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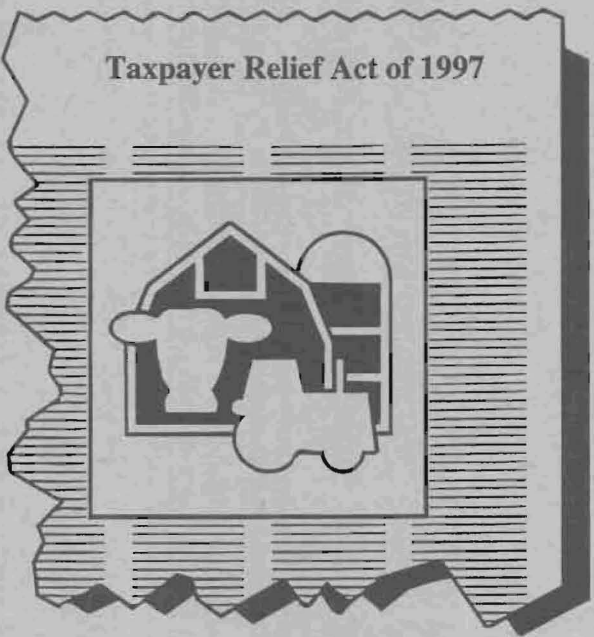
FARM INCOME TAX MANAGEMENT AND REPORTING

Reference Manual



1997 Farm Tax Schools

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1997 TAX LEGISLATION AND FARM INCOME SITUATION

Federal Legislation

The Taxpayer Relief Act of '97 (TRA '97) carries a wide variety of important tax changes that affect, individuals, families, investors, farmers and businesses. It is one of the most complex tax laws enacted in recent memory. While many of the new provisions aren't effective until tax year 1998, it may be necessary to plan now to get the most benefit out of these provisions. For example, some of the new credits available next year are lost in whole or in part if income exceeds a specified level. It may be possible to take steps now to reduce potential 1998 income and thus get a greater benefit from one or more of these credits. One the other hand, some provisions are effective retroactively and provide refund opportunities that you should take advantage of as soon as possible. The major new tax breaks for individuals, farmers, and small business taxpayers are as follows:

- **Child Tax Credit** - Taxpayers get a new tax credit equal to $400 in '98 ($500 after '98) for each qualifying child under age 17. It phases out when AGI exceeds $75,000 ($110,000 for marrieds filing jointly, $55,000 for marrieds filing separately).

- **IRAs** - More individuals will be able to make deductible IRA contributions beginning in '98. In TRA '97, AGI phase-out levels have been raised, a spouse without a retirement plan can contribute more and the new Roth IRA provides tax-free distributions but no up-front deduction.

- **Education** - A wide range of new tax incentives for higher education begin in 1998 including HOPE credit (up to $1500 per year for 2 yrs), Lifetime Learning Credit (starts at maximum of $1000 per contributing taxpayer), education IRA ($500 per beneficiary), and an above-the-line education-loan interest deduction.

- **Capital Gains** - The top tax rate on long-term capital gains is reduced from 28% to 20% (10% for taxpayers in 15% bracket). There are several tricky holding period rules to contend with and six different rates to apply to various assets sold in 1997. Rates drop again in 2001.

- **Sale of Home** - Up to $250,000 ($500,000 for married filing jointly) of the gain on the sale after 5/6/97 of a principal resident's home is tax free. This new exclusion is available every two years for taxpayers of any age and replaces home sale rollover rules.

- **AMT** - For tax years beginning after '97 the Alternative Minimum Tax is repealed for small corporations and the depreciation adjustment is modified. Farmer's installment sale income qualifies retroactive to 1987.

- **SE Health Insurance** - A self-employed individual's above-the-line deduction for health insurance costs (40% of eligible expenses for '97), will increase at a quicker pace than it would have under prior law. The deduction will be equal to 45% of eligible costs in '98 and '99, and 50% in 2000 and 2001. The deductible percentage will grow in later years until it reaches 100% in 2007 and later years.

- **Estate and Gift Taxes** - More of a person's assets can be passed on or given to family members (or anyone else) free of estate or gift taxes. The amount exempted from estate or gift tax (currently $600,000) rises to $625,000 for decedents dying and gifts made in '98, $650,000 in '99, and $675,000 in 2000 and 2001, with still more increases in later years until the exempt amount tops out at $1 million in 2006 and later years. If more than 50% of a person's estate consists of qualified family owned business interests or a farm, his or her executor can exclude up to $675,000 of such interests from the gross estate. This exclusion, which is available for decedents dying after '97, plus the $625,000 to $675,000 individual exemption, cannot exceed $1.3 million.

The following proposed provisions were dropped from TRA '97 before passage: gain from sale of livestock would be disregarded for purposes of EIC disqualified income, increase in AMT exemptions, indexing of dependent care exemption, supplementary education credit, extension of estate tax installment period to 24 months, indexing of certain capital gain assets, tax credit for employee child care facilities, new safe-harbor for independent contractor status, combination of farm and non-farm optional SE tax methods.

1997 Farm Income Tax Situation

Average 1997 dairy farm incomes will be considerably lower than in 1996. New York Farm Gate milk prices were down 13% through the first three quarters of 1997 and costs of production were up approximately 2%. Milk prices will strengthen in the last quarter of 1997 but average dairy farm net incomes will be down 12 to 15% at year's end. Lower grain prices have helped livestock producers but 1997 income from corn sales will be down 30% or more. Hay prices were somewhat higher in 1997. Fruit and vegetable prices varied depending upon seasonal supply and demand with no dramatic changes expected in 1997 producer incomes.

Tax management suggestions for low income farmers in 1997:

- Postpone paying for year-end feeds and supplies until 1998.
- Select slow cost recovery options, don't take Sec. 179 deduction.
- Cull enough livestock/sell enough crops to offset 1997 expenses and deductions.
- Don't go overboard moving potential 1998 farm income into 1997, but cover current expenses and personal deductions that cannot be moved forward.
- Capitalize costs of inputs that have a life of more than one year (e.g. lime, alfalfa and grassland establishment, major repairs).
- Use optional farm method for reporting self-employment income.

FEDERAL TAX PROVISIONS AFFECTING INDIVIDUALS

Standard Deduction

The standard deduction is indexed to inflation and is adjusted annually. The 1997 standard deduction is about 3.0% higher than the 1996 standard deduction. The inflationary adjustment will be around 2.9% for 1998.

Basic Federal Standard Deduction for 1996, 1997 and 1998

Filing Status	1996	1997	1998[1]
Married filing jointly; or qualifying widow(er)	$6,700	$6,900	$7,100
Head of household	$5,900	$6,050	$6,250
Single individuals	$4,000	$4,150	$4,250
Married filing separately	$3,350	$3,450	$3,550

[1] projected

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

Each taxpayer over age 65 or blind receives the regular standard deduction plus an additional $800 (increases to $850 in 1998) deduction if married and filing a joint or separate return. The additional deduction is $1,000 (increases to $1,050 in 1998) if single or head of household. The additional deductions are subject to the inflationary adjustment. A taxpayer who is both elderly and blind receives double the additional deduction. The additional deductions for age and blindness cannot be claimed for dependents.

Personal Exemption

The 1997 personal exemption is $2,650, up $100 from 1996, and increases to $2,750 in 1998.

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

The phaseout of the personal exemption for certain high-income individuals was made permanent by the RRA of 1993. For 1997, the benefit of the personal exemption is phased out for taxpayers with the following specific high levels of adjusted gross income (AGI). These threshold amounts are up 2.7% from 1996 and are adjusted for inflation annually:

$181,800 if married filing jointly or qualifying widow(er) with dependent child;
(exemptions completely lost at $304,300 AGI)
$151,500 if head of household; (exemptions completely lost at $274,000 AGI)
$121,200 if single (exemptions completely lost at $243,700 AGI)
$ 90,900 if married filing separately; (exemptions completely lost at $152,150 AGI)

The 1998 threshold amounts are projected to be $186,800, $155,650, $124,500, $93,400 respectively.

The phaseout in personal exemptions is 2% of the exemption amount for each $2,500 increment (or any fraction thereof) by which AGI exceeds the appropriate high or threshold amount. A married taxpayer filing separately will lose 2% of his or her exemption for each $1,250 increment above $90,900.

The personal exemption phaseout or reduction is calculated on a nine-line worksheet called the **Deduction for Exemptions Worksheet** included in the 1040 instructions. If adjusted gross income exceeds the threshold, complete the worksheet before claiming the personal exemption deduction on line 37 of Form 1040.

Example: Mr. and Mrs. Dairy file jointly, have two children, and their 1997 AGI is $198,000. They claim four personal exemptions. Their reduction and net exemption are calculated as follows:

> AGI $198,000 - $181,800 threshold = $16,200 excess. $16,200 excess ÷ $2,500 = 6.48 or 7 excess increments. Their reduction is 7 x .02 (2%) = .14 x $10,600 (4 @ $2,650) = $1,484. Their net personal exemption is $10,600 - 1,484 = $9,116.

A way to evaluate the cost of the personal exemption phaseout to the taxpayer is to calculate the additional tax liability. In the example, Mr. and Mrs. Dairy are in the 36% taxable income bracket, where the $1,484 of phased-out personal exemption will cost $534 in additional taxes. In other words, their $16,200 of excess AGI caused an additional tax liability of $534 or added 1.04% to their tax liability and effectively increased their marginal rate to 39.3%.

Dependents

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

Taxpayers may not claim an exemption for a dependent who has gross income of $2,650 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 five calendar months. Individuals who can be claimed as dependents on another taxpayer's return may not claim a personal exemption on their own return.

A qualified child, student or other qualified dependent's basic standard deduction is limited to the greater of $650 or the individual's earned income up to his or her standard deduction. The $650 rule limits the basic standard deduction but not additional deductions for blind and elderly taxpayers. For tax years after December 31, 1997 the qualified child, student, or other qualified dependent's basic standard deduction allowable, is limited to the smaller of the basic standard deduction or (1) the larger of $700 (inflation projected) or (2) the individuals earned income plus $250.

Examples of Pre 97 and Post 97 TRA Rule

	Indexed $500	Earned Income	Earned Income + $250	Larger of the Two	Standard Deduction	Smaller of the Two
Pre TRA'97	$650	0	NA	$650	$4150	$650
Pre TRA '97	$650	$4100	NA	$4100	$4150	$4100
Post TRA '97	$700	0	$250	$700	$4250	$700
Post TRA '97	$700	[$4100]	$4350	$4350	$4250	$4250

Investment or unearned income in excess of $1,300 received by a dependent child under age 14 is taxed at the parent's marginal rate if greater than the income tax using the child rates. A three-step procedure is required to compute the tax on **Form 8615, Tax for Children Under Age 14 Who Have Investment Income of More than $1,300**, where the excess over $1,300 will be taxed at the parent's marginal rate and unearned income greater than $650 but less than $1,300 will be taxed at 15%. (The $1,300 base will increase to $1,400 in 1998.)

The election to claim the child's unearned income on the parent's return with **Form 8814, Parent's Election to Report Child's Interest and Dividends**, is still available, and the adjusted $1,300 base amount and $650 tax exemption are indexed for inflation on Form 8814. This election cannot be made if the child has income other than interest and dividends or if estimated tax payments were made in the child's name, or the child's income is more than $6,999.

1997 Tax Rates

All the tax brackets have been adjusted for inflation this year. Each tax bracket has been moved up approximately 2.8% from 1996, which results in many taxpayers with constant taxable incomes paying somewhat less income taxes in 1997. Married taxpayers filing jointly with $41,200 of taxable income in 1996 and 1997 will gain $165 in tax savings from the adjustments in tax rates.

1997 Tax Rate Schedules

Single Taxpayer		Married Filing Joint Return & Qualifying Widow(er)	
Taxable Income	Tax	Taxable Income	Tax
$0-$24,650	15%	$0-$41,200	15%
$24,650-59,750	$3,697.50 + 28% on excess*	$41,200-99,600	$6,180.00 + 28% on excess*
$59,750-124,650	$13,525.50 + 31% "	$99,600-151,750	$22,532.00 + 31% "
$124,650-271,050	$33,644.50 + 36% "	$151,750-271,050	$38,698.50 + 36% "
> $271,050	$86,348.50 + 39.6% "	> $271,050	$81,646.50 + 39.6% "

Head of Household		Married Filing Separate Returns	
Taxable Income	Tax	Taxable Income	Tax
$0-$33,050	15%	$0-$20,600	15%
$33,050-85,350	$4,957.50 + 28% on excess*	$20,600-49,800	$3,090.00 + 28% on excess*
$85,350-138,200	$19,601.50 + 31% "	$49,800-75,875	$11,266.00 + 31% "
$138,200-271,050	$35,985.00 + 36% "	$75,875-135,525	$19,349.25 + 36% "
> $271,050	$83,811.00 + 39.6% "	> $135,525	$40,823.25 + 39.6% "

* on excess over first number in bracket

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

The tax rates for married taxpayers continue to be higher than for single taxpayers. Two married taxpayers each with $59,000 of taxable income will pay $1,605 more federal income taxes in 1997 than two singles with the same taxable income. As taxable income increases, the "marriage penalty tax" increases. A single taxpayer is not subject to the 36% rate until taxable income exceeds $124,650, but a married taxpayer reaches the 36% tax rate when taxable income exceeds $75,875 per person.

For single taxpayers for 1998, the 28%, 31%, 36% and 39.6% rate bracket projected changes will respectively occur at: $25,350, $61,400, $128,100 and $278,450 of taxable income.

For married filing joint return and qualifying window(er) taxpayers for 1998, the 28%, 31%, 36%, and 39.6% rate bracket projected changes will respectively occur at: $42,350, $102,300, $155,950, and $278,450 of taxable income.

For head of household taxpayers for 1998, the 28%, 31%, 36% and 39.6% rate bracket projected change will respectively occur at: $33,950, $87,700, $142,000, and $278,450 of taxable income.

For married filing separate returns, taxpayers for 1998, the 28%, 31%, 36% and 39.6% rate bracket projected changes will respectively occur at: $21,175, $51,150, $77,975, and $139,225 of taxable income.

Itemized Deductions

A taxpayer should itemize if total itemized deductions are greater than his or her standard deduction. The election to itemize can be made or revoked on a timely-filed, amended return. The limitation for high-income taxpayers must be considered when comparing itemized deductions with the standard deduction. The itemized deduction 3%/80% reduction rule for married filing separately in 1997 begins at $60,600 (AGI) and the 1997 limit for all other taxpayers starts at $121,200 (AGI).

Home mortgage interest (qualified residence interest) on the taxpayer's principal and second home is an itemized deduction providing the mortgage does not exceed the following limitations:

1. $1 million ($500,000 if married filing separate return) to buy, build or remodel a home reduced by home mortgage outstanding before October 14, 1987. This is called "acquisition indebtedness". Interest on home mortgages acquired prior to this date is deductible.

2. The lesser of $100,000 ($50,000 if married filing a separate return) or the fair market value minus the acquisition indebtedness qualifies for home equity indebtedness. Home equity indebtedness may be used for personal expenditures.

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

Investment interest expense is deductible on the 1997 return and is limited to the amount of net investment income. Investment interest expense is interest paid on debt incurred to buy investment property. It does not include investments in passive activities or activities in which the taxpayer actively participates, including the rental of real estate. Net investment income is gross investment income (including investment interest, interest received from the IRS, dividends, taxable portion of annuities, and certain royalties) less investment expenses (excluding interest). Gross investment income was redefined by the 1993 Act to exclude net capital gain on the disposition of investment property. A taxpayer may elect to include net capital gain as investment income only if it is excluded from income qualifying for the long term capital gain tax rate.

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

Personal interest is not deductible.

