CO<sub>2</sub>) captured and transported from an industrial source for use in enhanced oil recovery, and \$20 credit per ton for CO<sub>2</sub> captured and transported from an industrial source for permanent storage in a geologic formation. Facilities were required to capture at least 500,000 metric tons of CO<sub>2</sub> per year to qualify. The new law requires that any taxpayer claiming the \$10 credit per ton for CO<sub>2</sub> captured and transported for use in enhanced oil recovery must also ensure that such CO<sub>2</sub> is permanently stored in a geologic formation.

## **Treasury Department Low-Income Housing Grants in Lieu of Tax Credits**

Under prior law, taxpayers were allowed to claim a low-income housing tax credit for certain investments made in low-income housing. These tax credits help attract private capital to invest in the

construction, acquisition, or rehabilitation of qualified low-income housing buildings. Current economic conditions have severely undermined the effectiveness of these tax credits. As a result, the bill would allow taxpayers to receive a grant from the Treasury Department in lieu of tax credits. Under this provision, states' housing agencies would receive a grant equal to up to 85% of 40% of the state's low-income housing tax credit allocation in lieu of the low-income housing tax credits they would have received.

### **Clean Renewable Energy Bonds (CREBs)**

The new law authorizes an additional \$1.6 billion of new clean renewable energy bonds (CREBs) to finance facilities that generate electricity from the following resources: wind, closed-loop biomass, open-loop biomass, geothermal, small irrigation, hydropower, landfill gas, marine renewable, and trash combustion facilities. This \$1.6 billion authorization will be subdivided into thirds: one third will be available for qualifying projects of state, local, or tribal governments; one third for qualifying projects of public power providers; and one third for qualifying projects of electric cooperatives.

### **Qualified Energy Conservation Bonds**

The act authorizes an addition \$2.4 billion of qualified energy conservation bonds to finance state, municipal, and tribal government programs and initiatives designed to reduce greenhouse gas emissions. The new law also clarifies that qualified energy conservation bonds may be issued to make loans and grants for capital expenditures to implement green community programs. The act also clarifies that qualified energy conservation bonds may be used for programs in which utilities provide ratepayers with energy-efficient property and recoup the costs of that property over an extended period of time.

### **Industrial Development Bonds (IDB)**

Under prior law, certain manufacturing facilities were eligible for tax-exempt bond financing. I.R.C. § 144(a)(12)(C) specifically limits the definition of a manufacturing facility for the purposes of such financing to facilities that are used in the manufacturing or production of tangible personal property. The act amends the definition of manufacturing facility to any facility used in the manufacturing, creation, or production of tangible or intangible property described in I.R.C. § 197(d)(1)(C)(iii). Intangible property is any patent, copyright, formula, process, design, pattern, knowhow, format, or other similar item. The proposal also clarifies which physical components of a manufacturing facility qualify as "ancillary" and therefore are subjected to a 25% limitation in the amount of bond issuance used to build or reconstruct those components.

### **New Markets Tax Credit**

Under prior law, there were \$3.5 billion of new markets tax credits (NMTC) available for each of 2008 and 2009. The provision increases the available credits to \$5 billion for each of the 2 years.

### **Recovery Zone Bonds**

The new law creates a new category of tax credit bonds for investment in economic recovery zones. The act authorizes \$10 billion in recovery zone economic development bonds and \$15 billion in recovery zone facility bonds. These bonds would be issued during 2009 and 2010. Each state will receive a share of the national allocation based on that state's job losses in 2008 as a percentage of national job losses in 2008 (each state will receive a minimum allocation of these bonds). These allocations will be sub-allocated to local municipalities. Municipalities receiving an allocation of these bonds will be permitted to use these bonds to invest in infrastructure, job training, education, and economic development in areas within the boundaries of the state, city, or county (as the case may be) that has significant poverty, unemployment, or home foreclosures.

## **Tribal Economic Development Bonds**

Under prior law, tribal governments were limited in their ability to issue tax-exempt bonds. Projects funded by bonds issued by tribal governments must satisfy an “essential governmental function” requirement. This requirement is not imposed on projects funded by bonds issued by state and local governments, and can limit the ability of tribal governments to use tax-exempt bonds for economic development. The new law temporarily allows tribal governments to issue \$2 billion in tax-exempt bonds for projects without this restriction in order to spur economic development on tribal lands, and requires the secretary of the treasury to study whether this restriction should be repealed permanently.

## **Modify Speed Requirement for High-Speed Rail Exempt Facility Bonds**

Under prior law, states were allowed to issue private activity bonds for a high-speed rail facility that is a facility for the transportation of passengers between metropolitan areas using vehicles that are reasonably expected to operate at speeds in excess of 150 miles per hour between scheduled stops. The new law allows these bonds to be used to develop rail facilities that are used by trains capable of attaining speeds in excess of 150 miles per hour.

## **De Minimis Safe-Harbor Exception for Tax-Exempt Interest Expense for Financial Institutions**

Under prior law, financial institutions were not allowed to take a deduction for the portion of their interest expense allocable to its investments in tax-exempt municipal bonds. In determining the portion of interest expense that is allocable to investments in tax-exempt municipal bonds, the act excludes investments in tax-exempt municipal bonds issued during 2009 and 2010 to the extent that these investments constitute less than 2% of the average adjusted bases of all the assets of the financial institution.

## **Modification of Small-Issuer Exception to Tax-Exempt Interest Expense Allocation Rules for Financial Institutions**

As described above, financial institutions are not allowed to take a deduction for the portion of their interest expense that is allocable to such institution’s investments in tax-exempt municipal bonds. For purposes of this interest disallowance rule, bonds that are issued by a “qualified small issuer” are not taken into account as investments in tax-exempt municipal bonds. Under prior law, a “qualified small issuer” was defined as any issuer that reasonably anticipates that the amount of its tax-exempt obligations (other than certain private activity bonds) will not exceed \$10,000,000. The new law increases this dollar threshold to \$30,000,000 when determining whether a tax-exempt obligation issued in 2009 and 2010 qualifies for this small issuer exception. The small issuer exception would also apply to an issue if all of the ultimate borrowers in such issue would separately qualify for the exception. For these purposes, the issuer of a qualified I.R.C. § 501(c)(3) bond shall be deemed to be the ultimate borrower on whose behalf a bond was issued.

## **Delay Application of Withholding Requirement on Certain Governmental Payments for Goods and Services**

For payments made after December 31, 2010, the Internal Revenue Code requires withholding at a 3% rate on certain payments to persons providing property or services made by federal, state, and local governments. The withholding is required regardless of whether the government entity making the payment is the recipient of the property or services (those with less than \$100 million in annual expenditures for property or services are exempt). Numerous government entities and small businesses have raised concerns about the application of this provision. The provision would delay for 1 year (through December 31, 2011) the application of the 3% withholding requirement on government payments for goods and

services in order to provide time for the Treasury Department to study the impact of this provision on government entities and other taxpayers.

## **Qualified School Construction Bonds**

The new law creates a new category of tax credit bonds for the construction, rehabilitation, or repair of public school facilities or for the acquisition of land on which a public school facility will be constructed. There is a national limitation on the amount of qualified school construction bonds that may be issued by state and local governments of \$22 billion (\$11 billion allocated initially in 2009 and the remainder allocated in 2010). There is a national limitation on the amount of qualified school construction bonds that may be issued by tribal governments of \$400 million (\$200 million allocated initially in 2009 and the remainder allocated in 2010).

## **Extension and Increase in Authorization for Qualified Zone Academy Bonds (QZABs)**

The act allows an additional \$1.4 billion of qualified zone academy bonds (QZABs) issuing authority to state and local governments in 2009 and 2010, which can be used to finance renovations, equipment purchases, developing course material, and training teachers and personnel at a qualified zone academy. In general, a qualified zone academy is any public school (or academic program within a public school) below college level that is located in an empowerment zone or enterprise community and is designed to cooperate with businesses to enhance the academic curriculum and increase graduation and employment rates. QZABs are a form of tax credit bonds that offer the holder a federal tax credit instead of interest.

## **Tax Credit Bond Option for State and Local Governments ("Build America Bonds")**

The federal government provides significant financial support to state and local governments through the federal tax exemption for interest on municipal bonds. Both tax credit bonds and tax-exempt bonds provide a subsidy to municipalities by reducing the cash interest payments that a state or local government must make on its debt. Tax credit bonds differ from tax-exempt bonds in two principal ways: (1) interest paid on tax credit bonds is taxable; and (2) a portion of the interest paid on tax credit bonds takes the form of a federal tax credit. The federal tax credit offsets a portion of the cash interest payment that the state or local government would otherwise need to make on the borrowing. For 2009 and 2010, the new law provides state and local governments with the option of issuing a tax credit bond instead of a tax-exempt governmental obligation bond. Because the market for tax credits is currently small given current economic conditions, the bill would allow the state or local government to elect to receive a direct payment from the federal government equal to the subsidy that would have otherwise been delivered through the federal tax credit for bonds.

## **COBRA Benefits**

The new law provides a government subsidy for an individual who is involuntarily terminated from employment between August 31, 2008, and January 1, 2010. A qualifying individual may pay 35% of their COBRA coverage and have the remainder paid by their former employer. Employers receive a credit against payroll taxes on Form 941 for the remaining 65% paid. Income phase-out applies to taxpayers with MAGI in excess of \$125,000 (\$250,000 for joint filers).



## **The Children's Health Insurance Program Reauthorization Act (CHIPRA) of 2009**

The Children's Health Insurance Program Reauthorization Act (CHIPRA) of 2009 (enacted February 4, 2009) amended the estimated tax rules to require corporations with at least \$1 billion in assets to pay an increased estimated amount for the payment due in July, August, or September 2013. The payment was to be 120.25% of the amount otherwise due for that quarter to avoid the penalty imposed by I.R.C. § 6655.

## **The Corporate Estimated Tax Shift Act (CETSA) of 2009**

The Corporate Estimated Tax Shift Act (CETSA) of 2009 (enacted July 28, 2009) repealed TIPRA § 401 and all amendments to it for any installment of corporate estimated tax that is due after December 31, 2009. This includes the CHIPRA amendment. Corporations with at least \$1 billion in assets (determined at the end of the prior tax year) are required to pay 100.25% of the otherwise required amount of the estimated tax payment due in July, August, or September 2014. The next required installment is reduced to reflect the amount of the increase.

## **The Economic Stimulus Act (ESA) of 2008**

### **Enhanced I.R.C. § 179 Expense Deduction**

#### **Effective for tax years beginning in 2008**

For tax years beginning in 2008, the maximum total expenditure qualifying for an I.R.C. § 179 expensing election was scheduled to be \$128,000, reduced dollar-for-dollar if the taxpayer placed in service more than \$510,000 in qualifying property during the tax year. The \$128,000 and \$510,000 amounts have been increased to \$250,000 and \$800,000, respectively, for tax years beginning in 2008. (ARRA 2009 extended this provision through 2009.)

### **Additional First-Year Depreciation (50% Bonus Depreciation)**

A bonus depreciation deduction equal to 50% of adjusted basis is allowed for qualified property placed in service after December 31, 2007, and before January 1, 2009. The deduction is allowed for both regular tax and AMT purposes, and the amount of the deduction is not affected by a short tax year. A taxpayer may elect out of the bonus depreciation for any class of property for any tax year. (ARRA 2009 extended this provision through December 31, 2009.)

#### ***Election Out***

Taxpayers have the opportunity to elect out of the bonus depreciation. The election must be made by the due date, including extensions, of the return for the year the qualifying property was placed in service. The election out of bonus depreciation applies to all assets in the same class that are placed in service in the same tax year. Fiscal-year taxpayers will have 2 tax years in each calendar year affected by this provi-

sion to make the election out of bonus depreciation and can make different elections for each period. If the election out is not made, depreciation for the qualifying property must be calculated as if the bonus deduction had been claimed.

### **Qualifying Property**

Property must meet all five of the following requirements to qualify for the 50% bonus depreciation:

1. The original use of the property must commence with the taxpayer. Property that was previously used by another taxpayer does not qualify.
2. It must be one of four types of property:
  - a. a. MACRS (modified accelerated cost recovery system) property with a recovery period not exceeding 20 years
  - b. b. Off-the-shelf computer software—software that is readily available for purchase by the general public, is subject to a nonexclusive license, and has not been substantially modified (3-year property)
  - c. c. Qualified leasehold improvements—generally, improvements made to an interior part of nonresidential building by either the lessee or the lessor (who must be unrelated to the lessee), if the building was placed in service by anyone more than 3 years earlier and the improvements do not benefit a common area (15-year property)
  - d. d. Water utility property that is either a municipal sewer or 20-year property that is an integral part of the gathering, treatment, or commercial distribution of water
5. The taxpayer must either purchase the property or enter into a binding contract to purchase it during calendar year 2008 (extended through 2009). If a taxpayer manufactures, constructs, or produces property for its own use, the manufacture, construction, or production must begin during calendar year 2008. Property does not qualify if there was a binding contract to acquire it before January 1, 2008.
6. The property generally must be placed in service during calendar year 2008 (extended through 2009). The placed-in-service deadline is extended through 2009 for some property with a recovery period of 10 years or longer and transportation property, but only the portion of basis attributable to progress expenditures made during 2008 qualifies for bonus depreciation.
7. Use of the alternative depreciation system (ADS) must not be required for the property.

### **Effect on I.R.C. § 280F Limit**

#### **Generally effective for new property placed in service in calendar year 2008**

The current I.R.C. § 280F deduction limitation of \$2,960 for cars placed in service in 2008 has been increased by \$8,000 to \$10,960 where the taxpayer utilizes the 50% bonus depreciation, and the \$3,160 limitation for trucks and vans has been increased to \$11,160. (ARRA 2009 extended this \$8,000 increase to the I.R.C. § 280F limit through December 31, 2009.)

### **The Heartland, Habitat, Harvest, and Horticulture Act of 2008**

The Heartland, Habitat, Harvest, and Horticulture Act of 2008, better known as the Farm Bill or the Farm Act, addresses a wide range of issues that affect agriculture, including farm programs, environmental initiatives, nutrition, credit, commodity markets, and trade.

## **Farmers' Optional Method for Self-Employment (SE) Tax**

### **Effective for tax years beginning after December 31, 2007**

The Farm Bill amended I.R.C. § 1402(a) by replacing \$1,600 each place it appears with the term “the lower limit.” The *lower limit* is defined as the amount required for earning four quarters of coverage under the Social Security Act (\$4,200 in 2008 and \$4,360 in 2009). The bill also replaces \$2,400 each place it appears in I.R.C. § 1402(a) with the term “the upper limit” and defines that as 150% of the lower limit. Consequently, as the amount required for one quarter of coverage increases, taxpayers who elect the optional method of paying self-employment (SE) tax will acquire four quarters of coverage. Therefore, beginning in 2008, the two circumstances in which farmers can elect the optional method of paying SE tax are as follows:

1. If their gross farm income is not more than the upper limit (\$6,300 for 2008 and \$6,540 for 2009), they can elect to pay SE tax on two-thirds of their gross farm income.
2. If their gross farm income is greater than the upper limit (\$6,300 for 2008 and \$6,540 for 2009), and their net farm profit is less than the result of dividing the lower limit by 0.9235 [\$4,548 for 2008 ( $\$4,200 \times 0.9235$ ) and \$4,721 for 2009], they can elect to pay SE tax on net earnings equal to the lower limit (\$4,200 for 2008 and \$4,360 in 2009).

## **SE Tax**

### **Effective for tax years beginning after December 31, 2007**

The nonfarm optional method is modified so that electing taxpayers can secure up to four credits of social security benefit coverage each tax year.

The \$1,600 prior-law figure is replaced by a lower limit equal to the dollar amount needed to earn four quarters of coverage for the tax year, and the \$2,400 figure is replaced by an upper limit equal to 150% of the lower limit. The \$1,733 pre-2008 law figure is replaced by the lower limit divided by 0.9235. For 2008, the lower limit is \$4,200, the upper limit is \$6,300, and the \$4,200 lower limit divided by 0.9235 is \$4,548. For 2009, the lower limit is \$4,360, the upper limit is \$6,540, and the \$4,360 lower limit divided by 0.9235 is \$4,721.

## **Conservation Easements**

### **Effective for contributions in tax years beginning after December 31, 2007, and before January 1, 2010**

The Farm Bill changes the expiration date of the enhanced deduction from the end of 2007 to the end of 2009. Therefore, taxpayers can claim the enhanced deduction for easements granted in 2008 and 2009 as well as in 2006 and 2007.

## **Conservation Reserve Program**

### **Effective for Conservation Reserve Program (CRP) payments made after December 31, 2007**

The Farm Bill amends I.R.C. § 1402(a)(1) by adding CRP payments made to individuals who are receiving social security retirement, survivor, or disability payments to the SE exclusion for rent from real estate. Under the new provision, CRP payments to taxpayers who are receiving specified social security payments are not included in net earnings from self-employment. The taxpayer's participation in the maintenance of the CRP land or a farming business is not considered. CRP recipients who are not receiving social security payments are not protected by the new legislation from paying SE tax on their CRP payments. However, this act could affect the treatment of their CRP payments by implication.

## **Commodity Credit Corporation Transactions**

**Effective for loans repaid after December 31, 2007**

The Farm Bill codifies the Form 1099-G reporting requirement of IRS Notice 2007-63.

## **Limitation on Farming Losses**

**Effective for tax years beginning after December 31, 2009**

Beginning in 2010, the Farm Bill limits the amount of farming losses that some taxpayers may use to offset nonfarm income to the greater of two amounts:

1. \$300,000 (\$150,000 for married individuals filing a separate return)
2. The total net farm income received over the last 5 years

Losses that are limited in a particular year may be carried forward to subsequent years and treated as a deduction attributable to farming businesses that year.

This provision applies only to taxpayers other than C corporations who receive CCC loans or direct or countercyclical payments under Title 1 of the Farm Bill. For purposes of this provision, the Farm Bill broadens the definition of *farming business* to include the processing of commodities without regard to whether the activity is incidental for a taxpayer who is otherwise engaged in a farming business with respect to the commodities. This loss limitation is applied before the passive loss rules under I.R.C. § 469.

## **Racehorse Depreciation**

Effective for property placed in service after December 31, 2008, and before January 1, 2014

The Farm Bill creates a uniform recovery period of 3 years for all racehorses that are placed in service in calendar years 2009–2013. It does not change the recovery period for work or breeding horses.

## **Agricultural Bonds**

**Effective for bonds issued after May 22, 2008**

The Farm Bill improves Aggie Bonds by

1. Increasing the loan limit from \$250,000 to \$450,000 and indexing that limit amount for inflation
2. Eliminating the dollar limitation in the definition of substantial farmland

## **Endangered-Species Recovery Deduction**

**Effective for expenditures paid or incurred after December 31, 2008**

The Farm Bill expands I.R.C. § 175 to allow a tax deduction for costs incurred in 2009 and later years to implement site-specific management measures included in recovery plans under the Endangered Species Act. The total deduction is still limited to 25% of gross income from farming.

## **Ethanol Excise Tax Credit**

**Effective after May 22, 2008**

The Farm Bill reduces the 51¢-per-gallon incentive for ethanol to 45¢ per gallon for calendar year 2009 and thereafter. If the Treasury Department determines (in consultation with the Environmental Protection Agency) that 7.5 billion gallons of ethanol (including cellulosic ethanol) were not produced in or imported into the United States in 2008, the reduction in the credit amount will be delayed. If the threshold was not reached in 2008, the reduction for 2010 also will be delayed if the Treasury Department determines that 7.5 billion gallons were not produced or imported in 2009.

### **Corporate Tax Rate Reduction**

The Farm Bill provides a 15% tax rate for corporations on the portion of a corporation's taxable income that consists of qualified timber gain (or, if less, the net capital gain) for a tax year. The alternative 15% tax rate applies to both the regular tax and the AMT. Qualified timber gain is the net gain described in I.R.C. §§ 631(a) and (b) for the tax year, determined by taking into account only trees held longer than 15 years.

The corporate tax rate provision applies to tax years ending after May 22, 2008, and beginning no later than May 22, 2009.

## **The Heroes Earnings Assistance and Relief Tax Act**

### **Combat Pay**

Nontaxable combat pay may continue to be treated as earned income for the earned income credit for 2008 and all future years.

### **Health Care Flexible Spending Account Withdrawals**

Reservists called to active duty for at least 180 days can withdraw funds from their civilian employer's health care flexible spending account for any purpose without payment of a penalty.

### **Penalty-Free Withdrawals**

Reservists called to active duty for at least 180 days may continue to make penalty-free withdrawals from tax-advantaged retirement plans. They may make an after-tax contribution to an IRA within 2 years after the end of the active-duty period to replenish their retirement savings. The repayment is limited to the amount withdrawn as a qualified reservist distribution.

### **Military Death Benefits**

Survivors who receive military death benefits may contribute the full amount to a Roth IRA or a Coverdell education savings account (ESA). Although the death benefit is tax-free, it is treated as basis in the Roth IRA or the Coverdell ESA.

### **Survivor Benefit Enhancement**

Qualified retirement plans must be amended to enhance survivor benefits for employees who die while they are absent for qualified military service. The survivors should receive the benefits that would be payable if the employees returned to work before dying.

### **Military Service Death or Disability**

Qualified retirement plans may be amended to treat a former employee who left for qualified military service, but who cannot be reemployed because of death or disability resulting from the military service, as if the individual had been rehired on the date before death or disability and terminated employment on the date of death or disability.

