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Farmer's Tax Guide

For use in preparing
1999 Returns

Acknowledgment The valuable advice and assistance given us each year by the National Farm Income Tax Extension Committee is gratefully acknowledged.



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Introduction

You are in the business of farming if you cultivate, operate, or manage a farm for profit, either as owner or tenant. A farm includes stock, dairy, poultry, fish, fruit, and truck farms. It also includes plantations, ranches, ranges, and orchards.

This publication explains how the federal tax laws apply to farming. Use this publication as a guide to figure your taxes and complete your farm tax return. If you need more information on a subject, get the specific IRS tax publication covering that subject. We refer to many of these free publications throughout this publication. See chapter 21 for information on ordering these publications.

The explanations and examples in this publication reflect the Internal Revenue Service's interpretation of tax laws enacted by Congress, Treasury regulations, and court decisions. However, the information given does not cover every situation and is not intended to replace the law or change its meaning. This publication covers subjects on which a court may have made a decision more favorable to taxpayers than the interpretation of the Service. Until these differing interpretations are resolved by higher court decisions, or in some other way, this publication will continue to present the interpretation of the Service.

IRS Mission. Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.

Comments and recommendations. In compiling this *Farmer's Tax Guide*, we have adopted a number of suggestions that readers sent to us. We welcome your suggestions for future editions.



Please send your comments and recommendations to us at the following address:

Internal Revenue Service
Technical Publications Branch
OP:FS:FP:P
1111 Constitution Avenue N.W.
Washington, DC 20224

We respond to many letters by telephone. It would be helpful to include your area code and daytime phone number with your return address.

Farm tax classes. Many state Cooperative Extension Services conduct farm tax workshops in conjunction with the IRS. Please contact your county extension office for more information.

Important Changes for 1999

The following items highlight a number of administrative and tax law changes for 1999. They are discussed in more detail throughout the publication. Changes are also discussed in Publication 553, *Highlights of 1999 Tax Changes*.

Business use of your home. Beginning in 1999, you may be able to deduct expenses for your home office even if it is not where you perform your most important business activities or spend most of your business time. See chapter 5.

Child tax credit. You may be able to claim a tax credit for each of your qualifying children under the age of 17. For 1999, this credit can be as much as \$500 for each qualifying child. See the instructions for Form 1040.

Depreciation limits on business cars. The total section 179 deduction and depreciation you can take on a car you use in your business and first place in service in 1999 is \$3,060. Special rules apply to certain clean-fuel vehicles. See chapter 8.

Earned income credit. The maximum earned income credit has been increased to \$3,816 for 1999. To claim the credit, you must have earned income (including net earnings from self-employment) and modified adjusted gross income of less than \$30,580 and meet certain other requirements. For more information, including what counts as earned income, see Publication 596, *Earned Income Credit*.

Photographs of missing children. The Internal Revenue Service is a proud partner with the National Center for Missing and Exploited Children. Photographs of missing children selected by the Center may appear in this publication on pages that would otherwise be blank. You can help bring these children home by looking at the photographs and calling 1-800-THE-LOST (1-800-843-5678) if you recognize a child.

Section 179 deduction. For 1999, the total cost you can elect to deduct under section 179 of the Internal Revenue Code is increased to \$19,000. See chapter 8.

Self-employed health insurance deduction. The part of your self-employed health insurance premiums that you can deduct as an adjustment to income increased to 60% for 1999. See chapter 5.

Standard mileage rate. The standard mileage rate for the cost of operating your car, van, pickup, or panel truck in 1999 is 32½ cents a mile for all business miles driven before April 1. The rate is 31 cents a mile for business miles driven after March 31. See chapter 5.

Tax rates and maximum net earnings for self-employment tax. The maximum net self-employment earnings subject to the social security part (12.4%) of the self-employment tax increased to \$72,600 for 1999. There is no maximum limit on earnings subject to the Medicare part (2.9%). See chapter 15.

Important Changes for 2000

The following items highlight a number of administrative and tax law changes for 2000. More information on these and other changes can be found in Publication 553, *Highlights of 1999 Tax Changes*.

Electronic deposits of taxes. The threshold that determines whether you must deposit taxes electronically has been increased to \$200,000. You must use the Electronic Federal Tax Payment System (EFTPS) to make electronic deposits of all depository tax liabilities that occur after 1999 if you deposited more than \$200,000 in federal depository taxes in 1998. If you do not meet the \$200,000 threshold, electronic deposits are voluntary, even if you were required to deposit electronically under a previous threshold.

The waiver of the penalty for failure to deposit taxes electronically that was scheduled to expire on July 1, 1999, has been extended to deposit obligations incurred before January 1, 2000, except for taxpayers who

deposited more than \$200,000 in taxes in 1998. See chapter 16.

Section 179 deduction. For 2000, the total cost you can elect to deduct under section 179 of the Internal Revenue Code is increased to \$20,000. See chapter 8.

Tax rates and maximum net earnings for self-employment tax. The maximum net self-employment earnings subject to the social security part of the self-employment tax for 2000 will be published in Publications 533 and 553. There is no maximum limit on earnings subject to the Medicare part.

Wage limits for social security and Medicare taxes. The maximum wages subject to the social security tax for 2000 will be published in Publication 51, *Circular A, Agricultural Employer's Tax Guide*. There is no wage base limit for wages subject to the Medicare tax.

Important Reminders

The following reminders and other items may help you file your tax return.

Principal agricultural activity codes. You must enter on line B of Schedule F (Form 1040) a code that identifies your principal agricultural activity. It is important to use the correct code, since this information will identify market segments of the public for IRS Taxpayer Education programs. The U.S. Census Bureau also uses this information for its economic census. See the list of *Principal Agricultural Activity Codes* on page 2 of Schedule F.

Averaging of farm income. For tax years beginning after 1997, individual farmers can choose to average all or part of their taxable farm income. See chapter 4.

Voluntary withholding. You can request income tax withholding from the following payments on Form W-4V, *Voluntary Withholding Request*.

- 1) Commodity Credit Corporation (CCC) loans.
- 2) Certain crop disaster payments received under the Agricultural Act of 1949 or title II of the Disaster Assistance Act of 1988.
- 3) Social security benefits.
- 4) Unemployment compensation.
- 5) Certain other government payments.

See chapter 4 for information on CCC loans and disaster relief payments.

Direct deposit of refund. If you are due a refund on your tax return, you can have it deposited directly into your account at a bank or other financial institution. See your income tax package for details.

Change of address. If you change your home or business address, you should use Form 8822, *Change of Address*, to notify the IRS. Be sure to include your suite, room, or other unit number. Send the form to the Internal Revenue Service Center for your old address.

Written tax questions. You can send written tax questions to your local district director. You should get an answer in about 30 days. Call **1-800-829-1040** if you need the address.

IRS e-file (electronic filing). You can file your tax returns electronically using an IRS e-file option. These options offer faster refunds, increased accuracy, acknowledgment of IRS receipt, and the ability to pay electronically. You can use one of the following IRS e-file options.

- 1) Use an authorized IRS e-file provider.
- 2) Use a personal computer.
- 3) Visit a VITA/TCE site.
- 4) Use an employer or financial institution.

For details on these fast filing methods, see your income tax package.

Overdue tax bill. If you receive a bill for overdue taxes, do not ignore the tax bill. If you owe the tax shown on the bill, you should make arrangements to pay it. If you believe it is incorrect, contact the IRS immediately to suspend action until the mistake is corrected. See Publication 594, *The IRS Collection Process*, for more information.