Medical expenses that exceed 7.5% of AGI are itemized deductions not subject to the additional 2% AGI limit. "Medical expenses" are broadly defined to include payments made for nearly all medical and dental services, therapeutic devices and treatments, home modifications and additions made primarily for medical reasons, travel (auto mileage deduction for 1997 is $.10 per mile) and lodging expenses associated with qualified medical care trips, legal fees required to obtain medical services, prescribed medicine and drugs, special schooling and institutional care, qualified health insurance premiums and the costs to acquire, train and maintain animals that assist individuals with physical disabilities. Most cosmetic surgery, general health maintenance, such as gym fees and weight loss programs, and well-baby care programs will not qualify. Remember that itemized medical expenses must be reduced by any reimbursement, including health insurance payments received.

Long-term Health Care premiums are deductible for 1997, by itemizers when combined with other premiums and medical expenses that exceed 7.5% of adjusted gross income. However, there are annual limits on the deductible premiums tied to age. Filers over 70 years old can include long term health care premiums of up to $2,500 per year per person subject to the 7.5% exclusion. Those between 60 and 70 years may include $2,000 per person; 50 to 60 years $750 per person; 40 to 50 years $375 per person, 40 years and under only $200 per person.

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

Charitable contributions made after 12/31/93 are subject to substantiation and disclosure rules. One set of rules applies to separate contributions of $250 or more. For separate cash contributions exceeding $250, a taxpayer cannot rely solely on a canceled check but needs substantiation from the charity showing the amount and date the contribution was made. For 1997 returns, acknowledgment must be obtained from the charity by the earlier of the filing date or the due date of the return, including extensions. For noncash contributions, the taxpayer must obtain from the charity a receipt that describes the donated property, a good-faith estimate of its value, and whether anything was given to the taxpayer in exchange. Taxpayers must use **Form 8283** to report total noncash charitable contributions over $500.

For contributions exceeding $75 where the taxpayer receives something in exchange (such as a dinner), the charity must provide a statement to the taxpayer that informs the donor that the value of the contribution that is deductible is the difference between the contribution and the value of the goods or services received by the taxpayer. Also, the charity must provide the donor with a good-faith estimate of the value of whatever the charity gave to the donor. The standard mileage rate for passenger car use for charitable causes remains at $.12 per mile for 1997 and will increase to $.14 per mile for tax years beginning after December 31, 1997.

Moving expenses are no longer itemized deductions. Report qualified moving expenses on **Form 3903** and deduct them on line 25 of Form 1040.

For expenses incurred after December 31, 1993, moving expenses are defined as the reasonable costs of (1) moving household goods and personal effects from the former residence to the new residence, and (2) travel, including lodging during the period of travel, from the former residence to the new place of residence. The standard mileage rate for passenger car use for moving is $.10 per mile for 1997. Meal expenses are no longer included. The new place of work must be at least 50 (rather than the old 35) miles farther from the taxpayer's former residence than was the old place of work. The deduction will be subtracted from gross income in arriving at AGI.

The following expenses, previously allowed as moving expenses, no longer qualify: selling and buying expenses on the old and new residences, meals while traveling or living in temporary quarters near the new place of work, cost of pre-move house hunting, and temporary living expenses for up to 30 days at the new job location.

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

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

Miscellaneous Deductions Subject To 2 Percent AGI Limit Include:

1. Unreimbursed employee business expenses including employment-related educational expenses, travel, meals and entertainment expenses (subject to 50 percent rule), lodging, work clothes, dues, fees, and small tools and supplies. Employee business expenses reimbursed under a nonaccountable plan are also subject to the 2% AGI limit.

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

3. Job hunting expenses may be deductible if one is looking for employment. Job hunters expenses are deductible if incurred in looking for a new job in their present occupation. The job searching expenses are not deductible if looking for a job in a new occupation or looking for a first job. Factors to determine if the employment is in the same occupation include: job classification, job responsibility, and nature of employment. The following are expenses that may be deductible: cost of typing, printing and mailing resumes; long distance phone calls and mailing; career counseling and agency fees; and travel or transportation expenses.

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

Meal expenses must be directly related to the active conduct of the taxpayer's trade or business (i.e. an organized business meeting or a meal at which business is discussed). A meal taken immediately preceding or following a business meeting will qualify if it is associated with the active conduct of the taxpayer's trade or business. The deductible portion of meal and entertainment expenses paid in connection with a trade or business is 50%. Effective for tax years beginning after December 31, 1997, the deductible percentage of the cost of meals consumed by employees subject to DOT, will gradually increase from 50% to 80% over the next 10 years. DOT employees include FAA employees (pilots, crews, etc.) railroad employees, and interstate truck and bus drivers under DOT regulations.

Limitation for High-Income Taxpayers

Taxpayers with a 1997 AGI in excess of $121,200 ($60,600 if married and filing separately) must reduce all itemized deductions except medical expenses, investment interest, casualty losses, and wagering losses to the extent of wagering gains. The reduction equals the lesser of 3% of excess AGI or 80% of the applicable itemized deductions. Three percent of excess AGI will be the most common reduction and will not be a major additional tax burden unless AGI is very high and/or the applicable itemized deductions are relatively low. The 7.5% of AGI medical expense adjustment and 2% floor on miscellaneous itemized deductions must be applied before the high-income deduction. (The projected base for excess calculations for 1998 is $124,500 and $62,250.)

Example: Fred and Ann Veryrich's 1997 AGI is $141,200. Their itemized deductions total $17,000 including $12,000 of deductible medical expenses (after the 7.5% AGI deduction) and investment interest. They claim no casualty or wagering losses. They must reduce their itemized deductions as follows:

$141,200 AGI - $121,200 maximum = $20,000 excess x .03 = $600. $600 is less than $4,000 (.80 x $5,000 of applicable itemized deductions). They reduce itemized deductions by $600; $17,000 - $600 = $16,400 adjusted itemized deductions.

Earned Income Credit (EIC)

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

For taxpayers with one qualifying child, the 1997 EIC is 34.0% of the first $6,500 of earned income. The maximum credit is $2,210 and is reduced by 15.98% of modified AGI exceeding $11,930. For taxpayers with two or more qualifying children, the EIC is 40% of the first $9,140 of modified AGI. The maximum credit is $3,656 and is reduced by 21.06% of modified AGI exceeding $11,930.

The definition of modified AGI for the phase-out disregards certain losses, including: a) losses from the sale or exchange of capital assets in excess of gains b) net losses from trusts and estates and c) net losses from non-business rent and royalties. Prior to TRA '97, 50% of the net losses from businesses, computed separately with respect to sole proprietorships, sole proprietorships in farming and other businesses was also disregarded. The disregarded items did not include tax-exempt interest or nontaxable pension or annuity distribution. With the passage of TRA '97, the net losses from trades or businesses as outlined above that are disregarded in determining modified AGI are increased from 50% to 75%. The TRA '97 also expands the list of disregarded items in modified AGI to include interest that is received or accrued that is exempt from federal income tax and amounts received as pensions or annuities or IRAs to the extent not included in gross income. Since the provision does not become effective until after December 31, 1997 watch for a technical modification as Congress may have intended these items to be included rather than excluded in determining modified AGI.

Earned Income Credit Rates, Income Ranges, and Phaseouts*

		Earned income range			
Qualifying Children	Credit rate	Maximum credit	Phaseout	Phaseout rate	Maximum credit
		For 1997			
None	7.65%	$4,340- 5,430	$5,430- 9,770	7.65%	$332
One	34.00%	6,500-11,930	11,930-25,760	15.98%	2,210
Two or more	40.00%	9,140-11,930	11,930-29,290	21.06%	3,656
		For 1998			
None	7.65%	$4,460- 5,570	$5,570-10,028	7.65%	$341
One	34.00%	6,680-12,260	12,260-26,472	15.98%	2,271
Two or more	40.00%	9,390-12,260	12,260-30,095	21.06%	3,756

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

It is possible for some low-income taxpayers to be eligible for EIC even though that taxpayer doesn't have a qualifying child. To be eligible, such a taxpayer must be age 25 or more, but under 65 years of age. A married taxpayer who does not meet the minimum age requirement may be eligible if his or her spouse meets the minimum age requirement. Other eligibility rules for the low-income taxpayer are: he or she cannot be claimed as a dependent or a "qualified child" on another person's tax return; his or her principal residence was in the USA for more than one-half of the tax year; the return must cover a 12-month period; the taxpayer cannot file a separate return if married, and cannot file Form 2555 or Form 2555-EZ. The credit percentage is much smaller (7.65%)for taxpayers with no qualifying children, and the credit is phased out over a lower income range.

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

In 1997 this credit is denied to taxpayers with an excess of $2,250 of taxable and nontaxable interest income, dividends and net income from rents and royalties not derived in the ordinary course of business. The 1996 act expanded disqualified income to include the excess of gains over losses from the sale of capital assets. It appears as of now that the net capital gains from the sale of assets used in a trade or business (Form 4797 Part I and Part III), such as land, buildings, and livestock in excess of $2,250, will continue to disqualify many dairy farmers from the earned income credit. Ordinary gains (Form 4797 Part II) and gains recaptured as ordinary income (Form 4797 Part III) will not be included in disqualified income. A letter from the Deputy Assistant Chief Counsel, concludes "if a dairy farmer has net gain in any taxable year from the sale of Section 1231 assets, including the sale of dairy cows held for at least 24 months, such gains are treated as long-term capital gains by operation of the legal requirements set forth in Section 1231. Thus, such gains are properly taken into account in determining the dairy farmer's capital gain net income under Section 1222 for the taxable year." Consequently, if the farmers aggregate amount of disqualified income including capital gain net income exceeds the threshold, that farmer is not eligible to receive earned income tax credit under amendments made to Section 32 by the 1996 act. There are several prominent educators and lawyers that continue to disagree with this ruling.

Example 1. Farmer Bill sold 5 cull cows in 1997 for $500 each. The cows were raised (zero basis) and were more than 24 months old. IRS treats this as $2500 of disqualified income and Bill is not eligible for EIC.

Example 2. Dairy person Jane sold 5 cull cows in 1997 for $500 each. She paid $900 each for the cows in 1992. She claimed $863 of depreciation on each, consequently basis was $37 when sold. The gain of $500-$37 is treated as ordinary income under Section 1245 recapture rules. IRS does not treat this gain of $2315 as disqualified income and she may claim EIC if she otherwise qualifies.

Example 3. Herd manager Stuart culled 5 raised heifers prior to 24 months old. They were not Section 1231 assets, therefore, the gain was ordinary income and not disqualified income for claiming EIC.

Example 4. Mr. Jones purchased a bull for $500 and put him in service in 1994. The bull was sold in 1997 for $1200. The bull had a basis of $300 when sold. Due to depreciation recapture of $200, Mr. Jones has a $700 capital gain on Form 4797 Part III and this is disqualified income counting toward the total disqualification of EIC at the $2,250 limit for 1997.

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

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

To meet the residency test, the child must live with the taxpayer in his or her main home for more than half the year (all year if a foster child), and the home must be in the U.S. However, a child that was born, or died, anytime in 1996 and lived in the taxpayer's home will meet the residency test.

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

TRA '97 imposes restrictions on the availability of EIC for taxpayers who improperly claimed credit in prior years. Where there is evidence that a taxpayer's claim of EIC was due to fraud, the disallowance period is 10 years after the most recent year for which the determination was made. Where the claim of EIC was due to reckless or intentional disregard of rules and regulations, the disallowance period is two years. In addition the taxpayer who is denied EIC may also be subject to accuracy-related penalty or the fraud penalty.

Earned Income Credit Reminders for Farmers

If earned income is negative, there is no credit. Therefore, a farmer with a negative Schedule F net farm profit would not get a credit unless there were wage and Schedule C income more than enough to offset the loss on F, or the optional method of reporting self-employment income is used. A farmer with a negative 1996 net farm profit may use the optional method of reporting up to $1,600 of self-employment income, to collect an EIC which would partially or wholly cover the self-employment tax and thus provide two quarters of social security coverage, providing nonearned income (such as gains from cattle sales) plus earned income are less than the maximum allowed.

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

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

The Earned Income Credit Advance Payment Certificate (Form W-5), must be used by any employee eligible for EIC to elect advanced payments from his or her employer. EIC payments made by an employer to his or her employee offset the employer's liability for federal payroll taxes. Use IRS tables to determine advanced payments of EIC. Advanced payments are limited to the credit amount for one qualifying child, regardless of the total number of children a taxpayer may have. An employer's failure to make required advanced EIC payments is subject to the same penalties as failure to pay FICA taxes. Employers of farm workers do not have to make advance payments to farm workers paid on a daily basis (IRS Pub. 225).

Child Tax Credits

For the taxable year 1998 a $400 credit is allowed for each qualifying child under 17 years of age. This nonrefundable credit increases to $500 in 1999 and thereafter. For taxpayers with adjusted gross income in excess of the applicable threshold amount, the credit is phased out. The phaseout rate is $50 for each $1000 of modified adjusted gross income (for fraction thereof) in excess of the following threshold:

	Threshold Starting	Completely Gone
Married joint return	$110,001	$119,001
Single or head of household	$75,001	$84,001
Married separate return	$55,001	$64,001

For taxpayers with one or two children, some of the child credit may be treated as a supplemental child credit. The supplemental child credit is calculated as the excess of 1) number of qualifying children times $400 (1998) up to the excess of the regular tax liability (net of any credits except EIC) over the taxpayers tentative minimum tax (disregarding AMFT) **over** 2) the sum of the taxpayer's regular tax liability (net of any credits except EIC) plus the employee portion of FICA and one-half of any self-employment tax liability reduced by EIC.

For taxpayers with three or more qualifying children, the maximum child credit cannot exceed the larger of 1) the excess of regular tax liability (net of any credits except EIC) over the tentative minimum tax liability (disregarding AMFT) **or** 2) the amount equal to the excess of the sum of regular tax liability (net of any credits except EIC) and employee's share of FICA (and one-half the SE tax) reduced by the EIC. If the amount in 1) is greater than 2) the difference is the supplemental child credit. In this case, if the allowable child credit (determined in 2)) exceeds regular tax liability, the excess is refundable.

See details in TRA '97 as they are too complex for the room allocated in this workbook. It is anticipated that IRS will determine a simplified method of calculating the credit consistent with the statutory formula.

Education Incentive Opportunities

In the tables below the benefits restrictions and limitations on several tax incentives for participants in higher education are presented.

Education Incentive Opportunities in the TRA'97

	HOPE Credit	**Lifetime Learning Credit**
Tax Incentive	Per Student; 100% of first $1,000 and 50% of second $1,000 used for tuition and fees for higher education for at least ½ time students incurring expenses after 12/31/97	Per taxpayer; 20% of first $5,000 (20% of first $10,000 after 2002) for tuition and fees for any higher education including upgrading skills paid after 6/30/98, on behalf of taxpayer, spouse, or dependent to whom taxpayer is allowed an exemption.
Restrictions	• Only for first two post secondary years. • May not be claimed in same year as an education IRA distribution. • Nonrefundable and cannot reduce AMT. • Not allowed for persons claimed as dependents on another taxpayer's return.	• Credit may not be claimed in the same tax year for the same expenses as claimed for the HOPE credit. • May not be claimed in same year as an education IRA distribution. • Nonrefundable and cannot reduce AMT.
Modified Adjusted Gross Income Limits	Phaseout starts at $40,000 and is gone at $50,000 for singles; $80,000 to $100,000 for joint returns; the credit is not available to married filing separately.	Phaseout starts at $40,000 and is gone at $50,000 for singles; $80,000 to $100,000 for joint returns; the credit is not available to married filing separately.