## Emergency Responders

### Effective for tax years beginning in 2008, 2009, and 2010

Members of qualified volunteer emergency response organizations may exclude from their income both of the following amounts:

- Qualified state or local tax benefits
- Qualified reimbursement payments

A *qualified state or local tax benefit* is a reduction or rebate of qualified taxes granted to individuals who provide volunteer services as members of a qualified volunteer emergency response organization. The qualified taxes can be state or local income taxes, state or local real property taxes, and state or local personal property taxes.

A *qualified reimbursement payment* is a payment provided by a state (or a political subdivision of a state) as a reimbursement for expenses incurred in performing services as a member of a qualified volunteer emergency response organization. The exclusion for these payments is limited to \$30 times the number of months in the year that the taxpayer performs the services.

A *qualified volunteer emergency response organization* is a volunteer organization that meets two requirements:

1. It is organized and operated to provide firefighting or emergency medical services.
2. There is a written agreement with a state or political subdivision requiring the organization to furnish firefighting or emergency medical services in the area.

A volunteer's potential itemized deduction for state or local taxes is reduced by the excluded tax rebate or reduction. A volunteer's potential charitable deduction for out-of-pocket expenses is reduced by the excluded reimbursements.

## Peace Corps Volunteers and Intelligence Community

### Effective January 1, 2008, for Peace Corps

### Effective June 18, 2008, for the intelligence community

For sales of a principal residence after 2007, Peace Corps volunteers also may elect to suspend the 5-year test period. If the election is made, the 5-year period ending on the date of the home is sold or exchanged does not include up to 10 years of time during which the taxpayer or spouse served as a Peace Corps volunteer.

For sales after June 17, 2008, members of the intelligence community may elect the suspension for qualified extended-duty absences that do not require them to move outside of the United States. The election provision is also made permanent.

## State Bonuses

### Effective for all years

I.R.C. § 134 is amended to provide that gross income does not include bonuses paid by state or local governments to active or former military personnel or their dependents because of service in a combat zone. The provision is effective for all prior years, as well as the current tax year and future tax years. Amended returns can be filed for any open years, but no window was included for amending returns for which the refund statute of limitations is already closed.

## Differential Wage Withholding

**Effective January 1, 2009**

For remuneration paid after December 31, 2008, *differential wage payments* are included in the definition of wages for federal income tax withholding requirements.

A differential wage payment is a payment that meets two criteria:

1. It is made by an employer for a period of time when the individual is serving on active duty in the U.S. uniformed services, if the active duty service period exceeds 30 days.
2. It represents all or a portion of the wages that the service member would have received if he or she were performing services for the employer.

The differential wage payments must also be treated as compensation when determining qualified retirement plan benefits and contributions, and they qualify as wages for IRA contribution purposes.

## Credit for Differential Wages

**Effective for payments after June 17, 2008, and before January 1, 2010**

Eligible small-business employers may take an income tax credit equal to 20% of the eligible differential pay they disburse to qualified employees after June 17, 2008, and no later than December 31, 2009.

An eligible small-business employer averages fewer than 50 employees per business day for the tax year. Taxpayers under common control are aggregated for purposes of determining whether a taxpayer is an eligible small-business employer.

- The employer must have adopted a written plan that provides eligible differential wage payments to every qualified employee.
- A qualified employee must have worked for the employer for at least 91 days immediately preceding the active-duty period for which the differential wage payment is made.
- The eligible differential wage payments are limited to \$20,000 per employee per year.
- The employer must comply with the federal law employment and reemployment rights of members of the uniformed services. If a U.S. district court determines that the employer has violated those rules, the credit is barred for a 3-year period.

The employer's compensation deduction is reduced by the amount of compensation equal to the credit, and the amount of any other wage credit otherwise allowable for compensation paid to the employee must be reduced by the differential wage payment credit allowed for that employee's compensation. The differential wage payment credit is part of the general business credit and is subject to the rules applicable to business credits, including carryovers. The credit can reduce regular income tax liability only to the extent the regular tax exceeds the tentative minimum tax. Consequently, it cannot reduce AMT liability.

## American Employer

**Effective for services performed after July 31, 2008**

Effective for service performed in August 2008 and later, a foreign employer who is controlled by a domestic corporation is treated as an American employer for wages paid to employees who are performing services in connection with a U.S. government contract. The contract can be between the United States (or an instrumentality of the United States) and any member of a domestically controlled group that includes the foreign employer. Thus, wages paid for services performed for the foreign employer outside the United States by an employee who is a U.S. citizen or resident are subject to FICA taxes if they are performed in connection with a government contract.

The I.R.C. § 1563(a)(1) definition of a controlled group of entities generally applies, but the ownership threshold is 50% rather than 80%, and partnerships and other noncorporate entities may be considered members of a controlled group.

Wages exempted from FICA taxes because of a totalization agreement are still exempt under the new law. In addition, FICA taxes will not apply if the employer establishes to the satisfaction of the Treasury secretary that the compensation is subject to a foreign tax that is substantially equivalent to FICA. A tax is substantially equivalent to FICA only if it is imposed on wages at a rate equivalent to at least 80% of the combined 15.3% employer/employee FICA rate.

The domestic parent is jointly and severally liable with its foreign subsidiary for payment of the FICA tax, but the parent is not permitted to deduct any amount of the tax that it pays.

## **Failure-to-File Penalty**

### **Effective for returns due in 2009 and later**

Effective for tax returns required to be filed after December 31, 2008, the minimum penalty for failure to file a tax return within 60 days of its due date is increased to the lesser of \$135 or 100% of the tax shown on the return.

## **IRS Disclosure to Department of Veterans Affairs**

The IRS's authority to make disclosures to the VA is made permanent effective as of October 1, 2008.

## **The Housing Assistance Tax Act of 2008**

### **First-Time Homebuyer Credit**

**Effective for purchases on or after April 9, 2008, and before July 1, 2009 (extended and modified for purchases after December 31, 2008, and before December 1, 2009).**

A first-time homebuyer anywhere in the United States is allowed a refundable tax credit equal to the lesser of \$7,500 (\$3,750 for a married individual filing separately) or 10% of the purchase price of a principal residence. A *first-time homebuyer* is an individual who had no ownership interest in a principal residence in the United States during the 3-year period prior to the date the qualifying home is purchased. No credit is allowed if the D.C. homebuyer credit is allowable for the year the residence is purchased or any prior tax year. The credit is not allowed if the taxpayer's financing is from tax-exempt mortgage revenue bonds, if the taxpayer is a nonresident alien, if the home is acquired from a related party or inherited, or if the taxpayer disposes of the residence (or it ceases to be a principal residence) before the close of the tax year for which the credit would otherwise be allowable.

The credit phases out for individual taxpayers with MAGI between \$75,000 and \$95,000 (\$150,000 to \$170,000 for joint filers). MAGI adds back to AGI any excluded foreign earned income and any income excluded from sources in Puerto Rico, Guam, American Samoa, or the Northern Mariana Islands.

The credit is recaptured ratably over 15 years with no interest charge, beginning in the second tax year after the year of purchase (\$500 per year if the maximum \$7,500 credit was allowed). If the taxpayer sells the home (or ceases to use it as his or her principal residence) before the credit is completely repaid, any remaining credit balance must be repaid on the tax return for the year the home is sold (or the year it ceases to be used as the principal residence).

If the home is sold to an unrelated person, the credit recapture is limited to the gain from the sale. In determining the gain, the home's basis is reduced by the amount of the outstanding credit. (The credit does not reduce basis for any other purpose.) No amount is recaptured after the death of a taxpayer.



Recapture is not accelerated by an involuntary conversion if a new principal residence is acquired within a 2-year period. If the residence is transferred to a spouse or to a former spouse incident to divorce, the transferee spouse (and not the transferor spouse) is responsible for any future recapture.

A home purchased before July 1, 2009, can be treated as if it were purchased on December 31, 2008, for purposes of claiming the credit on a 2008 tax return and establishing the beginning of the recapture period. Taxpayers may amend their returns for this purpose. The provision is effective for qualifying homes purchased on or after April 9, 2008, and before July 1, 2009 (even if there was a binding contract to purchase the home prior to April 9, 2008). The closing date generally governs, but if a house is constructed by the taxpayer, the purchase date is the date of occupancy.

## Credit Use for AMT

### Effective for 2008 and later years

The bill treats the tentative minimum tax as zero for determining the tax liability limitation for the low-income housing credit and the rehabilitation credit. Thus, these credits may offset all of the taxpayer's regular tax and the taxpayer's AMT liability.

The change applies to low-income housing credits for buildings placed in service after December 31, 2007 (including any carryback of the credits), and to rehabilitation credits attributable to qualified rehabilitation expenses properly taken into account for periods after December 31, 2007 (including any carryback of the credits).

## Credit-Card Information Reporting

### Effective in 2011 for information returns and in 2012 for backup withholding

For credit card transactions occurring in 2011 and later years, processors are required to file information returns reporting a merchant's gross credit card receipts. A *payment settlement entity* must report annually to the IRS and to the *participating payee* the gross amount of *reportable payment transactions*, as well as the name, address, and TIN (tax identification number) of the participating payees.

- Reportable payment transactions include payment card transaction and third-party network transactions.
- A participating payee is a person who accepts a payment card as payment or who accepts payment from a third-party settlement organization.
- Payment settlement entities include merchant-acquiring entities and third-party settlement organizations. Merchant-acquiring entities are banks or other organizations with a contractual obligation to make payments to participating payees to settle payment-card transactions.

A payment card is any card (credit or debit) issued pursuant to an agreement or arrangement with three characteristics:

1. One or more card issuers (merchant-acquiring entities)
2. A network of persons unrelated to each other and to the issuer who agree to accept the cards as payment
3. Standards and mechanisms for settling transactions between the merchant-acquiring entities and the merchants who agree to accept the cards as payment

A third-party network is an agreement or arrangement with a central organization that

1. Establishes accounts for a substantial number of unrelated providers of goods or services who agree to settle transactions using the arrangement
2. Provides standards and mechanisms for settling the transactions
3. Guarantees the providers that they will be paid for the goods or services

The payment settlement entity is the central organization that has the contractual obligation to make payments to participating payees. An organization is required to file information returns if it provides the network that enables buyers to transfer funds to sellers who have a contractual obligation to accept payment through the network. An organization operating a network that merely processes electronic payments between buyers and sellers without contractual agreements with sellers is not required to file the information returns.

A de minimis rule applies for third-party settlement organizations: An information return is not required to be filed for a participating payee that has no more than 200 transactions if the total value of those transactions does not exceed \$20,000.

Reporting requirements are also imposed on intermediaries who receive payments from a payment settlement entity and distribute the payments to participating payees.

Beginning in 2012, reportable payment transactions will be subject to backup withholding requirements.

## **Worldwide Interest Allocation**

**Effective July 30, 2008**

The worldwide interest allocation rules are delayed for 2 years, until tax years beginning after December 31, 2010.

## **Corporate Income Tax in 2013**

**Effective in 2013**

A corporation with assets of at least \$1 billion must increase its estimated tax payment due in the third calendar quarter of 2013 (the months of July, August, and September) by 16.75% of the payment otherwise due. The next required payment is reduced accordingly. The increased payments due in the third calendar quarter of 2012 under special rules in prior legislation are repealed. The general rule is applied for 2012, so that the corporations are required to make quarterly estimated tax payments based on their income tax liability.

## **The Mortgage Forgiveness Debt Relief Act of 2007**

### **Mortgage Insurance Premiums**

**Effective for tax years beginning in 2008, 2009, and 2010**

The deduction for private mortgage insurance is extended to amounts paid or accrued after December 31, 2007, and before January 1, 2011, if the insurance contract was issued after 2006 and the amounts are allocable to those tax years.

### **Sale by Surviving Spouse**

**Effective for sales after December 31, 2007**

If the surviving spouse has not remarried, and he or she sells the home within 2 years after the date of the other spouse's death, the surviving spouse may exclude up to \$500,000 of gain from the post-death sale. The couple must have met the usual criteria for the \$500,000 exclusion immediately before the other spouse's death.

## Disclosure for Material Interest

Effective December 20, 2007

Any supporting schedule, attachment, or list included with the entity's return that contains taxpayer identification information for any person other than the entity making the return or the person making the inspection is excluded from the authorized disclosure.

## FARM INCOME CONSIDERATIONS

### Anaerobic Digesters

Anaerobic digestion of solid wastes to produce biogas is one of many possible technologies available for waste management on animal farms. Anaerobic digestion (AD) involves the breakdown and conversion of organic materials to biogas by methanogenic bacteria. The primary constituents of biogas are methane ( $\text{CH}_4$ ) and carbon dioxide ( $\text{CO}_2$ ). While the methane content of biogas is variable, biogas produced by livestock waste is typically between 55% and 65% methane (Martin; Scott and Ma; U.S. EPA; Wright; Scott, et. al.). The vast majority of the remaining gas is carbon dioxide, but biogas also contains a variety of other compounds, such as hydrogen sulfide ( $\text{H}_2\text{S}$ ), which is a corrosive compound. The presence of compounds like hydrogen sulfide and other impurities can complicate the use of biogas. For instance, hydrogen sulfide can significantly increase maintenance costs when used in combustion engines.

When biogas is captured and combusted in an electrical generation system, the process creates renewable energy. In addition to reducing or eliminating the farm's purchases of electricity, this renewable energy can be substituted for fossil fuel-based energy, reducing the greenhouse gas emissions associated with energy consumption. Likewise, because methane is a potent greenhouse gas, its combustion results in a reduction in the livestock operation's net contribution to greenhouse gas emissions. Currently there are some voluntary programs available to monetize these reductions in green house gas emissions.

The anaerobic digestion gas (ADG)-to-electricity system consists of a digester system that converts solid waste into reduced solid and gas forms. The nongas product of the AD process is rich in nutrients and can be used as field fertilizers much like undigested manure. Biogas produced from the digester is utilized in an electrical generation system. This generator is then connected to the farm electrical system, making the energy available to power on-farm equipment with excess generation metered and sold on the electrical grid.

AD systems provide an opportunity for livestock producers to produce renewable energy from livestock wastes. These systems are typically quite capital intensive with costs as high as \$1,000 per cow. However, economic fundamentals such as rising energy prices continue to improve the economic potential of these systems. In addition, various incentive programs have emerged to further encourage the development of AD systems. For instance, the New York State Energy Research and Development Authority (NYSERDA) is offering up to \$11 million (maximum of \$1 million per ADG-to-electricity system) in financial incentives, under the customer-sited tier (CST) anaerobic digester gas-to-Electricity Program, to support the installation and operation of ADG-to-electricity systems in New York State.

The NYSEDA program provides two types of financial incentives: capacity and performance incentives. The former are capacity buy-down payments that offset some of the costs for the purchase and installation of ADG-fueled electric power generation equipment at customers' (host) sites, while performance-based incentives encourage on-site electricity production. For customers such as livestock farms, the program would assist in the adoption of anaerobic digester technologies that can produce energy for on-site use (and possible sale) as well as address waste-management problems.<sup>1</sup>

1. NYSEDA offers financial incentives for the adoption of solar photovoltaics, small wind-turbine, and fuel-cell technologies for energy generation under other customer-sited tier (CST) programs.

The Cornell Program on Agricultural and Small Business Finance has developed a variety of materials and spreadsheet tools to help evaluate these projects. This information is available online at [www.agfinance.aem.cornell.edu/](http://www.agfinance.aem.cornell.edu/). In addition, the Cornell manure management program Web site, [www.manuremanagement.cornell.edu/](http://www.manuremanagement.cornell.edu/), provides resources related to producing energy from the anaerobic digestion of agricultural waste.

## Gas and Oil Leases

Many farm operators and land owners are receiving payments for natural gas leases. The drilling of the Marcellus Shale formation has led to gas companies providing lease bonus payments to many taxpayers. These payments are lease payments and are entered on Schedule E of Form 1040. There will be few, if any, expenses that will be attributable to this income. Expenses may include an allocation of real estate taxes and insurance paid for the property and possibly some consulting expenses for legal and tax advice. The only depletion that may be used against these payments is cost depletion; percentage depletion is not allowed unless there is actual production. Few recipients of the lease money will be able to take advantage of cost depletion, as there was no allocation to the minerals when the land was acquired.

## Oil and Gas Depletion

Oil and gas wells, as well as timber, mineral deposits, geothermal deposits, and other natural deposits are considered exhaustible natural resources (“wasting” assets) and as such are subject to an allowance for depletion. The depletion allowance permits owners to deduct certain dollar amounts each year in recognition of the reduction to their supply of the resource, therefore the deduction permits an owner to account for the reduction of their natural resource for tax purposes.

To qualify for a depletion deduction, the owner must have an economic interest in the mineral property. Mineral interests, royalties, working interests, overriding royalties, and net profits interests are all economic interests in mineral deposits. The depletion deduction begins when the mineral property becomes productive.

The Internal Revenue Code provides two specific methods for computing the depletion deduction:

1. Cost depletion
2. Percentage depletion

Cost depletion is allowable for all exhaustible natural resources; percentage depletion is allowable for most mineral properties, including some oil and gas wells.

Cost depletion allows the taxpayer an allowance of the capital investment in the asset. Determining cost depletion requires an estimate of the number of recoverable units that make up the deposit, thus it must have an ascertainable basis. The adjusted basis of the property that is allocable to the asset reserves is then divided by the number of units, and the result is the cost depletion per unit. This per-unit amount is multiplied by the number of units extracted or sold or exchanged where a payment was received during the year, and determines the year’s cost-depletion deduction. The lessee and lessor are each entitled to claim cost depletion using their respective bases in the property.

Percentage depletion is a percentage of income from the property and is unrelated to the basis of the property. Because it may be continued as long as the property produces income, it offers the possibility of recovering more than the cost of the property.

Percentage depletion is only allowed with regard to actual production for an oil, gas, or geothermal property; therefore, it is not allowed for lease bonuses, advance royalty payments, delay rentals, or other amounts payable. Percentage depletion is allowed for domestic crude oil or natural gas production only to independent producers and royalty owners that are not disqualified retailers or disqualified refiners. (Disqualified retailers are those with more than \$5,000,000 in oil and gas gross receipts for the tax year; disqualified refiners are those with daily runs exceeding 75,000 barrels.) Percentage depletion for an eligible producer or royalty owner is 15% of the gross income from the property, subject to a maximum

depletable quantity. (The limitation allows percentage depletion for average daily production of 6,000,000 cubic feet of gas). A percentage depletion deduction is also limited by the taxpayer's income: It cannot exceed the smaller of 65% of the taxpayer's taxable income before the depletion allowance or 100% of the taxable income from the property before the depletion allowance and the I.R.C. § 199 deduction.

The gross income from the property is the price received for selling the oil and gas in the immediate vicinity of the well. It *does not* include amounts allocable to transportation or refining costs. It *does* include both the gross income to the owner of the working mineral interest and the production shares attributable to other owners of economic interests in the property; therefore, the lessee must reduce his or her share of the gross income by royalties paid to the lessors.

Taxable income for the 65% limit is also computed without regard to carrybacks of NOLs or capital losses. Any portion of the depletion allowance that is disallowed under the 65% limit may be carried over. A taxpayer entitled to a depletion allowance for eligible oil and gas wells is allowed to deduct a flat 15% of his or her gross income from the property. The lessee and lessor are each entitled to use percentage depletion if they otherwise qualify.

Where a property qualifies for cost *and* percentage depletion, the allowable depletion deduction is the larger of the two amounts. It is possible that a taxpayer may not be entitled to either type of depletion deduction. For example, cost depletion could be barred because the adjusted basis of the mineral property is zero, and percentage depletion could be barred due to lack of taxable income.

## Planning Cost Recovery Deductions in 2010

The bonus depreciation and enhanced I.R.C. § 179 deduction rules provide tax planning opportunities for taxpayers who want to maximize their cost recovery deductions for the year property is placed in service. The rules for both of these provisions are optional and different from each other. Taxpayers have the ability maximize their cost recovery deduction by carefully choosing how to apply the provision to specific pieces of property.

- Used property qualifies for the I.R.C. § 179 deduction, whereas in order to qualify for bonus depreciation, the original use of the property must begin with the taxpayer. Taxpayers who purchase both new and used property can claim bonus depreciation on new property and elect the I.R.C. § 179 deduction for the used property.
- Another difference between the I.R.C. § 179 deduction and bonus depreciation is that the I.R.C. § 179 deduction is limited to the taxpayer's net income from active trades or businesses, but the bonus depreciation is not limited by income. The I.R.C. § 179 election that exceeds the taxable income limit is carried forward to the next tax year and can be deducted subject to both the dollar limit and taxable income limit for that year. The bonus depreciation deduction in excess of taxable income can create an NOL that can be carried back 2 years (5 years in the case of qualified farmer) and then carried forward 20 years.
- The I.R.C. § 179 rules require the taxpayer to be actively participating in the business to claim the I.R.C. § 179 deduction for property purchased for use in that business. There is no active participation requirement for the bonus depreciation. Taxpayers who are planning their 2010 purchases should purchase at least \$500,000 of qualifying property for businesses in which they actively participate if they want to maximize their 2010 cost recovery deductions.
- The effective dates of the bonus depreciation and the increased I.R.C. § 179 deduction are different for fiscal-year taxpayers. Bonus depreciation is allowed for property placed in service during calendar year 2010. The increased I.R.C. § 179 deduction is allowed for property placed in service in tax years beginning in 2010. Based on the timing of the purchase, property may qualify for one or both of the cost recovery provisions.