Help with unresolved tax problems. If you have attempted to deal with an IRS problem unsuccessfully, you should contact your **Taxpayer Advocate**.

The Taxpayer Advocate represents your interests and concerns within the IRS by protecting your rights and resolving problems that have not been fixed through normal channels. While Taxpayer Advocates cannot change the tax law or make a technical tax decision, they can clear up problems that resulted from previous contacts and ensure that your case is given a complete and impartial review.

To contact your Taxpayer Advocate:

- Call the Taxpayer Advocate's toll-free number: **1-877-777-4778**.
- Call the IRS toll-free number: **1-800-829-1040**.
- Call, write, or fax the Taxpayer Advocate office in your area.
- Call **1-800-829-4059** if you are a TTY/TDD user.

For more information, see Publication 1546.

Comments on IRS enforcement actions. The Small Business and Agricultural Regulatory Enforcement Ombudsman and 10 Regional Fairness Boards were established to receive comments from small business about federal agency enforcement actions. The Ombudsman will annually evaluate the enforcement activities and rate each agency's responsiveness to small business. If you wish to comment on the enforcement actions of the IRS, call **1-888-734-3247**.

Treasury Inspector General for Tax Administration. If you want to confidentially report misconduct, waste, fraud, or abuse by an IRS employee, you can call **1-800-366-4484** (**1-800-877-8339** for TTY/TDD users). You can remain anonymous.

Publication on employer identification numbers (EIN). Publication 1635, *Understanding Your EIN*, provides general information on employer identification numbers. Topics include how to apply for an EIN and how to complete Form SS-4.

Form W-4 for 2000. You should make new Forms W-4 available to your employees and encourage them to check their income tax withholding for 2000. Those employees who owed a large amount of tax or received a large refund for 1999 may need to file a new Form W-4. See chapter 16.

Earned income credit. You, as an employer, must notify employees who worked for you and from whom you did not withhold income tax about the earned income credit. See chapter 16.

Form 1099-MISC. File Form 1099-MISC if you pay at least \$600 in rents, services, and other income payments in your farming business to an individual (for example, an accountant or veterinarian) who is not your employee.

Children employed by parents. Wages you pay to your children age 18 and older for services in your trade or business are subject to social security and Medicare taxes. See chapter 16.

Farmers and crew leaders must withhold income tax. Farmers and crew leaders must withhold federal income tax from farm workers who are subject to social security and Medicare taxes. See chapter 16.

Social security tests for hand-harvest laborers. If you pay hand-harvest laborers less than \$150 in annual cash wages, the wages are not subject to social security and Medicare taxes, even if you pay \$2,500 or more to all your farm workers. The hand-harvest laborer must meet certain tests. See chapter 16.

Medical savings accounts (MSAs). If you are covered only under a high deductible health plan, you may be able to participate in an MSA program. You can deduct contributions to your MSA even if you do not itemize your deductions. See Publication 969, *Medical Savings Accounts (MSAs)*.

Important Dates

You should take the action indicated on or before the dates listed. Saturdays, Sundays, and legal holidays have been taken into account, but statewide holidays have not. A statewide legal holiday delays a due date only if the IRS office where you are required to file is located in that state.

Due dates for deposits of withheld income taxes, social security taxes, and Medicare taxes are not listed here. For these dates, see Publication 509, *Tax Calendars for 2000*.

Fiscal year taxpayers. Generally, the due dates listed apply, whether you use a calendar or a fiscal year. However, if you have a fiscal year, refer to Publication 509 for certain exceptions that may apply to you.

2000 Calendar Year

During January

Farm employers. Give your employees their copies of Form W-2 for 1999 as soon as possible. The due date is January 31, 2000.

January 18

Farmers. Pay your estimated tax for 1999 using Form 1040-ES. You have until April 17 to file your 1999 income tax return (Form 1040). If you do not pay your estimated tax by January 18, you must file your 1999 return and pay any tax due by March 1, 2000.

January 31

Farm employers. Give your employees their copies of Form W-2 for 1999.

Social security, Medicare, and withheld income tax. File Form 943 to report social security and Medicare taxes and withheld income tax for 1999. Deposit any undeposited tax. (If the total is less than \$1,000 and not a shortfall, you can pay it with the return.) If you deposited the tax for the year in full and on time, you have until February 10 to file the return. (Do not report wages for nonagricultural services on Form 943.)

All farm businesses. Give annual information statements to recipients of certain payments you made during 1999. You can use the appropriate version of Form 1099 or other information return. For more information, see *Information Returns* in chapter 2.

Federal unemployment (FUTA) tax. File Form 940 (or 940-EZ) for 1999. If your undeposited tax is \$100 or less, you can either pay it with your return or deposit it. If it is more than \$100, you must deposit it. However, if you deposited the tax for the year in full and on time, you have until February 10 to file the return. For more information on FUTA tax, see chapter 16.

February 10

Social security, Medicare, and withheld income tax. File Form 943 to report social security, Medicare, and withheld income tax for 1999. This due date applies only if you deposited the tax for the year in full and on time.

Federal unemployment (FUTA) tax. File Form 940 (or 940-EZ) for 1999. This due date applies only if you deposited the tax for the year in full and on time.

February 28

All farm businesses. File information returns (Form 1099) for certain payments you made during 1999. There are different forms for different types of payments. Use a separate Form 1096 to summarize and transmit the forms for different types of payments.

If you file Forms 1099 electronically (not by magnetic media), your due date for filing them with the IRS is extended to March 31. The due date for giving the recipient these forms is still January 31.

February 29

Farm employers. File Form W-3, *Transmittal of Wage and Tax Statements*, along with Copy A of all the Forms W-2 you issued for 1999.

If you file Forms W-2 electronically (not by magnetic media), your due date for filing them with the SSA is extended to March 31. The due date for giving the recipient these forms is still January 31.

For more information, see *Form W-2* under *Other Forms* in chapter 2.

March 1

Farmers. File your 1999 income tax return (Form 1040) and pay any tax due. However, you have until April 17 to file if you paid your 1999 estimated tax by January 18, 2000.

March 15

Corporations. File a 1999 calendar year income tax return (Form 1120 or 1120-A) and pay any tax due. For more information, see *Paying and Filing Income Taxes* in Publication 542, *Corporations*.

March 31

Electronic filing of Forms 1099 and W-2. File Forms 1099 with the IRS and Forms W-2 with the SSA. This due date applies only if you file electronically (not by magnetic media). Otherwise, the due date is February 28 for Forms 1099 and February 29 for Forms W-2.

The due date for giving the recipient these forms is still January 31.

For information about filing Forms 1099 electronically, see Publication 1220, *Specifications for Filing Forms 1098, 1099, 5498, and W-2 Magnetically or Electronically*. For information about filing Forms W-2 electronically with the Social Security Administration, call 1-800-772-6270.

April 17

Farmers. File an income tax return (Form 1040) for 1999 and pay any tax due if you did not file by March 1.

Partnerships. File a 1999 calendar year return (Form 1065). For more information, see *Partnership Return (Form 1065)* in Publication 541, *Partnerships*.

May 1

Federal unemployment (FUTA) tax. If you are liable for FUTA tax, deposit the tax owed through March, if more than \$100.

July 31

Federal unemployment (FUTA) tax. If you are liable for FUTA tax, deposit the tax owed through June. No deposit is necessary if the liability for the quarter plus undeposited FUTA tax for the 1st quarter does not exceed \$100.