Education Incentive Opportunities in the TRA'97 Continued

	Education IRA	Student Loan Interest Deduction
Tax Incentive	Up to $500 nondeductible contribution per beneficiary after 12/31/97 as a trust account for qualified higher education expenses for the withdrawal year.	An above the line deduction, where no itemization required of up to $1000 for 1998 up to $1500 for 1999 up to $2000 for 2000 up to $2500 after 2001 for interest paid on loans for higher education expenses while at least ½ time student.
Restrictions	• Contributions must be made during calendar tax year. • 10% penalty plus tax on unqualified withdrawals. • Cash contributions only. • No contributions after account holder attains age 18.	• Deduction is allowed only with respect to interest paid during the first 60 months in which interest payments are required. • No deduction if student is allowed as dependent on another taxpayer's return. • No double benefits, as in home equity loans.
Modified Adjusted Gross Income Limits	Phaseout starts at $95,000 and is gone at $110,000 for singles; $150,000 to $160,000 for joint returns; and the credit is not available to married filing separately.	Phaseout starts at $40,000 and is gone at $55,000 for singles; $60,000 to $75,000 for joint returns; and the deduction is not available to married filing separately.

	Qualified State Tuition Plan Modification
Tax Incentive	The taxpayer makes after tax cash contributions to an account established solely for meeting qualified higher education expenses of the child. The earnings grow tax-deferred and distributions of earnings are taxable to distributee when withdrawn. Penalties apply on refund of unused earnings unless extenuating circumstances.
Restrictions	Distribution use has expanded from post-secondary higher education expenses to include reasonable room and board costs incurred by an eligible student while extending an eligible educational institution.
Modified Adjusted Gross Income Limits	None

Most colleges and universities, invoice students for the winter and spring semesters prior to the beginning of the calendar year. These invoices for college expenses most often have due dates prior to the beginning of the year. To be eligible for the Hope Credit, some cash basis taxpayers may have a timing problem. If the student is eligible and attends school in the following fall, payment then would qualify for the Hope Credit up to the maximum of $1500. The following is a review of "constructive" payments by a cash basis taxpayer.

a) Amounts paid with borrowed funds are deductible when paid, not when the loan is repaid.

b) When a bank credit card is used to pay an expense, the payment is considered to have been made in the year the credit charge is made, regardless of when the cardholder pays the bank.

c) A payment by check is considered payment at the time the check is delivered to the payee provided it later is paid by the bank. Although a US District Court held that the date of mailing the check is the date of payment, IRS ruled wages are not constructively paid for withholding and employment tax purposes when they are mailed to employees on the last day of the year and not received the same day.

There are several technical amendments that likely will be forth-coming before and during the 1998 tax year. One very important issue with the Child Credit and Education Credit is many taxpayers may find they now owe alternative minimum tax. Look for the update in next year's *Farm Income Tax Reference Manual.*

Estimated Tax Rules for 1997

The estimated tax rules have not changed for 1997 using the 100% of last year's tax safe harbor rule. 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. Individuals who exceed the $150,000 ($75,000 if married, filing separately) prior year's AGI limit must increase the 100% safe harbor to 110%. TRA '97 changes the 110% of last year's liability safe harbor to 100% for taxable years beginning in 1998; 105% for taxable years beginning in 1999, 2000, and 2001 and to 112% for years beginning in 2002. For taxable years beginning in 2003 the last year's safe harbor is back to 110%. Similar rules apply to trusts and estates.

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

Limitation on Compensation for Retirement Plan Calculations

The maximum amount of compensation that can be taken into account under qualified retirement plans, SEPs, etc., was lowered to $150,000 by the '93 tax act. This amount is adjusted annually for inflation, but only in increments of $10,000. If the annual adjustment calculates to less than $10,000, no adjustment will be made. The 1997 maximum amount increased to $160,000. Transition rules apply to governmental plans and plans maintained under a collective bargaining agreement.

Employer-Provided Education Assistance

The exclusion for up to $5,250 of employer-provided educational assistance for undergraduates has been extended and is available for courses beginning before May 31, 2000 and is retroactive for tax years beginning after December 31, 1994. The exclusion date was not changed for graduate-level education expenses up to $5,250 is for any course beginning before July 1, 1996. Consequently, withholding must be made on the cost of graduate courses.

Backup Withholding Rate

For amounts paid after December 31, 1992, the backup withholding rate on interest, dividends and other reportable payments is 31%.

Employer-Provided Transportation Benefits

For benefits provided by the employer on or after January 1, 1993, limits have been placed on the amount of parking and other transportation benefits that are excludable from an employee's gross income. The amount of tax-free employer-paid parking is $170 a month for 1997 ($175 for 1998) and tax-free transit passes cannot exceed $65 per month.

Clean Fuel Vehicles and Electric Vehicles

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

There is a 10% credit (maximum $4,000) for either business or personal electric vehicles (with at least four wheels) placed in service between June 30,1993 and December 31, 2001.

SALE OF TAXPAYERS PRINCIPAL RESIDENCE

The TRA of '97 increases the exclusion of gain from the sale of a principal residence to $250,000 ($500,000 for joint filers), on sales and exchanges made after May 6, 1997. Here are other related changes:

1. The old rollover of gain provision, IRC Sec. 1034, has been repealed and replaced with the new exclusion.

2. The old one-time restriction and the 55 years of age requirement are gone. The new exclusion can be used by taxpayers of any age on each home they have owned and used as a principal residence for at least two years during the five-year period ending on the sale date. Use of the exclusion is limited to once every two years beginning May 7, 1997. Earlier sales do not count.

3. Married taxpayers filing joint returns get a $500,000 exclusion if either spouse has owned the residence for at least two years, both spouses have lived in it for at least two years and neither spouse has used the new exclusion in the past two years.

4. 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 two-year period. Those married filing jointly but living a part also get the $250,000 exclusion on the qualified sale of each spouses principal residence. A recently married spouse does not lose eligibility for the $250,000 exclusion by marrying a taxpayer who has used the exclusion within two years.

5. A pro-rated exclusion may be claimed by taxpayers who do not meet the two year ownership and use requirements if the sale is due to a change in place of employment, health or unforeseen circumstances.

6. A taxpayer will be eligible for a full exclusion regardless of length of ownership, use and reason for sale, if the principal residence was in qualified use on August 5, 1997 and is sold before August 6, 1999.

7. The length of ownership and use of the current principal residence may include the period of ownership and use of prior residences on which gain was rolled over to the current residence.

8. The old rules including the roll over provision may be elected and applied to sales made before August 5, 1997; to later sales pursuant to a binding contract in effect on August 5, 1997; and to transactions where the replacement residence was acquired on or before August 5, 1997.

Other specific rules; 1) effect transfers incident to a divorce, 2) define time of ownership for surviving spouses, 3) define periods of use for taxpayer's transferred to nursing homes, 4) apply to involuntary conversions and sales of remainder interests, and 5) disqualify from the exclusion, gain that is attributed to depreciation from the business use of a home.

LONG TERM CAPITAL GAINS RATES CUT

The tax rate on long-term capital gains for individuals, estates and trusts has been reduced and holding periods have generally been increased. The maximum rate on long-term capital gains after May 6, 1997 is 20% but there is a new mid-term capital gain with a maximum rate of 28% and some assets are ineligible for the lowest long-term rates. Short-term gains are still taxed as ordinary income.

The following table identifies the different maximum rates that will apply to net capital gains occurring in 1997 and subsequent tax years.

Capital Gains Holding Periods and Tax Rates

Date of sale or exchange[1]	Required holding period[2]	Maximum capital gain rate
Before 5/6/97	>12 months	28%
After 5/6/97 and before 7/29/97	>12 months	20% or 10% for taxpayers in 15% bracket[3]
After 7/28/97	>18 months	20% or 10% as above[3]
After 7/28/97 (mid-term)	>12 months but <18 months	28% or 15% for taxpayers in 15% bracket
After 12/31/2000	>18 months	20% or 10% as above
After 12/31/2000	>5 years	18% or 8% for taxpayers in 15% bracket[4]

[1] The date of sale or exchange also applies to the date installment sale payments are received.

[2] TRA '97 did not change the required holding periods for livestock held for breeding, dairy, draft and sporting purposes. It appears as though cattle and horses must be held 24 months and other livestock 12 months to qualify for the lower capital gain rates.

[3] Gain from the sale of Sec. 1250 property (general purpose buildings and other depreciable real estate) that would be ordinary income under Sec. 1245 depreciation recapture rules, will have a maximum tax rate of 25% through 2000. The maximum rate on net capital gain from the sale of collectibles remains at 28%.

[4] The 18% and 8% rates apply only if the assets holding period begins after 2000. Therefore this asset could not be sold before 2006. A taxpayer may elect to treat an asset as having been sold and reacquired for its fair market value on 1/1/2001. Gain must be recognized and losses disallowed under this option. Few taxpayers would benefit from this election.

Holding Period Rules for Inherited Property

Generally the holding period of property acquired from a decedent starts with the date of death. But inherited property sold in less than one year is considered to have been held more than a year when the property has a new basis determined by a FMV appraisal and is sold within one year after the decedents death (IRC Sec. 1223 (ii)). Therefore, inherited property held less than one year and sold after May 6, 1997 and before July 29, 1997 receives the new lower rates. However, inherited property held less than one year and sold after July 28, 1997 is mid-term property taxed at the highest rate.

Other provisions

If a taxpayer elects to treat any net capital gain as investment interest, that amount is subtracted in computing net capital gain subject to the maximum capital gains rate. A special relief provision prevents taxpayers from paying tax on gains at a higher rate than they would have before TRA '97.

AGI will still include the entire net capital gain and will continue to influence the determination of the floor on certain itemized deductions, the phaseout of personal exemptions and itemized deductions.

The new, lower long-term capital gains rates will be used to compute AMT. Entities such as S corporations, partnerships, estates and trusts may pass through capital gains to their owners or beneficiaries and must make the determination of when a long-term capital gain is taken into account on its books. The determination of this date in 1997 is of major importance.

On the sale or exchange of small business stock (Sec. 1202 stock), held for more than five years, 50% of the gain may be excluded from the taxpayer's gross income, the remaining capital gain is taxed at 28%. If such small business stock is sold before meeting the five year holding requirement, the gain will be taxed at the 20% maximum capital gains tax rate.

Capital Gains Example:

Lick U. Dates sold the following assets in 1997:

1. 40 raised cows for $36,000 on May 1.
2. Machinery and equipment for $75,000 (cost $150,000, basis $25,000) on July 1.
3. 12 raised heifers, 20 months old for $10,000 on August 1.
4. Farmland for $200,000 (purchased 1980, basis $100,000) on Sept. 1.
5. Camp for $45,000 (built August '96, basis $20,000) on Oct 1.

Here are the gains and applicable marginal rates on the items Mr. Dates sold in 1997:

1. Cows were sold before 5/6/97, they meet 2 year holding period requirement, $0 basis, $36,000 capital gain at 28%.
2. $50,000 gain, all subject to depreciation recapture, ordinary income, 36% marginal rate (est).
3. Don't meet 24 month holding period, $10,000 short-term gain, 36% (est).
4. Held more than 18 months, $100,000 capital gain at 20%.
5. Held less than 18 months, $25,000 capital gain at 28%.

PROVISIONS APPLYING PRIMARILY TO BUSINESS ACTIVITY

Business Use of Home

Expenses associated with the business use of the home are deductible only if they can be attributed to a portion of the home or separate structure used exclusively and regularly as the taxpayer's principal place of business for any trade or business, or a place where the taxpayer meets or "deals with" customers or clients in the ordinary course of business. Because a farmer's principal place of business is the entire farm, and most farmers live in homes that are on the farm, an office in their home would be at their principal place of business (Pub. 225). A self-employed farmer who lives on the farm must still use the home office exclusively and regularly for farm business in order to deduct the applicable business use of home expenses.

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

Effective for tax years beginning after December 31, 1998 the home office rules are more relaxed. The definition of principal place of business has been expanded. It allows a deduction for administration and management even through the work is performed elsewhere. All other rules continue to apply.

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

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

Schedule C filers who claim expenses for business use of the home must file Form 8829. Form 4562 will be required if it is the first year the taxpayer claims such expenses. Limitations on use of home expenses as business deductions are calculated on Form 8829.

Caution: When a taxpayer sells a home on which expenses for business use have been claimed, tax consequences may occur.

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

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

Self-employed Health Insurance Premiums

The provision that allows self-employed taxpayers to deduct a percentage of health insurance premiums paid as an adjustment to income on 1040 was retroactively restored on April 11, 1995. The deduction was 30% for 1996 and increased to 40% in 1997, with the balance subject to the 7.5% rule for itemizers. In 1998 and 1999 the deduction moves to 45%, followed by several annual increases until reaching a maximum of 100% in 2007 and thereafter. Self-employed taxpayers include sole proprietors, partners and more than 2% S corporation shareholders.

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

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

Employee Health and Accidental Insurance Plans

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

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

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

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

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

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

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

Reporting Rental of Personal (Non-Real) Property

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

Business Use of Automobiles

Automobile expenses are deductible if incurred in a trade or business or in the production of income. Actual costs or the standard mileage rate method may be used. Employers with 10 or more employees using their own cars for company business may use the Fixed and Variable Rate (FAVR) allowance or may devise their own consistent mileage allowance. The FAVR allowance is not available to self-employed individuals.

The 1997 standard mileage rate increased to 31.5 cents per mile for all business miles driven. The standard mileage rate may not be used when the automobile has been depreciated using a method other than straight line, the car is used for hire, two or more cars are used at once, or the car is leased. The use of Section 179, ACRS, or MACRS depreciation also causes disqualification. When a taxpayer uses the standard rate on a vehicle in the first year it is used in the business, the taxpayer is making an election not to use MACRS depreciation or Section 179.

Rural mail carriers are allowed a special mileage rate equal to 150% of the basic standard mileage rate (47.25 cents for 1997). The special mileage rate applies to all business uses of an automobile (including vans, pickups, and panel trucks) while performing "qualified services." But this special rate may not be used if the mail carrier claimed depreciation on the vehicle for any tax year beginning after 1987. Effective for tax years beginning after December 31, 1997, a rural mail carrier who receives a qualified reimbursement for expenses incurred for use of their vehicle will be allowed a deduction for an amount equal to the reimbursement received. In other words "a wash."

Business Tax Credit for Social Security Tax on Tips

Employers in food or beverage establishments may receive a tax credit (as part of the general business credit) for the employer's 7.65% FICA obligation attributable to reported tips in excess of those treated as wages for the purpose of satisfying minimum wage provisions. The 1996 law clarifies that this credit is available whether or not the employee reported the tips on which the employer FICA taxes were paid. To prevent a double benefit, no deduction is allowed for any amount used in determining the credit.

Deductibility of Borrowed Funds To Satisfy Interest Due

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

CORPORATE PROVISIONS

Corporate Tax Rates

C or regular corporations are subject to federal income tax rates ranging from 15 to 39%. The favorable rates below 34% are phased out when taxable income ranges from $100,000 to $335,000. The marginal tax rate increases to 35% on taxable income exceeding $10 million. Capital gains are taxed at the regular corporate tax rates. TRA '97 did not give corporations a capital gains tax break. Form 4626 is used to compute and file the C corporation's AMT.

1997 Corporate Tax Rates

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

* on excess over first number in taxable income bracket

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

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

Estimated Tax Payments

A corporation that bases its estimated tax on the current year's tax is required to make estimated tax payments equal to 100% of the tax shown on its return for the current year. Corporations may continue to pay estimated tax based on 100% of last year's tax. A corporation must make installment payments, if the estimated tax for the year is expected to be $500 or more.

Personal Service Corporations

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

Alternative Minimum Tax (AMT)

The AMT is repealed after 1997 for small corporations. A small corporation is one with less than $15 million of total gross receipts from 1995 through 1997 and does not exceed $22.5 million in any succeeding three-year period. For 1996 the AMT rate remains at 20%, the exemption is $40,000 and the exemption phase-out rules are unchanged. The 0.12% environmental tax computed on Form 4626 has not been repealed and applies to C corporations with AMTI's exceeding $2 million.