Property placed in service during 2010 is eligible for both bonus depreciation and the increased I.R.C. § 179 deduction.

# 2

## INDIVIDUAL ISSUES

### FEDERAL PROVISIONS FOR 2010

#### Standard Deduction

The standard deduction is indexed to inflation and is adjusted annually, as shown in Figure 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 and reverting to prior law for 2011.

**Figure 1. Basic Federal Standard Deduction for 2009, 2010, and 2011**

Filing Status	2009	2010	2011*
Married filing jointly, or qualifying widow(er)	\$11,400	\$11,400	\$7,650
Head of household	8,350	8,400	8,500
Single individuals	5,700	5,700	5,800
Married filing separately	5,700	5,700	4,850

\*Projected

Each taxpayer who is over age 65 or blind receives the regular standard deduction plus an additional \$1,100 deduction if married and filing a joint or separate return. The additional deduction is \$1,400 if the taxpayer is single or is the head of the household. The additional deductions are subject to the inflationary adjustment. A taxpayer who is both elderly and blind receives double the additional deduction. The additional deductions for age and blindness cannot be claimed for dependents.

#### Personal Exemption

The 2010 personal exemption allowed on the federal return is \$3,650 for the taxpayer, his or her spouse, and his or her dependents. 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.

The phase-out of the personal exemption for certain high-income individuals does not apply for 2010. For 2009, the benefit of the personal exemption was phased out for taxpayers with the following specific high levels of AGI (these threshold amounts were adjusted for inflation annually):

- \$250,200 if married filing jointly or qualifying widow(er) with a dependent child (exemptions completely lost at \$372,700 AGI)
- \$208,500 if head of household (exemptions completely lost at \$331,000 AGI)
- \$166,800 if single (exemptions completely lost at \$289,300 AGI)
- \$125,100 if married filing separately (exemptions completely lost at \$186,350 AGI)

The phase-out in personal exemptions was 2% of the exemption amount for each \$2,500 increment (or any fraction thereof) by which AGI exceeds the appropriate threshold amount for 2005 and earlier years. A married taxpayer filing separately will lose 2% of his or her exemption for each \$1,250 increment above \$119,975. For 2006 and 2007, the phase-out was reduced by one-third and by two-thirds for 2008 and 2009, respectively. Full personal exemption is restored after the year 2009. The personal exemption phase-out or reduction was calculated on a 10-line worksheet, the “Deduction for Exemptions Worksheet,” that was included in the Form 1040, U.S. Individual Income Tax Return, instructions. If AGI exceeded the threshold, the worksheet needed to be completed before claiming the personal exemption deduction on line 42 of Form 1040.

## Dependents

Taxpayers must report the SSNs of all dependents. The penalty for failure to report this information is \$50. Apply for an SSN by filing Form SS-5 with the Social Security Administration, or file online at <http://www.ssa.gov>.

Taxpayers may not claim an exemption for a dependent who has a gross income of \$3,650 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) \$950 or (2) the individual’s earned income plus \$300, as shown in Figure 2. However, the additional deductions for age or blindness are still available in full.

**Figure 2. Examples of Dependent Child’s Standard Deduction**

	Earned Income + \$300	Standard Deduction	Smaller of the Two
Case #1	\$950	\$5,700	\$ 950
Case #2	950	5,700	3,300
Case #3	950	5,700	5,700

Investment or unearned income in excess of \$1,900 that is received by a dependent child 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 Certain Children Who Have Investment Income of More Than \$1,900. The form provides a calculation where the excess over \$1,900 will be taxed at the parent’s marginal rate, and unearned income greater than \$950 but less than \$1,900 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 \$1,900 with an \$950 tax exemption. This election cannot be made if the child has income other than interest and divi-

dends, if estimated tax payments were made in the child's name, or if the child's income is more than \$9,000.



**Practitioner Note**

The federal income tax on a taxpayer's child's income, including qualified dividends and capital gain distributions, may be less if the taxpayer files a separate return for the child rather than making the election. Furthermore, inclusion of the child's income on the parent's return may reduce other tax benefits due to increased AGI (e.g., earned income credit, exemptions, tuition credits, and IRA deductions).



**Planning Pointer**

The kiddie tax was expanded for tax years beginning after 2007. Planning for children's unearned income will be prudent.

**Tax Rates**

All the tax brackets have been adjusted for inflation this year. Each of the top four tax brackets has been increased from 2009, which results in many taxpayers with constant taxable incomes paying somewhat less for income taxes in 2010. The 10% bracket increased by \$25 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 \$50 in the 10% bracket rather than the 15% bracket is a savings of \$2.50 in income tax liability. After 2010, the 10% rate bracket reverts to the levels under the prior act, unless changed by legislation. There is no 10% bracket for estates and trusts. The 15% bracket for those married taxpayers filing jointly is twice the single bracket. The 2010 tax rate schedules are presented in Figure 3.

**Figure 3.**

**I.R.C. § 1(a)—Married Individuals Filing Joint Returns and Surviving Spouses**

<b>If Taxable Income Is</b>	<b>The Tax Is</b>
Not over \$16,750	10% of the taxable income
Over \$16,750 but not over \$68,000	\$1,675.00 plus 15% of the excess over \$16,750
Over \$68,000 but not over \$137,300	\$9,362.50 plus 25% of the excess over \$68,000
Over \$137,300 but not over \$209,250	\$26,687.50 plus 28% of the excess over \$137,300
Over \$209,250 but not over \$373,650	\$46,833.50 plus 33% of the excess over \$209,250
Over \$373,650	\$101,085.50 plus 35% of the excess over \$373,650



### I.R.C. § 1(b)—Heads of Households

<b>If Taxable Income Is</b>	<b>The Tax Is</b>
Not over \$11,950	10% of the taxable income
Over \$11,950 but not over \$45,550	\$1,195.00 plus 15% of the excess over \$11,950
Over \$45,550 but not over \$117,650	\$6,235.00 plus 25% of the excess over \$45,550
Over \$117,650 but not over \$190,550	\$24,260.00 plus 28% of the excess over \$117,650
Over \$190,550 but not over \$373,650	\$44,672.00 plus 33% of the excess over \$190,550
Over \$373,650	\$105,095.00 plus 35% of the excess over \$373,650

### I.R.C. § 1(c)—Single Individuals (Other Than Surviving Spouses and Heads of Households)

<b>If Taxable Income Is</b>	<b>The Tax Is</b>
Not over \$8,375	10% of the taxable income
Over \$8,375 but not over \$34,000	\$837.50 plus 15% of the excess over \$8,375
Over \$34,000 but not over \$82,400	\$4,681.25 plus 25% of the excess over \$34,000
Over \$82,400 but not over \$171,850	\$16,781.25 plus 28% of the excess over \$82,400
Over \$171,850 but not over \$373,650	\$41,827.25 plus 33% of the excess over \$171,850
Over \$373,650	\$108,421.25 plus 35% of the excess over \$373,650

### I.R.C. § 1(d)—Married Individuals Filing Separate Returns

<b>If Taxable Income Is</b>	<b>The Tax Is</b>
Not over \$8,375	10% of the taxable income
Over \$8,375 but not over \$34,000	\$837.50 plus 15% of the excess over \$8,375
Over \$34,000 but not over \$68,650	\$4,681.25 plus 25% of the excess over \$34,000
Over \$68,650 but not over \$104,625	\$13,343.75 plus 28% of the excess over \$68,650
Over \$104,625 but not over \$186,825	\$23,416.75 plus 33% of the excess over \$104,625
Over \$186,825	\$50,542.75 plus 35% of the excess over \$186,825

### I.R.C. § 1(e)—Estates and Trusts

<b>If Taxable Income Is</b>	<b>The Tax Is</b>
Not over \$2,300	15% of the taxable income
Over \$2,300 but not over \$5,350	\$345.00 plus 25% of the excess over \$2,300
Over \$5,350 but not over \$8,200	\$1,107.50 plus 28% of the excess over \$5,350
Over \$8,200 but not over \$11,200	\$1,905.50 plus 33% of the excess over \$8,200
Over \$11,200	\$2,895.50 plus 35% of the excess over \$11,200

## I.R.C. § 1(h)—Capital Gains Rates (Noncorporate 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 gain rate if ordinary tax rate is 10% or 15%*	0%

\*Reduced rate applies to 2008, 2009 and 2010.

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.

### Marriage Tax Penalty

The 15% income tax bracket for married taxpayers filing jointly continues at twice the single income tax bracket. This eliminated the marriage penalty in that income tax bracket only. This provision is effective through the end of 2010.



#### **Practitioner Note**

This provision fixed the 15% bracket and not any other brackets. Therefore, marriage tax penalty has not been completely eliminated.

The other part of the marriage tax penalty has to do with the comparison of the standard deduction between singles and married filing jointly. Two singles used to be afforded a larger standard deduction than a married couple filing jointly. The 2003 act changed this deduction 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 \$5,700 times 2, or a \$11,400 standard deduction in 2010. Inflationary adjustments currently apply only until the end of the year 2010. Increasing the earned income credit (EIC) phase-out amounts for joint filers will provide marriage tax penalty relief for earned income credit calculations. The 2001 act increased both the beginning and ending of the EIC phase-out ranges by \$1,000 in 2002, \$2,000 in 2005, and \$3,000 in 2008. 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.

### Moving Expenses

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 2010 standard mileage rate for a passenger car used for moving is \$0.165 per mile for the time period covering January 1, 2010, through December 31, 2010. Meal expenses are no longer included in moving expenses. The new place of work must be at least 50 miles farther from the taxpayer's former residence than 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
- Temporary living expenses for up to 30 days at the new job location

Report qualified moving expenses on Form 3903, Moving Expenses, and deduct them on line 26 of Form 1040, U.S. Individual Income Tax Return. 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.

## Itemized Deductions (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 the following:

- Nearly all medical and dental services
- Therapeutic devices and treatments
- Home modifications and additions made primarily for medical reasons
- Travel, including auto mileage deductions, which is \$0.165 per mile for the time period covering January 1, 2010, through December 31, 2010, 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
- 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. However, the cost of weight loss programs prescribed for the treatment of a disease exacerbated by obesity does qualify. Remember that itemized medical expenses must be reduced by any reimbursement, including health insurance payments received.

For purposes of the itemized medical expense deduction, the cost of over-the-counter drugs is nondeductible. Rev. Rul. 2003-102 allows over-the-counter drugs to be covered by health-care FSAs. This ruling allows reimbursements for nonprescription drugs by an employer health plan to be excluded from income if substantiated by the employee. The Patient Protection and Affordable Care Act of 2010 disallows the qualifying expense of over the counter drugs for FSAs, HASs, MSAs, and HRAs.

### Long-Term Health Care

Long-term health-care premiums are deductible for 2010 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 \$4,110 per year per person, subject to the 7.5% exclusion. Those aged 61 to 70 years old may include \$3,290 per person; 51 to 60 years old, \$1,230 per person; 41 to 50 years old, \$620 per person; and 40 years old and under, \$330 per person—all subject to the 7.5% exclusion.

Qualified long-term care (LTC) insurance contracts are generally treated as accident and health insurance contracts. Contract benefits are generally excludable from taxation as money received for personal injury and sickness. The 2010 excludable per-diem benefit limit is \$290 per day or \$105,850 for

the full year. Benefits are reported to taxpayers on 1099-LTC (Long-Term Care and Accelerated Death Benefits) and shown on Form 8853 (Archer MSAs and Long-Term Care Insurance Contracts) 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.

## 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 without 2% AGI Limit

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

## Sales Tax Deduction

The election to deduct state and local general sales taxes instead of state and local income taxes as an itemized deduction on Form 1040 Schedule A, Itemized Deductions, was not extended beyond December 31, 2009.

Prior legislation did not allow taxpayers to deduct both. Congress may decide to extend this item following the November election. Generally, to figure the state and local general sales tax deduction, one could use either actual expenses or the Optional State Sales Tax Tables. To the table amount, taxpayers could add state and local general sales taxes paid on motor vehicles, aircraft, boats, homes, and home-building materials, if the rate was the same as the general sales tax rate. Sales taxes paid on items used in a trade or business are not allowed; the sales tax becomes part of the asset's basis for expensing or depreciating.

## 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, Itemized Deductions, provided 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 2010, 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 2010 this debt was \$100,000 or less (\$50,000 or less if married filing separately).

To be deductible, both types of mortgages must be debt secured by a qualifying home, 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 a former spouse pays the mortgage interest 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 portions of annuities, and certain royalties) less investment expenses (excluding interest). Gross investment income was redefined by the 1993 act to exclude net capital gain on the disposition of investment property. The 2003 act extended this exclusion to qualified dividends that are eligible for the reduced tax rates. A taxpayer may elect to include net capital gain and qualifying dividends as investment income only if they are 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.

### Example 1.

In 2010, Charlie has \$6,000 of investment interest expense but only \$5,000 of investment income. Thus, Charlie can deduct only \$5,000 of his interest expense and must carry forward the other \$1,000 to the next tax year. But, Charlie has \$2,200 of qualified dividend income during 2010. Charlie can elect to have \$1,000 of that dividend income treated as investment income (and not eligible for the lower long-term capital gain rates). By this election Charlie can deduct the full \$6,000 of investment interest expense in 2009. The remaining \$1,200 (\$2,200–\$1,000) of qualified dividend income is subject to the 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 one 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 NOL.

## Personal Interest

Personal interest is not deductible.

## Charitable Contributions

The standard mileage rate for a passenger car used for charitable causes is \$0.14 per mile for 2010.

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, Noncash Charitable Contributions, to report total noncash charitable contributions exceeding \$500.

In general, the value of clothing and household items is less than the taxpayer's basis (cost) in such property with the result that taxpayers generally deduct the FMV of such contributions. A taxpayer can only deduct the *lower* of cost or market value.

### **Example 2.**

In 2010, Charlie purchased a shirt for \$22.00, wore it once, and then donated it to the church (a qualifying charity) yard sale when the FMV was only \$5.00. The amount of the Charlie's' contribution is the \$5.00 FMV.

Taxpayers must maintain reliable written records and the donor must retain a receipt from the donee organization.

### ***Limitation of Deduction of Household Items and Clothing***

Effective on August 18, 2006, and thereafter, no deduction is allowed for a charitable contribution of clothing or household items unless the clothing and item is in *good* used condition or better. The IRS is expected to issue guidance about what is "good condition." The new law cracks down on donations of broken household items and poor or soiled clothing. The IRS is authorized to deny by regulation a deduction for any contribution that has minimal monetary value, "such as used socks and used undergarments." In 2003, the IRS reported more than \$9 billion claimed as deductions for clothing and household items.

Under the provision a deduction may be allowed for a charitable contribution of an item of clothing or a household item *not* in good condition or better if the amount claimed for the item is more than \$500 and the taxpayer includes a qualified appraisal with their return.

### ***Modification of Record Keeping Requirements of Cash Donations to Charities***

Effective for the first tax year after August 17, 2006, charitable contributions will require more record keeping regardless of amount. Prior law required only a contemporaneous record of contributions of money in a log or ledger book. The 2006 provision requires a record of the contribution by a bank record or a written communication from the donee showing the name of the donee organization, the date of the contribution, and the amount of the contribution.

The rule requires those who want a charitable deduction for a cash contribution to a charity offering plate, a Sunday school plate, a Salvation Army kettle, the United Way, and so forth, to use either a check or an envelope identifying the donor. The alternative is to have the bell ringer or donor representative immediately write out a receipt (indicating donor, donee, date, amount) before dropping cash into the kettle or other donation collection box. In a nutshell, no bank record or receipt means no deduction. Logbooks no longer suffice.

### ***Substantiation Requirements***

In addition to previous record keeping requirements, substantiation requirements apply in the case of charitable contributions with a value of \$250 or more. No deduction is allowed for any contribution of \$250 unless the taxpayer has a contemporaneous written acknowledgment of the contribution by the donee organization. In general, if the total deduction claimed is more than \$500 for noncash property, the taxpayer must complete Form 8283 (Noncash Charitable Contribution).

### ***Special Tax-Free Treatment of Donated IRA Proceeds***

Prior legislation allowed individuals age 70½ or older to have a tax-free distribution of IRA proceeds up to \$100,000 per individual per taxable year to a charitable organization during years 2006 through 2009.

A qualified charitable distribution must be made directly by the IRA trustee to the charitable organization. Currently I.R.C. § 408(d)(8) has not been extended beyond December 31, 2009.

### **Rules for Certain Car Donations Made after December 31, 2004**

If a taxpayer donates a car to charity after December 31, 2004, and he or she is eligible to take a tax deduction in excess of \$500, the deduction is determined in one of two ways:

1. If the car is sold without any significant intervening use or material improvement by the charity, the deduction is limited to the amount of gross proceeds from its sale.
2. If the charity intends to make significant intervening use of or materially improve the car, the taxpayer generally can deduct its FMV.

Taxpayers must obtain a contemporaneous written acknowledgment from the charity and attach it to their income tax returns, Form 1040, U.S. Individual Income Tax Return. If taxpayers do not have an acknowledgment, they cannot deduct their contribution. Taxpayers must receive the acknowledgment no later than 30 days after the date the charity sells the car or 30 days from the date of the contribution if the charity intends to make significant intervening use of or materially improve the car.

Form 1098-C, Contributions of Motor Vehicles, Boats, and Airplanes, should be used by donor organizations to report the contributions of qualified vehicles to the IRS and may be used to provide the donor with written acknowledgment of the contribution.

## **Deductions Subject to the 2% AGI Limit**

### **Miscellaneous Deductions**

The following deductions are subject to a 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 (not deducted elsewhere in the tax return); 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 preceding or following a business meeting will qualify if it is associated with the active conduct of the taxpayer's trade or business. The deductible portion of meal and entertainment expenses paid in connection with a trade or business is limited to 50%. Self-employed individuals claim this deduction on the applicable schedule, Form 1040 Schedule C (Profit or Loss from Business [Sole Proprietorship]) or Schedule F (Profit or Loss from Farming), whereas employees deduct 50% of any unreimbursed business meals on Form 2106 which is transferred to Form 1040 Schedule A (Itemized Deductions and Interest & Dividend Income). The deductible percentage of the cost of meals consumed by employees subject to the Department of Transportation (DOT) increased from 75% for 2006 and 2007 to 80% in 2008 and thereafter. DOT employees include Federal Aviation Administration (FAA) employees (pilots, crews, etc.), railroad employees, and interstate truck and bus drivers that fall under DOT regulations.

## Itemized Deductions

A taxpayer should generally itemize deductions on Schedule A, Form 1040, if total itemized deductions are greater than his or her standard deduction in order to have the lowest possible income tax apply. The election to itemize can be made or revoked on a timely filed amended return. The limitation for high-income taxpayers, also known as the Pease Limitation, applied through December 31, 2009, and has not been extended at the time of this writing.

The itemized deduction 3%/80% reduction rule for married filing separately in 2009 began at \$83,400 (AGI), and the limit for all other taxpayers started at \$166,800 (AGI).

Taxpayers with a 2009 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). Starting in 2008, the reduction equals one-third of the lesser of 3% of excess AGI or 80% of the applicable itemized deductions.

## Interest and Ordinary Dividends (Form 1040, Schedule B)

Most taxpayers are not required to file a separate Schedule B (Form 1040), Interest and Ordinary Dividends, as long as they have interest or ordinary dividend income of \$1,500 or less. Form 1040, U.S. Individual Income Tax Return, 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, Interest and Ordinary Dividends for Form 1040A filers. In addition to having one less form to file (for many), this enables many taxpayers to use the shorter Form 1040EZ (TeleFile filing by telephone is no longer an option). This also affects filers with foreign bank accounts. Filers with less than \$1,500 to report no longer need to file Schedule B to report only on Part III. However, they may need to file Form TD F 90-22.1, Report of Foreign Bank and Financial Accounts. Note that failing to file Form TD F 90-22.1 may subject a taxpayer to a penalty.



## 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 long term capital gains. Qualified dividends currently (2008–2010) will be taxed at rates of 0% 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 AMT.

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 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 may be called dividends. Regulated investment companies (RICs; 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 REIT is subject to limitations of I.R.C. §§ 854 and 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 a 121-day period (a technical correction from 120 days) beginning 60 days before the stock trades without its dividend (the ex-dividend date) and including the 60 days after the ex-dividend date [I.R.C. § 246(c)]. 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-dividend date.
- Mutual funds, regulated investment companies, and REITs that pass through dividend income to a shareholder must meet the holding-period test in order to report qualified dividends on Form 1099-DIV, Dividends and Distributions.
- 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, U.S. Individual Income Tax Return, line 44, 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 2010 do not qualify, because the Internal Revenue 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 year, even if actually paid during January of the

following year.



**Practitioner Note**

On many Form 1040 returns, there have been 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.

## LONG-TERM CAPITAL GAINS RATES

The paperwork on capital gains continues to be challenging. Schedule D (Form 1040), Capital Gains and Losses, has been simplified, but there are two versions of a worksheet to complete in order to calculate the tax on capital gains. Capital gains also require careful attention on page 2 of Form 6251, Alternative Minimum Tax—Individuals. The 2003 tax act lowered the two basic capital gains rates to 5% and 15% (previously 10% and 20%). The 5% rate is reduced to 0% for 2008 through 2010. These lower rates of tax apply to adjusted net capital gain, which is calculated as the excess of net long-term capital gain over any 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 the required holding period. Rates of 25% and 28% continue to apply to certain types of capital gains (discussed later).