October 31

Federal unemployment (FUTA) tax. If you are liable for FUTA tax, deposit the tax owed through September. No deposit is necessary if the liability for the quarter plus undeposited FUTA tax for previous quarters does not exceed \$100.

1.

Importance of Good Records

Introduction

A farmer, like other taxpayers, must keep records to prepare an accurate income tax return and determine the correct amount of tax. This chapter explains why you must keep records, what kinds of records you must keep, and how long you must keep them for federal tax purposes.

Tax records are not the only type of records you need to keep for your farming business. You should also keep records that measure your farm's financial performance. This publication only discusses tax records. For information on financial recordkeeping, you may want to get a copy of *Financial Guidelines For Agricultural Producers*. You can order it from Countryside Marketing, Inc., by calling 1-630-637-0199 or you can write to:

Farm Financial Standards Council
PMB 316
1212 S. Naper Blvd., #119
Naperville, IL 60540

Topics

This chapter discusses:

- Why you should keep records
- What records to keep
- How long to keep records

Useful Items

You may want to see:

Publication

- 51 Circular A, Agricultural Employer's Tax Guide
- 463 Travel, Entertainment, Gift, and Car Expenses

See chapter 21 for information about getting publications.

Why Keep Records?

Everyone in business, including farmers, must keep records. Good records will help you do the following.

Monitor the progress of your farming business. You need good records to monitor the progress of your farming business. Records can show whether your business is improving, which items are selling, or what changes you need to make. Good records can increase the likelihood of business success.

Prepare your financial statements. You need good records to prepare accurate financial statements. These include income (profit and loss) statements and balance sheets. These statements can help you in dealing with your bank or creditors.

Identify source of receipts. You will receive money or property from many sources. Your records can identify the source of your receipts. You need this information to separate farm from nonfarm receipts and taxable from nontaxable income.

Keep track of deductible expenses. You may forget expenses when you prepare your tax return unless you record them when they occur.

Prepare your tax returns. You need good records to prepare your tax return. These records must support the income, expenses, and credits you report. Generally, these are the same records you use to monitor your farming business and prepare your financial statements.

Support items reported on tax returns. You must keep your business records available at all times for inspection by the IRS. If the IRS examines any of your tax returns, you may be asked to explain the items reported. A complete set of records will speed up the examination.

Kinds of Records To Keep

Except in a few cases, the law does not require any special kind of records. You may choose any recordkeeping system suited to your farming business that clearly shows your income and expenses.

You should set up your recordkeeping system using an accounting method that clearly shows your income for your tax year. See chapter 3. If you are in more than one business, you should keep a complete and separate set of records for each business. A corporation should keep minutes of board of directors' meetings.

Your recordkeeping system should include a summary of your business transactions. This summary is ordinarily made in accounting journals and ledgers. They must show your gross income, as well as your deductions and credits. In addition, you must keep supporting documents. Purchases, sales, payroll, and other transactions you have in your business generate supporting documents such as invoices and receipts. These documents contain the information you need to record in your journals and ledgers.

It is important to keep these documents because they support the entries in your journals and ledgers and on your tax return. Keep them in an orderly fashion and in a safe place. For instance, organize them by year and type of income or expense.

Travel, transportation, entertainment, and gift expenses. Special recordkeeping rules apply to these expenses. For more information, see Publication 463.

Employment taxes. There are specific employment tax records you must keep. For a list, see Publication 51 (Circular A).

Excise taxes. See *How To Claim a Credit or Refund* in chapter 18 for the specific records you must keep to verify your claim for credit or refund of excise taxes on certain fuels.

Assets. Assets are the property, such as machinery and equipment, that you own and use in your business. You must keep records to verify certain information about your business assets. You need records to figure your annual depreciation deduction and the gain or loss when you sell the assets. Your records should show all of the following.

- When and how you acquired the asset.
- Purchase price.
- Cost of any improvements.
- Section 179 deduction taken.
- Deductions taken for depreciation.
- Deductions taken for casualty losses, such as losses resulting from fires or storms.
- How you used the asset.
- When and how you disposed of the asset.
- Selling price.
- Expenses of sale.

The following are examples of records that may show this information.

- Purchase and sales invoices.
- Real estate closing statements.
- Canceled checks.

Financial account statements as proof of payment. If you do not have a canceled check, you may be able to prove payment with certain financial account statements prepared by financial institutions. These include account statements prepared for the financial institution by a third party. The following is a list of acceptable account statements.

- 1) An account statement showing a check clearing is accepted as proof if it shows the following.
 - a) Check number.
 - b) Amount.
 - c) Payee's name.
 - d) Date the check amount was posted to the account by the financial institution.
- 2) An account statement showing an electronic funds transfer is accepted as proof if it shows the following.
 - a) Amount transferred.
 - b) Payee's name.
 - c) Date the transfer was posted to the account by the financial institution.
- 3) An account statement showing a credit card charge (an increase to the cardholder's loan balance) is accepted as proof if it shows the following.
 - a) Amount charged.
 - b) Payee's name.
 - c) Date charged (transaction date).

These account statements must be highly legible.



Proof of payment of an amount alone does not establish that you are entitled to a tax deduction. You should also keep other documents, such as credit card sales slips and invoices.

How Long To Keep Records

You must keep your records as long as they may be needed for the administration of any provision of the Internal Revenue Code. Generally, this means you must keep records that support an item of income or deduction on a return until the period of limitations for that return runs out.

The period of limitations is the period of time in which you can amend your return to claim a credit or refund, or the IRS can assess additional tax. The period of time in which you can amend your return to claim a credit or refund is generally the later of:

- 1) 3 years after the date your return is due or filed, or
- 2) 2 years after the date the tax is paid.

Returns filed before the due date are treated as filed on the due date.

The IRS has 3 years from the date you file your return to assess any additional tax. If you file a fraudulent return or no return at all, the IRS has a longer period of time to assess additional tax.



Keep copies of your filed tax returns. They help in preparing future tax returns and making computations if you later file an amended return.

Employment taxes. If you have employees, you must keep all employment tax records for at least 4 years after the date the tax becomes due or is paid, whichever is later.

Assets. Keep records relating to property until the period of limitations expires for the year in which you dispose of the property in a taxable disposition. You must keep these records to figure any depreciation, amortization, or depletion deduction and to figure your basis for computing gain or loss when you sell or otherwise dispose of the property.

Generally, if you receive property in a nontaxable exchange, your basis in that property is the same as the basis of the property you gave up, increased by any money you paid. You must keep the records on the old property, as well as on the new property, until the period of limitations expires for the year in which you dispose of the new property in a taxable disposition.

Records for nontax purposes. When your records are no longer needed for tax purposes, do not discard them until you check to see if you have to keep them longer for other purposes. For example, your insurance company or creditors may require you to keep them longer than the IRS does.

2.

Filing Requirements and Return Forms

Important Reminders

Form 1099-MISC. File Form 1099-MISC if you pay at least \$600 in rents, services, and other income payments in your farming business to an individual (for example, an accountant or veterinarian) who is not your employee.

Payments to attorneys. The rule that attorneys' fees of \$600 or more must be reported to the IRS on Form 1099-MISC has not changed. However, if you made a payment to an attorney in the course of your farming business in connection with legal services and the attorney's fee cannot be determined, you must report the total amount paid to the attorney on Form 1099-MISC.