PARTNERSHIP ISSUES

Filing Rules

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

Schedules L, M-1 and M-2 on Form 1065 are to be completed on all partnership returns unless all three of the following apply; the partnership's total receipts are less than $250,000, total partnership assets are less than $600,000, and Schedules K-1 are filed and furnished to the partners on or before the due date of the partnership return, including extensions.

TRA '97

Many IRC Sections were modified by TRA '97. Most modifications affect electing large partnerships (generally partnerships with at least 100 partners) and will not affect farm and small business partnerships. Numerous changes made to the unified partnership audit procedures do not apply to small partnerships with 10 or fewer partners.

The rules on allocation of basis among properties distributed to partners (after August 5, 1997) upon partnership liquidation have been changed and could affect farmers. A distributee partner's basis adjustment (basis in partnership interest) is allocated among distributed assets first to unrealized receivables and inventory items in an amount equal to the partnership's basis in each such property. Remaining basis is allocated first to the extent of each distributed property's adjusted basis to the partnership. If the remaining basis adjustment is a decrease, it is allocated first to properties with unused depreciation and then to the basis of other properties.

Sales and exchanges of partnership interests of unrealized receivables and inventory after August 5, 1997 will result in ordinary income. Prior to TRA '97 unrealized receivables and substantially appreciated inventory were included in ordinary income. Previously, inventory with a FMV not exceeding 120% of its adjusted basis was excluded.

Distribution of Contributed Property

Appreciated property contributed to a partnership creates pre-contribution gains (FMV less basis) or loss that must be allocated to the contributing partner. Prior to TRA '97 the contributing partners pre-contribution gain or loss was taxed if the property was distributed to another partner within five years of the contribution. The recognition period of pre-contribution gain or loss is extended to seven years for contributions made to a partnership after June 8, 1997.

Prior law closed the partners tax year when his entire interest was sold, exchanged, or liquidated. TRA '97 adds closure of the tax year, with respect to a partner who dies (effective for tax years beginning after 1997). Thus a decreased partner's share of partnership income for the partnership year in which he dies will have to be reported on his final return.

Self-employed Health Insurance

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

LIKE-KIND TAX FREE (Deferred) EXCHANGES

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

Rules and Requirements

Generally, in order to have a deferred exchange, the transaction must be an exchange of qualifying property. A sale of property followed by a purchase of a like-kind does not qualify for non-recognition under Sec. 1031. Gain or loss is recognized if the taxpayer actually or constructively receives money or non-like-kind property before the taxpayer actually receives the like-kind replacement property. 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.)

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 non-recognition of gain merely because the replacement property is not in existence or is being produced at the time it is identified.

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

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 two-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. Sec. 1031 so long as the relinquished property was, and the acquired property is, used in a trade or business or held for investment. Consequently, a farm can be exchanged for city real estate and improved real estate can be exchanged for unimproved real estate.

Farm Business Personal Property

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

The safe harbor applicable to farm property includes all the four-digit product classes within Division D of the Standard Industrial Classification codes. Any two assets that are listed in the same four-digit product class (other than the miscellaneous classes) are like-kind property. Most personal property used in a farm business is included in product class 3523 Farm Machinery and Equipment. Farmers will generally qualify for I.R.C. Sec. 1031 treatment when they exchange farm equipment for farm equipment. Livestock of different sexes are not property of a like-kind but exchanges of same sex livestock have qualified as tax free exchanges.

Other Deferred Exchange Rules and Requirements

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

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

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

INDEPENDENT CONTRACTOR VS. EMPLOYEE

The safe harbor provisions that taxpayers may use to protect the status of workers treated as independent contractors was clarified by 1996 amendments to Sec. 530 of the Rev. Act of 1978. Section 530 allows employers to continue to treat workers as independent contractors and avoid income tax and FICA withholding as long as (1) the employer did not treat the worker as an employee, (2) there is a "reasonable basis" for not classifying the worker as an employee, and (3) all required tax returns including 1099's are filed.

There is reasonable basis for not classifying a worker as an employee if the taxpayer can rely on one of the following types of authority:

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

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

3. A long-standing, recognized practice of a significant segment of the industry.

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

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

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

2. Following are criteria used by the IRS to determine the extent of employer control. They are divided into two groups below. "High control" implies the worker is an employee. "Low/no control" favors independent contractor status. These criteria are based on the 20 factors set out in IRS Audit Manual Exhibit 4640-1 and in Rev. Rul. 87-41. Any single fact or small group of facts is not conclusive evidence of the presence or absence of control.

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

NEW PROVISIONS SPECIFIC TO AGRICULTURE

Income Averaging Returns in 1998

Farmers may elect to use a new three-year method of income averaging in tax year's beginning on or after January 1, 1998 and ending before January 1, 2001. "Elected farm income" (EFI) may be deducted from the current year's taxable income and one-third of it will be added to each of the three prior year's taxable income.

"Elected farm income" is taxable income attributed to any farming business and designated to be included in the election. Gains from the sale of farm business property excluding land, may be included in EFI. A "farming business" includes nursery production, sod farming, the production of ornamental trees and plants as well as the production of fruit, nuts, vegetables, livestock, livestock and horticultural products, and field crops.

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 three prior years tax liability caused by the carry back of EFI.

The election does not apply to self-employment tax or AMT. Current year's EFI is subject to current year's SE tax and AMT. The election may not be used by estates or trusts but may be available to farm corporations.

Farm taxpayers who elect income averaging will be able to spread taxable farm income over a four-year period if they are able to designate how much of the current year's farm income to include in EFI. Tax management opportunities will increase if the type of farm income to be included in EFI can be selected by the taxpayer.

Disaster Relief For More Livestock Sales

The two provisions that allowed special treatment of gains from livestock sold due to drought conditions have been amended to include livestock sold due to flood or other weather-related conditions. Both are effective for sales after December 31, 1996.

The first election is only available to cash basis farmers. They may postpone for one year, reporting the gain from the sale of livestock (excluding poultry), sold due to drought, flood or other weather-related conditions. Only gains on livestock sold in excess of the number that would have normally been sold may be postponed, and the drought must have resulted in an area being designated as eligible for federal assistance. The election is made by attaching a statement to the tax return and should include a reference to IRC Sec. 451(e), evidence of the drought, the affect the drought had on livestock sales, the number sold, comparisons with normal sales years, and computation of income to be postponed. See Publication 225 *Farmer's Tax Guide* for more details.

The second provision allows for the involuntary conversion of gains only from the sale of dairy, draft and breeding livestock disposed of because of drought, flood or other weather-related conditions. Gains from an involuntary conversion can be deferred by reinvesting the sale proceeds in similar property within a two-year period. Only livestock sold in excess of the number that would have normally been sold qualify. This provision does not require disaster area designation by a federal agency.

Large Farm Family Corporations

Farm family corporations with annual gross receipts exceeding $25 million in any year after 1985 must use accrual tax accounting. Non-family farm corporations with annual gross receipts exceeding $1 million in any year after 1976 must use accrual tax accounting. Partnerships with a corporate partner are subject to the same rules.

When farm corporations subject to the $1 million gross receipt rule are required to change to accrual accounting, an adjustment (IRC Sec. 481) resulting from the change is included in gross income over a 10-year period beginning with the year of change. Under prior law, farm family corporations established and used suspense accounts rather than making the Sec. 481 adjustment. Under TRA '97 suspense accounts are prohibited for tax year's ending after June 8, 1997. Any farm family corporation required, because of the $25 million rule, to change to accrual accounting must make the Sec. 481 adjustment. TRA '97 also provides phase-out rules for suspense accounts established under prior law and repeals rules that required income from suspense accounts to be included in taxable income when gross receipts declined.

OLD PROVISIONS SPECIFIC TO AGRICULTURE

Certain Conservation Payments Excluded From Income (IRC Sec. 126)

Payments farmers receive for certain conservation and environmental protection programs may be excluded from income when approved as qualified under IRC Sec. 126. Federal and NYS exclusion approval has been granted to payments for the purchase and installation of capital improvements and the implementation of best management practices made to farmers under the NYC Watershed Agricultural Program. The exclusion does not apply to incentive payments made to encourage the preparation of whole farm plans and participation in educational events. Payments for items that could be expensed on Sch. F are not excluded. If IRS determines payments have substantially increased the annual income derived from the farm, only part of the payment may be excluded. Determination is made on a case-by-case basis.

Expensing of Soil and Water Conservation Costs

In order to be expensed, rather than capitalized, soil and water conservation costs must be consistent with a conservation plan approved by the USDA Natural Resources Conservation Service or by a comparable state agency. Landowners must be materially participating in farm production to expense soil and water conservation costs. Report soil and water conservation expenses directly on Sch. F, line 14. Form 8645 has been eliminated.

Disaster Payments and Crop Insurance

Normally, cash basis farmers are required to report disaster payments and crop insurance benefits in the year the payments are received. An exemption (Treas. Reg. Sec. 1.451-61a) allows the taxpayer to elect to report such benefits in the following year if the taxpayer can show that under normal business practice the income from the crop for which the benefits were received would have been reported in a later year. This applies to federal payments received as a result of (1) the destruction of, or damage to, crops caused by drought, flood or any other natural disaster, or (2) the inability to plant crops because of such a natural disaster. This regulation is effective for payments received after December 31, 1973. The election does not allow the taxpayer to accelerate reporting the payment if it is received the year after the loss. See Publication 225, *Farmer's Tax Guide* for details on making the election. Revenue Ruling 91-55 reaffirms that disaster payments are treated the same as crop insurance.

Crop Indemnity Payments

Farmers may receive USDA subsidized crop indemnity payments from private carriers for losses of income due to crop failure/low prices. Payments for crop losses that result from reduced production due to natural disasters qualify for the election explained in the Disaster Payments and Crop Insurance section. Payments that compensate the producer for low market prices must be reported as income in the year they are received.

Income from Cancellation of Debt

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

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

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

Solvent farmer rules (debt discharged after 4-9-86): Discharged debt must be "qualified farm indebtedness" which is debt incurred directly in connection with the operation of the farm business. Additional "qualified farm indebtedness" rules are: (1) 50% or more of the aggregate gross receipts of the farmer for the three previous years must have been attributable to farming and (2) the discharging creditor must be (a) in the business of lending money and (b) not related to the farmer, did not sell the property to the farmer and did not receive a fee for the farmer's investment in the property. These rules are quite restrictive and will prevent some solvent farmers from using tax attributes to offset DII.

Solvent farmers must reduce tax attributes in exchange for not reporting DII as income. The basis reduction for property owned by the solvent taxpayer must take place in the following order: (1) depreciable assets, (2) land held for use in farming and (3) other property. Basis may be reduced below the remaining debt. DII remaining after the tax attributes have been reduced must be included in a solvent farmer's taxable income. Therefore, if the DII exceeds the total of the tax attributes, all the tax attributes will be given up and the excess of DII over the tax attributes will be included in income and may cause a tax liability.

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

Farm Service Agency (FSA) Recapture of Previously Discharged Debt

Some farmers and farm owners were required to give the Farmer's Home Administration 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 discharged debt for tax purposes at the time of the workout, then a recapture of the debt reduction will trigger an income tax liability. A typical buyout agreement would obligate the farmer to pay FSA the lesser of the excess of the amount received when the farm is sold over the amount paid FSA under the agreement or, the difference between the FMV of the farm at buyout and the amount paid under the agreement.

When discharge of debt is recaptured as taxable income the tax treatment of some discharged debt, may need to be changed. The amount of discharged debt recognized as ordinary income now becomes a deduction against ordinary income. Discharged debt offset by a reduction in attributes is added back to the same attributes and discharged debt not recognized under insolvency rules requires no adjustment.

Uniform Capitalization Rules for Farmers

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

Fruit Growers and Nurserymen

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

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

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

DEPRECIATION AND COST RECOVERY

The standard depreciation rules for regular income tax were not changed by TRA '97. AMT depreciation rules have been modified and will reduce the depreciation adjustment. This reference is for practitioners and taxpayers who want to apply depreciation rules to maximize after tax income. The modified accelerated cost recovery system (MACRS) provides for eight classes of recovery property, two of which may be depreciated only with straight line. MACRS applies to property placed in service after 1986. Pre-MACRS property continues to be depreciated under the ACRS or pre-ACRS rules. Most taxpayers will be using MACRS, ACRS, and the depreciation rules that apply to property acquired before 1981. This manual concentrates on the MACRS rules but some ACRS information is included. Additional information on ACRS and pre-ACRS rules can be found in the *Farmer's Tax Guide.*

Depreciable Assets

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

Depreciation or cost recovery is not optional. It should be claimed each year on all depreciable property including temporarily idle assets. An owner who neglects to take depreciation when it is due now has two opportunities to recover the lost depreciation. It may be recovered by filing an amended return or by following a new procedure for automatic change to a permissible accounting method for depreciable property, Rev. Proc. 96-31. The new procedure was effective May 13, 1996 and is available to taxpayers whose depreciation or amortization deduction claimed is less than the allowable amount. Form 3115 (Application For Change in Accounting Method) must be filed with the IRS within 180 days of the end of the tax year and a copy attached to the taxpayers return for the tax year that the catch-up depreciation is claimed. Procedure 96-31 carries detailed, line-by-line instructions on how to complete Form 3115.

MACRS Classes

The MACRS class life depends on the asset depreciation range (ADR) midpoint life of the property.

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

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

Three-year property:

1. Section 1245 property with an ADR class life of four years or less. This includes over-the-road tractors and hogs held for breeding purposes. It does not include cattle, goats or sheep held for dairy or breeding purposes because the ADR class life of these animals is greater than four years.

2. Section 1245 property used in connection with research and experimentation. Few farmers will have this type of property.

3. Race horses more than two years old when placed in service and all other horses more than 12 years old when placed in service.

Five-year property:

1. All purchased dairy and breeding livestock (except hogs and horses included in the 3 or 7-year classes).

2. Automobiles, light trucks (under 13,000 lbs. unladen), and heavy duty trucks.

3. Computers and peripheral equipment, typewriters, copiers and adding machines.

4. Logging machinery and equipment.

Seven-year property:

1. All farm machinery and equipment.

2. Silos, grain storage bins, fences, and paved barnyards.

3. Breeding or work horses (12 years old or less).

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

Fifteen-year property:

1. Depreciable land improvements such as sidewalks, roads, bridges, water wells, drainage facilities and fences other than farm fences (which are in the 7-year class). Does not include land improvements that are explicitly included in any other class, or buildings or structural components.

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

Twenty-year property includes farm buildings such as general purpose barns, machine sheds, and many storage buildings.

27.5-year property includes residential rental property.

39-year (31.5 if acquired before 5/13/93) property includes nonresidential real property.

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

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

*No class life specified. Therefore, 12-year life assigned.

**7 if placed in service before 1989.

***15 if placed in service before 1989.

****31.5 if placed in service before 5/13/93.

Cost Recovery Methods and Options

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

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

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

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

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

	3-Year Class		5-Year Class		7-Year Class		10-Year Class		15-Yr. Class	20-Yr. Class
Recovery Year	200% DB	150% DB	200% DB	150% DB	200% DB	150% DB	200% DB	150% DB	150% DB	150% DB[1]
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[2]	4.46
16									2.95	4.46
17-20										4.46
21										2.24

[1] Rounded to two decimals, see Pub. 946 for more precise 20-yr. class rates.
[2] 5.90 in years 12 & 14, 5.91 in years 13 & 15.

Half-Year and Mid-Month Conventions

MACRS provides for a half-year convention in the year placed in service regardless of the recovery option chosen. A half-year of recovery may be taken in the year of disposal. No depreciation is allowed on property acquired and disposed of in the same year. Property in the 27.5 and 39-year classes is subject to a mid-month convention in the year placed in service.