For 2010, the maximum rate of tax on adjusted net capital gain of an individual is 15%, or 0% if the taxpayer would have been taxed at the 10% or 15% rate on ordinary income. (Prior to 2008, this lower rate was 5%.) These lower rates apply to both regular and alternative minimum tax.

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 if I.R.C. § 1245 depreciation recapture rules applied, 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%.

In order to qualify as long-term, assets must be held the required holding period. Cattle (dairy or breeding) and horses (breeding, sport, work, or draft) must be held for 24 months to qualify for the 0% or 15% 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 (no lower

income tax rates apply). For assets other than livestock, the holding period begins the day after the date of acquisition.

Taxpayers that are not required to file a Form 1040 Schedule D, Capital Gains and Losses, 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. This worksheet provides the reduced capital gains tax rates on these distributions, even though a Schedule D is not completed.

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 2010 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 *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 are 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. Only after filling the 15% regular income tax bracket would the 25% maximum rate apply.
  - 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. Only after filling the 25% regular income tax bracket would the 28% maximum rate apply.
  - c. Adjusted net capital gain (remainder after (b)): The 15% maximum is reduced to 0%.
4. If there is unused 25% taxable regular income rate bracket after applying the ordinary income to the 25% brackets, then
  - a. Unrecaptured I.R.C. § 1250 gain: The 25% maximum on this type of gain is not reduced, and the gain is taxed at the 25% rate.
  - 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. Only after filling the 25% regular income tax bracket would the 28% maximum rate apply.
  - c. Adjusted net capital gain (remainder after (c) from list 1): The 15% maximum is not reduced.
4. If there are 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 on this type of gain is not reduced, and the gain is taxed at the 25% rate in the 28% bracket or any higher bracket.

- b. Collectibles and other 28% rate gain assets: The 28% maximum on this type of gain is not reduced, and the gain 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.

### Example 3.

Mr. and Mrs. F. P. Milker file a joint return, and their 2010 15% taxable income tax bracket goes to \$68,000. Their taxable income after personal exemptions and itemized deductions is \$68,100, exceeding the 15% bracket by \$100, as shown in Figure 4. Their taxable income includes \$6,000 of 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. Note that the 15% bracket was first filled with unrecaptured I.R.C. § 1250 gain and the 28% rate gain collectibles, allowing them to be taxed at the 15% rate. Then the 15% bracket was filled with ANCG (from the raised cows), allowing it to be taxed at 0%. Only the balance of the ANCG was pushed into the 15% capital gains rate.

**Figure 4. Determination of Tax Rates with Various Income Sources**

	Notes	Tax On	Tax Rate
Ordinary income		\$16,700	10%
Ordinary income		31,900	15%
Gain on farm building sale (unrecaptured I.R.C. § 1250 gain)	25%	6,000	15%
Gain on sale of antiques	28%	3,500	15%
Gain on sale of dairy cattle (ANCG, \$10,000 total)			
Held more than 2 years	15%	9,900	0%
Subtotal		\$68,000	
Amount in excess of 15% bracket sold		100	15%
Total taxable income		\$68,100	

## Netting Capital Gains and Losses

The following rules apply to the netting of capital gains and losses:

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 ANCG (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 (SL) 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 the 15% 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, Capital Gains and Losses, exceed capital gains. Only a maximum of \$3,000 of any such net capital loss may be deducted in determining gross income for 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, these losses 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

Property that passes through an estate (other than income in respect of a decedent) currently receive a basis to the beneficiary equal to the cost basis with a limited step-up in basis. Any step-up in basis is limited to the FMV of the property on the date of death. The step-up is \$1.3 million with an additional amount of \$3 million available for the decedant's spouse. Inherited property (except for I.R.C. § 1231 livestock) will automatically be considered as held for 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. Income in respect of a decedent (IRD), such as accounts receivable, traditional IRAs, and retirement plans, do not receive a step-up in basis.

## Capital Gains and AMT, Flow-Through Entities, and Small-Business Stock

The lower long-term capital gains rates are used to compute AMT (Form 6251, page 2). Entities such as S corporations, partnerships (including limited liability companies taxed as 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 1 year to their children (if the child is in the 10% or 15% bracket and is not subject to the kiddie tax) may be able to lower their overall tax liability. Parents may want to buy back the same securities in the open market, because wash-sale 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. Note that ARRA 2009 has increased the excluded gain to 75% for stock acquired between February 17, 2009, and January 1, 2011. The Small

Business Job Creation and Access to Capital Act of 2010 increased the excluded gain to 100% for stock acquired between September 27, 2009, and January 1, 2011. 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% (and 75%) 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). The old (pre-May 7, 1997) rollover of gain provision and the 55 years of age requirement were repealed and replaced with this current exclusion under I.R.C. § 121.

This 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 are eligible for 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 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 of a qualifying individual. 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 4.

Mr. and Mrs. Jobhopper sold and moved out of their first home March 2, 2010, because of a change in employment. They began renting and living in that home on July 1, 2008, but did not buy it until August 5, 2008. They lived in the home for 610 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 2010 is \$393,850 ( $575 \times 730 = 0.7877$ ;  $0.7877 \times \$500,000 = \$393,850$ ); therefore Mr. and Mrs. Jobhopper 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.

In certain situations, gain on the sale of a residence may be ineligible 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 excluded but would be recognized as gain from the sale of I.R.C. § 1250 property. Furthermore, if the structure with business use is not part of the dwelling unit, none of the gain from that structure qualifies for exclusion. Such a separate business-use structure would be reported on Form 4797, Sales of Business Property.

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, Capital Gains and Losses. 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 the taxpayer has received a Form 1099-S, Proceeds from Real Estate Transactions.

## KIDDIE TAX

Children with net unearned income may be subject to tax at the parent's top marginal rate if this results in a higher tax than would apply at the child's rate.

### Increase in Age of Children Whose Unearned Income Is Taxed as If Parents' Income

The Small Business and Work Opportunity Tax Act (SBWOTA) of 2007 expanded the kiddie tax to apply to children who are 18 years old or who are full-time students over age 18 but under age 24. The expanded provision applies only to children whose earned income does not exceed one-half of the amount of their support. The provision is effective for taxable years beginning after the date of enactment.

The kiddie tax applies to

1. Children under the age of 18
2. Children who are 18 years old and do not have earned income exceeding 50% of their support, and
3. Students under the age of 24 who do not have earned income exceeding 50% of their support (not including scholarships)

For 2010, a child below age 18 must have net unearned income of at least \$1,900 to be subject to the kiddie tax.

## 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.

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

### AMT Rate and Exemption Phase-Out

The AMT has a two-tiered 26% and 28% rate system for noncorporate taxpayers. The 26% rate applies to the first \$175,000 of alternative minimum taxable income (\$87,500 for married filing separately) in excess of the exemption. The 28% rate begins at \$175,000 of alternative minimum taxable income (AMTI). The lower capital gain rates used when computing regular taxes are also used to compute AMT on net capital gains. Additional legislation for 2010 thus far has not extended any increased exemption amounts for 2010; therefore, the exemption amounts will return to earlier levels, for example, \$45,000 for married filing jointly down from \$70,950 for 2009. The exemption is phased out at a rate of 25% of AMTI exceeding specific levels, as shown in Figure 5. 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.

Figure 5. AMT Exemption and Phase-Out

Filing Status	Maximum Exemption	AMTI Exemption Phase-out Threshold	Complete Phase-out At
Joint and qualifying widow(er)	\$45,000	\$150,000	\$330,000
Single and head of household	33,750	112,500	247,500
Married filing separately	22,500	75,000	165,000
Trusts and estates	22,500	75,000	165,000

The AMT exemption for individuals subject to the kiddie tax has been increased to the child's earned income plus \$6,700 for 2010. This amount is indexed for inflation. The annual exemption cannot exceed \$33,750.



## Alternative Minimum Taxable Income (AMTI)

AMTI is calculated on Form 6251, Alternative Minimum Tax—Individuals, by starting with Form 1040, U.S. Individual Income Tax Return, taxable income before subtracting personal exemptions or the standard deduction, but after subtracting itemized deductions, if any. Any NOL carryforward used in calculating the regular tax is added back (disallowed).

### Adjustments and Preferences

The first category of the following list 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. The exclusion items (in addition to the personal exemptions and standard deduction already excluded from the starting number from Form 1040) are certain itemized deductions from Form 1040 Schedule A (Itemized Deductions), including a reduction of medical deductions by an additional 2.5% of AGI, 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. Itemized deductions disallowed on Form 1040 Schedule A for higher-income taxpayers are now allowed.
3. The depreciation adjustment is the net difference between accelerated MACRS depreciation and that allowed for AMT. This continues to be an adjustment item on both farm and nonfarm tax returns. (See a discussion of this topic in the "Reporting Depreciation and Cost Recovery" section.) AMT depreciation for pollution-control facilities placed in service after December 31, 1998, must be computed using MACRS class lives and the SL method (for regular tax purposes, these facilities qualify for 5-year amortization).
4. Adjusted gain or loss from dispositions reported in Form 4797 (Sales of Business Property) or Form 1040 Schedule D (Capital Gains and Losses) and in Form 4684 (Casualties and Thefts) that have a different basis for AMT than for regular tax (because of the accumulated AMT depreciation adjustment).
5. Incentive stock option adjustments, passive-activity adjustments, AMTI from estates and trusts, and tax-exempt interest from private activity bonds.
6. Accelerated depreciation on real and leased property and amortization of certified pollution control facilities placed in service before 1987.
7. 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 alternative 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 a carryforward 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% phase-out is subtracted from AMTI before the 26% and 28% rates are applied. Taxpayers with net capital gains from Form 1040 Schedule D (Capital Gains and Losses) apply the appropriate capital gains rates by completing Part IV of Form 6251 (Alternative Minimum Tax—Individuals). However, be aware that the existence of capital gains may trigger AMT on ordinary income by causing the phase-out of the AMT exemption amount. The AMT foreign tax credit is then 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).



### **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 for ordinary income as well as the standard deduction and personal exemptions are lost when taxpayers are subject to AMT.

## 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, Alternative Minimum Tax—Individuals.

The limitation on the use of GBCs is calculated on Form 3800 (General Business Credit), 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 to offset AMT. For tax years through 2009, taxpayers are permitted to use their personal nonrefundable credits (e.g., education credits, dependent-care credit, and saver's credit) to offset both the regular tax and the minimum tax. For 2010, taxpayers are only be able to offset AMT by the adoption credit, the child tax credit, the savers' credit, and the EIC. The other personal

nonrefundable credits will reduce a taxpayer's regular income tax but only down to the amount of the tentative AMT.

The GBCs, 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 (Alternative Minimum Tax—Individuals) 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 AMT adjustments and preferences 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 carry-forward. The computation includes unallowed credit for producing fuel from a nonconventional source and the electric vehicle credit.

For tax years beginning after December 31, 2006, and before 2013, taxpayers may be eligible for an AMT refundable credit. The AMT refundable credit amount is the greater of (1) the lesser of \$5,000 or the long-term unused minimum tax credit, or (2) 20% of the long-term unused minimum tax credit. The long-term unused minimum tax credit for any tax year means the portion of the minimum tax credit attributable to the adjusted net minimum tax for taxable years before the third tax year immediately preceding the taxable year (assuming the credits are used on a first-in, first-out basis). The credit is phased out if an individual's income exceeds a certain threshold amount.

## 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, Wage and Tax Statement, was previously authorized.

## 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.



### **Practitioner Note**

The foster-care provider must live in the same home where the care is provided.

## Uniform Method for 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 clarified and made a more uniform determination of the age threshold for various sections of the tax code. A child born on January 1, 1994, is 17 on January 1, 2011. This same child on December 31, 2010, 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, 1946, is considered to be 65 on December 31, 2010, 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 reconciling the five definitions of a child in the tax code into a single definition for a "qualifying child" discussed later.

## 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 2010 will use AGI to determine if they qualify for EIC subject to disqualified income, number of children, and phase-outs.

Use Figure 8 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 2010 credit amount.

**Figure 8. EIC Rates, Income Ranges, and Phase-Outs\***

Earned Income or AGI Range for Taxpayers <i>Not</i> Filing as Married Filing Jointly (for 2010)					
Qualifying Children	Credit Rate (%)	Maximum Credit	Phase-Out	Phase-Out Rate (%)	Maximum Credit
None	7.65	\$5,980–7,480	\$7,480–13,460	7.65	\$457
One	34.00	8,970–16,450	16,450–35,535	15.98	3,050
Two	40.00	12,590–16,450	16,450–40,363	21.06	5,036
Three or more	45.00	12,590–16,450	16,450–43,352	21.06	5,666
Earned Income or AGI Range for Married Filing Jointly (for 2009)					
Qualifying Children	Credit Rate (%)	Maximum Credit	Phase-Out	Phase-Out Rate (%)	Maximum Credit
None	7.65	\$5,980–12,490	\$12,490–18,470	7.65	\$457
One	34.00	8,970–21,460	21,460–40,545	15.98	3,050
Two	40.00	12,590–21,460	21,460–48,362	21.06	5,036
Three or more	45.00	12,590–21,460	21,460–48,362	21.06	5,666

\*This is not an official IRS 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 older, 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.
- The taxpayer cannot file Form 2555, Foreign Earned Income, 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 as 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 said gains from the sale of passive investments should be included as disqualified income. The IRS *originally* said this included gain from the 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 the 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 (e.g., sows, boars, beef cattle, horses, or cull dairy cows) that are I.R.C. § 1231 property is not disqualified income.

In 2010, the EIC is denied to all taxpayers with an excess of \$3,100 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, Sales of Business Property, Part II) and gains recaptured as ordinary income (Form 4797, Part III), are not included in disqualified income.

A member of the U.S. armed forces who served in a combat zone may elect to treat combat pay that is otherwise excluded from gross income (under I.R.C. § 112) as earned income for purposes of the EIC. See "Combat Zone Exclusion" in Pub 3. The amount of nontaxable combat pay should be shown in box 12 of Form(s) W-2 with code Q. If the taxpayer is filing a joint return and both spouses received nontaxable combat pay, they can each make their own election to treat combat pay that is otherwise excluded from gross income as earned income for purposes of the EIC. The elected amount(s) must be reported on line 64b of Form 1040, U.S. Individual Income Tax Return.

## Uniform Definition of a Qualifying Child

Beginning in 2005, a single definition of a qualifying child is applied for each of the following tax benefits:

- Dependency exemption
- Head-of-household filing status
- Earned income credit (EIC)
- Child tax credit
- Credit for child- and dependent-care expenses

## Tests to Meet

In general, all four of the following tests must be met to claim someone as a qualifying child. Also, there is a citizenship test that must be met.

### 1. Relationship Test

The child must be the taxpayer's child (including an adopted child, stepchild, or eligible foster child), brother, sister, stepbrother, stepsister, or a descendant of one of these relatives. An adopted child includes a child lawfully placed with the taxpayer for legal adoption even if the adoption is not final. An eligible foster child is any child who is placed with the taxpayer by an authorized placement agency or by judgment, decree, or other order of any court of competent jurisdiction.

### 2. Residency Test

A child must live with the taxpayer for more than half of the year. A temporary absence for special circumstances, such as for school, vacation, medical care, military service, or detention in a juvenile facility, count as time lived at home. A child who was born or died during the year is considered to have lived

with the taxpayer for the entire year if the taxpayer's home was the child's home for the entire time he or she was alive during the year. Also, exceptions apply, in certain cases, for children of divorced or separated parents and parents of kidnapped children.

### 3. Age Test

A child must be under a certain age (depending on the tax benefit) to be a taxpayer's qualifying child.

### 4. Support Test

The child cannot have provided over one-half of his or her support during the year.

## Dependency Exemption, Head-of-Household Filing Status, and EIC

For purposes of these tax benefits, a child must be under the age of 19 at the end of the year, or under age 24 at the end of 2010 if a student, or any age if permanently and totally disabled.

A student is any child who, during any 5 months of the year

1. Was enrolled as a full-time student at a school, or
2. Took a full-time, on-farm training course given by a school or a state, county, or local government agency.

A school includes a technical, trade, or mechanical school. It does not include an on-the-job training course, correspondence school, or night school.



#### **Practitioner Note**

An adopted child is any child placed with a taxpayer 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 a taxpayer's son, daughter, stepchild, or adopted child. A foster child is any child a taxpayer cares for as his or her own child and who is placed with that taxpayer by an authorized placement agency.

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

## EIC Reminders for Farmers

If earned income is negative, there is no EIC. Therefore, a farmer with a negative net farm profit on Form 1040 Schedule F, Profit or Loss from Farming, would not get a credit unless there were wages and/or Form 1040 Schedule C, Profit or Loss from Business (Sole Proprietorship), 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 \$4,360 of SE income to collect an EIC that would partially or wholly cover the SE tax and also provide four quarters 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, Sales of Business Property (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. Note that advance EIC payments are not available effective January 1, 2011. 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 \$1,750, 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 2010 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 Pub. 225, *Farmer's Tax Guide*).

## Child Tax Credits

The child tax credit allows taxpayers to claim a credit for each qualifying child less than 17 years of age at the end of the year. Generally, a qualifying child is one whom the taxpayer claimed as a dependent and is a son, daughter, adopted child, grandchild, stepchild, eligible foster child, sibling, stepsibling, or their descendant as a U.S. citizen or resident alien. For the taxable year 2006 until the end of 2010 (2004 act extender), the tax credit is \$1,000. For taxpayers with AGI in excess of the applicable threshold amount, the credit is phased out. The phase-out rate is \$50 for each \$1,000 of MAGI (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 Figure 9 for an example of various filers with one child.

**Figure 9. One Eligible Child, Tax Credit Phase-Out Based on MAGI**

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

In addition, the child tax credit is limited by the amount of the income tax owed as well as any AMT tax owed. For example, if the amount of the credit a taxpayer can claim is \$1,000, but the amount of the taxpayer's income tax is \$500, the credit ordinarily will be limited to \$500.

For 2010, the total amount of the child tax credit and any additional child tax credit cannot exceed the maximum of \$1,000 for each qualifying child.

Individuals entitled to receive the child tax credit and additional child tax credit may also be eligible to receive the child- and dependent-care credit and the EITC.

Taxpayers may claim the child tax credit on Form 1040, U.S. Individual Income Tax Return, or 1040A, or file electronically; the credit is not available for those that file Form 1040EZ.

## Child- and Dependent-Care Credits

If a taxpayer paid someone to care for a child or a dependent so he or she could work, he or she may be able to reduce income tax by claiming the credit for his or her child- and dependent-care expenses on



his or her federal income tax return. This credit is available to people who, in order to work, have to pay for child-care services for dependents under age 13. The credit is also available if they paid for care of a spouse or a dependent of any age that is physically or mentally incapable of self-care.

The initial rate of credit is 35% of qualified expenses. The rate is decreased by 1% for each \$2,000 (or fraction thereof) of AGI over \$15,000, but the percentage never goes below 20%. 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 is \$1,050 for one qualifying individual and \$2,100 for two qualifying individuals.

For 2010, taxpayers may use up to \$3,000 of the expenses paid in 2010 for one qualifying individual or \$6,000 for two or more qualifying individuals. These dollar limits are reduced by the amount of any dependent-care benefits provided by an employer that was excluded from income.

To claim the credit for child- and dependent-care expenses, a taxpayer must meet the following conditions:

- Must have earned income from wages, salaries, or other taxable compensation, or net earnings from self-employment.
- If married, both must have earned income, unless one spouse was either a full-time student or was physically or mentally incapable of self-care.
- If the taxpayer chose to include nontaxable combat pay in earned income when figuring the earned income tax credit for 2008, the nontaxable combat pay must also be included in earned income when figuring the amount of dependent-care benefits to exclude or deduct from income.
- Payments for care expenses cannot be paid to someone claimed as a dependent on the return or to a child who is under age 19.
- The filing status for this credit must be single, head of household, qualifying widow(er) with a dependent child, or married filing jointly.
- The care must have been provided for one or more qualifying persons identified on Form 2441, Child- and Dependent-Care Expenses, to claim the credit.
- The taxpayer (and, if the taxpayer is married, his or her spouse) must maintain a home that he or she lives in with the qualifying child or dependent.

## Adoption Tax Benefits

For 2010, a \$13,170 credit 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 MAGI between \$182,520 and \$222,520. 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. To take this credit or exclusion, complete Form 8839, Qualified Adoption Expenses.

In addition to the adoption credit, employer-paid or employer-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.

## Automobile Credits

The clean-fuel vehicle deduction was replaced with new tax credits starting in 2006 with various termination dates. The new motor vehicle credits have different rates and criteria. The credits are for qualified fuel-cell motor vehicles, advanced clean-burn technology motor vehicles, qualified hybrid motor vehicles, and qualified alternative-fuel motor vehicles.

### Alternative Motor Vehicle Credit

Even though a manufacturer has certified a vehicle, a taxpayer must meet the following requirements to qualify for the credit:

- The vehicle must be placed in service after December 31, 2005, and purchased on or before December 31, 2010.
- The original use of the vehicle must begin with the taxpayer claiming the credit.
- The credit may only be claimed by the original owner of a new, qualifying, hybrid vehicle and does not apply to a used hybrid vehicle.
- The vehicle must be acquired for use or lease by the taxpayer claiming the credit.
- The credit is only available to the original purchaser of a qualifying hybrid vehicle. If a qualifying vehicle is leased to a consumer, the leasing company may claim the credit.
- For qualifying vehicles used by a tax-exempt entity, the person who sold the qualifying vehicle to the person or entity using the vehicle is eligible to claim the credit, but only if the seller clearly discloses in a document to the tax-exempt entity the amount of credit.
- The vehicle must be used predominantly within the United States.

