Recent Changes in
Federal Income Tax Laws
Affecting Farmers and Ranchers

Major changes have been made in Federal tax law over the past 4 years affecting all U.S. taxpayers. These changes were made as a result of three significant pieces of legislation:

- The Economic Recovery Tax Act of 1981 (ERTA)
- The Tax Equity and Financial Responsibility Act of 1982 (TEFRA)
- The Tax Reform Act of 1984 (TRA)

The Economic Recovery Tax Act of 1981 was the largest tax reduction package ever enacted. It was designed to increase savings and spur investment.

In the next year, the Tax Equity and Fiscal Responsibility Act of 1982 was the largest revenue-increasing bill ever passed.

Then came the Tax Reform Act of 1984, containing provisions to raise a projected $50 billion in tax revenues over the next 3 fiscal years.

This publication provides an overview of these new tax laws, emphasizing those provisions that will be of most interest to farmers and ranchers. We've included some background on previous tax treatment in each area so that you can more readily understand the changes.

The IRS is still issuing regulations covering these new laws. Future rulings will also change the interpretations of these laws. So this publication can't substitute for professional advice from accountants and lawyers familiar with these current rulings and their application to individual business decisions.

The provisions of these three tax acts are extensive and have added complexity to an already complex system. Some provisions are already in effect; others will be phased in over the next few months; and still others have been repealed. To know what to do and when to take advantage of these new tax provisions, first study this explanation, then consult with your tax advisor.

Changes affecting individuals

Individual income tax rates

The most significant change of the 1981 ERTA was the reduction in the individual income tax rates. From 1981 through 1984, a series of reductions in the tax rates resulted in a 23% total tax reduction. The highest tax bracket was reduced from 70% to 50%.

The 1981 law also established an indexing system to be implemented in 1985 that will adjust the individual tax brackets, zero bracket amounts, and personal exemptions for inflation, as measured by the Consumer Price Index (CPI). The average CPI for the 12-month period ending September 30, 1984, increased 4.1% compared to the 1983 CPI. As a result, on January 1, 1985, the $1,000 personal and dependent exemptions rose to $1,040. The standard deduction (zero bracket amount) for single taxpayers, formerly $2,300, increased to $2,390. For couples filing a joint return, the $3,400 standard deduction climbed to $3,540. And the individual tax brackets widned by 4.1%.

Similar adjustments will be made for 1986 and for each year thereafter when the CPI for the preceding period exceeds the CPI for 1983. This indexing system will reduce the "bracket creep" that has moved taxpayers into successively higher tax brackets because of the effects of inflation on their incomes.

Self-employment Social Security taxes

While income tax rates continue to decrease, Social Security tax rates are increasing. For 1984, the maximum amount subject to self-employment tax is $37,800. The self-employment tax rate for 1984 is 14%. However, self-employed taxpayers will pay an effective tax rate of 11.3% in 1984, because a credit is applied against the amount of self-employment tax equal to 2.7% of self-employment income.

On January 1, 1985, the maximum amount subject to Social Security tax rose to $39,600. The self-employment tax rate increased to 14.1%; the credit decreased to 2.3%; and the effective self-employment rate is now 11.8%. The maximum Social Security tax for self-employeds is $4,672.80, compared to $4,271.40 in 1984.

Retirement savings plans

The 1981 tax act increased the deductions for contributions to self-employed and individual retirement plans, as well as making other technical changes.

A Pacific Northwest Extension Publication
Oregon Idaho Washington ***PNW 263 / January 1985***

Self-employed retirement plans (H.R. 10 or Keogh). Self-employed individuals (those subject to self-employment tax) may establish and make contributions to retirement plans from their taxable income. To qualify, these plans must also include all employees of the taxpayer who have met certain minimum service requirements. Starting in 1984, self-employed individuals can deduct annual contributions to a traditionally defined plan of up to $30,000 or 25% of earnings from self-employment, whichever is less. However, if the Keogh plan is of the profit-sharing type (contributions are a percent of profit), the deduction can't exceed 15% of earnings.

Individual retirement account (IRA). The 1981 law extended the option of establishing an IRA for individuals who actively participate in a qualified employer or government plan. It also increased the annual deduction limits for contributions to an IRA in 1982 and after to the lesser of $2,000 or 100% of compensation.

Moreover, it allows married individuals when one spouse has no earned income to deduct contributions to their separate IRA's totaling no more than $2,250. The larger contribution may not exceed $2,000. When each spouse has earned income of at least $2,000, each can deduct the $2,000 maximum ($4,000 on a joint return) for contributions to the separate IRA's.

The 1984 TRA changed the rules governing these retirement plans. Contributions to an IRA must be made by the due date of the return to earn a deduction for that year. After 1984, it is no longer possible to extend the contribution deadline by getting a filing extension for the tax return. Also, after July 18, 1984, employees who continue as members of employer retirement plans can make partial rollover of plan benefits into an IRA.

Changes affecting business

Some significant changes have been made by the 1981, 1982, and 1984 tax acts to provide incentives for investment and increased business activity. A number of these affect farmers and ranchers.

Corporate taxes

An important 1981 tax law provision, affecting farms and ranches organized as regular (Subchapter C) corporations, was the reduction in tax rates on taxable incomes of less than $50,000. The rate reduction was phased in over 2 years, and it became fully effective in 1983.

