Tax Pointers for Farmers and Landowners in 1997 and Planning Notes for 1998

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Tax advice given below is intended as general advice and is believed to be correct. It does not substitute for a detailed review of the circumstances of an individual taxpayer by a professional tax practitioner. For more details, you and your tax adviser may wish to consult the sources referenced in the square brackets [thus] (I.R.C. = Internal Revenue Code; Tres. Reg. = Treasury Regulations).

New Legislation

The Taxpayer Relief Act of 1997 "TRA97" (Public Law 105-34) is one of the longest and most complex pieces of tax legislation passed by Congress. It has been called "mind-numbing" by members of the accounting profession. It also contains errors and omissions, some of which would have been fixed by the Technical Corrections Bill, had it been passed before the end of the 105th session of Congress. Many provisions become effective January 1, 1998, although some, most notably those affecting capital gains and sale of a principal residence, take effect during 1997. Note that instructions given in the Farmers' Tax Guide (Publication 225) on how to deal with capital gains and losses are out of date (or are correct only for sales of assets made before May 7, 1997). Income averaging that was repealed in 1986 has been re-instituted in a limited way for farm incomes only, starting in 1998.

Self-employed Health Insurance Deduction

Under the tax act passed in 1996, self-employed individuals can deduct from adjusted gross income (on line 27 of Form 1040) 40% of the amount paid in 1997 for health insurance for their spouses and dependents. TRA97 increases the maximum deduction to 100% by 2007 and speeds up the rate of increase. The part of the insurance premium not deducted is allowed as a medical expense on schedule A, though this will benefit very few people. [I.R.C. § 16(a)(1)(B)]

Long-term Care Insurance

TRA97 applies the rules for the deduction of health insurance expenses **separately** for health plans that cover long-term care and for those that do not.

Example: an employed husband might have employer-provided coverage that excluded long-term care. His self-employed wife could obtain long-term care insurance for both of them and deduct from adjusted gross income the same 40% of the insurance premium as shown in the previous section. [I.R.C. § 162]

Self-employment Tax on Rental Income

If you rent farmland to another entity (individual, partnership, corporation) you **do not** pay SE tax on the rental income **unless**: 1. There is an arrangement that you will materially participate in the production of agricultural or horticultural commodities, **and** 2. You actually do materially participate in production. The material participation rule applies to land **only**. Rent of personal property

used with the land **is not** subject to SE tax. [I.R.C. §§ 1401(a), 1402(a) and (b)]

Example: Bruce Bullock owns a farm and rents out the land for $20,000, buildings for $5,000 and machinery for $10,000 to a family partnership in which he materially participates. He mus pay SE tax on the $20,000 land rent but not on the $5,000 building rent. Rent on personal property is in general subject to SE tax so he must pay SE tax on the machinery rental of $10,000. The IRS is not likely to treat it as falling under the exception for personal property rented with real estate. [I.R.C. § 1402(a)(1)] *Note*: If Bruce's wife had owned the farm and she was not a member of the partnership, then she probably would avoid SE tax on the land and building rental.

Like-kind Exchanges

Property used in a trade or business, or held for investment, that is replaced by similar property will be a like-kind exchange if certain conditions are met. Any capital gain or loss realized on the property given up in a like-kind exchange **must** be deferred and the basis of the new property adjusted accordingly. Deferral is **not** elective. [I.R.C. § 1031] Form 8824 is used to report the transfer and the basis of the property acquired. It should be filed the year the exchange takes place.

Like-kind for real estate is interpreted quite broadly. For example, timberland for bare land, undeveloped farm land for a commercial building. For personal property, like-kind has a narrower definition. Automobiles, light general-purpose trucks (under 13,000 pounds actual unloaded weight) and heavy general-purpose trucks are separate categories. A trade from one category to another is not a like-kind exchange. Any two assets that are in the same four-digit SIC (Standard Industrial Classification) code are like-kind. Farm machinery qualifies since it is all in SIC code 3523. However, small farm tools and equipment are in several different categories. [Treas. Reg. § 1.1031(a)-2]

Sale of Principal Residence

Up to $250,000 ($500,000 if married, filing jointly) of gain on the sale of a principal residence is excluded from tax if **all** the following requirements are met: 1. The taxpayer (or **either** spouse) owned the home for two or more years during the five-year period preceding the sale; 2. The taxpayer (or **both** spouses) used the home as personal residence for two or more years during the five-year period preceding the sale; 3. The taxpayer (or **neither** spouse) has used the new exclusion during the two-year period preceding the sale; and 4. The sale occurred after May 6, 1997.