The exception for payments to corporations does not apply to payments for legal services. Those payments must also be reported on Form 1099-MISC. See the *Instructions for Forms 1099, 1098, 5498, and W-2G*.

Estimated tax. When you figure your estimated tax, you must include any alternative minimum tax you expect to owe. See chapter 14 and Publication 505.

Introduction

If you are a citizen or resident of the United States, single or married, and your gross income for the tax year is at least the amount shown later in your category under *Filing Requirements*, you must file a 1999 federal income tax return. This is true even if no tax is due. If you do not meet the gross income requirement, you may still need to file a tax return if any of the following apply.

- You have self-employment income.
- You are entitled to a complete refund of tax withheld.
- You are entitled to the earned income credit.

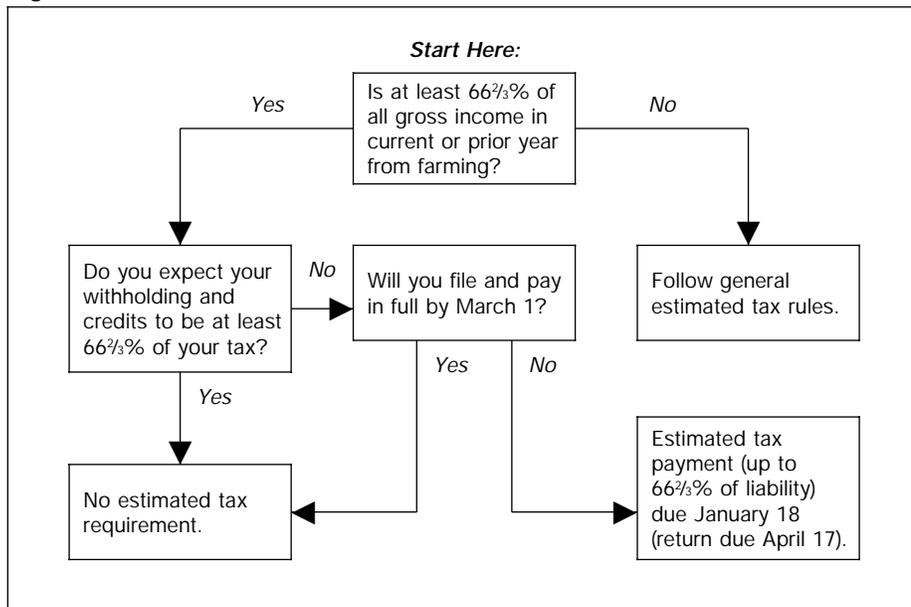
Gross income is explained later.

Topics

This chapter discusses:

- Filing requirements
- Taxpayer identification number
- Estimated tax and return due dates
- Main tax forms used by farmers

Figure 2-A. Estimated Tax for Farmers



- Partnership return
- Corporation return
- S corporation return

Useful Items

You may want to see:

Publication

- 505 Tax Withholding and Estimated Tax
- 541 Partnerships
- 542 Corporations

Form (and Instructions)

We have not listed the various forms you may have to file with the IRS because they are discussed later in this chapter.

See chapter 21 for information about getting publications and forms.

Filing Requirements

Check the following table to determine whether you must file a tax return, based on your age, income, and filing status.

Filing Status Is:	Who Must File	Income At Least:
Single		
Under 65		\$7,050
65 or older		8,100
Married, filing jointly		
Both under 65		12,700
One spouse 65 or older		13,550
Both 65 or older		14,400
Not living with spouse at end of year (or on date spouse died)		2,750
Married, filing separately		
All (any age)		2,750
Head of household		
Under 65		9,100
65 or older		10,150
Qualifying widow(er) with dependent child		
Under 65		9,950
65 or older		10,850

Dependent's return. If you can claim someone as a dependent on your tax return (for example, your son or daughter), that person must generally also file his or her own tax return if he or she:

- Had only earned income, such as salary or wages, and the total is more than \$4,300,
- Had only unearned income, such as interest and dividends, and the total is more than \$700, or
- Had both earned and unearned income, and the total is more than \$700.

Self-employed. You must file an income tax return if you are self-employed and you had net earnings of \$400 or more from self-employment, even though you may not be otherwise required to file a return. See chapter 15.

Certain credits. You must also file a return if you are eligible for the earned income credit (EIC) or the additional child tax credit. Also, you must file a return if you received any advance EIC payments from your employer.

Refund. Even if you do not otherwise have to file a return, you should file one to get a refund of any income tax withheld.

More information. See the Form 1040 instructions for more information on who must file a return for 1999.

Taxpayer Identification Number

You must enter your taxpayer identification number (your social security or employer identification number) on all returns, statements, or documents you are required to file. For example, it must be entered on your federal income tax return, your estimated tax payment voucher, and all information returns, such as Forms 1096 and 1099. You may be subject to a penalty of \$50 for each failure to enter the number.

Which number to use. If you file an excise, alcohol, tobacco, firearms, or employment tax return, you should have an employer identification number (EIN). Enter that EIN on your Schedule F (Form 1040). Otherwise, enter your social security number.

On your individual income tax return (Form 1040), schedule of self-employment tax (Schedule SE), and estimated tax payment voucher (Form 1040-ES), you should enter your social security number (SSN), regardless of which number you entered on your business returns.

If you are married, enter the social security numbers for you and your spouse on your Form 1040, whether you file jointly or separately. If you are filing a joint return, list the social security numbers in the same order as the names are shown on your label. Also enter both social security numbers on your Form 1040-ES if you make joint estimated tax payments.

Privacy protection. To protect your privacy, the IRS no longer prints your SSN(s) on the label mailed to you with your tax booklet. Be sure to enter your SSN(s) in the space provided on your tax form.

 **Applying for a social security number.** To apply for a social security number (SSN), use Form SS-5. You can get the form from any social security office or by calling 1-800-772-1213. If you are under 18 years of age, you must furnish evidence of age, identity, and U.S. citizenship (or lawful alien status) with your Form SS-5. If you are 18 or older, you must appear in person with this evidence at a social security office. It usually takes about 2 weeks to get an SSN.

 **Applying for an employer identification number.** To apply for an employer identification number, use Form SS-4. See chapter 21 for information about ordering this form.

Estimated Tax Payment and Return Due Dates

To determine when you must pay estimated tax and file your return, see Figure 2-A.

 **Gross income is not the same as total income shown on line 22 of Form 1040.**

Gross Income

Your gross income is all income you receive in the form of money, property, and services that is not exempt from tax. On a joint return, you must add your spouse's gross income to your gross income. To decide whether two-thirds of your gross income for 1999 was from farming, use as your gross income the total of the following **income** (not loss) amounts from your tax return.

- Wages, salaries, tips, etc.

- Taxable interest.
- Ordinary dividends.
- Taxable refunds of state and local taxes.
- Alimony received.
- Gross business income from Schedule C (Form 1040), line 7.
- Gross receipts from Schedule C-EZ (Form 1040), line 1.
- Capital gains from Schedule D (Form 1040). Losses cannot be netted against gains.
- Gains on sales of business property from Form 4797.
- Taxable IRA distributions, pensions, annuities, and social security benefits.
- Gross rental income from Schedule E (Form 1040), line 3.
- Gross royalty income from Schedule E (Form 1040), line 4.
- Your taxable net income from an estate or trust, Schedule E (Form 1040), line 36.
- Income from a REMIC reported on Schedule E (Form 1040), line 38.
- Gross farm rental income from Form 4835, line 7.
- Farm income from Schedule F (Form 1040), line 11.
- Your distributive share of gross income from a partnership or limited liability company treated as a partnership from Schedule K-1 (Form 1065).
- Your pro rata share of gross income from an S corporation from Schedule K-1 (Form 1120S).
- Unemployment compensation as reported on Form 1099-G.
- Other income reported on Form 1040, line 21, not reported with any of the items listed above.