Compared to the 1981 rates, the maximum tax savings in 1983 amounted to $1,000. While this was not a particularly significant change, it may be large enough for more farmers and ranchers to incorporate their businesses if they combine it with other considerations.

Before the 1981 Tax Act, regularly taxed corporations were permitted to accumulate up to $150,000 in uninvested funds without paying the accumulated earnings tax. This $150,000 figure was increased to $250,000 for tax years beginning after 1981.

As a result of the TRA of 1984, corporations with taxable incomes above $1 million a year will lose the use of lower tax rates (worth up to $20,250) on the first $100,000 of income; the graduated rates remain available to smaller firms.

Income averaging

Taxpayers whose taxable income fluctuates, such as farmers and ranchers, will find income averaging less advantageous. The 1984 tax law makes it more difficult to qualify for income averaging and also reduces the resulting tax savings for tax years beginning in 1984 and after.

To qualify for averaging, current income must be at least $3,000 more than 140% of the average taxable income in the 3 preceding years. To qualify for averaging previously, current income had to be at least $3,000 more than 120% of the average taxable income in the 4 preceding years.

Prepaid expenses

Farmers using the cash method for reporting their income taxes have the option of prepaying feed and other expenses to level out taxable income. The 1984 TRA limits the deductibility of prepaid expenses for operations defined as "tax shelters computing income using the cash receipts and dispersement method." This restriction is not intended to apply to ordinary farmers and ranchers. Proprietorships, partnerships, and corporations with no outside investors will be exempt from these new provisions.

The new provisions require operations defined as tax shelters to deduct the expenditure as economic performance (usage) occurs, rather than when the item is purchased. There is one exception: the deduction is still recognized as an expenditure in the previous year, if the performance occurs within the first 90 days of the new year. For example, a limited partnership involved in cattle feeding could deduct only the feed fed within 90 days of the end of the tax year.

Ordinary farmers who use cash-method reporting can continue to deduct prepaid expenses of feed, chemicals, and other supplies. As under the previous law, the prepayment must be an actual purchase, not merely a deposit; it must have a legitimate business purpose; and it must not materially distort income.

Accelerated Cost Recovery System

For farmers and ranchers, one of the most important provisions of the 1981 Economic Recovery Tax Act was the new Accelerated Cost Recovery System (ACRS). It replaces the old depreciation system for property purchased after December 31, 1980.

Under ACRS, property purchased after December 31, 1980, is assigned to one of four recovery period classifications—3, 5, 10, and 15 years. (For property purchased after March 15, 1984, the 15-year classification was changed to 18 years). No distinction is made between new and used property.

Unless taxpayers choose to use a longer recovery period, they recover the full cost of the property (without reduction for salvage value) over the corresponding period. The annual recovery allowance in each class is computed by using the IRS-designated ecovery rate for that year.

Eligible property. All property that was subject to depreciation under the old law is eligible for ACRS. However, property placed into service before 1981 will continue to be depreciated under the rules in force before the 1981 Tax Act. If you placed used property into service in 1981 and thereafter, it will be eligible for ACRS, even though some other taxpayer first placed it into service before 1981. This eligibility of used property holds only if you acquired it from an unrelated taxpayer.

Recovery periods. The number of years over which the cost of the property must be recovered (depreciated) depends on its classification. Property eligible for ACRS must be assigned to one of four classes of property. These classifications, and some examples of how farm property placed in service after March 15 would be classified under ACRS, are provided in table 1.

The rules for depreciating general-purpose buildings were modified by the Tax Reform Act of 1984. Under the new rules, the 15-year depreciation period has been changed to 18 years for general-purpose buildings placed in service after March 15, 1984. However, the 15-year rules remain in effect if a binding contract existed (or if you began construction) on or before March 15, 1984, and if you place the property in service before January 1, 1987.

An important feature of ACRS is that you must recover the cost of the asset over a period at least as long as the number of years associated with its classification—even though its actual useful life may be a shorter period of time. For example, if you purchase a used tractor that's expected to have a useful life of 4 years, it will still be classified as 5-year property. The recovery allowance will be based on 5 or more years, even though you may not use the machine for more than 4 years.

Table 1.—Property classes, alternative recovery periods, and agricultural property examples under the Accelerated Cost Recovery System

ACRS class	Alternative recovery periods	Agricultural property examples
3-year property	3, 5, or 12 years	Automobiles used in the farm business.
		Pickups and other light trucks (under 13,000 pounds when empty).
		Sows and boars.
		Race horses over 2 years old when placed in service.
		All horses over 12 years old when placed in service.
		Small tools.
5-year property	5, 12, or 25 years	Breeding livestock that is not 3-year property (dairy and beef cattle, sheep, goats, and horses not in the 3-year category).
		Machinery and equipment.
		Orchards and vineyards.
		Single-purpose agricultural structures (for example, milking parlor, loafing shed, swine facility, grain bin, silo, broiler production unit).
10-year property	10, 25, or 35 years	Mobile home or trailer used to house hired labor.
18-year property	18, 35, or 45 years[a]	General-purpose farm buildings.

[a]The alternative recovery periods are 15, 35, or 45 years for property placed in service before March 16, 1984.