The following vehicles qualify for the hybrid motor vehicle credit.

**Model Year 2011**

■ BMW	ActiveHybrid 750i	\$ 900
■ BMW	ActiveHybrid Li	\$ 900
■ BMW	ActiveHybrid X6	\$1,550
■ Mercedes-Benz	ML 450 Hybrid	\$2,200
■ Mercedes Benz	E350 BLUE TEC	\$1,550
■ Mercedes Benz	GL350 BLUE TEC	\$1,800
■ Mercedes Benz	R350 BLUE TEC	\$1,550
■ Mercedes Benz	ML350 BLUE TEC	\$ 900
■ Nissan	Altima Hybrid	\$2,350

**Model Year 2010**

■ BMW	ActiveHybrid X6	\$1,550
■ Cadillac	Escalade Hybrid (2wd & 4wd)	\$2,200
■ Chevrolet	Malibu Hybrid	\$1,550
■ Chevrolet	Silverado Hybrid C15 2wd	\$2,200
■ Chevrolet	Silverado Hybrid K15 4wd	\$2,200
■ Chevrolet	Tahoe Hybrid C1500 2wd	\$2,200
■ Chevrolet	Tahoe Hybrid K1500 4wd	\$2,200
■ Ford	Escape Hybrid 4x2	\$ 750*
■ Ford	Escape Hybrid 4x4	\$ 650*
■ Ford	Fusion Hybrid	\$ 850*
■ GMC	Sierra Hybrid C15 2wd	\$2,200
■ GMC	Sierra Hybrid K15 4wd	\$2,200
■ GMC	Yukon Hybrid C1500 2wd	\$2,200
■ GMC	Yukon Hybrid K1500 4wd	\$2,200
■ GMC	Yukon Denali Hybrid C1500 2wd	\$2,200
■ GMC	Yukon Denali Hybrid K1500 4wd	\$2,200
■ Mercury	Mariner Hybrid 2wd	\$ 750*
■ Mercury	Mariner Hybrid 4wd	\$ 650*
■ Mercury	Milan Hybrid	\$ 850*
■ Mercedes-Benz	S 400 Hybrid	\$1,150
■ Mercedes-Benz	ML 450 Hybrid	\$2,200
■ Nissan	Altima Hybrid	\$2,350

\*If purchased between September 30, 2009 and April 1, 2010

## Taxable Employer Cash Incentives for Hybrids

Some employers are encouraging their employees to purchase hybrid cars and are offering rebates or cash incentives to offset the purchase price of these vehicles. This rebate or cash incentive is just like other forms of compensation; it is taxable and should be included on the year-end W-2 earnings statement.

## Advanced Clean-Burn Technology Credit

For a taxpayer to claim the credit, the original use of the vehicle must begin with the taxpayer and the vehicle must be acquired for use or lease by the taxpayer and not for resale. Available credit amounts may vary and include a base credit amount based on fuel economy compared to the 2002 model year city fuel economy rating and an additional amount based on the vehicle's lifetime fuel savings.

The following vehicles qualify for the Advanced Lean-Burn Technology Motor Vehicle Credit.

### Model Year 2011

■ BMW	335d Sedan	\$ 900
■ BMW	x5 xDrive35d	\$1,800

### Model Year 2010

■ Audi	A3 2.0L TDI Automatic	\$1,300
■ Audi	Q7 3.0L TDI	\$1,150
■ BMW	335d Sedan	\$ 900
■ BMW	x5 xDrive35d	\$1,800
■ BMW	ActiveHybrid X6	\$1,550
■ Mercedes Benz	GL350 BLUE TEC	\$1,800
■ Mercedes Benz	R350 BLUE TEC	\$1,550
■ Mercedes Benz	ML350 BLUE TEC	\$ 900
■ Volkswagen	Golf 2.0L TDI Sedan automatic	\$1,700
■ Volkswagen	Golf 2.0L TDI Sedan manual	\$1,300
■ Volkswagen	Jetta 2.0L TDI	\$1,300
■ Volkswagen	Jetta 2.0L TDI Sportwagen	\$1,300
■ Volkswagen	Touareg 3.0L TDI	\$1,150

## Quarterly Sales

The credit is available for only a limited time. Tax preparers will need to inquire as to the actual vehicle purchase date. Taxpayers are allowed to claim the full amount of the allowable credit up to the end of the first calendar quarter after the quarter in which the manufacturer records its sale of the 60,000th hybrid or advance lean-burn technology. For the second and third calendar quarters after the quarter in which the 60,000th vehicle is sold, taxpayers may claim 50% of the credit. For the fourth and fifth calendar quarters, taxpayers may claim 25% of the credit. No credit is allowed after the fifth quarter.

## Education Incentive Opportunities

Figure 10 presents the benefits, restrictions, and limitations on several tax incentives for participants in higher education.



**Practitioner Note** The Hope Credit has generally been replaced by the American Opportunity Credit for years beginning in 2009 and 2010. However, the Hope Credit as enhanced for the midwestern disaster area is still available for those affected areas. Therefore, practitioners will need to review with taxpayers the colleges or universities and postsecondary year that each student is attending in order to compute the maximum credit available to the taxpayer.

**Figure 10. Education Incentive Program**

	American Opportunity Credit	Lifetime Learning Credit
Tax incentives	Per student: 100% of first \$2,000 and 25% of next \$2,000 used for tuition and fees for higher education for at least half-time students incurring expenses during the tax year (\$2,500 max for 2010)	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	<ul style="list-style-type: none"> <li>■ Only for first 4 postsecondary years</li> <li>■ May not be claimed using any expenses paid by a Coverdell ESA distribution</li> <li>■ Maximum of 4 tax years</li> <li>■ 40% of credit is refundable</li> <li>■ Not allowed for persons claimed as dependents on another taxpayer's return</li> </ul>	<ul style="list-style-type: none"> <li>■ May not be claimed in the same tax year for the same person as claimed for the Hope or American Opportunity credit</li> <li>■ May not be claimed using any expenses paid by a Coverdell ESA distribution</li> <li>■ Nonrefundable</li> </ul>
MAGI limits	Phase-out range starts at \$80,000 and ends at \$90,000 for singles; the range is \$160,000 to \$180,000 for joint returns; and the credit is not available to married filing separately.	Phase-out range starts at \$50,000 and ends at \$60,000 for singles; the range is \$100,000 to \$120,000 for joint returns; and the credit is not available to married taxpayers filing separately.

**Figure 10. Education Incentive Program (continued)**

<b>Coverdell ESA</b>	
Tax incentives	<ul style="list-style-type: none"> <li>■ Up to \$2,000 of nondeductible contributions (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</li> <li>■ Liberalized expense items including elementary, secondary, special-needs, and technology purchases</li> </ul> <p>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.</p>
Restrictions	<ul style="list-style-type: none"> <li>■ 10% penalty plus tax on unqualified withdrawals</li> <li>■ Cash contributions only</li> <li>■ No contributions after account holder attains age 18</li> </ul> <p>(The age 18 contribution rule does not apply to special-needs beneficiaries.)</p>
MAGI limits	<p>Phase-out 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 phase-outs; corporations and other entities may contribute regardless of AGI.</p>
Deadline for contribution	<p>Contribution deadline is April 15 (not including extensions) of the following year, and distributions of excess contribution will not be subject to additional tax if made on or before June 1 of the year following contribution.</p>

<b>Student Loan Interest Deduction</b>	
Tax incentives	<p>An above-the-line adjustment to gross income rather than an itemized Form 1040 Schedule A deduction: up to \$2,500 for 2010 for interest paid on loans for higher education expenses while at least a half-time student. Deduction is allowed with respect to interest paid over any period of time.</p>
Restrictions on a qualifying loan	<ul style="list-style-type: none"> <li>■ No deduction if student is allowed as dependent on another taxpayer's return</li> <li>■ No double benefits, as with home equity loans</li> <li>■ See Final Regulations T.D. 9125, 5/6/2004, summary following Figure 10.</li> </ul>
MAGI limits	<p>Phase-out range starts at \$60,000 and ends at \$75,000 for singles; the range is \$120,000 to \$150,000 for joint returns; and the deduction is not available to married taxpayers filing separately.</p>

**Figure 10. Education Incentive Program (continued)**

<b>Qualified Tuition Program</b>	
Qualified tuition program	Sponsored by a state to purchase tuition credits or save for payment of higher education expenses (known as 529 plans, named after the I.R.C. section that allows these plans). (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.

**The Tuition and Fees Deduction was available only through December 31, 2009**

2009 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 2009, \$4,000 is the maximum amount deductible for single taxpayers or heads of households (HOHs) whose MAGI doesn't exceed \$65,000 (\$130,000 for joint returns). For 2009, \$2,000 is the maximum amount deductible for single taxpayers or HOHs whose MAGI 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	<ul style="list-style-type: none"> <li>■ Married taxpayers filing separately and taxpayers that may be claimed by some one else</li> <li>■ Taxpayers whose MAGI exceeds the applicable dollar limits already shown</li> </ul> Taxpayers that have claimed a Hope or lifetime learning credit for the year for the same student
Eligible taxpayers	<ul style="list-style-type: none"> <li>■ Taxpayers under the preceding 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.</li> </ul>

The final regulations in T.D. 9125, May 6, 2004, clarify 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 and then paid by the taxpayer to the lender. If the third party pays interest on the taxpayer's behalf as a gift, the taxpayer may deduct the interest.

## 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.



### Practitioner Note

ARRA 2009 made a change for those individuals who received at least 50% of their prior year's gross income from a small trade or business and AGI for the prior year was less than \$500,000.

### Example 7.

Susan Ford, a salesperson, has the financial situation depicted in Figure 11.

**Figure 11. Susan Ford's Taxes on AGI**

Expected AGI for 2010	\$72,625
Tax shown on 2009 return	10,500
Projected tax on 2010 return	12,000
Projected tax to be withheld in 2010	10,900

Susan expects to owe at least \$1,000 additional tax ( $\$12,000 - \$10,900 = \$1,100$ ), so she should make an estimated tax payment; however, she expects her income tax withholding (\$10,900) to be at least 90% of the actual tax liability as shown on her 2010 return ( $\$12,000 \times 90\% = \$10,800$ ). Therefore, Susan does not need to pay estimated tax nor will she have a penalty. Furthermore, where the amount withheld in 2010 exceeds her 2009 tax liability, she also would avoid estimated tax payments and penalties.

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.

## 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 tax-



able 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 Educator Expense Deduction expired as of December 31, 2009, and has not been extended by legislation as of this writing. Therefore unless there is legislation that extends the I.R.C. § 62(a)(2)(D) deduction it will not be available for years after 2009. The deduction applied for tax years beginning in 2002 through 2009 for eligible educators in public and private elementary and secondary schools that worked at least 900 hours during the school year as a teacher, instructor, counselor, principal, or aide that purchased books and classroom supplies. They could have deducted up to \$250 in qualified expenses as an adjustment to income on their Form 1040, U.S. Individual Income Tax Return. Qualified expenses are unreimbursed expenses for supplies, books, equipment, and other materials used in the classroom. Educators needed to 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 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). TIPRA requires partial payments to be submitted with an offer in compromise.

### **5-Year NOL Carryback**

Two recent acts extended the NOL carryback period to 5 years for NOLs. The American Recovery and Reinvestment Act (ARRA) and The Worker, Homeownership, and Business Assistance Act of 2009 (WHBAA).

ARRA legislation allows certain taxpayers to make an irrevocable election to carry back applicable 2008 losses for up to five years (the normal carryback period is two years). The applicable 2008 losses are

losses incurred in one year (either beginning or ending in 2008) by eligible small businesses (those whose average gross receipts are equal to or less than \$15 million over a 3-year period).

WHBAA legislation allows almost all taxpayers with business losses to make an irrevocable election to carry back losses incurred in one year (ending after 2007 and beginning before 2010) for up to 5 years. WHBAA also allows life insurance companies to carry back losses from operations for either 4 or 5 years (the normal carryback period is 3 years). Unlike ARRA legislation, a taxpayer that elects a 5-year carry-back under WHBAA legislation will have a limitation in the amount that it may carry back. Taxpayers that received certain benefits (whether or not they were repaid) under the Emergency Economic Stabilization Act of 2008 (TARP recipients) or any taxpayer that was a member of the TARP recipient's affiliated group during 2008 or 2009 may not make a WHBAA election.

## **2010 Form 1040 Draft as of September 1, 2010**

- The 2009 line 23 for “Educator expenses” has been labeled “RESERVED” on the 2010 form.
- The 2009 line 34 for “Tuition and fees deduction” has been labeled “RESERVED” on the 2010 form.
- Line 40b on the 2009 form increasing your Standard Deduction and attaching Schedule L has been eliminated on the 2010 form.
- The 2009 line 52 for “Credits from” Form 8396, Form 8839 and Form 5695 has been changed on the 2010 Form to “Residential Energy credits.
- The 2008 form line 59, “Additional Taxes” has changed language and added Form 5405, line 16 for 2010.
- Line 70 for 2010 is labeled only for “Credit for federal tax on fuels” (Form 4136).
- The 2009 Line 71 was a summary line for “total payments” This has been moved to line 72 for 2010 and each line thereafter is increased one spot from 2009 to 2010.
- Line 71 for 2010 covers the remaining credits that appeared on line 70 for 2009.

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 the IRS.

## **Form 941 Quarterly Payroll Tax Return**

Employers that deposit less than \$2,500 per quarter in payroll taxes can file Form 941, Employer's Quarterly Federal Tax Return, once a year if they have an on-time payment record for at least 2 years.

# 3

## BUSINESS ISSUES

The provisions discussed in this chapter apply primarily to business activities.

### BUSINESS RECORD KEEPING

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

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

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

The IRS indicates that a taxpayer must keep these business records to prove the income or deductions on a tax return. The length of time records must be kept depends upon the individual business situation (Figure 12). This retention period is never less than 3 years from the due date of the return and can be for a lifetime. The taxpayer should always keep copies of his or her filed tax returns.

**Figure 12. Keeping Records for Income Tax Purposes**

<b>In This Situation</b>	<b>Keep for This Length of Time</b>
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 complete 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

## DEDUCTIBLE BUSINESS EXPENSES

### 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 purposes. If a farmer uses the family den, dining room, or his or her 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.

The definition of *principal place of business* was expanded for tax years beginning after December 31, 1998. 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. The space must still be used exclusively and regularly for business purposes. IRS Pub. 587, *Business Use of Your Home*, provides examples that describe situations in which a taxpayer's home office will qualify.

Farmers who reside off the farm, crop consultants, and sales representatives will be allowed home-office deductions if they meet two additional rules: (1) home-office activities must be equal to or of greater importance to their trade or business than are non-office activities, and (2) time spent at the home office must be greater than that devoted to nonoffice activities.

Form 1040 Schedule C, Profit or Loss from Business (Sole Proprietorship), filers who claim expenses for business use of the home must file Form 8829, Expenses for Business Use of Your Home. Form 4562, Depreciation and Amortization, 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 is not filed with Form 1040 Schedule F, Profit or Loss from Farming, 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 mortgage interest, real estate 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, Sales of Business Property, 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

The following provisions apply to expenses for health insurance and medical care.

### Self-Employed Health Insurance Premiums

This tax provision allows self-employed taxpayers to deduct 100% of health insurance premiums paid as an adjustment to income on Form 1040, U.S. Individual Income Tax Return. Also, if taxpayers pay premiums on a qualified long-term care contract for themselves, their spouses, or their dependents, they can include these premiums (subject to the annual limits stated previously). Self-employed taxpayers include sole proprietors, partners, and 2% or more 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. (This may be another reason to elect the optional method of computing SE tax in a farm loss year.) It does not reduce income subject to SE 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.

New for 2010, taxpayers may also deduct qualifying health insurance premiums from self-employment income when calculating SE tax (see tax legislation, Chapter 1).

## Medical Saving Programs

The HSA was originally introduced in 2004 to take the place of the Archer MSA. These accounts provide an opportunity for taxpayers to save tax-deferred income for future health needs. Contributions to an HSA may be made by the employer, the employee, the self-employed individual, 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. The HSAs are tax-exempt accounts with a financial institution in which employees of a small employer or self-employed taxpayer save money for future medical expenses. For details on this program, see IRS Pub. 969, *Health Savings Accounts and Other Tax-Favored Health Plans*.

## Employee Health and Accidental Insurance Plans

An employer can claim premiums paid for employee health and accident insurance plans as a business expense on Form 1040 Schedule F (Profit or Loss from Farming) or C (Profit or Loss from Business). 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 the plan 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). However, SE tax with the 100% deduction for self-employed health insurance premiums and now the deduction of a self-employed taxpayer's health insurance in the calculation of there will be no incentive to have the spouse on payroll for this purpose. Furthermore, 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.

As a result of these law changes, the prior strategy of hiring the spouse is no longer tax effective.

## 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 2010 standard mileage rate is 50 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 SL, or the car is used for hire. The standard mileage rate may be used on up to four vehicles. The use of I.R.C. § 179, accelerated cost recovery system (ACRS), or 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 continues to be concerned about the deductibility of cell-phone expenses and will continue to question their personal use. However, the Small Business Jobs Act of 2010 removed cell phones from the definition of listed property. Therefore the detailed substantiation requirements (contemporaneous log book) and special depreciation rules no longer apply.

## RETURN PREPARERS MUST ISSUE PRIVACY POLICY STATEMENTS

Under Reg. 16 CFR Part 313, 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 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.

## 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. The basis of the acquired property must be reduced by the gain realized (but not recognized) on the relinquished 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 these 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 property 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. Procs. 2000-37 and 2004-51 outline 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 (unless the reverse exchange requirements are met). 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.

## Business Personal Property

*Like kind* is interpreted to mean *like class* for personal property. Under final regulations issued May 18, 2005, *like class* means that both the relinquished and replaced properties are in the same product class under the North American Industry Classification System (NAICS).

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 like kind, whereas 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, Application for Change in Accounting Method, should be followed.



**Practitioner Note** 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. The election is made by noting at the top of Form 4562 "Election Made Under Section 1.168(i)-6 (i)." The election is available on an asset-by-asset basis.

**Example 8.**

Under rules prior to Notice 2000-4 (including the election to not follow this notice under the temporary regulations),

- Farmer Jack paid \$100,000 for a combine in 2007.
- Jack depreciated it as 7-year property using MACRS 150% declining balance.
- In 2010 Jack traded the combine and \$40,000 cash for a used tractor.
- Calculation of the basis in the 2010 tractor is as shown in Figure 13.

**Figure 13. Calculation of Basis**

Beginning combine basis		\$100,000
2007 depreciation	$\$100,000 \times 10.71\%$	(10,710)
2008 depreciation	$\$100,000 \times 19.13\%$	(19,130)
2009 depreciation	$\$100,000 \times 15.03\%$	(15,030)
2010 depreciation	$\$100,000 \times 12.25\% \times 1/2$	(6,125)
Ending basis		49,005
Boot cash for the tractor		40,000
Basis in 2010 tractor		<u>\$ 89,005</u>

Calculation of Jack’s total 2010 depreciation on these two assets is as shown in Figure 14 (note that bonus or additional first-year depreciation (AFYD) does not apply for this example).

**Figure 14. Calculation of Depreciation**

Combine from Figure 13		\$ 6,125
Tractor	$\$89,005 \times 10.71\%$	9,532
		<u>\$15,657</u>

**Example 9.**

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

- Farmer Jack paid \$100,000 for a combine in 2007.
- Jack depreciated it as 7-year property using MACRS 150% declining balance.
- In 2010 Jack traded the combine and \$40,000 cash for a used tractor.

- Calculation of the total 2009 depreciation on these two assets is as shown in Figure 15 (note that bonus or AFYD has been disregarded for this example).

**Figure 15. Calculation of Depreciation on Two Assets**

2010 (fourth-year depreciation) on combine that was traded and has left the farm:		
Combine traded (left the farm)	$\$100,000 \times 12.25\%$	\$12,250
2010 (first-year depreciation) on tractor that is on the farm:		
Tractor on farm (boot only)	$\$40,000 \times 10.71\%$	4,284
Total depreciation		<u>\$16,534</u>

The Notice 2000-4 rules result is a greater first-year depreciation for Jack than under prior 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 Jack trades that new tractor in for a baler, Jack will have a three-line calculation of depreciation, but only one piece of equipment left on the farm.

## Bookkeeping

Jack'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. Jack 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 Jack is a frequent trader, it may take several lines to support the depreciation and basis in the traded and acquired property. If Jack 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. Unless depreciation software is used that keeps track of all this detail, the election under the regulations starts to look attractive—even though it may result in less current depreciation expense.

## Other Like-Kind Exchange Rules and Requirements

IRS Form 8824, Like Kind Exchanges, is used as a supporting statement for like-kind exchanges that either generate no taxable gain or are 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, U.S. Individual Income Tax Return, 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 ordinary income 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.

## Domestic Production Activities Deduction—I.R.C. § 199

The American Jobs Creation Act of 2004 added I.R.C. § 199 as an incentive for businesses to hire U.S. workers to increase domestic production. I.R.C. § 199 provides a deduction for businesses that manufacture, produce, grow, or extract (MPGE) property within the United States.



### **Practitioner Note**

This section highlights those portions of I.R.C. § 199 most relevant to farm tax reporting. For further details, refer to T.D. 9263 for final regulations released May 24, 2006. This replaced proposed regulations released

October 20, 2005.