There are brief descriptions of forms and schedules used by farmers later.

Gross Income From Farming

Gross income from farming includes the following.

- Gross farm income from Schedule F (Form 1040), line 11.
- Gross farm rental income from Form 4835, line 7.
- Gross farm income from Schedule E (Form 1040), Parts II and III. See the instructions for line 41.
- Gains from the sale of livestock used for draft, breeding, sport, or dairy purposes reported on Form 4797.

 **Wages you receive as a farm employee are not farm income. This includes wages you receive from a farm corporation even if you are a stockholder in the corporation. If all or most of your income is from wages as a farm employee, your employer is usually required to withhold income tax from your wages. You may also have to make estimated tax payments if you do not have enough tax withheld. For more information, see Publication 505.**

Percentage From Farming

Total your gross income from all sources as shown earlier. Then total your gross income from farming. Divide your farm gross income by your total gross income to determine the percentage of gross income from farming.

Example 1. James Smith had the following total gross income and farm gross income in 1999:

	Total	Farm
Taxable interest	\$43,000	
Dividends	500	
Rental income (Sch E)	1,500	
Farm income (Sch F)	75,000	\$75,000
Schedule D	5,000	5,000
Total	\$125,000	\$80,000

Schedule D showed gain from the sale of dairy cows carried over from Form 4797 (\$5,000) in addition to a loss from the sale of corporate stock (\$2,000). However, that loss is not netted against the gain to figure Mr. Smith's total gross income or his gross farm income. His gross farm income is 64% of his total gross income ($\$80,000 \div \$125,000 = .64$). Therefore, based on his 1999 income, he does not qualify to use the special estimated tax payment and return due dates for 1999. However, he does qualify if at least two-thirds of his 1998 gross income was from farming.

Example 2. Assume the same facts as in Example 1 except that Mr. Smith also received gross farm rental income (Form 4835) of \$15,000. This made his total gross income \$140,000 and his farm gross income \$95,000. He qualifies to use the special estimated tax payment and return due dates since at least two-thirds of his gross income is from farming [$\$95,000 \div \$140,000 = .679$ (67.9%)].

Due Dates for Qualified Farmers

If at least two-thirds of your gross income for 1998 or 1999 was from farming, you have only one payment due date for 1999 estimated tax—January 18, 2000.

For your 1999 tax, you may either:

- 1) Pay all your estimated tax (figured on **Form 1040-ES**) by January 18, 2000, and file your Form 1040 by April 17, 2000, or
- 2) File your Form 1040 by March 1, 2000, and pay all the tax due. You are not required to make an estimated tax payment. If you pay all the tax due, you will not be penalized for failure to pay estimated tax.

 **If at least two-thirds of your gross income for 1999 or 2000 is from farming, for your 2000 tax, you may either:**

- 1) **Pay all your estimated tax by January 16, 2001, and file your Form 1040 by April 16, 2001, or**
- 2) **File your Form 1040 by March 1, 2001, and pay all the tax due.**

Required annual payment. If at least two-thirds of your gross income for 1998 or 1999 was from farming, the required annual payment due January 18, 2000, is the **smaller** of the following.

- 1) $66\frac{2}{3}\%$ (.6667) of your total tax for 1999, or
- 2) 100% of the total tax shown on your 1998 return. (The return must cover all 12 months.)

 **If at least two-thirds of your gross income for 1999 or 2000 is from farming, the required annual payment due January 16, 2001, is the **smaller** of the following.**

- 1) $66\frac{2}{3}\%$ (.6667) of your total tax for 2000, or
- 2) 100% of the total tax shown on your 1999 return. (The return must cover all 12 months.)

Fiscal year farmers. If you qualify to use these special rules but your tax year does not start on January 1, you may file your return and pay the tax by the first day of the 3rd month after the close of your tax year. Or you may pay your required estimated tax within 15 days after the end of your tax year. Then file your return and pay any balance due by the 15th day of the 4th month after the end of your tax year.

Due Dates for Nonqualified Farmers

If less than two-thirds of your gross income for **1998 and 1999** was from farming, you cannot use these special estimated tax payment and return due dates for your 1999 tax year. In this case, you generally must make quarterly estimated tax payments on April 15, June 15, and September 15, 1999, and on January 18, 2000. You must file your return by April 17, 2000.

If less than two-thirds of your gross income for **1999 and 2000** is from farming, you cannot use these special estimated tax payment and return due dates for your 2000 tax year. You generally must make quarterly estimated tax payments on April 17, June 15, and September 15, 2000, and on January 16, 2001. You must file your return by April 16, 2001.

For more information on estimated taxes, see Publication 505.

Estimated Tax Penalty for 1999

If you did not pay all your required estimated tax for 1999 by January 18, 2000, or file your 1999 return and pay the tax by March 1, 2000, you should have used **Form 2210-F, Underpayment of Estimated Tax by Farmers and Fishermen**, to determine if you owed a penalty. If you owed a penalty but did not file Form 2210-F with your return and pay the penalty, you will get a notice from the IRS. You should pay the penalty as instructed by the notice.

If you file your return by April 17 and pay the bill within 21 days (10 days if the bill is \$100,000 or more) after the notice date, the IRS will not charge you interest on the penalty.

 **Do not ignore a penalty notice, even if you think it is in error. Occasionally, you may get a penalty notice even though you filed your return on time, attached Form 2210-F, and met the gross income test. If you receive a penalty notice for underpaying estimated tax that you think is in**

error, write to the address on the notice and explain why you think the notice is in error. Include a computation, similar to the one in Example 1 (earlier), showing that you meet the gross income test.

Other Filing Information for 1999

Payment date on holiday or weekend. If the last day for filing your return or making a payment falls on a Saturday, Sunday, or legal holiday, your return or payment will be on time if it is filed or made on the next business day.

Automatic extension of time to file Form 1040. If you do not choose to file your 1999 return by March 1, 2000, the due date for your return will be April 17, 2000. However, you can get an automatic 4-month extension of time to file your return. Your Form 1040 would then be due by August 15, 2000. To get this extension, file Form 4868, *Application for Automatic Extension of Time To File U.S. Individual Income Tax Return*, by April 17, 2000. The filing of Form 4868 does not extend the time to pay the tax. For more information, see the instructions for Form 4868.



This extension does not extend the March 1, 2000, filing date for farmers who did not make an estimated tax payment and want to avoid an estimated tax penalty. Therefore, if you did not make an estimated tax payment by January 18, 2000, and you file your tax return after March 1, 2000, you will be subject to a penalty for underpaying your estimated tax, even if you file Form 4868.

Forms You May Need To File

When filing your income tax return, arrange your forms and schedules in the correct order using the sequence number located in the upper right corner of each form. Attach all other statements or attachments last, arranged in the same order as the forms or schedules they support.

Farmers can use the following forms and schedules. Some of them are illustrated in chapter 20.

Form 1040. This form is the income tax return. List taxable income from all sources on Form 1040, including profit or loss from farming operations as figured on Schedule F (Form 1040). Figure the tax on this form, also.