A person who moves house every two years could claim the exclusion each time. For sales after May 6, 1997, few homeowners should be faced with paying capital gains on the sale of their home. Form 2119 that was used to rollover the gain on sale is no longer needed and will be discontinued. (Note to Massachusetts homeowners: the Commonwealth still follows the Internal Revenue Code of previous years. Presumably State tax forms will in future include a substitute for Form 2119.) [I.R.C. § 121. I.R.C. § 1034, containing the rollover provisions, has been repealed.]

If part of the residence was used as an office, or for business, and had been depreciated, any gain allocated to that portion would be subject to capital gains tax. See Table 1.

Capital Gain

Schedule D of Form 1040, which was 23 lines in 1996 has grown to 54 lines in 1997, thanks to the complexities introduced by TRA97. Profitable sales of assets held for one year or less are short-term gains, whenever sold. Profitable sales of assets held for 18 months or less, sold **after July 28, 1997** are short-term gains. These are taxed at the same rate as ordinary income (maximum of 28%). For sales of long-term assets **after May 6, 1997** there are three rates: 28% (or 15% for

taxpayers in the 15% bracket) on collectibles (works of art, coins, etc.), on recaptured depreciation of personal property, and on recaptured depreciation on real property that exceeds the straight line depreciation amount; 25% (or 15% for taxpayers in the 15% bracket) on the depreciation of real estate taken on a straight line basis note this change, **all real estate depreciation is now recaptured**, not just the excess over straight line depreciation; or 20% (10% for taxpayers in the 15% bracket) on all other sales this rate is the basic rate for capital gains and losses except for the situations described for the higher rate. Beginning in 2001, the 20% rate drops to 18% (10% drops to 8%) for assets purchased on or after January 1, 2001 and then held for five years.

The way to treat capital losses was not clear from TRA97. On Schedule D of Form 1040, the IRS has followed the anticipated changes in the Technical Corrections Bill that still awaits passage. Basically, short-term losses, if any, are applied first to reduce short-term gains, then to reduce long-term gains in the order: gains in the 28%, 25%, then 20% group. Long-term losses in the 28% group are used against the 25%, then the 20% group. Losses in the 20% group are set off first against the 28% group, then the 25% group.

Massachusetts capital gains rules are different. Gain on property held more than one year is taxed at 5% and on property held more than two years at 4%. In each succeeding future year, the rate will drop one percentage point for each additional year that the property is held.

Alternative Minimum Tax

If you recently sold a commodity on a deferred-payment contract and paid alternative minimum tax, you can defer the payment for **both** regular income tax and AMT purposes. TRA97 repealed I.R.C. § 56(a)(b), effective 1987. You can amend your return for any past year that is still open to amendment (usually the prior three years).

Example: You delivered corn to an elevator in 1995 and received payment for it in 1996. For regular income tax purposes, you treated the sale as 1996 income. For AMT purposes it had to be treated as income in 1995. You paid AMT in 1995. You may file amended returns (1040X) for 1995 and 1996.

Alternative Minimum Tax Depreciation Adjustment

TRA97 allows the same recovery period for both regular tax and (AMT) purposes. Previously (AMT) required a longer alternative MACRS recovery period. Both regular and AMT recovery periods are now the same for assets placed in service **after 1998**.

Income Averaging for Farmers

To give farmers subject to year-to-year fluctuations in income some relief, TRA97 institutes a new code section (I.R.C. § 1301) that permits taxpayers "engaged in the farming business" (as defined in I.R.C. § 263A(e)(4)) to average over the three prior years all or a portion of their taxable income derived from farming. The provision is effective for the tax years **1998, 1999 and 2000**. An eligible taxpayer **elects** to have all or part of farming income averaged. The election is irrevocable (cannot be changed by filing an amended return in later years). Gains from the sale of assets (**other than land**) "regularly used by the taxpayer in the farming business for a substantial period" can be averaged also. One-third of the amount averaged ("elected farm income") is allocated to each of the three prior years. Tax of an electing farmer would be the tax on the amount remaining after allocation (say in 1998) plus the additional taxes that would have been paid in 1995, 1996, and 1997 if the one-third of elected farm income had actually been received in each of those years. Presumably, the IRS will develop a tax form where the election and the necessary calculations can be made. The amount of income allocated to prior years **stays in those years as additional income**, reducing the benefits from income averaging in succeeding years.