In general the deduction is based on net income from qualifying production activities (QPAI). The deduction is 9% for 2010 and thereafter (an increase from 6% of QPAI for 2007, 2008, and 2009; and 3% of QPAI in 2005 and 2006) for most businesses. However, for individuals, the deduction is based on the lesser of AGI or QPAI taxable income and then limited to 50% of allocable Form W-2 wages (both of which are discussed later). This deduction is available to sole proprietors, regular C corporations, and to S corporation shareholders, partners, limited liability company (LLC) members, and members of agricultural cooperatives.

### Qualified Production Activity Income

In order to calculate QPAI, it is first necessary to define a qualifying activity. The general definition is that the activity must involve the manufacture, production, growth, or extraction of property within the United States. In addition to sales from such activities, the income from the following is includable:

1. The rental or lease of tangible personal property if the property was produced by the taxpayer in the United States. However, rental income from a related party does not qualify. For this purpose, related party includes the following:
  - ❖ Members of an affiliated service group
  - ❖ Corporations that are part of a controlled group
  - ❖ Other trades or business under common control
2. The construction or substantial renovation of real property (e.g., buildings, roads, utilities)
3. Architectural and engineering services related to #2
4. The sale of natural gas produced by the taxpayer

Nonqualified receipts would include

1. Any increase in the value of the property occurring by activities outside the United States. This amount must be subtracted in determining domestic gross receipts.
2. Resale activities except to the extent that the taxpayer has added value to the product by manufacture or production.
3. Sales of food and beverages prepared by the taxpayer at a retail establishment.
4. Any receipts from a nonqualified activity, which would include the following:
  - ❖ Interest earned and finance charges on accounts receivable
  - ❖ Services provided other than those in #3 in the list of qualifying receipts

- ❖ Sale of tangible personal property not produced by the taxpayer, or produced outside the United States
- ❖ Sale, lease or rental of real property, even if constructed by the taxpayer

Grain, fruit, vegetable, and livestock production clearly qualify as production activities. However, service activities often provided by farmers, such as trucking and custom service (e.g., plowing, spraying, combining) do not qualify. Receipts from the storage of agricultural commodities qualify provided that the taxpayer owns the commodity at the time it is stored. Government payments qualify to the extent that they are substitutes for gross receipts that would qualify. Patronage income from cooperatives does not qualify, but the cooperative may pass through to patrons QPAI that it generated (Form 1099 PATR, Taxable Distributions Received from Cooperatives).



**Practitioner Note**

Beginning in 2008, several dairy cooperatives notified farmers of the pass-through of domestic production activity deductions (DPAD) based on prior-year milk sales. Most taxpayers and their practitioners had already used the 2007 milk sales as qualifying income on the 2007 tax return. The 2007 tax return may need to be amended to reclassify the milk receipts as nonqualifying—resulting in a smaller DPAD for 2007 in order to obtain the larger pass-through deduction for 2008. Milk receipts from these cooperatives are now being reported on Form 1099-PATR as per unit retains and therefore as nonqualifying in calculating a taxpayer’s DPAD for the current tax year. Milk payments are instead used by the cooperatives in calculating the pass-through DPAD.

For many farmers, QPAI will be the net income from Schedule F (Form 1040), Profit or Loss from Farming, plus any raised livestock sales reported on Form 4797, Sales of Business Property. (Purchased livestock that are reported on Form 4797 would not appear to qualify since the taxpayer did not manufacture or grow them.) If nonqualifying receipts are 5% or more of total gross receipts, it will be necessary to allocate expenses as discussed later. The reclassification of milk payments (qualifying) to per-unit retains (nonqualifying) will make such expense allocations necessary for most producers marketing their milk through co-ops.

The domestic production gross receipts (DPGR) from the qualifying activity are reduced by all related deductions and expenses plus a ratable portion of deductions not directly attributable to the qualifying activity (i.e., overhead). It becomes essential that a taxpayer’s records be able to identify expenses directly related to the qualified activity versus any nonqualifying activity. If cost of goods sold (COGS) cannot be directly identified, any reasonable method can be used to make the allocation. There is an exception for small businesses that allows COGS to be prorated based on qualifying gross receipts as a percentage of total gross receipts. A small business is defined as one having 3-year average annual gross receipts not exceeding \$5 million or as taxpayers permitted to use the cash method of accounting under Rev. Proc. 2002-28 (generally, where the principal business activity is *not* manufacturing). Indirect expenses may also be allocated by any reasonable method. In this case, if gross receipts of the taxpayer are \$100 million or less, these indirect expenses may be prorated based on relative gross receipts. If the taxpayer maintains allocation records for another purpose, such as cost control or profit center management, the taxpayer must use these same allocations in calculating QPAI (unless such allocations are “unreasonable”).



**Practitioner Note**

When inputs for production are imported, it is the greater of cost or *value at the time of import* that must be used as COGS.

**Practitioner Note**

I.R.C. § 199 provides a de minimis rule regarding allocations between qualified and nonqualified receipts that allows nonqualifying receipts to be included in the calculation of QPAI and exempts the taxpayer from any requirement to allocate expenses. The de minimis rule applies if the taxpayer's nonqualifying receipts are less than 5% of total gross receipts.

## Wage Limit

The qualified domestic production deduction is limited to 50% of the taxpayer's qualifying wages. Furthermore only wages allocable to domestic production may be used for this limit. Wages are allocated to domestic production using the same methods available for allocating expenses. Rev. Proc. 2006-22 (2006-23 I.R.B. 1033) provides three alternatives for calculating qualifying wages from Form W-2, Wage and Tax Statement, information. In all cases, only wages subject to FICA and federal income tax withholding are included. This means that agricultural wages paid in kind (commodities or other noncash compensation) do not qualify. Also, payments to partners or LLC members are not W-2 wages.

Form W-2 does not necessarily report wages that are consistent with the I.R.C. § 199 definition of W-2 wages. Three alternatives are provided in Rev. Proc. 2006-22. Most farm taxpayers will use the *unmodified box 1 method*. In this method, the employer-taxpayer uses the lesser of the totals from either box 1 or box 2 of all Forms W-2. However, if wages result in limiting the I.R.C. § 199 deduction, one of the alternate methods of calculating the wage limit should be considered, especially if the employees have made elective deferrals to retirement plans.

**Practitioner Note**

1. Wages paid to employees of the taxpayer through an agent are eligible wages for computing the I.R.C. § 199 deduction even though the Forms W-2 are issued from the agent.
2. The wage limit does not apply to DPAD passed through from a cooperative.

## Taxable Income Limit

For 2010 and years following, the I.R.C. § 199 deduction is limited to 9% of taxable income of a corporation and to 9% of the AGI of individuals, estates, and trusts (an increase from the 6% limit for 2007, 2008, and 2009; and the 3% limit for 2005 and 2006).

## Claiming the Deduction

Form 8903, Domestic Production Activities Deduction, is used to calculate the deduction. Individuals claim this deduction as an adjustment to gross income. Therefore, the deduction does not reduce the taxpayer's SE tax. C corporations claim this deduction on line 25. Trusts are entitled to the I.R.C. § 199 deduction if the income is not distributed to the beneficiaries.

Taxpayers may also receive QPAI and qualifying wage information from entities that do not pay taxes of their own (i.e., S corporations, partnerships, and LLCs). In addition, agricultural cooperatives may pass through this information to their patrons on Form 1099-PATR, Taxable Distributions Received from Cooperatives.

For tax years beginning before May 18, 2006, the W-2 wages that S corporations, partnerships, and LLCs could pass through to owners were limited to a maximum of two times the QPAI they are distributing. This restriction on W-2 wages passing through from such entities has been eliminated for tax years beginning after May 17, 2006.

Form 8903 applies the limits by first limiting QPAI to the taxpayer's taxable income (or AGI for individuals, estates, and trusts). Taking 9% of the lesser of these two income measures provides the tentative

I.R.C. § 199 deduction. This tentative deduction is then limited to 50% of Form W-2 wages allocable to domestic production from all sources.

### Example 10.

Mr. Domestic Dairy, a sole proprietor, has a 2010 Form 1040 Schedule F (Profit or Loss from Farming) net income of \$39,000, and \$1,000 of Form 4797 (Sales of Business Property) that is from raised cull cow sales. Make the assumption that all of his income is qualified and the dairy farm paid and reported W-2 (Wage and Tax Statement) hired chore wages of \$4,400. His wife had a W-2 income of \$60,000 as a school principal. How much domestic production can they claim, and how much will it save them in federal taxes?

Form 8903, Domestic Production Activities Deduction, compares the farm's net income from qualified production activities ( $\$39,000 \leq \$1,000 \nabla \$40,000$  QPAI), which is less than \$100,000 AGI without the DPAD. Then the form multiplies the QPAI \$40,000 times 9% for 2010, resulting in \$3,600 for potential DPAD. Next, compare this with 50% of Form W-2 wages ( $\$4,400 \times 50\%$ ) reported by the domestic production business (all allocable to domestic production), resulting in \$2,200 in wage limitation. The smaller of the two calculations, or \$2,200, is the DPAD that goes on Form 1040 line 35 (U.S. Individual Income Tax Return). This deduction lowers AGI to \$97,800 and saves  $\$2,200 \times 25\%$  tax bracket, or \$550 of federal income taxes. Note that DPAD does not reduce the taxpayer's SE tax.

### Alternative Minimum Tax

The I.R.C. § 199 deduction is allowed in the calculation of the AMT. However, for regular C corporations, the taxable-income limitation is replaced with an alternative minimum taxable-income limitation when computing the deduction for AMT purposes.

## DEPRECIATION AND COST RECOVERY

The Job Creation and Worker Assistance Act of 2002 made substantial changes to this area by allowing taxpayers to claim 30% bonus depreciation on qualifying property placed in service under a binding contract after September 10, 2001. 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. There was no bonus depreciation for assets placed in service after December 31, 2004. The Economic Stimulus Act of 2008 (ESA 2008) reinstated the 50% bonus depreciation for qualified property placed in service after December 31, 2007, and before January 1, 2009. This depreciation is now referred to as additional first-year depreciation (AFYD). ESA 2008 also increased the I.R.C. § 179 deduction to \$250,000 for 2008. ARRA 2009 extended bonus depreciation and the increased I.R.C. § 179 deduction to property placed in service prior to January 1, 2010. The 2008 Farm Bill changed the recovery period of *new* farm equipment (other than cotton gins) to 5 years rather than 7 years for property placed in service during 2009. The Jobs Act (2010) again increased IRC § 179 for 2010 and 2011 and extended AFYD through 2010 (and beyond for long-term contract items such as certain airplanes).

Other than the reinstated AFYD, the enhanced I.R.C. § 179 deduction, and the temporarily shorter recovery period for new farm equipment, 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 subsequent years.

MACRS provides for eight classes of recovery property, two of which may only be depreciated SL. 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 depre-

ciation 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, and buildings and on purchased livestock acquired for dairy, breeding, draft, and sporting purposes. 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 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 Figure 16.

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 Figure 17.



**Figure 16. MACRS Class Life and ADR Midpoint Life**

<b>MACRS Class</b>	<b>ADR Midpoint Life</b>
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

### **3-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. (Race horses aged 2 years or less if placed in service before January 1, 2009, or after December 31, 2013, are 7-year property.)

### **5-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
- New farm machinery and equipment (for 2009)

### **7-Year Property**

- All farm machinery and equipment (except new farm machinery and equipment in 2009)
- Silos, grain storage bins, fences, and paved barnyards
- Breeding horses or workhorses (12 years old or younger)
- Race horses under 2 years of age placed in service before January 1, 2009 or after December 31, 2013
- Office furniture
- Anaerobic digesters

### **10-Year Property**

- Single-purpose livestock and horticultural structures (7-year property if placed in service before 1989)
- Orchards and vineyards when they reach the production stage (15-year property if placed in service before 1989)

## 15-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)

## 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.

**Figure 17. ACRS, MACRS, and MACRS 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
Farm buildings (general-purpose)	19	20	25
Farm equipment and machinery	5	7 <sup>a</sup>	10
Fences (agricultural)	5	7	10
Goats (breeding or milk)	3	5	5
Grain bin	5	7	10
Greenhouse (single-purpose structure)	5	10 <sup>b</sup>	15
Hogs (breeding)	3	3	3
Horses (nonrace, younger 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 <sup>a</sup>	10
Methane (Anaerobic) Digester	5	7	10
Office equipment (other than calculators, copiers, or typewriters) & furniture	5	7	10
Orchards	5	10 <sup>c</sup>	20
Paved lots	5	15	20
Property with no class life	5	7	12
Rental property (nonresidential real estate)	19	39 <sup>d</sup>	40
Rental property (residential)	19	27.5	40
Research property	5	5	12 <sup>e</sup>

Asset	Recovery Period (Years)		
	ACRS	MACRS	ADS
Sheep (breeding)	3	5	5
Silos	5	7	12 <sup>e</sup>
Single-purpose livestock structure (housing, feeding, storage, and milking facilities)	5	10 <sup>b</sup>	15
Single-purpose horticultural structure	5	10 <sup>b</sup>	15
Solar property	5	5	12 <sup>e</sup>
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 than 13,000 lbs)	3	5	5
Vineyard	5	10 <sup>c</sup>	20
Water well	5	15	20
Wind-energy property	5	5	12 <sup>e</sup>

a. If new equipment placed in service after 2008 and before 2010, recovery period is 5 years. ADS life continues at 10 years.

b. If placed in service before 1989, recovery period is 7 years.

c. If placed in service before 1989, recovery period is 15 years.

d. If placed in service before May 13, 1993, recovery period is 31.5 years.

e. No class life specified; therefore, 12-year life assigned.

## Cost Recovery Methods and Options

Accelerated cost recovery methods for MACRS property are shown in Figure 18. 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 utilize crossover to SL). There are two SL options for the classes eligible for rapid recovery. The SL option may be taken over the MACRS class life or the MACRS 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 SL.

**Figure 18. 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 <sup>1</sup> 200% if placed in service 1987 through 1988 <sup>1</sup>
Nonfarm assets	200% DB
15- and 20-year	150% DB
27.5- and 39 (31.5)-year	SL <i>only</i>

1. See exception for orchards and vineyards earlier.

The MACRS law does not provide standard percentage recovery figures for each year. However, the IRS and several of the tax services have made tables available, such as Figure 19.

**Figure 19. 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.)

Recovery Year	3-Year Class		5-Year Class		7-Year Class		10-Year Class		15-Yr Class	20-Yr Class*
	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 <sup>†</sup>	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-year 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 (other than 27.5- and 39-year property) provides for a half-year convention in the year placed in service, regardless of the recovery option chosen (reflected in Figure 19). A half year of recovery is 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 11 in the "Election to Expense Depreciable Property" section).

## MACRS Alternative Depreciation

The MACRS ADS is required for some property and is an option for any other property. ADS uses SL depreciation 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 (which has various eligibility dates) but may still use the I.R.C. § 179 expense deduction.

## Election to Expense Depreciable Property

The I.R.C. § 179 expense deduction increased to \$500,000 for 2010 and 2011. Currently, the deduction is scheduled to revert to the pre-2003 act level of \$25,000 for 2012. The expense deduction continues to be phased out dollar for dollar for any taxpayer that places over \$1,000,000 of property in service in any year, with a complete phase-out at \$1,500,000. 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. As a result of the Jobs Act of 2010 qualified leasehold improvements (168(e)(6)), qualified restaurant property (168(e)(7)) and qualified retail improvement property (168(e)(8)) are eligible for this expense deduction if placed in service during 2010 or 2011. Property must be used more than 50% of the time in the business to qualify. General-purpose farm 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. I.R.C. § 179 deductions may not be claimed on the basis of the trade-in when property is acquired by trade (only the "boot" is eligible).

In the case of partnerships, the \$500,000 limit applies to the partnership as well as 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 \$500,000 may be expensed because of the \$500,000 limitation. Any allocations in excess of \$500,000 are lost forever, which is a different result from the limitation discussed in the next paragraph. The same concept applies to allocated I.R.C. § 179 deductions from 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 (Profit or Loss from Business) or F (Profit or Loss from Farming) 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, Sales of Business Property, are also included. Trade or business income includes the amount of such items flowing through to the taxpayer’s return from S corporations and partnerships.

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 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 C or F, whichever applies, subject to SE tax.

Every business owner who has purchased MACRS property should consider the I.R.C. § 179 expense deduction. Consideration should first be given to taking the expense deduction on highway vehicles, since these are ineligible for the New York State investment tax credit. Generally, I.R.C. § 179 should not be used to reduce AGI below standard (or itemized) deductions plus exemptions, unless an additional reduction in SE 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 Jobs Act of 2010 also extended the taxpayer’s ability to make or revoke an I.R.C. § 179 expensing election on an amended return for tax years before 2012 without consent of the commissioner (available for tax years beginning after 2002 as a result of the 2003 act and subsequent extensions).



**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. Current rules now 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 11.**

V. Sharp placed \$200,000 worth of 7-year MACRS property in service and does not want to use bonus (AFYD) depreciation. He could choose to use \$120,000 of the I.R.C. § 179 deduction and claim \$8,568 of depreciation ( $\$200,000 - 120,000 = \$80,000 \times 0.1071 = \$8,568$ ) under the half-year convention. If \$150,000 of Sharp’s property was placed in service in the last quarter and the \$120,000 I.R.C. § 179 election is applied to this \$150,000, \$30,000 is left to be used in the 40% mid-quarter convention test. Thus,  $\$30,000 \div (\$200,000 - 120,000) = 0.375$ , which is less than 40%, so Sharp avoids the mid-quarter rules.

However, without using any I.R.C. § 179 deduction, he would be caught by the 40% rule. That is,  $\$150,000 \div \$200,000 = 0.75$ , 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 or not 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 12.

A farmer purchased a used tractor, used harvester, and used combine in 2010. 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 7-year recovery for equipment purchased in 2008 and 150% DB for 7 years for equipment purchased in 2009 and could now select SL 10-year recovery for all machinery purchased in 2010.

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 and SL over 7 years on 7-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 (6,000 pounds or less) placed in service in 2010 is \$3,060 for the first year, \$4,900 for the second year and \$2,950 for the third year. Each of these limits represent an increase of \$100 from 2009. Unchanged for 2010 is the \$1,775 limit for each succeeding year (see Figure 20). If the business-use percentage is less than 100%, these limits are reduced accordingly. (Note that these first-year limits are increased by \$8,000 if the taxpayer does not elect out of the 50% AFYD. Also, there were higher limits in the first year if bonus depreciation was used in prior years). Sport-utility vehicles weighing more than 6,000 pounds but no more than 14,000 pounds are limited to a maximum I.R.C. § 179 expense of \$25,000 each. The balance of the cost is depreciable under MACRS rules without any further restrictions. Cellular telephones acquired after 1989 but before 2010 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 those of other automobiles, as shown in Figure 20. The 2010 limit for pickups and vans for the first year is increased by \$100 from 2009, and the second year limit is increased by \$200, as shown in Figure 20.

**Figure 20. Depreciation Limitations for Passenger Autos, Pickups, and Vans**

<b>Year Placed in Service</b>	<b>1st Year</b>	<b>2nd Year</b>	<b>3rd Year</b>	<b>Later Years</b>
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 only additional for 50% bonus*	7,650			
2005 regular for cars	2,960	4,700	2,850	1,675
2005 regular for pickups and vans	3,260	5,200	3,150	1,875
2006 regular for cars	2,960	4,800	2,850	1,775
2006 regular for pickups and vans	3,260	5,200	3,150	1,875
2007 regular for cars	3,060	4,900	2,850	1,775
2007 regular for pickups and vans	3,260	5,200	3,050	1,875
2008 regular for cars	2,960	4,800	2,850	1,775
2008 regular for pickups and vans	3,160	5,100	3,050	1,875
2008 only additional for 50% bonus	8,000			
2009 regular for cars	2,960	4,800	2,850	1,775
2009 regular for pickups and vans	3,060	4,900	2,950	1,775
2009 only additional for 50% bonus	8,000			
2010 regular for cars	3,060	4,800	2,850	1,775
2010 regular for pickups and vans	3,160	4,900	2,950	1,775
2010 only additional for 50% bonus	8,000			

\*Note: This limitation applies even if the taxpayer elects 30% bonus depreciation. For details, see the discussion of bonus depreciation that follows.

## **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 AMTI. 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 purposes due to prior-year



AMT depreciation 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 Figure 21.

**Figure 21. 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 what was allowed under MACRS ADS SL depreciation.

## Bonus or Additional First-Year Depreciation

Bonus depreciation continues in 2010 for qualifying property placed in service, or under a binding contract, during calendar years 2008 through 2010. Bonus depreciation had not been available on any item placed in service after December 31, 2004, and before January 1, 2008. It will also not be available after December 31, 2010. The following discussion provides the historic perspective, since these same rules apply to the 50% AFYD available during 2008 through 2010. (Through 2011 for certain long-lived and transportation property.)

As a result of the Job Creation and Worker Assistance Act of 2002, there was 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. The 2003 act provided a 50% bonus depreciation for similarly qualified property placed in service after May 5, 2003, but before December 31, 2004. ESA 2008 reintroduced a 50% AFYD on qualifying property, ARRA 2009 extended it through 2009 and The Jobs Act of 2010 extended it again through 2010. This deduction had previously been referred to as the *bonus depreciation* but is now referred to as *additional first-year depreciation*. This special depreciation allowance is in addition to the I.R.C. § 179 direct-expense deduction.