Schedule A, Itemized Deductions. List nonbusiness itemized deductions on this schedule.

Schedule B, Interest and Ordinary Dividends. Report interest and dividend income of more than \$400 on this schedule.

Schedule C, Profit or Loss From Business. List income and deductions and determine the net profit or loss from a nonfarm business on this schedule.

Schedule C-EZ, Net Profit From Business. Use this schedule in place of Schedule C if nonfarm business expenses are \$2,500 or less and other requirements are met.

Schedule D, Capital Gains and Losses. Report gains and losses from sales of capital assets on this schedule.

Schedule E, Supplemental Income and Loss. Report income or losses from rents, royalties, partnerships, estates, trusts, and S corporations on this schedule.

Schedule F, Profit or Loss From Farming. Use this schedule whether you file on the cash or an accrual method of accounting. List all farm income and deductions and determine the net farm profit or loss on this schedule.

Schedule SE, Self-Employment Tax. Figure self-employment tax on this schedule. See chapter 15.

Form 1040-ES. Figure and pay estimated tax on Form 1040-ES, *Estimated Tax for Individuals*. See *Estimated Tax Payment and Return Due Dates*, earlier.

Form 2210-F. Figure any underpayment of estimated tax and the penalty on Form 2210-F, *Underpayment of Estimated Tax by Farmers and Fishermen*.

Form 3468. Figure the investment credit on Form 3468, *Investment Credit*. See chapter 9.

Form 3800. Figure the general business credit on Form 3800, *General Business Credit*. See chapter 9.

Form 4136. Figure the credit for federal tax on gasoline and special fuels on Form 4136, *Credit for Federal Tax Paid on Fuels*. See chapter 18.

Form 4255. Figure the tax from the recapture of investment credit on Form 4255, *Recapture of Investment Credit*. See chapter 9.

Form 4562. Explain the deductions for depreciation and amortization on Form 4562, *Depreciation and Amortization*. See chapter 8.

Form 4684. Report gains and losses from casualty and theft of business and personal-use property on Form 4684, *Casualties and Thefts*. See chapter 13.

Form 4797. Report gains and losses from the sale or exchange of business property and from certain involuntary conversions on Form 4797, *Sales of Business Property*. See chapter 11.

Form 4835. Report on Form 4835, *Farm Rental Income and Expenses*, farm rental income received as a share of crops or livestock produced by a tenant if you, the landlord, did not materially participate in the operation or management of the farm. See chapter 4.

Form 4868. Apply for an extension of time to file your tax return on Form 4868, *Application for Automatic Extension of Time To File U.S. Individual Income Tax Return*. It does not, however, extend the time to pay any tax due.

Form 6251. Figure the alternative minimum tax on Form 6251, *Alternative Minimum Tax—Individuals*. See chapter 14.

Form 8824. Report the exchange of business or investment property for like-kind property on Form 8824, *Like-Kind Exchanges*. It is filed with Schedule D (Form 1040) or Form 4797. See chapter 10.

Other Forms

You may have to file the forms below in certain situations.

Form W-2. If you are in the trade or business of farming and you employ paid workers, prepare Form W-2, *Wage and Tax Statement*, for each employee, including any payment that was not in cash. You must show, in the space marked *Wages, tips, other compensation*, the total paid to the employee. Give copies B and C of Form W-2 to the employee by the last day of January. Send Copy A of each Form W-2 to the Social Security Administration with a completed Form W-3, *Transmittal of Wage and Tax Statements*, by the last day of February. See chapter 16.

Form 940. File Form 940, *Employer's Annual Federal Unemployment (FUTA) Tax Return*, by January 31 of the following year if you were subject to FUTA tax. If all the tax due was deposited by January 31, you can file Form 940 as late as February 10. See chapter 16.

Form 940-EZ. Form 940-EZ is a simplified version of Form 940. See chapter 16.

Form 943. File Form 943, *Employer's Annual Tax Return for Agricultural Employees*, by January 31 of the following year if you were required to withhold and pay withheld income, social security, and Medicare taxes on farm labor wages you paid during the calendar year. If you deposited all the tax due by January 31, you can file Form 943 as late as February 10.

Form 1065. A farm partnership files Form 1065, *U.S. Partnership Return of Income*, by the 15th day of the 4th month following the date the partnership tax year ended, as shown at the top of Form 1065. For calendar year partnerships, the due date is April 15. See *Partnership*, later.

Form 1120. A corporation files Form 1120, *U.S. Corporation Income Tax Return*, by the 15th day of the 3rd month following the date the corporation tax year ended, as shown at the top of Form 1120. For calendar year corporations, the due date is March 15. See *Corporation*, later.

Form 1120-A. Many small corporations can use Form 1120-A, *U.S. Corporation Short-Form Income Tax Return*, instead of Form 1120. They file by the 15th day of the 3rd month following the date the corporation tax year ended, as shown at the top of Form 1120-A. For calendar year corporations, the due date is March 15.

Form 1120S. An S corporation files Form 1120S, *U.S. Income Tax Return for an S Corporation*, by the 15th day of the 3rd month following the date the S corporation tax year ended, as shown at the top of Form 1120S. For calendar year S corporations, the due date is March 15. See *S Corporation*, later.

Form 2290. File Form 2290, *Heavy Highway Vehicle Use Tax Return*, if you use a truck or truck tractor registered in your name for the following purposes.

- To figure and pay the tax due on heavy highway vehicles (taxable gross weight 55,000 pounds or more) used during the period from July 1 to June 30.
- To claim an exemption from the tax when the vehicle is expected to be used 5,000 miles or less (7,500 for agricultural vehicles) during the period.

See the instructions for Form 2290.

Form 8109. Employment taxes not deposited electronically are deposited with Form 8109, *Federal Tax Deposit Coupon*. In general, income tax withheld plus the employer and employee's share of social security and Medicare taxes that total \$1,000 or more for the year must be deposited. The IRS will send you a coupon book for making deposits when you apply for an employer identification number (EIN).



Under certain circumstances you must deposit taxes electronically. See chapter 16.

Form 8822. Notify the IRS of a change in your home or business address with Form 8822, *Change of Address*. Include the suite, room, or other unit number if it is required in the address and send the form to the Internal Revenue Service Center for your old address.

Ordering forms. See chapter 21 for information about getting any of the forms listed in this section.

Information Returns

These returns provide information the IRS requires, other than taxes due. There are many different information returns, including Form W-2, discussed earlier. This discussion, however, is limited to Form 1099-INT, Form 1099-MISC, and Form 1096.

Form 1099-INT. Report interest of \$600 or more paid in the course of your farm business, including interest on installment sale contracts, on Form 1099-INT, *Interest Income*.

Form 1099-MISC. If you make total payments of \$600 or more during the calendar year to another person, other than a corporation, in the course of your farm business, you must file information returns to report these payments. Payments of \$600 or more made for custom harvesting, crop spraying, services of a veterinarian, rents, commissions, fees, prizes, awards, services of an independent contractor, other payments and compensation, and services provided by nonemployees are reported on Form 1099-MISC, *Miscellaneous Income*. Payments of \$10 or more for royalties are also reported on Form 1099-MISC.

Form 1099-MISC is also used to report to the payee and to the IRS payments you made that were subject to backup withholding and the amounts you withheld, regardless of the amount of the payment.

Report payments for compensation to employees on Form W-2, **not** on Form 1099-MISC. See chapter 16.