MACRS Alternative Depreciation

The MACRS alternative depreciation system (ADS) is required for some property and is an option for the rest. It is a straight line system based on the alternative MACRS recovery period (ADR midpoint lives). Farmers who are subject to capitalization of pre-productive expenses, discussed later, may elect to avoid capitalization, but if they do so, they must use the ADS life on all property.

Election to Expense Depreciable Property

The Section 179 expense deduction is $18,000 for property placed in service in 1997. It was $17,500 for tax years beginning after 1992 and before 1997. It increases to $18,500 for 1998, $19,000 for 1999, $20,000 for 2000, $24,000 in 2001 and $25,000 in 2003. The expense deduction is phased out for any taxpayer who places over $200,000 of property in service in any year, with complete phaseout at $218,000. Eligible property is defined as Sec. 1245 property to which Sec. 168 (accelerated cost recovery) applies. Prior to 1991 only Sec. 38 property qualified. Property must be used more than 50% of the time in the business to qualify. General purpose buildings, property acquired from a related person, and certain property leased by non-corporate lessors does not qualify. Excluded is property used outside the U.S., property used by tax exempt organizations, property used with furnished lodging, property used by governments and foreigners, and air conditioning and heating units (effective January 1, 1991). When property is acquired by trade, Sec. 179 deductions may not be claimed on the basis of the trade-in.

In the case of partnerships, the $18,000 limit applies to the partnership and also to each partner as an individual taxpayer. A partner who has Sec. 179 allocations from several sources could be in a situation where only $18,000 may be expensed because of the $18,000 limitation. The same concept applies to S corporations.

The amount of the Sec. 179 expense deduction is limited to the amount of taxable income of the taxpayer that is derived from the **active** conduct of all trades or businesses of the taxpayer during the year. Taxable income for the purpose of this rule is computed excluding the Sec. 179 deduction. Any disallowed Sec. 179 deductions are carried forward to succeeding years. The deduction of current plus carryover amounts is limited to $18,000 in 1997.

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

Gains from the sale of Sec. 179 assets are treated like Sec. 1245 gains. The amounts expensed are recaptured as ordinary income in the year of sale. The Sec. 179 expense deduction is combined with depreciation allowed in determining the amount of gain to report as ordinary income on Part III of Form 4797.

If post-1986 property is converted to personal use or if business use drops to 50% or less, the Sec. 179 expense recapture is invoked no matter how long the property was held for business use. The amount recaptured is the excess of the Sec. 179 deduction over the amount that would have been deducted as depreciation.

Every business owner who has purchased MACRS property in 1997 should consider the $18,000 expense deduction because only New York investment tax credit will be lost when Sec. 179 is used. It should not be used to reduce AGI below standard (or itemized) deductions plus exemptions, unless an additional reduction in 1997 self-employment tax is worth more than depreciation in a future tax year. Also, the taxpayer must be sure not to use more Sec. 179 deduction than the amount of taxable income from the "active conduct of a trade or business."

Mid-Quarter Convention

If more than 40% 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 Sec. 179 is not considered in applying the 40% rule. In other words, the amount expensed under Sec. 179 can be taken on property acquired in the last quarter, which may help avoid the mid-quarter convention rule.

Example: Newt placed $100,000 worth of 7-year MACRS property in service during 1997. He could expense $18,000 and claim $8,782 of depreciation in 1997 ($100,000 - 18,000 = $82,000 x .1071 = $8,782) under the half-year convention. If $50,000 of Newt's property were placed in service in the last quarter and the $18,000 Sec. 179 election is applied to this $50,000, $32,000 is left to be used in the 40% test. Thus, $32,000 ÷ ($100,000 - 18,000) = .39, which is less than 40%, so Newt avoids the mid-quarter rules. However, if his 1997 items had totaled $95,000 and $50,000 were placed in service in the last quarter, he would be caught by the 40% rule, even if he applied the $18,000 Sec. 179 to the items placed in service in the last quarter. That is, $32,000 ÷ ($95,000 - 18,000) = .42, and all the 1997 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 Sec. 179 could work to the advantage of a taxpayer who wanted to become subject to the rules. If third quarter property could be expensed and thereby have the 40% rule triggered, the depreciation on first and second quarter property would be increased. Whether this increases total depreciation for the year would depend on the proportion placed in service in each quarter.

MACRS Property Class Rules

For 3, 5, 7, and 10-year MACRS property, the same recovery option must be used for all the property acquired in a given year that belongs in the same MACRS class.

Example: A farmer purchased a tractor, harvester and combine in 1997, all belong in the 7-year property class. The farmer may not recover the tractor over seven years with rapid recovery (150% DB) and the other items over seven or ten years with SL. However, a taxpayer may choose a different recovery option for property in the same MACRS class acquired in a subsequent year. For example, a farmer could have chosen SL 10-year recovery for equipment purchased in 1995 (7-year property), 150% DB for seven years for equipment purchased in 1996, and could now select SL 7-year recovery for all machinery purchased in 1997.

A taxpayer may select different recovery options for different MACRS classes established for the same year. For example, a taxpayer could select fast recovery on 5-year property, straight line over seven years on 7-year property, and straight line over 15 years on most 10-year property.

Some Special Rules on Autos and Listed Property

There are special rules for depreciation on automobiles and other "listed property." If used less than 100% in the business, the maximum allowance is reduced, and if used 50% or less, the Sec. 179 deduction is not allowed and depreciation is limited to SL. The maximum first year allowance for depreciation and Sec. 179 expense is $3,160 on cars placed in service in 1997. The maximum second year depreciation allowance is $5,000 for listed property placed in service in 1997. Cellular telephones acquired after 1989 are listed property. Computers are listed property unless they are used only for business.

Additional Rules

For Sec. 1245 property placed in service after 1986 and before 1999, accelerated depreciation in excess of 150% over the assets ADS life is an income adjustment subject to inclusion in alternative minimum taxable income. The AMT depreciation adjustment for Sec. 1250 property is the difference between what was claimed for regular income tax and that allowed under MACRS ADS straight line depreciation. Farm property placed in service after 1998 will not be subject to the AMT depreciation adjustment. An adjustment will remain for property placed on a 200% DB depreciation schedule.

MACRS rules allow half a year's depreciation in the year of disposition using the half-year convention. Recovery may be claimed in the year of disposition (based on the months held in that year) on 27.5 and 39-year property.

When assets are sold, gain to the extent of all prior depreciation on all Sec. 1245; 3, 5, 7, 10 and 15-year MACRS property is ordinary income. There is no recapture of depreciation on property in the 20-year class if straight line recovery is used (see *A Review of Farm Business Property Sales* section for more on depreciation recapture).

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

Choosing Recovery Options

Taxpayers will maximize after-tax income by using Sec. 179 and rapid recovery on 3, 5, 7, 10, and 15-year MACRS property, assuming the deductions can be used to reduce taxable income and do not create an AMT adjustment that results in AMT liability. The taxpayer who will not be able to use all the deductions in the early years may want to consider one of the straight line options.

Using straight line rather than 150% declining balance on 20-year property will preserve capital gain treatment (at a 25% maximum rate), at the time of disposal. However, the tax savings will be realized many years from now. For most taxpayers, the choice of the best recovery option for 20-year MACRS property should be based on the value of concentrating depreciation in early years versus spreading it out. The time value of money makes 1997 depreciation more valuable than that used in later years. However, depreciation claimed to reduce taxable income below zero is depreciation wasted.

Reporting Depreciation and Cost Recovery

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

ACRS Recovery Percentages

Many taxpayers own depreciable property placed in service before 1987 that is on ACRS depreciation. Tables for rapid recovery of ACRS property are available in Pub. 534. A table for straight line ACRS depreciation is shown below.

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

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

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

Accurate Records Needed

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

GENERAL BUSINESS CREDIT

General business credit is a combination of investment tax credit (generally repealed 1/1/86), work opportunity credit, a new welfare-to-work credit, research credit, low-income housing credit, disabled access credit, plus others (see following page). Form 3800 is used to claim the credit for the current year, to apply carryforward from prior years, and claim carryback from future years. The credit allowable is limited to the AMT or 25% of net regular tax liability above $25,000. Special limits apply to married persons filing separate returns, AMT taxpayers, controlled corporate groups, estates and trusts, and certain investment companies and institutions (Sec. 46(e)(i)). TRA '97 changed the carryback period to one year and the carryforward period to 20 years beginning in 1998. The old three year carryback and 15 year carry-forward rules remain for 1997 and for all credits earned before 1998.

Review of Federal Investment Credit

Federal investment tax credit (IC) was repealed for most property placed in service after 12/31/85. IC may still be earned on rehabilitated buildings, qualified reforestation expenses, and certain business energy investments. IC (Sec. 45(a)(1)) is 10% of the amount of qualified investment with more liberal allowances for some rehabilitated buildings. IC is a direct reduction against income tax liability. If it cannot be used in the year it is earned, it can be carried back and carried forward to offset tax liability in other years. Unused investment credit carried over from 1986 and earlier years may still be used but only 65% of that left over from 1986 may be carried to later years. Reforestation IC does not require the 35% reduction.

If property is disposed of before IC claimed is fully earned, it must be re-computed to determine the amount to recapture. Recapture rules apply when there is early disposition of rehabilitated buildings, business energy property and/or reforested land for which investment credit has been claimed. The amount of recapture is 100% during the first year of service and declines to zero after five full years of service. Form 3468 is used for computing IC.

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 business or productive activities except buildings that are used for residential purposes. However, the credit may be earned on a certified historic structure that is used for residential purposes. The use of a building is determined based on its use when placed in service after rehabilitation. Thus, rehabilitation of an apartment building for use as an office building would render the expenditure eligible for credit. The basis for depreciation must be reduced by 100% of the investment credit claimed.

Qualified reforestation expenses consist of up to $10,000 ($5,000 if married filing separately) of the direct expenses of planting or replanting a forest or woodlot held for timber or wood production. Direct expenses include site preparation, seedlings, labor, and depreciation of equipment used. These are the same expenses that qualify for amortization. Deductible operating costs, all costs reimbursed through government cost-sharing programs, and all costs associated with planting Christmas trees are excluded. The basis of any depreciable reforestation expense must be reduced by 50% of IC claimed.

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

Other General Business Credits

Work opportunity credit extended and modified. TRA '97 extends the credit through June 1998, establishes two levels of credit and increases the number of targeted groups (eligible groups of employees). The minimum employment period for credit eligibility has been simplified and reduced to 120 hours of service performed for the employer. First year wages paid 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 now eight targeted groups including qualified SSI recipients, recipients of aid to families with dependent children, (IV-A recipients), certain food stamp recipients, high risk youth living in empowerment zones, economically disadvantaged ex-felons, and certain disabled workers and veterans. Qualification rules were modified for IV-A recipients and veterans. The changes are effective for workers employed after September 1997. The credit is scheduled to expire July 1, 1998 and is no longer available to tax-exempt organizations other than farmer cooperatives.

New Welfare-to-Work Credit begins in 1998. Its available to employers on first and second year wages paid to long-term family assistance recipients. The credit is 35% on qualified first year wages and 50% on qualified second year wages. The credit applies to the first $10,000 of an eligible employees wage each year for a maximum credit of $8,500 over two years. Wages include the value of benefits, health insurance benefits and employer contributions, educational assistance and dependent care expenses.

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

Research credit was extended from June 1, 1997 through June 30, 1998. It continues to be 20% of a taxpayers excess qualified research expenditure above a specified base amount for the tax year. There is also an alternative incremental research credit available to qualified taxpayers.

Disabled access credit may be claimed by an eligible small business that incurs expenses for providing access to persons with disabilities. The maximum amount of the refundable credit is $5,000 per year (50% 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.

Other general business credits: Low-income housing credit, alcohol fuels credit, enhanced oil recovery credit, renewable electricity production credit, empowerment zone credit, Indian employment credit and employer FICA tax credit on tips.

Other nonrefundable credits: Credit for interest on certain home mortgages, foreign tax credit, fuel from non-conventional sources and credit for qualified electric vehicles. The orphan drug credit was made permanent by TRA '97. The credit for buyers of diesel powered cars, vans and light trucks is no longer available.

A REVIEW OF FARM BUSINESS PROPERTY SALES

The major reduction in capital gains rates increases the spread between the regular marginal income tax rate and the capital gain rate for all individual taxpayers. Since more farm taxpayers will be affected by the new capital gain rates and increased potential tax savings, tax planning and management of farm property sales has increased in importance. Making the distinction between gains from sales of property used in the farm business that are eligible for capital gain treatment, gains subject to recapture of depreciation, and Schedule F income is the first step in tax planning.

The reporting of gains and losses on the disposition of property held for use in the farm business continues to be a complicated but an important phase of farm tax reporting. Form 4797 must be used to report gains and losses on sales of farm business property. Schedule D is used to accumulate capital gains and losses. The treatment of gains and losses on disposition of property used in the farm business can be better understood after a review of IRS classifications for such property.

1. Section 1231 - Includes gains and losses on farm real estate and equipment meeting the new TRA '97 holding period requirements, cattle and horses held 24 months, other livestock held 12 months, casualty and theft losses and other involuntary conversions, qualified sales of timber, and un-harvested crops sold with farmland which was held at least one year. There are instances, however, when gain on livestock, equipment, land, buildings, and other improvements is treated specifically under Section 1245, 1250, 1252, and 1255.

   Note: Net Sec. 1231 gains are treated as ordinary income to the extent of un-recaptured net Sec. 1231 losses for the five most recent prior years. A taxpayer that claimed a net Sec. 1231 loss on the 1992, 1993, 1994, 1995 or 1996 return and has a net Sec. 1231 gain for 1997, must recapture the losses on the 1997 return. Losses are to be recaptured in the order in which they occurred.

2. Section 1245 - This is the depreciation recapture section. Farm machinery, purchased breeding, dairy, draft and sporting livestock held for the required period and sold at a gain are reported under this section. It also applies to depreciation claimed on capitalized production costs and to amounts which would have been capitalized if the taxpayer had not elected out of capitalization. Gain will be ordinary income to the extent of depreciation or cost recovery taken after 12/31/61 for equipment and 12/31/69 for livestock. Gain will also be ordinary income to the extent of Sec. 179 expense deductions recaptured.

   Tangible real property (except some Sec. 1250 buildings and their structural components) used as an integral part of farming is Sec. 1245 property. Single-purpose livestock and horticultural structures (placed in service after 1980) are Sec. 1245 property. Nonresidential 15, 18, and 19-year ACRS property becomes Sec. 1245 property if fast recovery has been used. Other tangible real property includes silos, storage structures, fences, paved barnyards, orchards and vineyards.

3. Section 1250 - Farm buildings and other depreciable real property held over one year and sold at a gain are reported in this section unless the assets are Sec. 1245 property. If other than straight line depreciation was used on property placed in service before 1981, the gain to the extent of depreciation claimed after 1969 that exceeds what would have been allowed under straight line depreciation is recaptured as ordinary income. No recapture takes place when only straight line depreciation has been used. A taxpayer may shift such real property to straight line depreciation without special consent.

Gain not subject to recapture on Sec. 1250 assets sold after May 6, 1997 and before 2001, will be taxed at a maximum rate of 25%.

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

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

Farm buildings placed in service after 1986 are MACRS 20-year property eligible for 150% DB depreciation. The amount claimed that exceeds straight line must be recaptured as ordinary income when the buildings are sold. A different MACRS option may be used on a substantial improvement than that used on the original building. If fast recovery has been used on either the building or a substantial improvement to it, gain will be ordinary on the entire building to the extent of fast recovery, and any remaining gain will be capital gain. For residential real estate, gain will be ordinary only to the extent that fast recovery deductions exceed straight line on 15, 18, and 19-year property.