It's possible to choose a longer recovery period. These optional recovery periods use the straight-line method to calculate the recovery allowance for each year (it's not possible to use the accelerated recovery for these optional recovery periods). The options available depend on the property class.

The longer optional recovery periods are an advantage for those taxpayers who would not have enough income to use the deductions that are available under the shorter recovery period. If you choose an optional straight-line recovery period, you must use that recovery period for all the property in that class placed in service during that taxable year. For 18-year real property, you make your choice on a property-by-property basis.

Choosing a longer recovery period does not affect the investment tax credit allowed. For example, choosing to write off 3-year property over 5 years does not make it eligible for a higher investment tax credit.

Accelerated recovery rates. The annual recovery allowance for each classification of property is computed by using rates provided by the 1981 act. These vary according to the class of the property and the number of years since you placed the property into service.

To calculate the annual recovery allowance, multiply the cost of the property times the appropriate rate from table 2. These rates are based on the 150% declining-balance method in the early years of the recovery period, switching to straight-line or sum-of-the-digits methods in later years. Salvage value is disregarded.

As originally specified in the 1981 ERTA, the rates in table 2 were to increase for 1985, but the 1982 TEFRA eliminated these increases. Thus the rates in table 2 still apply for property you purchased after December 31, 1980. These recovery rates apply for both new and used property.

Table 2.—Percentage recovery rates for 3-, 5-, and 10-year property under the Accelerated Cost Recovery System

	Property class		
Recovery year	3-year	5-year	10-year
1	25	15	8
2	38	22	14
3	37	21	12
4		21	10
5		21	10
6			10
7			9
8			9
9			9
10			9

The "half-year convention" is assumed in these rates for the year you first place the property in service. This means you are considered to have placed the property in service at midyear, regardless of whether you bought it at the beginning or end of the year.

To illustrate, suppose you bought a tractor with a $30,000 adjusted basis and placed it in service on February 11, 1984. The recovery allowance for the first year (1984), calculated using the rates for 5-year class property in table 2, would be $4,500 (.15 × $30,000). For 1985, a total of $6,600 would be allowed (.22 × $30,000). At the end of the 5 years, you will have recovered a total of $30,000.

The procedure for calculating the recovery allowance for 18-year real property is somewhat more complicated. The recovery rate depends on the actual number of months that the property was in service during the first year.

The 1984 act also establishes a midmonth convention on general-purpose buildings. It allows a half-month's depreciation on property placed in service that month, regardless of the actual date. This provision applies to buildings placed in service after March 15, 1984. For buildings you place in service on or before March 15, 1984, continue to use the procedure established by the 1981 ERTA.

A table published by the IRS, showing the annual percent recovery factors according to the month placed in service, is used to calculate annual depreciation allowances.

Straight-line method. Taxpayers can also choose to use the more familiar straight-line method for recovering capital costs, rather than the accelerated rates. You can use this method to recover the costs over the regular recovery period or over the optional longer recovery periods for that class of property.

For 3-, 5-, and 10-year property, the "half-year convention" also applies to the straight-line method, and it has the effect of extending the recovery period by 1 year. There is no table to use for the straight-line method.

To illustrate how to compute the recovery allowances using the straight-line method, assume you acquired a tractor with $30,000 adjusted basis as of February 11, 1984, and that you chose the regular recovery period of 5 years, rather than the optional periods of 12 or 25 years.

Your recovery allowance for 1984 would be $3,000 (½ × $30,000 ÷ 5). For the years 1985 through 1988, your allowance would be $6,000 ($30,000 ÷ 5). In 1989, you would recover the remaining $3,000.

If you choose the straight-line method of recovery, you must use it for all property of that same class that you placed in service during the year. However, you can recover the costs of property in another class using a different method; you can also use different methods within the same class

if you placed the property into service in different tax years.

For example, you might decide to recover the cost of 3-year property using the accelerated rates, and to recover the 5-year property using the straight-line method for 12 years.

Or you might decide to recover the cost of 5-year property using the accelerated method this year, and to recover the cost of 5-year property using the straight-line method next year.

You make your decision of which method of cost recovery to use the year you acquire the property—and your choice is important because you can change it only with IRS consent.

You can also use the straight-line method for recovering the cost of 18-year property, such as buildings: use it over an 18-, 35-, or 45-year recovery period. For property you acquired on or before March 15, 1984, the straight-line recovery periods are 15, 35, and 45 years.

It's not necessary to use the same method of recovery for all 18-year property that you acquired during the same tax year. You decide which method to use on a property-by-property basis—and IRS must consent to any change.

Unlike the straight-line method you might use for 3-, 5-, and 10-year property, don't use the half-year convention for 18-year property. The recovery allowance you calculate for the first year (using the straight-line method) is prorated according to the number of months that the property is in service during that first year.

For property you acquired on or before March 15, 1984, the recovery period begins on the first day of the month in which you placed the property in service.

For property you acquired after March 15, 1984, the recovery period begins in the middle of the month in which you placed the property in service.

For example, property you placed in service November 1 or November 30 would be written off beginning November 15. The amount written off in the first year would be 3/24 of the first year's depreciation (which would be 1/15 of the property's cost if you used the 15-year recovery period).