## Qualified Property

The following qualifications are used to determine whether assets are eligible for AFYD:

- Under regulations issued September 5, 2003, the *total cost (including adjusted basis of any traded item)* is eligible for this bonus depreciation.
- The asset has a depreciable life of 20 years or less.
- The original use of the asset must commence with the taxpayer. (See additional details under the “What Constitutes New?” section.)
- The property must be used over 50% for the business.

## 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 should qualify.

## Mandatory Use or Election Out

The use of AFYD 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. (During 2003 and 2004 the taxpayer was also able to elect out of 50% bonus depreciation and claim 30%.)

## 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 the uniform capitalization rule (discussed in a later section), they are ineligible for AFYD. However, if a taxpayer simply elects to use ADS to stretch the useful life (rather than being required to do so), he or she must still claim AFYD on otherwise qualifying property unless the taxpayer elects out.

## Luxury Car Limits Modified

To accommodate 50% AFYD on eligible lightweight vehicles, the amount of first-year depreciation allowed on passenger vehicles was increased (taxpayers must prorate for business-use percentage; see Figure 20). However, this increased limit was only available if bonus depreciation was used.

## Interaction with I.R.C. § 179

AFYD is in addition to the I.R.C. § 179 deduction on qualifying property. The I.R.C. § 179 deduction is taken first, and then the remaining basis is eligible for AFYD.

### Example 13.

A farmer purchased \$800,000 of new equipment in July 2010. Since this is below the \$1,000,000 statutory maximum for qualifying I.R.C. § 179 property, the farmer may elect to deduct the full \$500,000. Since the property is new and has a recovery class of 20 years or less, the farmer may claim 50% AFYD of \$150,000 and regular farm MACRS depreciation of \$10,065 for a grand total deduction of \$660,065.

Total Cost	\$800,000
Less I.R.C. § 179	– 500,000 A
Balance	300,000
Less 50% AFYD	– 150,000 B
Balance	150,000
Times 7 year MACRS 150% depreciation	× 10.71%
MACRS depreciation	16,065 C
Total depreciation expense (A + B + C)	\$666,065

## Alternative Minimum Tax

AFYD is also allowed in the calculation of AMTI, so there will be no additional depreciation adjustment for AMT as a result of using bonus depreciation.

### 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 under the mid-month convention rule. The depreciation tables reflect the full year's depreciation except in the final year of the recovery period. Therefore it is necessary to adjust the table amount of depreciation based on the months the asset was actually held. An asset under the mid-quarter convention sold in May will receive only 4.5 months of depreciation in the year of disposition.

When assets are sold, gain to the extent of all prior depreciation on all I.R.C. § 1245 (including 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, AFYD 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. A 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 reserve tax deductions for future years if higher tax brackets are expected.

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 only 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 generally wasted.

### Reporting Depreciation and Cost Recovery

Form 4562, Depreciation and Amortization, is used to report the I.R.C. § 179 expense election, AFYD, 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, Profit or Loss from Farming. 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, Self-Employment Tax, if the partner meets the test for the I.R.C. § 179 deduction to be taken (i.e., business income limitation and overall \$500,000 limit).

## 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, Depreciation and Amortization. A complete depreciation and cost recovery record is needed to supplement Form 4562; however, it is not necessary to file with the taxpayer's tax return 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 below for other GBCs). Form 3800, General Business Credit, is used to claim the credit for the current year, to apply carryforward from prior years, and to claim carryback from later years. The credit allowable cannot reduce regular tax below the 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. The Jobs Act of 2010 increased the carryback period to 5 years and the carryover period to 25 years for certain business credits of small business (less than \$50 million average gross receipts). For all other business credits, TRA 97 had 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 investment tax credit (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 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 the 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 (Investment Credit) is used for computing ITC; Form 4255 (Recapture of Investment Credit) 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.

## Gasification

The credit is equal to (1) 30% of the qualified investment in advanced coal-based generation technology projects, (2) 20% of the qualified investment in integrated gasification combined cycle projects, and (3) 15% of the qualified investment in projects that use other advanced coal-based generation technologies. Certification by the Department of Energy and approval by the IRS are required. Any credit claimed reduces the depreciable basis of the property.

## Energy

Business energy investment credit is equal to 10% of the basis of qualified microturbine property and geothermal energy equipment placed in service during the tax year. For tax years ending after October 3, 2008, combined heat and power system property qualifies for the 10% credit. A 30% credit applies to qualified fuel-cell property; equipment that illuminates the interior of a structure using fiberoptic distributed sunlight; or equipment that provides solar-process heat or uses solar energy to generate electricity, provide hot water, or heat or cool a structure. For tax years ending after October 3, 2008, the 30% credit also applies to qualified small wind-energy property (up to 100 kilowatts), biomass fuel systems, and geothermal heat-pump systems. The basis of any qualifying equipment must be reduced by 50% of ITC claimed.

## Other GBCs

In addition to federal investment credits, a variety of other GBCs are available to taxpayers.

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

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. Employers' 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 or the deduction for expenses must be reduced by the credit claimed.

## **Pension Plan Credit for Start-Up Costs for Small Businesses**

Any small business that sets up a new qualified defined-benefit or defined-contribution plan may receive a nonrefundable income tax credit for 50% of the first \$1,000 in administrative and retirement education costs. 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.

## **Work Opportunity Credit**

The work opportunity credit (which now applies to qualifying individuals who start to work no later than September 1, 2011) is available to employers on first-year employee wages paid (Form 5884, Work Opportunity Credit). 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 12 targeted groups, including qualified SSI recipients, recipients of long-term family assistance and temporary assistance for needy families (TANF), certain food-stamp recipients, qualified summer youth employees, designated community residents, economically disadvantaged ex-felons, certain disabled workers, two groups of veterans, Hurricane Katrina victims, and disconnected youth. Qualification rules have been modified for disabled workers, veterans, and youth targeted groups.

### ***Qualified Veterans Targeted Groups***

An unemployed veterans group has been added for 2009 and 2010. To qualify, the individual must have been discharged from active duty within 5 years of hiring and be in receipt of unemployment compensation for at least 4 weeks in the year ending the hiring date.

The qualified veterans' targeted group continues and includes an individual who is certified as entitled to compensation for a service-connected disability and (1) having a hiring date that is not more than 1 year after having been discharged or released from active duty in the U.S. armed forces, or (2) having been unemployed for 6 months or more (whether or not consecutive) during the 1-year period ending on the date of hiring. Being entitled to compensation for a service-connected disability is defined with reference to section 101 of Title 38, U.S.C., which means having a disability rating of 10% or higher for service-connected injuries.

### ***Disconnected Youth Targeted Group***

This group has been added for 2009 and 2010 and includes individuals (1) age 16 or over but not yet 25, (2) not regularly attending school during the 6 months prior to hiring, (3) not regularly employed during that 6-month period, and (4) not readily employable due to a lack of basic skills.

### ***Designated Community Residents (Formerly High-Risk Youth) Targeted Group***

The definition of high-risk youths changed to include otherwise qualifying individuals age 18 but not yet age 40 on the hiring date. Also, the definition of eligible individuals under this category was expanded to include otherwise qualifying individuals from rural renewal counties. For these purposes, a rural renewal county is a county outside a metropolitan statistical area (as defined the Office of Management and Budget) that had a net population loss during the 5-year periods 1990–1994 and 1995–1999. Finally, the provision changes the name of the category to the *designated community residents* targeted group.

### ***Vocational Rehabilitation Referral Targeted Group***

The definition of vocational rehabilitation referral includes any individual who is certified by a designated local agency as having a physical or mental disability that constitutes a substantial handicap to employment and who has been referred to the employer while receiving, or after completing, an individual work plan developed and implemented by an employment network pursuant to subsection (g) of section 1148 of the Social Security Act.

### ***Qualified First-Year Wages***

The definition of qualified first-year wages increased from \$6,000 to \$12,000 in the case of individuals who qualify under either of the new expansions of the qualified veteran group, discussed in the preceding paragraph. The wage limit is reduced to \$3,000 for qualified summer youth employees. The expanded definition of qualified first-year wages does not apply to the veterans qualified with reference to a food stamp program, as defined under present law.

### ***Certification***

Under present law, designated local employment agencies may enter into information-sharing agreements to facilitate certification for purposes of work opportunity tax credit (WOTC) eligibility. Such agreements are subject to confidentiality requirements. Congress expects that the Department of Defense, the Department of Veterans Affairs, and the Social Security Administration will work with the designated local agencies to facilitate certification of the expansions of the qualified veteran category and the SSI recipient category. Finally, Congress expects that the IRS will develop procedures to allow (in addition to original documents) paper versions of electronically completed prescreening notices and photographic copies of hand-signed original prescreening notices for purposes of the credit. This allowance of prescreening notices that are not original documents should be allowed only to the extent it does not foster incorrect or fraudulent filings. The provisions are effective for individuals who begin work for an employer after the date of enactment.

### ***Disabled Access Credit***

The disabled access credit may be claimed on Form 8826, Disabled Access Credit, 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 and agricultural chemicals security.

## A REVIEW OF 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 (Profit or Loss from Farming) 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 (Sales of Business Property) must be used to report gains and losses on sales of farm business property. Form 1040 Schedule D (Capital Gains and Losses) 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 the 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 2006, 2007, 2008, or 2009 return and has a net I.R.C. § 1231 gain for 2010 must recapture the losses on the 2010 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 gain 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. 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 14.

A general-purpose farm building was purchased in 2008 for \$20,000. Regular MACRS was used until the building was sold for \$23,000 in 2010. Accumulated depreciation totaled \$2,861. Total gain was therefore \$5,861, as shown in Figure 22. 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 (0% or 15%).

**Figure 22. 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
<b>Tax on Gain</b>	
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
	<b>\$ 5,861</b>

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 affect 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: 80% for the sixth year after acquisition of the land, 60 % for the seventh year, 40% for the eighth year, and 20% for the ninth year. Figure 23 gives an illustration.

**Figure 23. Example of Recaptured Gain**

Cost of farmland acquired April 1, 2005	\$100,000
Soil and water expenses deducted on 2006 tax return	8,000
Price land was sold for on May 15, 2010	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. However, the land was sold during the sixth year of ownership, so 80% of the soil and water conservation expenses ( $\$8,000 \times 0.80 = \$6,400$ ) must be recaptured as ordinary gain. The balance of the gain ( $\$30,000 - \$6,400 = \$23,600$ ) 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

All sales of farm business properties are reported on Form 4797 (Sales of Business Property), which segregates I.R.C. § 1231 gain and loss from ordinary gain and loss. Casualty and theft gains and losses are reported on Form 4684 (Casualties and Thefts) 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, where it is combined with other I.R.C § 1231 gains and losses.

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 (Capital Gains and Losses) 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, U.S. Individual Income Tax Return.

## Gifts and Below-Market Sales

If a taxpayer sells an asset at below market value, the transaction is in essence part sale and part gift. A taxpayer should always determine FMV and file the appropriate income 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 2010 annual gift tax exclusion which remains at \$13,000 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 or other ordinary income 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, Installment Sale Income, 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 are also 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 15.

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 using 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 siblings.) The amount of gain accelerated is the excess of the amount realized on the resale over the payments made on the installment sale, multiplied by the gross profit ratio. 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

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.

The 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.

The 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)]. With related parties, the remaining balance of the installment obligation is its deemed sales price.

## 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 as 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 Figure 24 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 \$5,131,700 (in 2009, indexed thereafter) must have an interest rate of the lesser of 100% of the AFR or 9% (compounded semiannually). Sales in excess of this amount do not have the 9% rate cap.
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 (i.e., 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.

**Figure 24. Recent Applicable Federal Rates (AFRs)**

Term	Compounding Period	Sept. 2010	Oct. 2010	Nov. 2010
Short-term (3 yrs or less)	Annual	0.46%	0.41%	%
	Monthly	0.46%	0.41%	%
Mid-term (over 3 to 9 yrs)	Annual	1.94%	1.73%	%
	Monthly	1.92%	1.71%	%
Long-term (over 9 yrs)	Annual	3.66%	3.32%	%
	Monthly	3.60%	3.27%	%

Source: IRS Web site [http://www.irs.gov/irb/2009-37\\_IRB/ar05.html](http://www.irs.gov/irb/2009-37_IRB/ar05.html).

# 4

## FARM ISSUES

### 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)

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, Profit or Loss from Farming, but also an owner's share of net farm income from an S corporation (including wages), partnership, or LLC. It does not include wages from 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, which may reduce the benefit of income averaging. 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, 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 Internal Revenue Code 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. Effective in 2004 and later years, the use of income averaging will not result in an increase in AMT.

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, Income Averaging for Farmers and Fishermen, 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 16.**

Fruit growers Mr. and Mrs. B & B Goodyear have a substantial increase in farm income in 2010. Receipts are up, and costs are down. Mrs. Goodyear works off-farm. When Form 1040 Schedule F, Profit or Loss from Farming, profits of \$58,000 are combined with nonfarm income and deductions, taxable income is \$92,000. They file a joint return. Their taxable income for 2010 and the previous 3 years is shown in Figure 25.

**Figure 25. Goodyears' Taxable Income**

Year	Taxable Income
2010	\$ 92,000
2009	30,900
2008	57,750
2007	28,200

The Goodyears elect to income average in 2009. 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 (\$92,000 – 68,000). They decide to use \$24,000 of their Form 1040 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 2008 their 15% tax bracket ended at \$65,100, and their taxable income was \$57,750, leaving \$7,350 of the 15% rate bracket available for EFI from the current year. Therefore, \$650 (\$8,000 – \$7,350) added to the 2008 base-year income will be taxed at 25%.

**Question 2.** Should the Goodyears reduce EFI to avoid the 25% tax bracket in 2008?

**Answer 2.** For each \$1 of EFI subject to the 25% tax rate in 2008, \$2 is taxed at 15% in the other base years. Therefore, the marginal tax rate for the Goodyear's EFI is 18.33%  $[(15 + 15 + 25) \div 3]$ . If they put less than \$24,000 in the 2010 EFI, their 2010 taxable income will exceed \$68,000, and their marginal tax rate will be 25%.

**Question 3.** How much income tax will the Goodyears save by income averaging in 2010?

**Answer 3.** They will save 10% (25% rate – 15% rate) on the first \$22,050 (3 × \$7,350) or \$2,205, and 6.67% (25% – 18.33%) on the remaining \$1,950 of EFI or \$130, for a total tax reduction of \$2,335.

## 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 17.

Sam had a \$45,000 Schedule F, Profit or Loss from Farming, loss in 2009. He and his wife filed a joint return and claimed five exemptions (including three children). Taxable income was calculated as shown in Figure 26.

**Figure 26. Sam's Taxable Income**

Schedule F	(\$45,000)
Standard deduction	(11,400)
Exemptions	(18,250)
Taxable income	(\$74,650)

Sam's NOL for 2009 would be \$45,000. This NOL must be removed from taxable income, leaving (\$29,650) to be used as base-year income for 2009 on Sam's Schedule J, Income Averaging for Farmers and Fishermen.

## 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 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, 2010 farm business gains of a taxpayer in a 25% income tax bracket could be eligible for a 5% 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 (0% rate would apply if this 15% rate base year were 2008 or 2009).

**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, Profit or Loss from Farming, 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, Farm Rental Income and Expenses). This is a change from prior interpretation. For crop-share rents the lessor needs to have a written crop-share lease agreement. Cash rental income reported on Form 1040 Schedule E, Supplemental Income and Loss, 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, Sales of Business Property, 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 at the 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 any 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, the base-year’s income, deductions, and credits are not affected by the additional income allocated to that year (e.g., 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 taxpayers may have to override their 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 (and marginal tax rates) to even out in anticipation of income averaging in future years. Note that optimizing base-period income has become easier again with regular income tax brackets being the same for the current and all 3 base years. Use caution when including capital gains in the income-averaging computation due to the 0% rate of tax on adjusted net capital gains for 2008, 2009 and 2010 (but not 2007).

**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 tax to be determined for the AMT comparative computation without regard to income averaging. That is, tentative AMT is compared to regular income tax before income averaging.

## Planning Guidelines and Information

Generally, it is better to 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, and then elect income averaging as needed. An exception to this would be the case where net earnings from self-employment exceed the base for the retirement component on the SE tax. Allowing high income that is then taxed at lower base-year rates may be advantageous.

Income averaging should be used to transfer as much high-bracket income as possible 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 2010 farm income should be averaged:

- Taxable income for 2010 as well as ordinary income and capital gain attributed to farming
- Taxable income from his or her 2007, 2008, and 2009 tax returns
- Income tax brackets for 2010 and the 3 prior years (see Figure 27)

### 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. 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. 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.

**Figure 27. Top End of Taxable Income Tax Brackets**

<b>Bracket</b>	<b>Single</b>	<b>Married Filing Jointly</b>	<b>Head of Household</b>	<b>Married Filing Separately</b>
<b>2010</b>				
10%	\$ 8,375	\$ 16,750	\$ 11,950	\$ 8,375
15%	34,000	68,000	45,550	34,000
25%	82,400	137,300	117,650	68,650
28%	171,850	209,250	190,550	104,625
33%	373,650	373,650	373,650	186,825
<b>2009</b>				
10%	\$ 8,350	\$ 16,700	\$ 11,950	\$ 8,350
15%	33,950	67,900	45,500	33,950
25%	82,250	137,050	117,450	68,525
28%	171,550	208,850	190,200	104,425
33%	372,950	372,950	372,950	186,475
<b>2008</b>				
10%	\$ 8,025	\$ 16,050	\$ 11,450	\$ 8,025
15%	32,550	65,100	43,650	32,550
25%	78,850	131,450	112,650	65,725
28%	164,550	200,300	182,400	100,150
33%	357,700	357,700	357,700	178,850
<b>2007</b>				
10%	\$ 7,825	\$ 15,650	\$ 11,200	\$ 7,825
15%	31,850	63,700	42,650	31,850
25%	77,100	128,500	110,100	64,250
28%	160,850	195,850	178,350	97,925
33%	349,700	349,700	349,700	174,850

## Prepaid Expenses

Cash-basis taxpayers may be able to expense currently supplies and fertilizer that will not be used until the year after purchase.

Revenue Ruling 79-229 outlines three tests which must be met before a prepaid item can be currently deductible.

1. The expenditure must be an actual purchase, not a deposit.

2. The expenditure must be made for a business purpose, not just to avoid taxes.
3. The expenditure must not result in a material distortion of income.

Furthermore, a requirement was added in 1986 that to the extent prepaid expenses exceed 50% of deductible nonprepaid farming expenses for the tax year, the prepaid expenses are only deductible as the purchased items are consumed. For farmers living on the farm, this test is based on the average expenses of the prior 3 years.

## **Uniform Capitalization Rules for Fruit Growers and Nursery Owners**

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 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. Nursery owners could use the farm-price method to establish their preproductive costs of growing trees, vines, and ornamentals. Capitalization requires the recovery of orchard, vineyard, and ornamental tree preproductive period expenses over 10 years, using the SL method.

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.

## **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, Profit or Loss from Farming. 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 replaces the previous option of forfeiting the grain to the CCC.

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 (market gain). 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.
- These 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.

## CONSERVATION AND ENVIRONMENTAL PAYMENTS AND GRANTS

Farmers and participating landowners are receiving NYS 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. To be excluded, the payment must be for capital expenditures such as concrete pads, storage tanks, tile drains, diversion ditches, and manure storage. The fact that the agency states that the payments qualify under I.R.C. § 126 is not sufficient to allow exclusion. Payments for items that can be expensed on Form 1040 Schedule F, Profit or Loss from Farming, including soil and water conservation expenses, may not be excluded. A portion of a payment that increases annual gross receipts from the improved property by 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 after 10 and before 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. In Notice 2006-108, 2006-51 IRB 118 (December 2006), the IRS stated its position that CRP payments

are subject to SE tax whether the taxpayer fulfills the contractual obligations for maintaining the land or arranges for a third party to do so. However, the 2008 Farm Bill specifically excludes CRP payments from SE income for retired and disabled taxpayers who are receiving social security benefits. This leaves uncertainty for other landowners who receive such payments and are deemed not to be providing material participation. The IRS notice is designed to eliminate the idea of reporting such payments on either Form 1040 Schedule E, Supplemental Income or Loss, or Form 4835, Farm Rental Income and Expenses, which arose as a result of the Wuebker Tax Court case.

## **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. 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 18.**

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 1971, is \$35,000. True reduces the basis to \$0 and realizes a \$15,000 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 that 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 SE 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 (Profit or Loss from Farming) 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 qualify to be deducted as soil and water conservation expenses (subject to the 25% of gross farming income limitation) or depreciated as improvements. Income and expenses associated with managing and maintaining the WRP land are reported on Form 1040 Schedules F or C (Profit or Loss from Business).

## AGRICULTURAL CHEMICALS SECURITY CREDIT

The 2008 Farm Bill provides a 30% credit for qualified chemical security expenditures incurred after May 22, 2008, and before January 1, 2013. Expenditures are eligible for the credit if incurred by an eligible agricultural business for protecting specified agricultural chemicals. Eligible businesses are generally those that sell such chemicals at retail to farmers or manufacture, formulate, distribute, or aeri-ally apply such chemicals. Qualified expenditures include employee security training and background checks, access controls, tagging, perimeter protection, security lighting and surveillance, computer secu-rity, and other measures provided by regulation. The credit is limited to \$100,000 per facility in a 6-year period and to \$2,000,000 annually per taxpayer. The deductible expense is reduced by the amount of credit claimed.