4. Section 1252 - Gain on the sale of land held less than 10 years will be part ordinary and part capital gain when soil and water conservation expenditures have been expensed. If the land was held five years or less, all soil and water or land clearing expenses taken will be "recaptured" as ordinary gain. If the land was held more than five and less than 10 years, part of the soil and water expenses will be recaptured. The percentages of soil and water conservation expenses subject to recapture during this time period are: 6th year after acquisition of the land, 80%; 7th year, 60%; 8th year, 40%; and 9th year, 20%.

   Here is an illustration:

Farmland acquired, April 1, 1991 cost	$100,000
Soil and water expenses deducted on 1992 tax return	$8,000
Land was sold May 15, 1997 for	$130,000

   During the time the land was owned, no capital improvements were made other than the soil and water expenses, so the adjusted tax basis at time of sale was $100,000. The gain of $30,000 would normally be all capital gain. The land was held for six years, so the gain is divided; $8,000 x .80 = $6,400 is ordinary gain and $30,000 - $6,400 = $23,600 qualifies as capital gain.

5. Section 1255 - If government cost sharing payments for conservation have been excluded from gross income under the provisions of Sec. 126, the land improved with the payments will come under Sec. 1255 when sold. All the excluded income will be recaptured as ordinary income if the land has been held less than 10 years after the last government payment had been excluded. Between 10 and 20 years, the recapture is reduced 10% for each additional year the land is held. There is no recapture after 20 years.

Livestock Sales

The majority of livestock sales from Northeast farms are animals that have been held for dairy, breeding or sporting purposes. Income from such sales is always reported on Form 4797. Dairy cows culled from the herd and cows sold for dairy or breeding purposes are the most common of these sales. Sales of horses and other livestock held for breeding, draft or sporting purposes also go on Form 4797.

Income from livestock held primarily for sale is reported on Schedule F. Receipts from the sale of "bob" veal calves, feeder livestock, slaughter livestock, and dairy heifers raised for sale are entered on Schedule F, line 4. Sales of livestock purchased for resale are entered on line 1 of Schedule F, and for a cash basis farmer the purchase price is recovered in the year of sale on line 2. The intent of holding livestock is a key issue in determining if sales are reported on 4797 or Schedule F.

Breeding, Dairy, Draft or Sporting Livestock

Dairy cattle raised or purchased to replace or add to the taxpayers herd are held for dairy purposes. Dairy cattle that are raised or purchased and developed as breeding stock to be sold to other farmers are held for sale. Livestock held for breeding, dairy, draft or sporting purposes are classified into two groups according to length of holding periods:

1. Cattle and horses held two years or more, and other breeding livestock held one year or more. Animals in this group are Sec. 1231 livestock and these holding periods were not changed by TRA '97. Emus and ostriches are currently excluded from the IRS definition of Sec. 1231 livestock.

2. Cattle and horses held less than two years, and other breeding livestock held less than one year. These sales do not meet holding period requirements.

Most dairy animals will meet the two-year holding period requirement. Major exceptions are raised young stock sold with a herd dispersal and the sale of cows that were purchased less than two years prior to sale. The age of raised animals sold will determine the length of the holding period. The date of purchase is needed to determine how long purchased animals are held. The holding period begins the day after the animal is born or purchased and ends on the date of disposition.

Reporting Sales of Sec. 1231 Livestock

Sales of Sec. 1231 livestock are entered in Part I or Part III of Form 4797. Since Part III is for recapture, purchased Sec. 1231 livestock that produce a gain upon sale will be entered in Part III where they become Sec. 1245 property. Sales of raised animals on which costs were capitalized are also reported in Part III as are animals on which pre-productive costs would have been capitalized if the taxpayer had elected not to do so during the years when livestock were required to be capitalized. Sales of raised Sec. 1231 livestock not subjected to the capitalization rules are entered in Part I which includes all raised cattle and horses two years of age and older that are held for breeding, dairy, draft or sporting purposes. All purchased Sec. 1231 livestock that result in a loss when sold are also entered in Part I.

Reporting Sales of Livestock Not Meeting Holding Period Requirements

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

Use of Form 4797 and Schedule D by Farmers

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

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

Summary of Reporting Most Common Farm Business Property Sales

Type of Farm Property	Tax Form and Section
1. Cattle and horses held for breeding, dairy, draft or sporting purposes & held for 2 years or more; plus other breeding or sporting livestock held for at least one year.	
a) Raised, pre-productive costs not subject to capitalization rules (1231 Property)	4797, Part I
b) Purchased (and raised subject to capitalization rules), sale results in gain (1245 Property)	4797, Part III
c) Purchased (and raised subject to capitalization rules), sale results in loss (1231 Property)	4797, Part I
2. Livestock held for breeding, dairy, draft, & sporting purposes but not held for the required period.	4797, Part II
3. Livestock held for sale.	Schedule F, Part I
4. Machinery held for one year or more (18 mos. after 2000)	
a) Sale results in gain	4797, Part III
b) Sale results in loss	4797, Part I
5. Buildings, structures & other depreciable real property held for one year or more (18 mos. after 2000)	
a) Sale results in gain	4797, Part III
b) Sale results in loss	4797, Part I
6. Farmland, held for one year or more (18 mos. after 2000) sold at a gain	
a) Soil & water expenses were deducted or cost sharing payments excluded	4797, Part III
b) If 6a does not apply	4797, Part I
7. Machinery, buildings, & farmland held for less than one year (18 mos. after 2000)	4797, Part II

INSTALLMENT SALES

The installment method of reporting may still be used by non-dealers for the sale of real property or personal property (except property subject to depreciation recapture). It continues to be a practical and useful method used in transferring farms to the next generation. The installment method is required when qualified property is sold and at least one payment is received in the following tax year unless the seller elects to report all the sale proceeds in the year of disposition.

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

Depreciation Recapture

Recaptured depreciation does not qualify for the installment sale. That portion of the gain attributed to recaptured depreciation of Sec. 1245 and 1250 property must be excluded. Sec. 179 expenses and capitalized expenditures also are treated as Sec. 1245 dispositions. The full amount of recaptured depreciation is reported as ordinary income in the year of sale regardless of when the payments are received.

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

When the sale of Sec. 1245 and 1250 property produces gain in addition to that which is recaptured, the amount of recaptured depreciation reported in the year of sale is added to the property's basis to compute the correct gross profit ratio. This adjustment must be made to avoid double taxation of installment payments.

Related Party Rules (IRC Sec. 453)

The installment sale/resale rules should be reviewed before farmers or other taxpayers agree to a sales contract. Gain will be triggered for the initial seller when there is a second disposition by the initial buyer, and the initial seller and buyer are closely related. (Closely related persons would include spouse, parent, children, and grandchildren, but not brothers and sisters.) The amount of gain accelerated is the excess of the amount realized on the resale over the payments made on the installment sale. Except for marketable securities, the resale recapture rule will not generally apply if the second sale occurs two or more years after the first sale and it can be shown that the transaction was not done for the avoidance of federal income taxes. The two-year period will be extended if the original purchaser's risk of loss was lessened by holding an option of another person to buy the property.

In no instance will the resale rule apply if the second sale is also an installment sale where payments extend to or beyond the original installment sale payments. Also exempt from the resale rule are dispositions (1) after the death of either the installment seller or buyer, (2) resulting from involuntary conversions of the property (if initial sale occurred before threat or imminence), (3) non-liquidating 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 (IRC §453(g) and 1239).

Use of Escrow Accounts

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

Rule Changes from TRA'97

Farmers may use the installment method of accounting for AMTI from the disposition of property used or produced in farming (see Alternative Minimum Tax). Manufacturers of tangible personal property will not be able to use the installment method to report income from sales to their dealers in tax years beginning after August 5, 1998.

General Rules Still in Effect

Losses cannot be reported on an installment sale. A partnership may use the installment sale method of reporting gain on the sale of partnership property even though an individual partner may have a loss and recognize it in the year of sale.

The capital gains rules in effect when an installment payment is received and reported determines how the income is treated. However, a change or increase in the capital gain holding period requirement during an installment sale would not move a long-term gain to a short-term gain.

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

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

Grain and other farm inventory property, including livestock held for sale, may be included in a cash basis taxpayer's installment sale and it no longer requires an AMT adjustment in the year of sale (retroactive to 1987).

All payments received from a dealer disposition of property must be reported as received in the year of sale. A dealer disposition is (1) any disposition of real property held by the taxpayer for sale to customers in the ordinary course of a trade or business; and (2) any disposition of personal property by a taxpayer who regularly sells such property on the installment plan.

Unstated and Imputed Interest Rules

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

Imputed interest rules applicable to certain debt instruments including installment sales are covered under IRC Section 1274 and Section 483. There are several special rules and numerous exceptions that complicate the understanding and application of imputed interest rules. Following is our understanding of the rules most applicable to farm business property installment sales.

1. All sales and exchanges (other than "new" Sec. 38 property) where seller financing does not exceed $3,731,000 (indexed estimate) must have an imputed interest rate of the lesser of 100% of the applicable federal rate (AFR) or 9% (compounded semiannually).

2. Sales exceeding $3,731,000 (indexed estimate) are subject to an imputed interest rate equal to 100% of the AFR. Sale-leaseback transactions of any amount are subject to interest rates equal to 110% of AFR.

3. The sales or exchanges of land between related persons, (brothers, sisters, spouse, ancestors or lineal descendants), must have a test or stated rate of 6% compounded semiannually or interest will be imputed at 7%. This rule applies to the first $500,000 of land sold or exchanged between related people in one calendar year.

4. The imputed interest rules do not apply to the sale of personal use property, annuities, patents, and any other sale that does not exceed $3,000.

5. Imputed as well as stated interest may be accounted for on the cash accounting method on sales of farms not exceeding $1 million and any other installment sale not exceeding $250,000.

The AFR is the lower of the computed six-month rate or the monthly rate. The monthly rate can be the current month's rate or the lower of the two preceding months' rates.

The October 1997 monthly AFR was 5.69% for short term (not over three years), 6.16% for mid term (three to nine years), 6.48% for long term (over nine years). The monthly AFRs have decreased slightly (.22 to .43 basis points) in the last year.

LEASING OF LAND AND OTHER FARM ASSETS

Production Flexibility Contract (PFC) Payments on Leased Land

The 1996 Farm Bill provides PFC payments to land owners and tenants based on the crop acreage base for the leased land. In general, these PFC payments are divided between the land owner and the lessee according to their respective share of the crop produced. This bill may induce many landowners to shift from a cash rent arrangement to a share lease, to be able to share in the government payments. If the landowner begins to materially participate, then it will affect the landowner's self-employment taxes and social security benefits, as the income would be reported on Schedule F. If the landowner does not meet any one of the material participation tests (*Farmers Tax Guide*, Pub. 225) then they can report their share of the crop on Form 4835 rather than as cash rent on Sch. E and still not be subject to self-employment taxes. [For NYS taxpayers, this has an added benefit of shifting this income from non-farm income to farm income, thus increasing the ratio of gross farm income to total gross income to possibly qualify for a Farm Property School Tax Credit.]

Valid Tax Lease or Conditional Sales Contract

To determine if 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. Generally, an agreement will be a conditional sales contract rather than a lease for tax purposes if any of the following are true:

a) The agreement applies part of each payment toward equity interest.

b) The lessee gets title to the property upon payment of a stated amount under the contract.

c) 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.

d) The lessee pays much more than the current fair rental value of the property.

e) The lessee can purchase the property at a nominal price compared to the value of the property at the time of purchase.

f) 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.

g) The lease designates part of the payments as interest or part of the payments are easy to recognize as interest.

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

1) When the property is placed in use by the lessee, the minimum investment of the lessor must be equal to 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 fair market value when exercised.

4) None of the cost of the property may be furnished by lessee.

5) Lessee may not lend to the lessor any of the money or guarantee indebtedness to acquire the property.

6) Lessor must expect to receive a profit from the transaction.

For accrual method taxpayers, any advance lease payments (prepaid rent) above the terms of the lease can be deducted only for the months of the tax year which have expired. The balance can be deducted only over the period to which it applies. For cash method taxpayers, the allowable deduction for prepaid lease payments, as a general rule, are limited to the taxable year for the months expired. In a recent case of Zaninovich vs. Comm. 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 "one-year rule" which treats an expenditure as a capital expenditure (buildings, machinery and equipment) if it creates an asset or secures a like advantage to the taxpayer and has a useful life in excess of one year. On the other hand, an expenditure can be deducted in full if the benefit of the payment does not exceed one year e.g. cash rent.

ALTERNATIVE MINIMUM TAX (AMT)

The AMT is a separate but parallel tax system. It's 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. AMT may be created by adding back certain deductions and exemptions used to compute the regular tax, and by disallowing most tax credits.

TRA '97 included some AMT relief as well as new concerns for taxpayers. The relief provisions will reduce some major AMT exclusions (see explanation below). One concern is that more taxpayers may be subject to AMT because non-deductible credits, including child credit, have increased. A proposed increase in the AMT exemption was not included in TRA '97.

Three changes in AMT Affect Farmers

1. AMT depreciation for personal property will change to a maximum rate of 150% declining balance over the applicable MACRS recovery period for property placed in service after December 31, 1998. The ADS requirement has also been repealed for depreciable real property (Sec. 1250). Farmers will be able to use regular tax depreciation for AMT within the limits of the effective date. Non-farmers who use 200% decline balance depreciation for regular tax will still be required to make an AMT depreciation adjustment.

2. Cash basis farmers may use the installment method for reporting sales of inventory or property held primarily for sale to customers in the ordinary course of business in computing AMTI. This provision is retroactively effective for tax year's beginning after 1987. Therefore, qualified farmers are eligible to use the installment sale method for deferred payment contracts in computing AMT and regular income tax. Deferred payment contracts must avoid constructive receipts to defer income to the following year.

3. Corporations with a three-year average annual gross receipts of less than $5 million will be exempt from AMT for tax year's beginning after December 31, 1997 (increasing to $7.5 million for any later year).

Capital Gain Rates Reduced

Prior to TRA '97 net capital gain for non-corporate taxpayers was taxed at the standard AMT rates of 26%/28%. Effective for tax year's ending after May 6, 1997 the lower 10%/20% capital gain rates available to low bracket taxpayers computing regular taxes, will be used to compute AMT on net capital gains. The lower 10%/20% rates do not apply to net capital gains occurring before May 7, 1997.

Other AMT Changes

The AMT exemption for children under age 14, has been increased to the child's earned income plus $5,000 for tax years beginning in 1998. The $5,000 will be indexed for inflation beginning in 1999. The annual exemption can not exceed $33,750. The parent's AMTI or AMT exemption will no longer be used to determine the child's AMT exemption.

Corporations with gross receipts of $5 million or more are still subject to a 35% AMT rate. For tax year's ending after December 31, 1997 the 35% AMT rate is applied to the lesser of the corporation's net capital gain or its taxable income.

AMT depreciation for pollution control facilities placed in service after December 31, 1998 may be computed using MACRS class lives and the SL method. Prior to TRA '97 longer ADS lives were required.

AMT Rate and Exemption Phaseout

The AMT has a two-tiered 26 and 28% rate system for non-corporate taxpayers. The 26% rate applies to the first $175,000 of AMTI ($87,500 for marrieds filing separately) in excess of the exemption. The 28% rate begins at $175,000 of AMTI. The exemptions are not indexed and are phased out at a rate of 25% of AMT income exceeding specific levels, as shown in the table below. If the taxpayer's AMTI exceeds the exemption, he or she will have a calculated AMT but will pay AMT only if it exceeds the regular tax.