Building improvements. Under ACRS, a "substantial" improvement that you add to a building is treated as a separate building. A substantial improvement is one for which the cost over 2 years is at least 25% of the cost of the building. You must make the improvement at least 3 years after you place the building in service. You can choose any optional method or recovery period for this improvement.

For example, you can use an 18-year period for the improvement even though you're using a 35-year period for the rest of the building. You can use the accelerated method of cost recovery for the improvement, even though you used the straight-line method for the rest of the building.

Furthermore, if you make an improvement in 1984 to a building you placed in service before 1981, it's eligible for the accelerated cost recovery system, even though the main building is not.

Expensing capital purchases. The 1981 ERTA gives taxpayers the option of expensing (deducting as a current expense), rather than depreciating, certain capital expenditures you make after 1981. This option allows you to treat the cost of qualifying property as a deductible current expense up to a maximum dollar limit.

The option applies to new or used personal property on which you can claim investment tax credit. Property that you acquire from a relative or as a gift or inheritance is not eligible. For property acquired through a trade, only the cash boot paid (cash paid in addition to the value of the property traded to acquire the new property) is eligible for expensing. The amount expensed is also subject to recapture when you dispose of the asset.

As amended by the Tax Reform Act of 1984, the annual limits for the amount that you can expense are $5,000 in 1984 through 1987, $7,500 in 1988 and 1989, and $10,000 for 1990 and later years. For partnerships, the limits apply to the partnership and to each partner. The limits are reduced by one-half for married individuals filing a separate return.

Returning to the $30,000 tractor you purchased in February 1984, you may choose to deduct $5,000 as a current expense, assuming you didn't expense any other capital purchases in that year. The deduction for 1984, then, would amount to $5,000 expense, plus the depreciation allowance for the first year of $3,750 (.15 × $25,000).

Note that you subtract the $5,000 expense deduction from the adjusted basis before you multiply by the recovery rates. For 1985, the depreciation allowance would be $5,500. For 1986, 1987, and 1988, it would be $5,250. At the end of the 5 years, you would recover a total of $30,000, including the expense deduction. By using the expense deduction, you speed up the recovery of the total cost.

Another important point about this expensing option is that no investment tax credit is allowed on that portion of the cost that you expense.

Your decision to expense property must be made on the original tax return for the year in which you placed the property in service, with a specific description of the property. Once you make it, you may not revoke it without the consent of the IRS.

Gain or loss on disposition. In general, the 1981 tax act did not change the depreciation-recapture requirements of the tax laws. Old recapture rules still apply to dispositions of property you placed in service before 1981.

The treatment of gain or loss on the disposition of property you acquired after December 31, 1980 (other than 15-year and 18-year real property) is generally the same as under the old law. Gain or loss will be recognized when you sell or exchange the property, unless another provision of IRS code won't allow it (an example would be nontaxable exchanges).

Gain is treated as ordinary income to the extent of the recovery allowance deductions that you take (including the amounts you expensed, if you chose that option). Any gain in excess of these deductions is treated as capital gain.

When you sell ACRS property before the end of the recovery period, you can't take a recovery allowance for the year of disposition. This is true for 3-, 5-, and 10-year property, because of the use of the half-year method, and it applies regardless of whether you used the straight-line or the accelerated method.

In the case of 15-year and 18-year real property (you had to acquire 15-year property on or before March 15, 1984; 18-year property, after March 15, 1984), the recovery allowance is prorated for the last year if you have not completely recovered the cost.

For example, if you sell a building before the end of the recovery period, the recovery allowance for the year of sale is prorated to reflect the months that the property was in service during that year.

Some other important exceptions to the recapture rules apply for 15-year and 18-year real property. The treatment of any gains realized on the sale or exchange of nonresidential real property depends on the method you used for calculating the recovery allowance. If you used the accelerated method, gain will be taxed as ordinary income to the extent that the recovery-allowance deductions you took exceed the depreciation for the same period, using the straight-line method.

However, if you used the straight-line recovery method over either the 15-, 18-, 35-, or 45-year period, your total gain will be taxed as capital gain. Thus, for 15- and 18-year real property, you'll have a more difficult decision about which method to use for calculating the recovery allowance.

If you use the accelerated method, part of your gain on disposition would be ordinary income. On the other hand, if you use the straight-line method, all your gain on disposition will be capital gain.

The provisions for reporting depreciation recaptured on assets sold through an installment sale were changed by the 1984 tax act. If you sell property subject to depreciation recapture on an installment sale contract, the entire amount of depreciation recapture income is taxable in the year of the sale.

Recapture is required even if you didn't receive any principal payments in the year of the sale. This rule applies to sales made after June 6, 1984. Previously, the depreciation recapture on installment sales was recognized as income when principal payments were received.

Investment tax credit

There have been significant changes in investment tax credit rules through legislation enacted in recent years. Many of the changes were adopted to comply with the new ACRS. You subtract the investment tax credit, allowed for certain types of capital purchases, from the tax you owe.

The tax credit rate depends on the property's recovery period. Table 3 shows the rates for the ACRS classifications.