Septic Credit

If you own and occupy a principal residence in Massachusetts and you incur expenses to make your sewer system comply with Title V you may claim a credit directly against taxes on your Massachusetts return. The credit is 40% of the costs up to $15,000 for design and construction to repair or replace a failed cesspool or septic system. The maximum aggregate credit of $6,000 is limited to $1,500 in any year. Unused credit may be carried forward for up to three years. Massachusetts Schedule SC must be completed and enclosed with the tax return claiming the credit.

Individual Retirement Accounts (IRAs)

Several kinds of IRA are now available:

1. Deductible IRA (input is deducted from gross income, output is taxable). The maximum amount is $2000 per spouse, the amount phases out at higher incomes, and the phase-out levels keep changing. Under prior law, a spouse not covered by a retirement plan could not make a deductible IRA contribution if the other spouse was covered by a qualified retirement plan. TRA97 permits a non-covered spouse to make a deductible IRA deduction. No contributions may be made after age 70.5 at which point required withdrawals must begin. [I.R.C. § 408 and § 219(b), (c) and (g)]

2. Non-deductible IRA (non-deductible input, taxable output). Where phase-out rules have limited the amount contributed as a deductible IRA, non-deductible contributions can be made (into the same account if desired; Form 8606 must be filed and establishes the tax-free basis of the non-deductible IRA).

3. "Roth IRA" (non-deductible input, non-taxable output). The Roth IRA will be available starting in 1998. It is more flexible than existing IRA's. For an investment made more than 5 years ago and withdrawn after age 59.5, the earnings are not taxable. Not subject to the current minimum distribution requirements at age 70.5. Contributions can be made after that age. The maximum contribution that can be made to a Roth IRA is phased out for individuals with AGI between $95,000 and $110,000 and for joint filers with AGI between $150,000 and $160,000. Only taxpayers with AGI of less than $100,000 are eligible to roll over or convert a current IRA into a Roth IRA. In 1998, all or part of a current IRA can be rolled into a Roth IRA with the income tax spread over a four-year period. In no case can contributions to all an individual's IRAs for a taxable year exceed $2,000. [I.R.C. § 408A]

Which IRA to choose? At a constant tax rate there is no difference to the taxpayer between a deductible IRA and a Roth IRA. (The difference is to the Government; tax payments are accelerated.) If your marginal tax rate will rise after retirement, choose the Roth IRA; if it will fall, choose the deductible IRA. In general, always make a contribution to a deductible IRA if you can, then to a Roth IRA, and then to a non-deductible IRA. If you want to increase the amount you put into a retirement fund over the $2000 per year allowed for each person's combined IRAs, consider the SIMPLE described below.

SIMPLE Simplified Employee Pension IRAs

Beginning in 1997, small-business employers can set up SIMPLE (Savings Incentive Match Plan for Employees) retirement plans. A self-employed person can set one up also. Generally, the SIMPLE plan must be the only retirement plan of the employer.

SIMPLE plans are written qualified salary reduction arrangements that allow an employee to elect to reduce his or her compensation by a certain percentage each pay period and have the employer contribute the salary reductions to the SIMPLE plan on behalf of the employee. Any employee qualifies who

Table 1. *Example*: Jane Carter used one room (10%) of her personal residence as a home office. She purchased the house in 1993 for $120,000 and sold it in June 1997 for $200,000. She lived in the house during the four years and took $3,000 depreciation on the business part. Jane has two transactions.

Personal residence portion		Business portion		
Amount of sale		Amount of sale		
(90% of $200,000)	$180,000	(10% of $200,000)		$20,000
Cost basis (90% of $120,000)	108,000	Unadjusted basis (10% of $120,000)	$12,000	
		Depreciation	3,000	
		Adjusted basis		9,000
Realized and excluded gain	72,000	Recognized (taxable) gain		11,000

received at least $5,000 in compensation from the employer last year and is reasonably expected to make at least that amount next year. For 1997, the amount of the employee's salary reductions cannot exceed $6,000, however it is not subject to percentage limitations. Therefore, an employed person who has a part-time self-employment activity that earns $6,000 could deposit the entire $6,000 in a SIMPLE plan. Employers are also required to make contributions to the SIMPLE plan on behalf of eligible employees, an equal match up to 3% of pay of each contributing employee or a flat 2% of pay of all employees, whether they contribute or not. Contributions to a SIMPLE plan are not subject to income tax until they are distributed. The IRS has provided forms (Form 5303-SIMPLE for use with a designated financial institution and Form 5304-SIMPLE for use with no designated financial institution). These forms are not filed with the IRS but form the legal contract between employer and employees for implementation of the SIMPLE IRA.