Alternative Minimum Tax Exemption and Phaseout

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

Alternative Minimum Taxable Income (AMTI) for 1997

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

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

1. Exclusion items: Standard deduction or certain itemized deductions from Schedule A, including most medical deductions, miscellaneous deductions subject to the 2% rule, state and local taxes, and interest adjustments. Interest adjustments include the difference between qualified housing interest and qualified residence interest, interest income on private activity bonds that are exempt from regular tax, and a net investment interest adjustment which could be either positive or negative. These are lines 1 through 7 on Form 6251. 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. Depreciation on personal property placed in service after 1986 that exceeds 150% declining balance using alternative MACRS years of life. Exceptions include property depreciated under the unit-of-production method, and property subject to transition rules for MACRS. The depreciation adjustment is the net difference between accelerated MACRS depreciation and that allowed for AMT. If straight line is used for regular tax, it must be used for AMT. The Sec. 179 deduction is allowed in calculating AMTI. (See future changes above.)

3. Adjusted gain or loss from dispositions reported in Forms 4797, Sch. D and 4684 that have a different basis for AMT than for regular tax.

4. Incentive stock option adjustments, passive activity adjustments, AMTI from estates and trusts, tax-exempt interest from private activity bonds (lines 9-13, Form 6251).

5. Accelerated depreciation on real and leased property and amortization of certified pollution control facilities placed in service before 1987.

6. Other adjustments may be required for intangible drilling costs, long-term contracts, certain loss limitations, mining costs, patron's distributions, pollution control facilities, research and experimental costs and tax shelter farm activities.

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

Alternative Tax Net Operating Loss Deduction (ATNOLD)

The deduction of ATNOLD is the last step in calculating alternative minimum taxable income. The alternate tax net operating loss is limited to 90% of AMTI and is calculated and deducted after all adjustments and preferences have been added in. 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 above exceptions are included.

Tentative Minimum Tax

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

Alternative Minimum Tax and Credits

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

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

Who Must File Test

More taxpayers are required to file Form 6251 than have an AMT liability. Form 6251 must be filed if the taxpayer is liable for AMT (AMTI on line 21 is greater than the exemption on line 22). If the total of preference items is negative, Form 6251 should be filed to show the IRS that the taxpayer is not liable for AMT.

The AMT Credit

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

Part I of Form 8801 (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 net operating loss deduction, which is calculated like the ATNOLD except that only the exclusion adjustments and preferences are included. It also requires computation of the minimum tax foreign tax credit on the exclusion items.

Part II of 8801 is used to compute the allowable minimum tax credit and the AMT credit carryforward. The computation includes unallowed credit for producing fuel from a non-conventional source, orphan drug, and electric vehicle credit.

NET OPERATING LOSSES

Taxpayers who sustain a net operating loss in 1997 may carry it back to recover taxes paid in former years or carry it forward to reduce taxes to be paid in future years. TRA '97 reduced the carry-back period from three to two years and increased the carryforward period from 15 to 20 years effective for NOL's from tax years beginning after August 5, 1997. The old rules are in effect for 1997 NOL's. NOL's attributable to casualty and theft losses, and Presidentially declared disasters incurred by farmers and small businesses retain a three-year carryback period.

The calculation of a net operating loss, and its application to recover taxes in another year, is a complex process governed by strict rules of procedure. The *1996 Cornell Cooperative Extension Income Tax Workbook* contains an excellent NOL chapter including illustrations and worksheets. IRS Pub. 536 covers NOLs. Following are guidelines to consider before computing an NOL.

A net loss on Schedule F or Schedule C is not equal to a net operating loss. The NOL is usually less than the net business loss. Business losses must be combined with all other income, losses, and deductions on form 1040 to determine if there is a net operating loss.

Example: Dan Dairy farmer has a 1997 Schedule F loss of $22,000 and net long term gain of $11,500 from cattle sales. Mrs. Dairy has a wage income of $9,000, they file a joint return, claim the $6,900 standard deduction and four personal exemptions for $10,600. Total deductions $39,500 exceed income $20,500 by $19,000 but they cannot include the standard deduction and personal exemptions in their NOL. Their 1997 NOL is only $1,500 ($19,000 - $17,500).

The opportunities and consequences of carrying an NOL back should always be considered first. If the 1997 NOL is carried back, it must be carried back three years, then to each succeeding year, if necessary, to use it up. A 1997 NOL would be first carried back to 1994, then to 1995, 1996, and then forward to 1998 and in order to 2012 if necessary. The 1997 carryforward provision is 15 years.

A taxpayer may elect to forego the entire carryback period. The election must be made by the due date for the return of the year the NOL occurred by attaching a statement to the return. **It cannot be made on an amended return.** Once the election is made, it is irrevocable for that tax year. If the election is not made by the applicable date, the NOL will be considered absorbed as if it had been carried back, even if it had not been claimed in a carryback year. If there is more than one NOL to be carried to the same year, the NOL from the earliest year is applied first. Reasons to forego the carryback period may include low income during the carryback period and recomputation of investment tax credit.

In making a claim for an NOL, a concise statement showing its computation must be filed with the return for the year the NOL is used. For a carryback year, the statement can be filed with a Form 1045 or 1040X. Form 1045 (or Form 1139 for a corporation) must be filed within one year after the close of the NOL year. Form 1040X may be filed within three years of due date for the NOL year return. Schedules A and B (Form 1045) are used to compute the NOL and NOL carryovers.

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

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

INFORMATIONAL RETURNS

Informational Forms (often issued or received by farmers)

1099-MISC - Must be filed by any person engaged in a trade or business, on each non-employee paid $600 or more for services performed during the year. Rental payments, royalties, prizes, awards, and fishing boat proceeds must also be reported when one individual receives $600 or more. Payments made for non-business services and to corporations are excluded. When payments of $600 or more are made to the same individual for independent services and merchandise, payments for the merchandise can be excluded only if the contract and bill clearly show that a fixed and determinable amount was for merchandise.

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

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

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

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

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

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

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

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

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

Filing Dates and Penalties

The 1099's 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 $50 per return penalty for failure to file correct and timely information returns. There is no penalty if failure is due to reasonable cause. The penalty is reduced when the failure is corrected on or before August 1. The penalty applies to each failure, and there is a $25,000 penalty cap for small businesses. If failure to file or include correct information is due to intentional disregard of the regulations, the penalty is $100 or 10% of the amount reported on the information return, whichever is greater. The penalty for intentional disregard of reporting cash payments over $10,000 received is now the greater of $25,000 or the amount of the cash payment up to $100,000.

SOCIAL SECURITY TAX AND MANAGEMENT SITUATION, AND OTHER PAYROLL TAXES

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

The Current Social Security Tax

The social security earnings base increased to $65,400 for 1997. There is no longer a cap on the amount of earnings subject to Medicare tax. FICA and self-employment tax rates remain the same as in 1996. The total rate is divided into two components representing the social security and Medicare tax. The maximum 1997 social security tax is $4,054.80 (employer's share), up $167.40 from 1996.

Social Security Tax Table

	Earnings Base		FICA Rate %[1]		Self-Employment Rate %	
Year	Soc. Sec.	Medicare	Soc. Sec.	Medicare	Soc. Sec.	Medicare
1996	$62,700	Unlimited	6.20	1.45	12.40	2.90
1997	$65,400	Unlimited	6.20	1.45	12.40	2.90
1998	$ [2]	Unlimited	6.20	1.45	12.40	2.90

[1] Paid by both employer and employee.
[2] Not available at press deadline.

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

Two Deductions for Self-Employed

1. Self-employed taxpayers deduct from taxable income on line 26, Form 1040, one-half of self-employment taxes that can be attributed to a trade or business. The rationale for this tax deduction is that employees do not pay income taxes on the one-half of FICA taxes paid by their employer.

2. Self-employed taxpayers deduct 7.65% from self-employment income when computing net earnings from self-employment. This is achieved by multiplying total profit (or loss) from Schedules C and/or F by 0.9235 on Schedule SE. This adjustment is made before applying the social security and Medicare tax earnings base. Taxpayers reporting less than $65,400 of self-employment income will receive the greatest benefit from the deduction. This adjustment is allowed because employees do not pay social security tax on the value of their employer's share of FICA tax.

Farmer's Optional Method

Low-income farmers may still use the optional method and report up to $1,600 of self-employment income when net farm income is less than $1,733. Self-employed non-farmers have a similar option. Self-employed workers should give serious consideration to using the optional method if they are not currently insured under the social security system. To be eligible for social security disability benefits, a worker must be fully insured and have 20 of the last 40 quarters of coverage. The earnings required to receive one quarter of credit increased to $670 in 1997. Thus, the optional method will yield only two quarters of coverage. Earning $2,680 any time during 1997 will net four quarters of coverage.

Wages Paid to Spouse, Children and Farm Workers

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

Wages earned by a person employed in a trade or business by his or her spouse and wages paid to individuals 18 years old and over working for their parent(s) in a trade or business are subject to FICA taxes and income tax withholding. Children under age 18 working for a parent's partnership, corporation, or estate also are covered by social security. Sole proprietors and husband-wife partnerships who hire their kids under 18 years old needn't pay social security tax on them nor FUTA if under 21. Wages paid by a parent to a child for domestic service in the home are not covered until the child reaches 21.

Payment of Agricultural Wages with Commodities

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Remember even if the non-cash wages are ruled exempt from FICA, FUTA and income tax withholding they are still subject to income taxes. When farm commodities are used to pay employees for services, the employer must report the fair market value of the commodity on the date of payment as Schedule F income. The same amount is claimed by the employer as a labor expense on Schedule F, but it is not reported as a social security wage on Form 943 or the employee's W-2. It is included as other compensation in box 1 of Form W-2 but not in box 3 and 5.

Employees who receive commodities in lieu of wages must report their initial market value as wage income. When the commodities are sold, the sale price is reported on Schedule D, less the basis which is the initial market value plus storage and marketing expenses. If the employee is a farmer or dealer, then they would use Schedule F or C respectively to report the commodities sold.

In summary, the employee should be given complete possession and control, and the sale or other disposition of the "in-kind" payment should be at the discretion of the employee and independent of that of the employer.

<u>Taxation of Social Security Benefits</u>

In 1994 and later, social security recipients are potentially subject to two sets of rules on taxation of social security benefits. Disability benefits are treated the same way as other social security benefits. The rules that tax 50% of social security benefits have been in effect for several years. The new rules that tax up to 85% of social security benefits for higher-income taxpayers became effective in 1994. Starting in 1996, U.S. residents receiving Canadian Social Security will not owe U.S. income tax on those benefits but will now be subject to Canadian tax rules on the benefits.

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

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

1. 85% of the taxpayer's social security benefit, <u>or</u>
2. the sum of 85% of the excess of the taxpayer's provisional income above the applicable threshold amount plus the smaller of:
   a. the amount of social security benefit included under previous law <u>or</u>
   b. $4,500 ($6,000 for married taxpayers filing jointly).

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

<u>Example 1</u>: His and Her Taxpayers have the following 1997 income:

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

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

1. 85% of $16,000 social security benefits = $13,600; **<u>or</u>**
2. the sum of 85% of the excess of $53,000 over $44,000, which is $9,000 x .85 = $7,650 plus the smaller of:
   a. 1/2 of $16,000 = $8,000 **<u>or</u>**
   b. $6,000.

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

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

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

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

1. 85% of $16,000 social security benefits = $13,600, **<u>or</u>**
2. the sum of 85% of the excess of $47,000 over 44,000, which is $3,000 x .85 = $2,550 plus the smaller of:

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

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

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

The 50 percent rules apply to single taxpayers with provisional incomes between $25,000 and $34,000 and married persons filing jointly with provisional incomes between $32,000 and $44,000. For taxpayers in these ranges, the inclusion is still limited to the lessor of (1) one-half of the benefits received, or (2) one-half of the excess of the sum of the taxpayer's adjusted gross income, interest on tax-exempt obligations, and half of the social security benefits over the base amount. ($32,000 for persons filing jointly, $0 for married persons filing separately but living together, and $25,000 for all others.) Medicare payments are excluded from gross income.

<u>Example</u>: Me and You Retiree received $15,200 in 1997 social security benefits, $3,000 of tax-exempt interest, and their AGI (joint return) was $26,400 (excluding social security).

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

<u>Reduction of Benefits</u>

When a person's wage and self-employment earnings exceed the earnings limit, social security benefits of the working beneficiary and dependents are reduced by a percentage of the excess earnings. In 1997 the annual earnings limit for those less than age 65 is $8,640, and for those age 65 to 70 it is $13,500. For those aged 70 and older there are no reductions. The reduction of benefits is one-half of excess earnings when less than age 65 and one-third of excess earnings when age 65 to 70. The 1996 cost of living increase in benefits was 2.9%.

<u>"Nanny Tax" Social Security Domestic Employment Act of 1994</u>

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

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

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

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

Schedule H (Form 1040)

Taxpayers must file Schedule H if any of the following conditions apply:

(a) They paid any one household employee cash wages of $1,000 or more in 1997.

(b) They withheld Federal Income Tax during 1996 at the request of any household employee.

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

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

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

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

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

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

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

Paying Rent to a Spouse

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

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

If you deduct rental payments made to the spouse for use of his or her jointly owned property, follow these precautions:

(1) have evidence that the spouse acquired equity in the property; and even a more desirable fact would be that the farm operator has no equity interest in the rented property

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

(3) deduct the taxes, interest, and insurance on the rented property on the spouse's Schedule E;

(4) the spouse should deposit the rental income in a separate account and his or her tax and interest payments from the account;

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

(6) the spouse should avoid material participation.

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

Exemptions for Members of Religious Orders

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

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

Rules for Depositing FICA and Federal Income Taxes

The deposit rules for 1998 are as follows: Farm employers who reported $50,000 or less of federal payroll taxes in 1995 must make timely monthly deposits in 1998. FICA and federal income taxes accumulated from cash wages paid during a calendar month must be deposited by the 15th day of the following month.

The Small Business Bill requires that if an employer's 1995 Federal tax deposits were more than $50,000, treasury deposits must be made by electronic funds transfer using the Electronic Federal Tax Payment System (EFTPS). The effective date was delayed to July 1, 1997 with June 30, 1998 as the date when penalties for non-compliance begin.

An employer who accumulated less than $500 of payroll taxes for the entire year may make the payment with the annual tax return. However, a farm employer can no longer wait for payroll taxes to accumulate to $500 and then make timely quarterly deposits. Most farmers with annual cash payrolls of $2,000 to $150,000 will be subject to the monthly deposit rule. Farm employers with annual cash payrolls exceeding $150,000 will be subject to the Wednesday/Friday rules.

Federal Unemployment Tax (FUTA)

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

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

Unemployment taxes must be paid by the employer; they may not be deducted or withheld from employee wages. The FUTA rate is 6.2% on the first $7,000 of cash wages paid to each employee in 1997. The 1996 NYSUI rates range from 2.6 to 7.1% on the first $7,000 of each employee's total earnings. The standard and maximum basic rate is 5.4%. The 1997 "new employer" rate is 4.4%. Employers may receive a credit of up to 5.4% for NYSUI taxes paid on their FUTA liability even when their NYS experience rate is less than 5.4%. A farmer subject to the NYSUI may pay a FUTA rate as low as 0.8% in 1997.

The FUTA tax deposit rule is different from those for other payroll taxes. When the amount subject to deposit reaches $100, it must be deposited within one month following the close of the current calendar quarter. Form 940 (or 940-EZ) is the annual FUTA return to be filed by January 31. Exception: FUTA taxes withheld from household employees are deposited with FICA and income taxes on Schedule H (Form 1040).

NEW YORK STATE INCOME TAX

The 1997 New York State Budget Bill was passed on August 7, 1997. The tax highlights of this year's bill are the following:

- The Farm property school tax credit was modified to exempt up to $30,000 of qualified income for determining taxpayer eligibility and modified AGI limitations can be adjusted by an amount equal to farm principal payments, both changes are effective January 1, 1998.
- A school tax relief (STAR) property tax exemption for senior citizens and other homeowners is phased in over five years.
- A New York Tuition Savings program, beginning after 1997, will allow taxpayers to contribute up to $5,000 per year, NY State tax exempt, for higher educational expenses at qualified institutions.
- The state tax unified credit is increased to exempt estates of $300,000 or less from taxation beginning October 1, 1998.
- State sales tax exemption on clothing excluding footwear under $100 for one week in September 1997 and 1998, then permanent starting January 1, 1999.