The TEFRA of 1982 gave taxpayers two choices in calculating the amount of investment tax credit they take on qualified property they purchased after December 31, 1982:

Table 3.—Investment tax credit rates for ACRS property classifications

ACRS class	Standard credit rate (%)	Optional credit rate (%)
3-year property	6	4
5-year property	10	8
10-year property	10	8

1. Take 6% of the cost of 3-year ACRS property and 10% of the cost of 5- and 10-year ACRS property. If you take this option, you must reduce the cost basis for purposes of determining depreciation by one-half of the investment credit you took. (In effect, only 97% of the cost of 3-year property and 95% of 5- and 10-year ACRS property can be depreciated if you take this option.)
2. Take 4% of the cost of 3-year ACRS property and 8% of 5- and 10-year ACRS property. This option doesn't require a reduction in the cost basis to determine depreciation allowances.

You can use either of these options on each item of qualifying property. For example, if you choose the 6% option on 3-year property, your investment tax credit is equal to 6% of the qualified investment in the property. The qualified investment is the cost or basis of the property. If you trade an old tractor for a new one, the cost for figuring the tax credit is the book value (original cost less depreciation) of the old tractor plus any additional cash boot paid to acquire a new one. The total amount you can write off under the ACRS is limited to 97% of the cost.

If you choose the 4% optional credit, the investment tax credit is equal to 4% of the cost. You can write off 100% of the cost as ACRS allowances.

Note that even if you use a longer recovery period (such as 5 years for 3-year property), the property is not eligible for the higher 10% or the optional 8% credit. If your property is classified as 3-year property, the 6% or the optional 4% credit is used, regardless of the length of the recovery period.

Qualifying property. To qualify for the investment credit, your property must be depreciable under one of the ACRS classifications, and you must have placed it in service during the year. A number of different types of farm property qualify for the investment credit.

In general, all tangible business property (except certain types of general-purpose buildings) will qualify: machinery, equipment, trucks, automobiles, fences, and storage facilities such as silos and grain bins. Purchased breeding and dairy livestock and income-producing orchards and groves also qualify for the investment credit.

The new tax laws generally don't change the qualifications that property must meet to be eligible for the investment tax credit. The same types of farm and ranch property eligible for investment tax credit under the old law are eligible now. Most buildings and their structural components don't qualify, except single-purpose livestock structures (milking parlors, poultry houses, etc.) and greenhouses. Other examples of qualifying property are fences, drain tiles, paved barnyards, and water wells and systems.

The maximum annual amount of used property that qualifies for investment tax credit is limited by 1984 legislation to $125,000 in 1984-1987, with an increase to $150,000 for 1988 and after. Married individuals filing separate returns have limits on used property of $62,500 for 1984-1987 and $75,000 for 1988 and after.

Carryover of credit. The amount of investment tax credit that a person can take in a year was changed by the 1982 TEFRA. In 1983 and later years, the amount of investment tax credit that you can take in any year is limited to the income tax liability shown on your return, or $25,000 plus 85% of the income tax liability over $25,000, whichever is less.

If the credit for any taxable year exceeds this limitation, the excess is carried back to each of the earlier 3 years and forward to each of the next 15 years, until it is all used. Carryforward credits are used first, then credits earned in the current year, and (finally) carryback credits.

Recapture. The old law (before 1981) provided for recomputing the credit if you disposed of the item before the end of its estimated useful life. If your recomputed credit was less than the credit you originally claimed, the excess was recaptured (in other words, you paid the difference).

The investment credit was refigured, based on the actual number of years you held the property, and you paid the difference as higher taxes for the year when you sold or exchanged the property.

Thus, if you claimed the full 10% and disposed of the property within the fifth or sixth year, you would recapture one-third of the credit; if you disposed of it within the third or fourth year, you'd recapture two-thirds of the credit. If you disposed of it in less than 3 years, you'd recapture all of the credit.

These rules continue to apply for investment credit taken on property placed in service before 1981. Just as with depreciation, there are two sets of rules—one for pre-1981 property, and one for 1981 and later property.

The new recapture rules are more liberal for property placed in service during 1981 and after. No recapture is necessary for 5- or 10-year property held for at least 5 years and for 3-year property held for at least 3 years.

Table 4.—Investment tax credit recapture percentages

If property is disposed of within	Property class (%) For 3-year property	For 5- and 10-year property
First year	100	100
Second year	66	80
Third year	33	60
Fourth year	0	40
Fifth year	0	20
After 5 years	0	0

Use table 4 to determine the amount of investment tax credit that would be recaptured, depending on the length of time you keep the property. If you bought $20,000 worth of machinery in 1984, your investment credit for 1984 would be $2,000. If you sold that machinery in 1987 (within 3 years of the date you bought it), 60% or $1,200 of the credit would be recaptured.

ACRS and investment credit options

This new accelerated cost recovery system reserves a great deal of flexibility for taxpayers in choosing the investment tax credit and how fast to depreciate property. For example, for 5-year class property, you can use either the accelerated method over 5 years or the straight-line method over 5, 12, or 25 years to compute the writeoffs.

Furthermore, you can expense up to $5,000 of the property's cost (up to $2,500, if you file a separate return). Finally, you can choose either the 10% or the 8% tax credit.