## LEASING OF LAND AND OTHER FARM ASSETS

### Production Flexibility Contract (PFC) Payments on Leased Land

The 1996 Farm Bill provided 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, in order to be able to share in the gov-ernment payments. If the landowner begins to materially participate, then it will affect the landowner's SE taxes and social security benefits, because the income would be reported on Form 1040 Schedule F, Profit or Loss from Farming. If the landowner does not meet any of the material participation tests (*Farmer's Tax Guide*, IRS Pub. 225), then they can report their share of the crop on Form 4835 (Farm Rental Income and Expenses), rather than as cash rent on Form 1040 Schedule E (Supplemental Income and Loss), 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 (Supplemental Income and Loss) and not included in net earnings from self-employment. Crop- and livestock-share rents are reported on Form 4835 (Farm Rental Income and Expenses) 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. That is, only land rent may be affected.

Income and expenses from the rental of personal property (not leased with real estate) is reported on Form 1040 Schedule C, Profit or Loss from Business (Sole Proprietorship), or C-EZ, Net Profit from Business (Sole Proprietorship). 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, with one operating the farm as the sole proprietor and paying 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 to 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 farmland, with at least annual payments.
2. Deduct the taxes, interest, and insurance on the rented property on the owner's Form 1040 Schedule E, Supplemental Income and Loss.
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 not only would cause additional SE tax to be paid but also could affect eligibility for social security benefits of those landowners collecting benefits prior to full retirement age.

Passive-activity issues also arise with rental arrangements. Although it may be possible to structure arrangements between spouses to avoid material participation for SE tax issues, the passive-activity rules are different. For the passive-activity rules, participation by a spouse is considered participation by the landowner. This deemed participation invokes the “self-rental” rules, which prevent any profits from the activity being used to allow the deduction of passive losses from other sources. However, under the self-rental rules, any losses from the rental arrangement would still be subject to the passive-activity loss rule limitations.

### 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 the 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, in which 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. The lessee may furnish none of the cost of the property (i.e., no trade-ins).
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 (i.e., 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).

## Farm Diesel Fuel Tax Refund

The 2005 Transportation Act eliminated ultimate vendor claims for nondyed diesel fuel or kerosene sold for farm use after September 30, 2005. If nondyed diesel fuel or kerosene was used for farming purposes, the refund payments were previously paid to the ultimate registered vendor making the claim. Under the 2005 legislation, the refunds will be paid to the ultimate purchaser under the rules applicable to nontaxable uses of these nondyed fuels. Ultimate purchasers must keep detailed records of usage, dates, suppliers, and amounts and will file Form 4136, Credit for Federal Tax Paid on Fuels, annually; or Form 8849, Claim for Refund of Excise Taxes, for quarterly claims over \$749.

## Tax Suggestions for Farmers

Here are some tax management suggestions for farmers with 2010 net farm profits:

- Purchase quantities of feed and supplies before the year end in certain situations. These prepaid expenses may be limited to 50% of other expenses on Form 1040 Schedule F, Profit or Loss from Farming.
- Buy needed machinery now to take advantage of the enhanced I.R.C. § 179 deduction as well as the additional first-year 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.
- Utilize income averaging when preparing tax returns
- Perhaps as significantly, ideas for farmers with losses include
- Delay payment of operating expenses and purchases of depreciable items.
- Accelerate income.
- Sell excess or less profitable assets.
- Use ADS depreciation.
- Be sure major repairs are capitalized.
- Consider converting traditional IRA to Roth IRA.
- Elect optional SE tax, especially in view of self-employed health insurance deduction and EIC.
- Consider NOL carryback election options when preparing tax returns.

# 5

## RETIREMENT ISSUES

### RETIREMENT PLANS

Taxpayers with earned income have the opportunity to take advantage of IRA contributions that will increase their nest egg at retirement. There are three types of IRAs: traditional, nondeductible and Roth.

Small business and farm owners have several retirement plan options available to them:

- SEP IRA
- SIMPLE IRA
- SIMPLE 401k
- 401K
- Defined benefit
- Defined contribution

Taxpayers have both opportunities and rewards for contributing to retirement plans. Figure 28 illustrates increased limits in the plans over last year's limitations.

The upper and lower limits of the phase-out range for deductible IRAs has increased for all filing statuses other than married filing separately. The deductible IRA phase-out MAGI limits for employees covered by a pension are as follows (dependent upon filing status):

Single, head of household	\$56,000–\$66,000
Married filing jointly	89,000–109,000
Married filing separately	0–10,000

A spouse's participation in a pension plan may also limit the deduction of a taxpayer's IRA contribution. The phase-out range for the spouse who is not an active participant (based on MAGI) is \$167,000 to \$177,000.

Regardless of any other pension of the taxpayer or spouse, Roth IRA contributions are restricted for higher income taxpayers.

The MAGI phase-out ranges for contribution to a Roth IRA are as follows

Single, head of household	\$105,000–\$120,000
Married filing jointly	167,000–177,000
Married filing separately	0–10,000

**Figure 28. Limitations on Contributions**

	<u>2008</u>	<u>2009</u>	<u>2010</u>
IRAs, traditional & Roth	\$ 5,000	\$ 5,000	\$ 5,000
Simple	10,500	11,500	_____
401(k), 403(b), 457, and SEP	15,500	16,500	_____
Defined contribution	46,000	49,000	_____
Defined-benefit plan <sup>1</sup>	185,000	195,000	_____
Compensation limit	230,000	245,000	_____
Stock bonus & profit share	25%	25%	25%

1. 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 age 50 and older. These contributions are additions to the above limits, but total contributions still cannot exceed the taxpayer's earnings. The IRA contributions are still subject to AGI phase-out 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 Figure 29.

**Figure 29. Catch-Up Contribution Limits**

<u>Year</u>	<u>IRA</u>	<u>SIMPLE</u>	<u>401(k), 403(b), 457, and SEP</u>
2003	500	1,000	2,000
2004	500	1,500	3,000
2005	500	2,000	4,000
2006–			
2008	1,000	2,500	5,000
2009	1,000	2,500	5,500
2010	1,000	2,500	5,500
2011	1,000	TBA	TBA

### **Nonrefundable Credit Allowed for Elective Deferrals and IRA Contributions**

Contributions to some IRAs and employer-sponsored retirement plans are deductible or excludable from income. Beginning in 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 AGI, and the maximum annual contribution eligible for the credit is \$2,000. There are limits on AGI, dependent upon the taxpayer's filing status. The AGI is determined without adjustments 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 Figure 29.

There is an exception that excludes distributions from a Roth IRA. The AGI-based credit rates for 2010 are given in Figure 30.

**Figure 30. Credit Rates Based on AGI**

Joint Return		Head of Household		All Other Filers		Credit Percentage
Over	Not Over	Over	Not Over	Over	Not Over	
\$ 0	\$33,500	\$ 0	\$25,125	\$ 0	\$16,750	50%
33,500	36,000	25,125	27,000	16,750	18,000	20%
36,000	55,500	27,000	41,625	18,000	27,750	10%
55,500		41,625		27,750		0%

### Roth 401(k)

For tax years after 2005, a 401(k) plan is permitted (but not required) to include a qualified Roth contributions program, under which a participant can elect to have all or a portion of the participant's elective deferrals (called designated Roth contributions) under the plan contributed to a designated Roth account and included in income when earned. A Roth 401(k) allows participants, after January 1, 2006, to make after-tax contributions up to the 401(k) maximum of \$16,500 for 2010 (plus \$5,500 catch-up if eligible). The advantage of the Roth 401(k) over the original Roth IRA is that it is not limited by the taxpayer's MAGI. Distributions at retirement will be tax-free.

## SOCIAL SECURITY



### 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.

### Current Social Security Tax

The social security earnings base continues at \$106,800 for 2010. There is no cap on the amount of earnings subject to Medicare tax. FICA and SE tax percentage rates remain the same as in 2009. The total rate is divided into two components representing the social security and the Medicare tax. The

maximum 2009 social security tax is \$6,621.60 (employer's share). See Figure 31 for the 2008 through 2010 social security and Medicare tax rates.

**Figure 31. Social Security Tax Table**

Year	Soc. Sec.	Medicare	FICA Rate %		Self-Employment Rate %	
			Soc. Sec. <sup>1</sup>	Medicare <sup>1</sup>	Soc. Sec.	Medicare
2008	102,000	Unlimited	6.20	1.45	12.40	2.90
2009	106,800	Unlimited	6.20	1.45	12.40	2.90

<sup>1</sup>Paid by both employer and employee.

Employers use separate social security and Medicare tax withholding tables. Forms 941 (Employer's Quarterly Federal Tax Return) and 943 (Employer's Annual Federal Tax Return for Agricultural Employees) require social security and Medicare taxes to be reported separately. The SE tax is calculated on Form 1040, Schedule SE (Self-Employment Tax). 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%.

### Self-Employment Tax Deductions for Self-Employed Taxpayers

The following three deductions are available to self-employed taxpayers:

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 (Profit or Loss from Business) or F (Profit or Loss from Farming) by 0.9235 on Schedule SE (Self-Employment Tax). This adjustment is made before applying the social security and Medicare tax earnings base. Taxpayers reporting less than \$106,800 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.
3. As a result of the Jobs Act of 2010, self-employed individuals may not subtract health insurance premiums on policies covering them and their family when determining self-employment income subject to SE tax.

### Farmer's Optional Method

The optional method allows taxpayers to pay SE tax on two-thirds of gross farm income if gross income is below \$6,720. Taxpayers with gross farm income in excess of \$6,720 may use this optional method and report \$4,480 of SE income when net farm income is less than \$4,851. 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 \$1,120 in 2010. Thus, the optional method will now yield four quarters of coverage. This is an important change in the coverage for farmers trying to be currently insured under the social security system. Earning \$4,480 (net of  $\frac{1}{2}$  of SE tax) anytime during 2010 will provide four quarters of coverage.

### Example 19.

Ima Cow has \$6,720 of 2010 gross farm income netting only \$1,300 of net farm income. He would pay SE tax of  $\$1,300 \times 0.9235 \times 0.153 = \$184$ . The optional method would result in  $\$4,480 \times 0.153 = \$685$  of SE tax and earn four quarters of coverage. Ima may realize an additional benefit by using this method and paying the SE tax—namely, an increase of reportable income for the EIC.

## Nonfarm Optional Method

There is an optional method for determining net earning from nonfarm self-employment, much like the method discussed earlier. A taxpayer may use this optional method if he or she meets all of the following tests:

1. He or she is self-employed on a regular basis. This means that his or her actual net earnings from self-employment were \$400 or more in at least 2 of the 3 tax years before the one for which this method was used. The net earnings can be from either farm or nonfarm earnings or both.
2. He or she has used this method less than 5 years. (There is a 5-year lifetime limit.) The years do not have to be one after another.
3. His or her net nonfarm profits were less than \$4,851 (or \$4,480 when reduced by  $\frac{1}{2}$  of SE tax) and less than 72.189% of gross nonfarm income.

## 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 who work 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 must also be 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, and they are not required to pay FUTA for children under age 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 up to 85% of social security benefits for higher-income taxpayers became effective in 1994 (previously a maximum of 50% of benefits were taxed). US and Canadian social security benefits are taxed exclusively in the country where the recipient resides.

### 85% Rules

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. Since these numbers have not been increased for inflation, additional taxpayers each year will find themselves subject to taxation of social security benefits.

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

1. 85% 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).

### 50% Rules

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 lesser 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 receipts are excluded from gross income.

## Reduction of Benefits

When a person's wage and SE 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 2010, the annual earnings limit for those less than full retirement age is \$14,160; and for those who have attained full retirement age, earnings are 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 1941 is 65 and 8 months; for those born in 1942 it is 65 and 10 months; and for those born in 1943–1954 it is 66 (see the Social Security Administration Web site for those born in later years).

## Retirement Planning Considerations

Although the earnings cap for those workers over full retirement age who are getting social security benefits has been eliminated, those under full retirement age still have to stay under \$14,160 in earnings in 2010 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 into 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, Profit and Loss from Farming, and Schedule SE, Self-Employment Tax (Form 1040).

The retirement earning test for loss of some benefits for the year the individual reaches full retirement age in 2010 is \$3,140 per month before the month of full retirement age. 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 for that period of months. There is no limit on earnings beginning the month an individual attains full retirement age.

## “Nanny Tax” Social Security Domestic Employment Act

The Social Security Domestic Employment Act, or “nanny tax,” allows the payment of employment taxes for domestic workers (e.g., babysitters, yard workers, house cleaners) to be reported on the employer’s income tax return. The 2010 wage threshold for reporting and paying social security taxes is \$1,700 annually.

Household employers use Schedule H, Household Employment Taxes (Form 1040), to report and pay social security, Medicare, FUTA (threshold is still \$1,000 per calendar quarter), and withheld income taxes. Farmers may treat wages paid to domestic workers under the \$1,700 annual 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 Form W-2 (Wage and Tax Statement) and Form 1040 Schedule H. An EIN can be obtained by completing and filing Form SS-4, Application for Employer Identification Number. Form SS-4 can be obtained by calling (800) TAX-FORM or online at <http://www.irs.gov>.

Wages paid to household workers under the age of 18 are exempt from any social security and Medicare taxes unless household employment is the worker’s principal occupation.

# 6

## ADDITIONAL PROVISIONS AND ISSUES

### CORPORATE AND PARTNERSHIP PROVISIONS

This chapter covers limited provisions of legislation for corporations and partnerships.

#### 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 2009 tax rates for small businesses are presented in Figure 32.

**Figure 32. 2010 Corporate Tax Rates for Small Businesses\***

<b>Taxable Income</b>	<b>Tax Rate</b>
\$0 to \$50,000	15%
\$50,001 to \$75,000	\$7,500 plus 25% on amount over \$50,000
\$75,001 to \$10,000,000	\$13,750 plus 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 100% of last year's tax (the prior year's tax must be greater than \$0).

Corporations that have elected S corporation status are generally not tax-paying entities and must file Form 1120S, U.S. Income Tax Return for an S Corporation. S corporation shareholders will include their allocated share of business income, deductions, losses, and credits on their individual returns.

The AMT has been repealed, effective January 1, 1998, for small corporations (not more than \$22.5 million of total gross receipts in the preceding 3-year period).

Farm-family C 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.

Additional exceptions to accrual accounting are provided for S corporations and C 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.

## Partnership Filing Rules and Issues

*The Family Business Tax Simplification provision* generally permits a qualified joint venture whose only members are a husband and wife filing a joint return to not be treated as a partnership for federal tax purposes. A qualified joint venture is one that involves the conduct of a trade or business, if (1) the only members of the joint venture are a husband and wife, (2) both spouses materially participate in the trade or business, and (3) both spouses elect to have the provision apply. All items of income, gain, loss, deduction, and credit are divided between the spouses in accordance with their respective interests in the venture. Each spouse takes into account his or her respective share of these items as a sole proprietor. Thus, it is anticipated that each spouse would account for his or her respective share on the appropriate form, such as Schedule C, Profit or Loss from Business (Sole Proprietorship). The provision is not intended to change the determination under present law of whether an entity is a partnership for federal tax purposes (without regard to the election provided by the provision). For purposes of determining net earnings from self-employment, each spouse's share of income or loss from a qualified joint venture is taken into account just as it is for federal income tax purposes under the provision (i.e., in accordance with their respective interests in the venture). A corresponding change is made to the definition of net earnings from self-employment under the Social Security Act. The provision is not intended to prevent allocations or reallocations, to the extent permitted under present law, by courts or by the Social Security Administration of net earnings from self-employment for purposes of determining social security benefits of an individual. The provision is effective for taxable years beginning after December 31, 2006.

*Failure to file a timely and complete return* subjects a partnership to penalty unless it can show reasonable cause for not filing Form 1065, U.S. Return of Partnership Income. A family-farm partnership with 10 or fewer partners will usually be considered as meeting 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.



### Law Change

For tax returns required to be filed after December 31, 2009, the penalty for failure to timely file Form 1065 has been increased to \$195 per partner/member per month for a maximum of 12 months (previously, this penalty had increased from \$86 per partner/member per month for a maximum of 12 months). Note that the \$195 per month penalty also applies to S corporations on a per-shareholder basis.

*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 \$1 million; and (3) Schedules K-1 are filed and furnished to the partners on or before the due date of the partnership return, including extensions. Even though the IRS does not require these records, the companies should still maintain records dealing with assets, liabilities, and equity, in addition to the reconciliation needed to arrive at taxable income.

*LLCs* with more than one member will 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). 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. Beginning in 2006, paper Form 8453-P, U.S. Partnership Declaration and Signature for Electronic Filing, is generally no longer required to be filed by the partnership.

## FINANCIAL DISTRESS

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 excluding 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.

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 to be reported in the same manner as if the property had been sold. 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.

### 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

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 as follows:

1. For the previous 3 years, 50% or more of the aggregate gross receipts of the farmer must have been attributable to farming; and
2. The discharging creditor must
  - a. Be in the business of lending money,
  - a. Not be related to the farmer,
  - b. Not have sold the property to the farmer, and
  - c. 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
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.

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 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.

## **INFORMATIONAL RETURNS**

### **Informational Forms (Often Issued or Received by Small Businesses)**

#### **Form 1099-MISC**

Form 1099-MISC, Miscellaneous Income, must be filed by any person engaged in a trade or business for 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 of \$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.



### **Law Change**

For years beginning after December 31, 2010, real estate rentals will be considered a trade or business. Therefore, any of the payment discussed here and made by the landlord will require 1099 reporting. (Jobs Act 2010)

## **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, Report of Cash Payments over \$10,000 Received in a Trade or Business, 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 (e.g., cashier's checks, bank drafts, traveler's checks, and money orders). The report must be filed within 15 days after receiving more than \$10,000.

## **Money Services Businesses**

Money services businesses (MSBs) include any person conducting business of more than \$1,000 with the same person on the same day in currency dealing or exchange, check cashing, issuing or selling or redeeming traveler's checks or money orders, or providing money transfers in any amount.

Businesses must register with the Department of the Treasury and are required to file suspicious activity reports and to file currency transaction reports. The required forms include FinCEN Form 107, Registration of Money Services Business; FinCEN Form 104, Currency Transaction Report; and TD F 90-22.56, Suspicious Activity Report by Money Services Business.

## **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 (Request for Waiver from Filing Information Returns on Magnetic Media), 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.

## 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, Application for Preparer Tax Identification Number. The number, when issued, will begin with a "P" followed by eight digits with no dashes. NYS also allows use of the PTIN.

## SMALL FIRMS WILL PAY FUTA LESS OFTEN

Employers are required to make a quarterly deposit for the FUTA only if the accumulated tax exceeds \$500. By raising the requirement, it has reduced the burden for employers with up to eight employees or fewer.

This amount will be reported on federal Form 940, Employer's Annual Federal Unemployment (FUTA) Tax Return. The Form 940-EZ has been discontinued. Previously, quarterly FUTA deposits were required if FUTA liability exceeded \$100 in the quarter, even if other payroll tax thresholds were not met.

## 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:

- Dates and locations of current and future scheduled seminars
- Problems encountered by other Cornell Tax School practitioners
- Tax issues affecting NYS filers

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## OTHER A.E.M. EXTENSION BULLETINS

EB No	Title	Fee (if applicable)	Author(s)
2010-11	2010 New York State Reference Manual for Regional Schools, Income Tax Management and Reporting for Small Businesses and Farms.	(\$25.00)	Bennett, J. and K. Bennett
2010-10	Dairy Farm Business Summary, Intensive Grazing Farms, New York, 2009		Conneman, G., Karszes, J., Grace, J., Murray, P., Carlberg, V., Benson, A., Staehr, A., Ames, M., Glazier, N., Anderson, J. and L. Putnam
2010-09	Profiles of Successful Farm Transfers on Long Island		Staehr, A.
2010-08	Dairy Farm Business Summary, New York Small Herd Farms, 80 Cows or Fewer, 2009	(\$16.00)	Knoblauch, W., Putnam, L., Kiraly, M. and J. Karszes
2010-07	Dairy Farm Business Summary, Hudson and Central New York Region, 2009	(\$12.00)	Knoblauch, W., Putnam, L., Karszes, J., Buxton, S., Shoen, K., Hadcock, S., Kiraly, M., Hulle, L., Smith, R., Skellie, K., Conneman, G. and R. Overton
2010-06	Dairy Farm Business Summary, Northern NY Region, 2009	(\$12.00)	Knoblauch, W., Putnam, L., Karszes, J., Murray, P., Vokey, F., Prosper, J., Deming, A., Balbian, D., Buxton, S., Manning, J., Collins, B. and R. Overton
2010-05	Dairy Farm Business Summary, Western NY Region, 2009	(\$12.00)	Knoblauch, W., Putnam, L., Karszes, J., Hanchar, J., Grace, J., Carlberg, V., Petzen, J., Welch, D., Ames, M., Overton, R. and K. Skellie
2010-04	Dairy Farm Business Summary, New York Large Herd Farms, 300 Cows or Larger, 2009	(\$16.00)	Karszes, J., Knoblauch, W. and L. Putnam
2010-03	The Effectiveness of Farm-to-Chef Marketing of Local Foods: an Empirical Assessment from Columbia County, NY"		Schmit, T., Lucke, A. and S. Hadcock
2010-02	Business Planning for the Agriculture Sector: A guide to business plan development for Start-up to Mid-Size Operations	(\$12.00)	Perry, J. and R. Overton
2010-01	When to Exit Dairy Farming: The Value of Waiting		Tauer, L. and J. Dressler

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