Farm Property School Tax Credit

A very important tax relief program was included in the 1996 NY State Budget Bill and modified in 1997. Effective for the 1997 tax year, NY taxpayers whose federal gross income from farming equals at least two-thirds of total federal gross income will be allowed a credit against personal income tax or corporation franchise tax equal to school property taxes paid on certain agricultural property. Gross income from farming includes gross farm income from Sch. F, gross farm rents Form 4835 and gains from livestock Form 4797. It also includes gross income from farming from a partnership, S corporation, estate or trust. The NY tax credit limitation is based on school taxes paid on qualified agricultural property plus 50% above the base acreage. The 1997 base acreage is 100 acres; 1998 base is 175 acres and there after 250 acres. If a taxpayer's farmland acreage exceeds the base acreage, the school taxes paid credit is scaled back in proportion to the sum of the base acreage and 50% of the acreage in excess of the base.

For example: 1997 school property tax paid on 300 acres of qualified land and buildings (residence excluded) was $15,000. The excess acreage is 300 - 100 = 200 acres and 50% of the excess is 100 acres. Therefore, the allowable percentage is 100 + 100 = 200/300 or 66.6%. Therefore credit is $10,000 ($15,000 x 66.6%).

The credit is claimed against NY State personal income tax, corporate franchise tax, S corp or LLC income tax liabilities. Refunds can be claimed or carried over. Qualified agricultural property is land located in New York State which is used for agricultural production. The credit is not allowed for the lessee, as the operator must be the owner of the leased land. Lessors of farm land may or may not qualify dependent upon their qualifications as farm taxpayers. The income limitation starts at $100,000 AGI and scales the credit back to zero at $150,000 AGI. If agricultural property is converted to non-qualified use, no credit is allowed that year and recapture is triggered for the previous two taxable years.

The 1997 budget bill made some changes in definitions that will include more eligible farmers for the 1998 tax year. Effective for the 1998 tax year, NY taxpayers whose federal gross income from farming equals at least two-thirds of excess federal gross income will be allowed the school property tax credit. Excess federal gross income is federal gross income from all sources for the taxable year in excess of a special $30,000 subtraction. The special $30,000 deduction can be composed of earned income (wages, salaries, tips and items of gross income included in computation of net earnings from self employment) pension payments (SS), interest and dividends. For 1998 and thereafter, the federal gross income of a corporation may, likewise, be reduced by up to $30,000 for the special subtraction. A special ruling only for this section of law will include gross income from the production of maple syrup and cider and from the sale of wine from a licensed farm winery, to be included in the term federal gross income from farming.

If the modified New York adjusted gross income of the taxpayer exceeds $100,000 the credit is scaled back and completely lost at $150,000. Modified NY adjusted gross is the NY gross income for the taxable year reduced by the principal paid on farm indebtedness during the tax year. Farm indebtedness is the debt incurred or refinanced that is secured by farm property, where the proceeds of the debt are used for expenditures incurred in the business of farming.

New York State School Tax Relief (STAR)

This program provides a partial exemption from school property taxes for owner-occupied primary residences. Senior Citizen property owners must be 65 years of age or older, have incomes that do not exceed $60,000 a year to qualify the first time for school year 1998-99 for at least a $12,500 full value assessment exemption. The "enhanced" STAR senior citizen exemption when fully phased in by the year 2001-02 will be a $50,000 exemption from the full value of their property. The eligible senior citizen must apply with the local assessor for the "enhanced" STAR exemption by March 2, 1998 in most towns. This is the "taxable status date" but deadlines vary so most taxpayers should apply earlier (e.g. Nassau County's deadline is January 2, 1998).

The "basic" STAR program is available to all primary residence homeowners regardless of age starting with the school year 1999-2000. The full value assessment exemption will be phased in from $10,000 to $30,000 by the school year 2001-02. To be eligible an owner must own and live in a one, two or three-family residence, mobile home, condominium, cooperative apartment or farm house.

STAR Property Tax Exemption Table

School Year	1998-99	1999-00	2000-01	2001-02 and after
Eligible Senior Citizen Homeowners	$12,500	$25,000	$37,500	$50,000
All Primary Residence Homeowners	None	$10,000	$20,000	$30,000

NY Tuition Savings Program

For tax years beginning after 1997, taxpayers may contribute up to $5,000 per year exempt from New York personal income tax to a family tuition account to be used for higher education expenses at qualified institutions. These contributions are subtracted from a taxpayers federal adjusted gross income in calculating the New York adjusted gross income. The interest earned receives tax-exempt treatment for New York State purposes and should receive deferred tax treatment for federal income tax purposes, thus taxed when used. The account must have been open for at least three calendar years before a qualified withdrawal can be made. Non-qualified withdrawals are subject to a 5% penalty.

Exemptions and Standard Deductions

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

(Year: 1995, 1996, 1997 and after)

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

Itemized Deductions

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

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

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

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

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

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

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

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

   Example of second percentage: NYAGI = $550,000
   $550,000 - $475,000 = $75,000; $50,000 is lesser.
   $50,000 ÷ $50,000 = 1.0; 1.0 x 25% = 25% reduction

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

Supplemental Tax for Taxpayers with NYAGI Exceeding $100,000

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

Example: New and York Taxpayers have a NY taxable income of $105,000 and a NYAGI of $120,000. Tax on $105,000 from the tax table is $6,398.50, but at the top rate of 6.85% is $7,192.50. The $20,000 that exceeds the NYAGI level of $100,000 is 40% of $50,000. The difference between $7,192.50 and $6,398.50 is $794; 40% of this is $317.60, which is added to the tax computed from the table to make the total tax $6,716.10.

Spousal IRAs Allowed

A spousal IRA deduction claimed on a joint federal return is allowed on the New York return. If separate returns are filed, each spouse's deduction must equal the amount contributed to his or her own account.

Rates

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

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

Married Filing Jointly and Qualifying Widow(er)

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

Single, Married Filing Separately and Estates and Trusts

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

Head of Household

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

Household Credit

Single taxpayers with household gross income (HGI) up to $28,000 and all other taxpayers with income up to $32,000 qualify for a household credit providing they cannot be claimed as a dependent on another taxpayer's return. Household gross income is federal adjusted gross income (total for both spouses if filing separately).

In 1997, the amount of household credit for single taxpayers ranges from $75 (taxpayers with less than $5,000 of HGI) to $20 for taxpayers with $25,000 to $28,000 of HGI. A separate schedule allows more credit for married taxpayers, head of household, and surviving spouse, plus additional credit ($5 to $15) for additional exemptions. The maximum credit for a married couple with less than $5,000 of HGI is $90 plus $15 for each personal exemption less one.

Earned Income Tax Credit (NY EIC)

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

Credit for Child and Dependent Care (CDC)

A credit is allowed against New York State personal income tax for household and dependent care services necessary for gainful employment. The credit is a percentage of the federal CDC under IRC Sec. 21 for the same tax year. (Federal CDC does not have to be claimed.) The percentage is the sum of 20% and a multiplier which is 40% for 1997 multiplied by a fraction. The fraction is a numerator which is the lessor of $4,000 or $14,000 less the taxpayer's NYS AGI for the year. The increase is such that taxpayers with NY AGI below $10,000 get the full 30% while between $10,000 and $14,000 the credit is reduced and those over $14,000 receive only 20% of the federal credit. The numerator may not be less than zero and the denominator is $4,000. For resident individuals, the credit is applied against all personal income tax after allowable credits and the excess, if any, may be refunded.

Example: Mr. and Mrs. Child Care has a 1997 NYS AGI of $12,000.

To determine multiplier 20% + 40% x $\frac{\$2,000}{\$4,000}$ = 40%

Resultant percentage times Federal CDC is the NY credit amount.

The CDC will increase to 100% of the federal credit available to taxpayers with AGI of $17,000 or less, beginning with the 1998 tax year. Taxpayers with income between $17,000 and $30,000 can claim a credit phased down from 100% to 20% of the federal credit available.

Real Property Tax Credit

The tax credit computations and limits are shown below for 1997. Few farm or nonfarm real estate owners will qualify. Owners of real property valued in excess of $85,000 are excluded. Here are other rules and limitations:

1. The household gross income limit is $18,000.

2. The maximum adjusted rent is an average of $450 a month. The taxpayer must occupy the same residence for six months or more to claim rent paid to qualify for the credit. Credit for renters is computed the same as for owners.

3. Real property tax credit is the lesser of the maximum credit or 50% of excess real property taxes. Taxpayers age 65 and older who elect to include the exempt amount of real property taxes will receive no more than 25% of excess real property taxes. Excess real property taxes are computed by multiplying household gross income times the applicable percentage and deducting the answer from real property taxes. This tax credit is reduced by any other personal income tax credit to which the taxpayer is entitled.

Partial Table for Computing Real Property Tax Credit, 1997

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

New York State Investment Credit (NYIC)

The credit for individuals is 4% on qualified tangible personal property acquired, constructed, reconstructed or erected on or after January 1, 1987. For corporations, the rate is 5% on the first $350,000,000 of investment credit base and 4% on any excess.

MACRS property placed in service after December 31, 1986 qualifies for NYIC. This means that farm property in the ACRS or MACRS 3-year class should qualify. There is no reduction in the amount of credit allowed for 3-year property, and if kept in use for three years it will earn 4% NYIC. The fact that pickups are 5-year MACRS property will not change the disallowance of NYIC for farmers.

All ACRS and MACRS property that qualifies for NYIC and is placed in a 5-year or longer life class earns full credit after 5 years even if a longer straight line option is elected. The same is true of 7, 10, 15, and 20-year MACRS property. Non-ACRS/MACRS properties that qualify for NYIC must still be held 12 years.

Excess or unused credit may be carried over to future tax years but the carryforward period is limited to 10 years. In no event may the credit claimed prior to 1987 be carried over to taxable years beginning on or after 1997. The 1997 bill expanded general business corporations carry forward period for unused investment tax credits from 10 to 15 years. There is no provision for carryback of NYIC. Unused NYIC claimed by a **new business** is refundable. The election to claim a refund of unused credit can be made only once in one of the first four years. A business is new during its first four years in New York State. Only proprietorships and partnerships qualify. This refundable credit is not an additional credit for new businesses. A business that is substantially similar in operation and ownership to another business that has operated in the state will not qualify.

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

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

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

Effective January 1, 1998 the employment incentive credit and economic development zone credit that applies to C corporations are expanded to sole proprietorship, partnerships and S corporations. The credits are available to those entities that make investments eligible for the investment tax credit and in the years following the investment increase their employee numbers.

Rehabilitation Credit for Historic Barns

NY Taxpayers are allowed a credit (as defined in IRC Sec. 47) of 25% of their qualified rehabilitation expenses to restore barns originally constructed on or before 1936. The New York State requirements for this credit follow the federal regulations which were covered earlier in this workbook.

For newly constructed or reconstructed agricultural structures, New York's real property tax law Sec. 483 allows a 10 year property tax exemption from any increase in the property's assessed value resulting from the improvement. See the local assessor or board of assessors to determine eligibility and file an application for exemption. In addition, for those rehabilitated historic barns which do not qualify for the 10 year exemption, there is a district exemption that require the approval of the locality and school district. Again contact the local assessor for qualification rules and application. The owner cannot receive both the 10 year exemption and this new assessment reduction.

Other Credits

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

New York State Minimum Tax

Federal items of tax preference after New York modifications and deductions are subject to the New York State minimum tax rate of 6%. The specific deduction is $5,000 ($2,500 for a married taxpayer filing separately). A farmer who has over $5,000 of preference items must complete Form IT-220 but may not be subject to minimum tax. New York personal income tax (less credits) and carry-over of net operating losses are used to reduce minimum taxable income. NYIC cannot be used to reduce the minimum income tax.

Payment of New York State Income Taxes Withheld

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

Estimated Tax Rules

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

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

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

The definition of farmers and fishermen for estimated tax purposes was changed so that Federal Gross Income rather than New York Adjusted Gross Income is used in determining whether at least two-thirds of the person's income is from farming.

State Taxation of Pensions of Non-Residents

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

Other Items of Importance From The 1997 New York State Budget Bill:

- A state-financed reduction in the New York City personal income tax was enacted through rate relief and credits.
- The employment incentive credit and economic development zone credit was expanded from only C corporations to S corporations, sole proprietorships and partnerships effective January 1, 1998.
- Sales tax on articles of clothing, excluding footwear, costing less than $100 are exempt from State Sales Tax from September 1, 1998 to September 7, 1998 and permanently after December 31, 1998.
- The New York State estate tax unified credit exclusion is increased from $115,000 to $300,000 beginning October 1, 1998 and increases to the then current federal unified credit on February 1, 2000.
- Businesses may take a credit against their 1998 NY income or franchise tax for employing qualified disabled persons in 1997:
  - employee must be certified by the Education Department
  - must work on a full-time basis for at least 180 days or 400 hours.
- The period for general business corporations carry forward unused investment tax credits is expanded from 10 to 15 years, retroactively.
- A 30% reduction in the utility (gross receipts) tax of utility companies will be phased-in over five years. The tax reduction will start October 1, 1998 from 3.5% to 3.25% of gross receipts.

OTHER A.R.M.E. EXTENSION BULLETINS

EB No	Title	Author(s)
97-18	Lake Erie Grape Farm Cost Survey, 1991-1995	Shaffer, B. and G.B. White
97-17	LEAP, Lease Analysis Program -- A Computer Program for Economic Analysis of Capital Leases	LaDue, E.L.
97-16	Analyzing Capital Leases	LaDue, E.L.
97-15	Dairy Farm Business Summary, Eastern New York Renter Summary, 1996	Knoblauch, W.A. and L.D. Putnam
97-14	Dairy Farm Business Summary, Intensive Grazing Farms, New York, 1996	Conneman, G., C.Crispell, J. Grace, K. Parsons and L. Putnam
97-13	Fruit Farm Business Summary, Lake Ontario Region, New York, 1996	White, G.B., A.M. DeMarree and L.D. Putnam
97-12	Dairy Farm Business Summary, Northern New York Region, 1996	Milligan, R.A., L.D. Putnam, P. Beyer, A. Deming, T. Teegerstrom, C. Trowbridge and G. Yarnall
97-11	Dairy Farm Business Summary, Central Valleys Region, 1996	LaDue, E.L., S.F. Smith, L.D. Putnam, D. Bowne, Z. Kurdich, C. Mentis, T. Wengert and C.Z. Radick
97-10	"Maximizing the Environmental Benefits per Dollar Expended": An Economic Interpretation and Review of Agricultural Environmental Benefits and Costs	Poe, G.
97-09	Dairy Farm Business Summary, Northern Hudson Region, 1996	Smith, S.F., L.D. Putnam, C.S. Wickswat, S. Buxton and D.R. Wood
97-08	Dairy Farm Business Summary, New York Large Herd Farms, 300 Cows or Larger, 1996	Karszes, J., W.A. Knoblauch and L.D. Putnam
97-07	Dairy Farm Business Summary, Southeastern New York Region, 1996	Knoblauch, W.A., L.D. Putnam, S.E. Hadcock, L.R. Hulle, M. Kiraly, C.A. McKeon
97-06	Dairy Farm Business Summary, Western and Central Plateau Region, 1996	Knoblauch, W.A., L.D. Putnam, C.A. Crispell, J.S. Petzen, J.W. Grace, A.N. Dufresne and G. Albrecht
97-05	Dairy Farm Business Summary: Western and Central Plain Region, 1996	Knoblauch, W.A., L.D. Putnam, J. Karszes, M. Stratton, C. Mentis and George Allhusen

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