Table 5.—Example investment tax credit and recovery allowance calculations for $50,000 of machinery purchased in 1984, with and without expensing

	10% Tax credit				8% Tax credit			
	W/O expensing		W/expensing		W/O expensing		W/expensing	
	Accelerated	SL-12 yrs	Accelerated	SL-12 yrs	Accelerated	SL-12 yrs	Accelerated	SL-12 yrs
Investment credit	5,000	5,000	4,500	4,500	4,000	4,000	3,600	3,600
Recovery allowance								
1984	7,125	1,979	11,413[a]	6,781[a]	7,500	2,083	11,750[a]	6,874[a]
1985	10,450	3,958	9,405	3,563	11,000	4,167	9,900	3,750
1986	9,975	3,958	8,978	3,563	10,500	4,167	9,450	3,750
1987	9,975	3,958	8,977	3,563	10,500	4,167	9,450	3,750
1988	9,975	3,958	8,977	3,563	10,500	4,167	9,450	3,750
1989	0	3,958	0	3,563	0	4,167	—	3,750
1990	0	3,958	0	3,563	0	4,167	0	3,750
1991	0	3,958	0	3,563	0	4,167	0	3,750
1992	0	3,958	0	3,563	0	4,167	0	3,750
1993	0	3,958	0	3,563	0	4,167	0	3,750
1994	0	3,958	0	3,563	0	4,167	0	3,750
1995	0	3,958	0	3,563	0	4,167	0	3,750
1996	0	1,983	0	1,776	0	2,080	0	1,875
Total allowance	47,500	47,500	47,750	47,750	50,000	50,000	50,000	50,000

[a]Includes $5,000 expense deduction.

To illustrate some of the alternatives available, assume that you acquired machinery (5-year-class property) with a $50,000 cost or basis in 1984. You bought it and placed it in service on February 11, 1984. However, the calculations would be the same as if you had bought it July 1, 1984, or December 24, 1984. (You're assumed to be married, filing jointly, and using a calendar tax year.)

Table 5 presents eight different alternatives for calculating investment tax credit and recovery allowances in each year. Actually, there are several more. For example, we could have used 5-year and 25-year straight-line methods, with or without the expensing option. However, these eight should be enough to illustrate the range of possibilities.

You maximize the deduction in the first year by using the accelerated method and taking the total $5,000 expense deduction. However, this reduces the allowances for the next 4 years.

The beginning farmer who currently has a low taxable income might decide to stretch the allowance out over a 12-year recovery period, using the straight-line method. In this case, the recovery allowance for 1984 would be $2,083.

A farmer with a high taxable income will generally prefer the accelerated method and shortest recovery period. The tax savings generated by using this approach provide additional funds for reinvestment. Consider, too, your taxable income in the year you make the purchase. If your income for the year is unusually high, the accelerated method and the $5,000 expense deduction will maximize deductions.

If your year's income is low, you might choose the straight-line method without taking the expense deduction. If you expect that your income will be substantially higher in future years, you might stretch out the straight-line method over one of the longer optional recovery periods. In deciding whether or not to take the expensing option, consider the effect on your investment credit.

Business and personal use of assets

The Tax Reform Act of 1984 imposes new restrictions on certain property purchased after June 18, 1984, that is used for both business and personal purposes. These restrictions apply to:

- automobiles;
- other property used as a means of transportation;
- property generally used for purposes of entertainment, recreation, or amusement;
- computers not used exclusively at a regular business establishment (including qualified home offices); and
- other property to be specified by regulations.

If your business use for these properties is 50% or less, no investment credit is allowed, and you must claim depreciation on the portion allowable to business use by the straight-line method over the following useful lives: a 5-year life for 3-year property; a 12-year life for 5-year property; a 25-year life for 10-year property; and a 40-year life for 18-year property. Business use does not include use of the property for investment purposes.

If you use the property more than 50% for business reasons, investment tax credit and ACRS depreciation is allowed, under the usual procedures, on the portion allowable to both business and investment uses. Recapture of excess depreciation and investment tax credit is required if your business use falls to 50% or below.

Furthermore, even if you used an automobile 100% for business, investment tax credit is limited to $1,000, and depreciation can't exceed $4,000 in the first year and $6,000 in each subsequent year. If your business use is less than 100%, your investment tax credit and depreciation must be reduced proportionately.

The 1984 act also imposes tougher record-keeping requirements on taxpayers when it comes to business and personal use of cars, computers, and certain other property. To qualify for investment tax credit and depreciation on these items, you must have records that reflect their business use with substantial accuracy.

For example, with an automobile, keep records that indicate trip dates and mileage for business purposes. These records must be complete—other evidence can't be used to prove expenses if you don't have them. These new rules became effective in 1985.

Rehabilitation tax credit

To offset the incentives provided by ACRS to build a new facility rather than remodeling existing buildings, the 1981 law provides a new system of credits on qualified rehabilitation expenditures for nonresidential buildings. It replaced the 10% credit with an increased credit that varies with the age of the building:

Building age	Credit
30 to 40 years old	15%
40 years or older	20%

The new rules apply to expenditures you made in 1982 and after. To qualify for the credit, you must make a substantial rehabilitation of the building. This means that the qualifying expenditures must exceed $5,000 or one-half of the adjusted basis (book value) of the property, whichever is greater. As under the present law, neither the acquisition cost of the building nor expenditures to enlarge the building qualify as rehabilitation expenditures.