Preparation of returns. If you are required to file Form 1099-MISC, you must prepare separate copies of the form for each person. File one copy with the IRS. Give each person a statement (or copy of the form) by January 31 of the following year. These forms are read by machine and there are very specific instructions for their preparation and submission. See the *Instructions for Forms 1099, 1098, 5498, and W-2G*.

Form 1096. When sending copies to the IRS, use a separate transmittal, Form 1096, *Annual Summary and Transmittal of U.S. Information Returns*, for each different type of form.

Backup withholding. In certain cases, the law requires you to withhold income tax at a rate of 31% (backup withholding) on payments of commissions, nonemployee compensation, and other payments you make for services in your farm business or other business activities. The backup withholding rules do not apply to wages, pensions, or annuities.

See the *Instructions for Forms 1099, 1098, 5498, and W-2G* for more information.

Penalties. If you file information returns late, without all information required to be on the return, or with incorrect information, you may be subject to a penalty. See the *Instructions for Forms 1099, 1098, 5498, and W-2G* for information on Form 1099 penalties.

Partnership

A partnership is the relationship between two or more persons who join together to carry on a trade or business, including farming. Each person contributes money, property, labor, or skill, and expects to share in the profits and losses.

For federal income tax purposes, the term "partnership" includes a syndicate, group, pool, joint venture, or similar organization carrying on a trade or business and not classified as a trust, estate, or corporation.

Family partnership. Members of the same family can, and often do, form valid partnerships. For instance, a husband and wife or parents and children can conduct a farming enterprise through a partnership. To be recognized as a partnership for federal tax purposes, a partner relationship must be established and certain requirements must be met. For information on these requirements, see *Family Partnership* in Publication 541. Merely doing chores, helping with the harvest, or keeping house and cooking for the family and hired help does not establish a partnership.

If a husband and wife are partners in a farm operation or other business, they should report their partnership income on Form 1065. See *Form 1065*, later.

Co-ownership and sharing expenses. Mere co-ownership of property that is maintained and leased does not constitute a partnership. For example, if an individual owner or tenants-in-common of farm property lease that property for cash rental or a share of the crops, a partnership is not necessarily created by the leasing. However, tenants-in-common may be partners if they actively carry on a

farm or other business operation and share its profits and losses. A joint undertaking merely to share expenses is not a partnership.

Self-employment tax. Unless you are a limited partner, your distributive share of income from a partnership is self-employment income. If you and your spouse are partners, each should report his or her share of partnership income or loss on a separate Schedule SE (Form 1040), *Self-Employment Tax*. This will give each of you credit for social security earnings on which retirement benefits are based. The self-employment tax of a member of a partnership engaged in farming is discussed in chapter 15.

Partner's distributive share. Each partner's distributive share of partnership income, gain, loss, etc., must be included on that partner's tax return, even if the items were not distributed.

Selling or exchanging a partnership. When you create a partnership, you generally do not recognize gain or loss on contributions of money or property you make to the partnership. However, you generally recognize gain or loss when you sell or exchange your interest in the partnership.

You may be able to avoid recognizing gain or loss when ending a partnership if you buy out your partners or change to a corporation status.

Form 1065. Partnerships file a return on Form 1065, *U.S. Partnership Return of Income*. This is an information return showing the income and deductions of the partnership, the name and address of each partner, and each partner's distributive share of income, gain, loss, deductions, credits, etc. No tax is due on Form 1065.

Form 1065 is not required until the first tax year the partnership has income or deductions. In addition, it is not required for any tax year a partnership has no income and expenses.

Schedule F (Form 1040). Use Schedule F (Form 1040) to report a farm partnership profit or loss. This schedule should be filed with Form 1065. The profit or loss shown on Schedule F, adjusted for amounts to be reported on Schedule K-1 and Schedule K of Form 1065, is entered on line 5 of Form 1065.

Other schedules. Each partner's distributive share of partnership items, such as ordinary income or loss, capital gain or loss, net earnings from self-employment, etc., is entered on Schedule K-1 of Form 1065. Fill in all other schedules listed on Form 1065 that apply to you.

Filing penalty. A penalty is assessed against the partnership if the partnership is required to file a partnership return and it does either of the following.

- Fails to file the return on time, including extensions.
- Files a return that fails to show all the information required.

The penalty is \$50 times the total number of partners per month (or part of a month) the return is late or incomplete, up to 5 months.

Exception to filing penalty. A partnership does not have to pay the penalty if it can show reasonable cause for failure to file a return. A small farm partnership with 10 or fewer partners is generally considered to

meet this requirement if it can show the following information.

- All partners have reported their entire share of all partnership items on timely filed income tax returns.
- All partners are individuals (other than nonresident aliens), estates, or C corporations.
- The partnership has not elected to be subject to the rules for “consolidated audit proceedings.”

Consolidated audit procedures. Under current examination procedures, the tax treatment of any partnership item is generally determined at the partnership level in a consolidated audit proceeding, rather than at the individual partner's level. After the proper tax treatment is determined at the partnership level, the IRS can automatically make related adjustments to the tax returns of the partners, based on their share of the adjusted items.

More information. For more information on partnerships, see Publication 541.

Limited Liability Company (LLC)

An LLC is an entity formed under state law by filing articles of organization as an LLC. None of the members of an LLC are personally liable for its debts.

An LLC can be classified as either a partnership or a corporation for federal income tax purposes. See *Corporation*, later, for the rules you must use to determine whether an LLC is treated as a corporation. If an LLC is not treated as a corporation and has 2 or more members, it is treated as a partnership.

Depending on its classification, an LLC would file either Form 1065 or Form 1120. However, if an LLC has a single owner, it would file Schedule C or C-EZ (Form 1040).

If an LLC is treated as a partnership, see Publication 541 for information on partnerships. If it is treated as a corporation, see Publication 542 for information on corporations.

Corporation

The rules you must use to determine whether your business is taxed as a corporation changed for businesses formed after 1996. However, if your business was formed before 1997 and taxed as a corporation under the old rules, it will generally continue to be taxed as a corporation.

Businesses formed after 1996. The following businesses formed after 1996 are taxed as corporations.

- A business formed under a federal or state law that refers to it as a corporation, body corporate, or body politic.
- A business formed under a state law that refers to it as a joint-stock company or joint-stock association.
- An insurance company.
- Certain banks.

- A business wholly owned by a state or local government.
- A business specifically required to be taxed as a corporation by the Internal Revenue Code (for example, certain publicly traded partnerships).
- Certain foreign businesses.
- Any other business that elects to be taxed as a corporation by filing Form 8832.

For more information, see the instructions for Form 8832, *Entity Classification Election*.

Corporate tax. Corporate profits are normally taxed to the corporation. When the profits are distributed as dividends, the dividends are taxed to the shareholders.

In figuring its taxable income, a farm corporation generally takes the same deductions that a noncorporate farmer would claim on Schedule F (Form 1040). Corporations are also entitled to special deductions.

Forming a corporation. A corporation is formed by a transfer of money, property, or both by prospective shareholders in exchange for capital stock in the corporation.

If money is exchanged for stock, no gain or loss is realized by the shareholder or corporation. The stock received by the shareholder has a basis equal to the money transferred to the corporation by the shareholder.

If property is exchanged for stock, it may be either a taxable or nontaxable exchange.