You must reduce the basis of the rehabilitated property by the amount of the credit for depreciation purposes. Thus a farmer who receives a 20% credit to rehabilitate a 40-year-old barn will be allowed to depreciate only 80% of the cost. And to qualify for the new credit, the straight-line recovery method must be used. Neither the regular investment tax credit nor the energy credit is available for expenditures on which a farmer takes the new rehabilitation credit.

Finance leasing

The 1981 act allowed some corporations to deduct tax shelter losses from "safe harbor leases," a new class of tax shelters created by the 1981 act. Because of perceived abuses of these provisions, the 1982 legislation revised the 1981 rules and provided for their repeal at the end of 1983. New finance lease provisions were to be implemented in 1984, but the 1984 TRA postponed them for leases entered into after March 6, 1984. Consequently, rules in force before 1981 apply to leases for March 7, 1984, through December 31, 1987.

However, special provisions for finance lease of farm property were made available for property purchased after July 1, 1982. The 1984 TRA extended these provisions through 1987. After 1987, favorable rules will still exist in some cases. The provisions for financial leases are quite complex. The *Farmers' Tax Guide* (see "References," page 12) provides more information; consult a tax expert before you enter into a finance lease agreement.

Interest on installment sales

Tax laws require that you treat a minimum portion of payments under certain installment sales contracts as interest, rather than as part of the sales price. These laws apply to contracts in excess of $3,000 and in which one or more payments are due more than a year after the date of the sale. On contracts after June 30, 1981, there must be simple interest of 9%, or interest will be charged at a 10% rate.

This rule was amended by the ERTA of 1981 so that the interest rate charged on the first $500,000 of land sales in any taxable year to a related party must be at least 6%, or a 7% rate will be charged.

The 1984 Tax Reform Act made additional changes for sales in 1985 and thereafter. If a land sale is $1 million or less, the first $500,000 of sales between related persons in any year must have an interest rate of 6%, or a 7% rate will be charged.

The next $500,000 of sales between related persons and the first $1 million of sales between unrelated persons must have a 9% interest rate, or a 10% rate will be charged.

However, if the land sale is for more than $1 million, interest will be charged on the entire unpaid price, using 120% of the applicable Federal treasury bond rate (short-term, mid-term, or long-term, depending on the length of the contract), if the actual interest rate is less than 110% of the Federal rate.

Just before adjournment, the 1984 Congress amended these rules: a stated interest rate of at least 9% will prevent IRS from charging a 10% rate on sales between unrelated persons for up to $2 million, for sales occuring between January 1, 1985, and July 1, 1985.

However, if the sale is for over $2 million and occurs between January 1, 1985, and July 1, 1985, or if it is for over $1 million and occurs after July 1, 1985, the tougher 110%-stated and 120%-charged interest rate rules apply.

The sale of a residence carries an interest rate of 10% on the purchase price up to $250,000 and 120% of the Federal rate on the excess.

Other sales must carry an interest rate of at least 110% of the Federal rate, or a rate of 120% of the Federal rate will be charged.

These interest rate rules and the 1984 amendments are really complex. Check with your tax advisor for the latest interpretations.

Below-market and interest-free loans

The attractiveness of interest-free and below-market interest loans as a tax-saving strategy has been severely curtailed by the Tax Reform Act of 1984.

Under the new rules, most loans to family members with a below-market interest rate will result in the foregone interest being treated as if it had been paid for income tax purposes and also as a gift from the lender to the borrower, with the gift subject to Federal gift taxation. Thus, for income tax purposes, the foregone interest is a deductible expense to the borrower and taxable income to the lender.

Loans from a corporation to a stockholder are also affected by the 1984 act. The foregone interest is treated as a dividend paid by the corporation and is included in the shareholder's income.

Gift loans between individuals and corporation shareholder loans of $10,000 or less are exempted from the new rules. However, individual loans are exempted under this $10,000 rule only if the loans are not used for business and investment purposes, and if the foregone interest is treated as a gift.

Term loans made after June 6, 1984, and demand loans outstanding after June 6, 1984, come under the 1984 act.

Capital gains and losses

Two major changes made by the 1984 Tax Reform Act are the reduction of the holding period for long-term capital gain treatment and the recapture of net losses for calculating capital gains.

Capital gains holding period. The 1984 act decreased the minimum holding period that is required for treatment as a long-term capital gain. Specifically, the minimum holding period has been reduced from 1 year to 6 months on most assets that are eligible for capital gain or loss treatment and that you bought after June 22, 1984, and before January 1, 1988. Real estate and machinery are included in this rule change.

There is no change in the long-term capital gain treatment for sale of livestock held for breeding or dairy purposes. The minimum holding period remains at 24 months for cattle and horses and 12 months for other livestock.

Recapture of net losses. In the past, capital losses from transactions of property used in your business were subtracted from the capital gains each year. If this process resulted in a net gain, the gain received the favorable long-term capital gains tax treatment. A net loss was treated as a loss that you could use to offset ordinary income.

This rule provided an incentive for the taxpayer to time sales and taxable exchanges of qualifying property, so that those with gains occurred in one year and those with losses in another year. This strategy insured that gains were taxed at the more favorable capital gains rate and that losses were used to offset ordinary income.

The 1984 act changes these rules for tax years beginning after 1984. Net capital gains from property used in your business are taxable as ordinary income rather than capital gain income to the extent the gain does not exceed

the sum of the losses on your business assets in the preceding 5 years, beginning after 1981.

Operating loss and credit carryovers

The 1981 act extended the net operating loss carryover period from 7 to 15 years. This new 15-year carryover period is effective for losses incurred in tax years ending after 1975.

In addition, the 1981 law extended the carryover periods for investment credit from 7 to 15 years for tax years with unused credit arising from tax years ending after 1973.

Subchapter S corporations

The provisions under Subchapter S of the Internal Revenue Code allow certain small businesses to operate in the corporate form without double taxation on corporate income paid as dividends to shareholders.

In a Subchapter S corporation, the shareholders are taxed as individuals, each on their share of the corporation's taxable income. The 1981 ERTA raised the maximum number of shareholders to qualify as a Subchapter S corporation to 35 after 1982.

Under the former law, only a few types of trusts were eligible to be shareholders in Subchapter S corporations. The 1981 Tax Act expanded this list of eligible trusts.

By increasing the maximum number of shareholders and allowing additional trusts as shareholders, more businesses can become Subchapter S corporations and (as a result) avoid double taxation of dividends.

Employee benefits

The 1984 Tax Reform Act tried to clarify the tax status of fringe benefits that businesses provide to employees. However, further definitions will have to come from new IRS regulations. The new rules do not affect fringe benefits like health and term insurance, which are not taxed under other IRS regulations.

The first clarification relates to services offered in the ordinary course of the business that you can provide free to employees at "no substantial additional cost." You must offer these without discrimination to qualify for nontaxable treatment. This means that the benefit can't be limited to only certain employees.

Employee discounts are not taxed, provided the employer offers them on a nondiscriminatory basis and that their value does not exceed either (a) the average profit margin for all products the employer sold or (b) 20% of the retail price of services the employer offered.

Services or property provided to an employee, such as housing or use of a pickup truck, that would be deductible to the employee as a business expense or through depreciation if purchased directly, are not taxable. Unlike the previous categories, employers may provide services or property under these rules on a discriminatory basis.

A final category of fringes not subject to tax are products or services with too small a value to make record keeping practical when an employer gives them to an employee (such as the Christmas turkey and milk for the employee's family). A beef steer, ready for slaughter, may not qualify.

Remember...

Interpretations and regulations are subject to change. For the most recent rules, you as taxpayer should contact the IRS—and an accountant or an attorney with Federal income tax experience.

1984 Payment-in-Kind program

The PIK tax rules implemented in 1983 have been extended to 1984 PIK program participants. Thus a wheat grower participating in 1984 PIK can treat for income tax purposes the PIK wheat he or she received from the government as though it had been grown on the land withdrawn from crop production. The PIK wheat is reported as taxable income when it is actually sold, not when it is received.

Commodity futures transactions

Farmers and agribusinesses use commodity futures contracts to reduce their risks in producing and marketing various agricultural commodities. However, IRS has been concerned that some taxpayers were also using these futures contracts to avoid income tax. Commodity-straddle transactions were used to defer income and to convert ordinary income and short-term capital gain into long-term capital gain.

The 1981 and 1984 Tax Acts contain provisions that affect the tax treatment of commodity transactions. The important point for farmers and ranchers is that hedging transactions are exempted from these new provisions.

A transaction is defined as a hedge if taxpayers enter into the transaction in the normal conduct of their business to reduce risk resulting from price changes. A hedging transaction involves only ordinary income or loss; to qualify for treatment as a hedging transaction, it must be identified as such.

References

Explanation of Tax Reform Act of 1984, Commerce Clearing House, Inc., 4025 W. Peterson Ave., Chicago, Illinois 60646.

Harl, Neil E., "Tax Reform Act of 1984," *Agrifinance,* September 1984.

"Highlights of the 1984 Tax Reform Act," *Doane's Agricultural Report,* vol. 47, no. 30-6, July 27, 1984.

Farmer's Tax Watch, Commerce Clearing House, Inc., Chicago, Illinois, September 1984.

Farmer's Tax Guide, U.S. Department of the Treasury, Internal Revenue Service, Publication 225, 1981-83 issues.

O'Byrne, J. C., and Charles Davenport, *Farm Income Tax Manual,* The Allen Smith Company, 1435 N. Meridian St., Indianapolis, Indiana 46202, 1984.

Pacific Northwest cooperative Extension bulletins are joint publications of the three Pacific Northwest states—Oregon, Washington, and Idaho. Similar crops, climate, and topography create a natural geographic unit that crosses state lines. Since 1949 the PNW program has published more than 250 titles. Joint writing, editing, and production has prevented duplication of effort, broadened the availability of faculty specialists, and substantially reduced costs for the participating states.

This publication was prepared by A. Gene Nelson, head, agricultural and resource economics, Oregon State University, and Gayle S. Willett, Extension economist, farm management, Washington State University.

Published and distributed in furtherance of the Acts of Congress of May 8 and June 30, 1914, by the Oregon State University Extension Service, O. E. Smith, director; the Washington State University Cooperative Extension Service, J. O. Young, director; the University of Idaho Cooperative Extension Service, H. R. Guenthner, director; and the U.S. Department of Agriculture cooperating.