Form 1120 and Form 1120-A. Unless exempt under section 501 of the Internal Revenue Code, all domestic corporations (including corporations in bankruptcy) must file an income tax return whether or not they have taxable income. A corporation must generally file Form 1120 to report its income, gains, losses, deductions, credits, and to figure its income tax liability. However, a corporation may file Form 1120-A if its gross receipts, total income, and total assets are each under \$500,000 and it meets certain other requirements. For more information, see the instructions for Forms 1120 and 1120-A.

More information. For more information on corporations, see Publication 542.

S Corporation

An S corporation is a qualifying corporation that chooses to have its income taxed to the shareholders rather than to the corporation itself, except as noted next under *Taxes*. Its shareholders will then include in income their share of the corporation's nonseparately stated income or loss and separately stated items of income, deduction, loss, and credit.

To make this election, a corporation, in addition to other requirements, must not have more than 75 shareholders. Each of its shareholders must also consent to the election.

Taxes. Although it is generally not liable for federal income tax itself, an S corporation may have to pay the following taxes.

- 1) A tax on:
 - a) Excess passive investment income,
 - b) Certain capital gains, or

- c) Built-in gains.
- 2) The tax from recomputing a prior year's investment credit.
 - 3) LIFO recapture tax.

An S corporation may have to make quarterly estimated tax payments for these taxes.

Form 1120S. An S corporation files its return on Form 1120S.

More information. For more information on S corporations, see the instructions for Form 1120S.

3.

Accounting Periods and Methods

Introduction

Each taxpayer (business or individual) must figure taxable income on an annual accounting period called a tax year. Also, each taxpayer must use a consistent accounting method that accurately accounts for income and expenses. For more detailed information, such as how to change an accounting period or method, see Publication 538, *Accounting Periods and Methods*.

Topics

This chapter discusses:

- Calendar tax year
- Fiscal tax year
- Cash method of accounting
- Accrual method of accounting

Useful Items

You may want to see:

Publication

- 538** Accounting Periods and Methods

Form (and Instructions)

- 1128** Application to Adopt, Change, or Retain a Tax Year
- 3115** Application for Change in Accounting Method

See chapter 21 for information about getting publications and forms.

Accounting Periods

A “tax year” is an annual accounting period for keeping records and reporting income and expenses. Generally, you can use the following tax years.

- 1) A calendar year.
- 2) A fiscal year.

You adopt a tax year when you file your first income tax return. You must adopt your first tax year by the due date (not including extensions) for filing a return for that year.

Calendar year. If you adopt the calendar year as your tax year, you must maintain your books and records and report your income and expenses from January 1 through December 31 of each year.

If you file your first return using the calendar year and you later begin business as a farmer, become a partner in a partnership, or become a shareholder in an S corporation, you must continue to use the calendar year unless you get IRS approval to change it. You must report your income from all sources, including dividends, farm, salary, and partnership, using the same tax year.

Generally, anyone can adopt the calendar year. However, if any of the following apply, you are **required** to adopt the calendar year.

- 1) You do not keep adequate records.
- 2) You have no annual accounting period.
- 3) Your present tax year does not qualify as a fiscal year.

Fiscal year. A fiscal year is 12 consecutive months ending on the last day of any month except December. A fiscal year also includes a tax year that varies from 52–53 weeks. If you adopt a fiscal year, you must maintain your books and records and report your income and expenses using the same tax year.

Partnership, S corporation, or personal service corporation. Special restrictions apply to the tax year that a partnership, an S corporation, or a personal service corporation can adopt. See *Partnerships, S Corporations, and Personal Service Corporations* in Publication 538.

Accounting Methods

An accounting method is a set of rules used to determine when and how income and expenses are reported. The term “accounting method” includes not only the overall method of accounting you use, but also the method of accounting you use for any material item. You must file your tax return using the same method you use for your tax records.

You choose your accounting method when you file your first tax return. However, you cannot use the crop method for any tax return, including your first tax return, unless you get IRS approval. The crop method is discussed later. Getting IRS approval to change an accounting method is discussed later in *Change in Accounting Method*.

You can use any of the following accounting methods.

- 1) Cash method.
- 2) An accrual method.
- 3) Special methods for certain items of income and expenses.
- 4) Combination (hybrid) method using elements of two or more of the above.

If you have two or more separate and distinct trades or businesses, you can use a

different accounting method for each business if you keep a complete and separate set of books and records for each business.

Cash Method

Most farmers use the cash method because they find it easier to keep cash method records. Certain farm corporations and partnerships, or any tax shelter, cannot use the cash method. See *Accrual Method*, later.

Income

Under the cash method, you include all items of income (whether in the form of cash, property, or services) you actually or constructively received during the year in gross income for that year. If you receive property or services, you must include their fair market value in income.

Constructive receipt. Income is constructively received when an amount is credited to your account or made available to you without restriction. You need not have possession of it. The receipt of a check is constructive receipt of money, even if you do not deposit or cash it in the tax year you receive it. An amount credited to your account at a bank, store, grain elevator, etc., is constructively received in the year it is credited.

Installment sale. If you sell an item under a deferred payment contract that calls for payment the following year, there is no constructive receipt in the year of sale. However, see the following example for an exception to this rule.

Example. You are a farmer who uses the cash method and a calendar year. You sell grain in December 1999 under a bona fide arm’s-length contract that calls for payment in 2000. You include the sale proceeds in your 2000 gross income since that is the year payment is received. However, if the contract says that you have the right to the proceeds from the buyer at any time after the grain is delivered, you must include the sale price in your 1999 income, regardless of when you actually receive payment.

Alternative minimum tax. When figuring the alternative minimum tax, a cash basis farmer who sells farm property under the installment method can also use that method to figure his or her alternative minimum taxable income for the year. See the instructions for Form 6251.

Items to include in income. Your gross income for the tax year includes the following.

- 1) Cash and the value of merchandise or other property you receive during the tax year from the sale of livestock, poultry, vegetables, fruits, etc., that you raised.
- 2) Your profit from the sale of any livestock or other items purchased.
 - a) To find your profit, deduct the cost or other basis of the property, plus selling expenses, from the sale proceeds.
 - b) You generally cannot deduct the cost of items purchased for resale in the year paid unless the payment and sale occur in the same year. However, see chapter 5 for information on when to deduct the cost

of chickens, seeds, and young plants.

- 3) Breeding fees, fees from the rent or lease of animals, machinery, or land, and other incidental farm income.
- 4) All subsidy and conservation payments you receive that are considered income.
- 5) Your gross income from all other sources.

Crop insurance proceeds can be reported in income in the year following the year of loss under certain conditions. See *Crop Insurance and Crop Disaster Payments* in chapter 4.

Sales of livestock caused by weather-related conditions can be reported in income in the year following the year of loss or it can be treated as an involuntary conversion under certain conditions. See chapters 4 and 13 for more information.

Expenses

You deduct farm business expenses only in the tax year you pay them. This can include farm business expenses for which you contest the liability. (See *Contested liabilities*, later.) However, you cannot deduct certain prepaid expenses for supplies until they are actually used or consumed. In addition, you can be required to capitalize certain costs. You cannot use an inventory method to figure income on the cash method or deduct certain prepayments. For more information on prepaid supplies, interest, and other expenses, see chapter 5.

Accrual Method

Under an accrual method of accounting, you generally report income in the year earned and deduct or capitalize expenses in the year incurred. If you use an accrual method of accounting, you must use an inventory method to figure your gross income. The purpose of this method of accounting is to match income and expenses in the correct year.

Income

You generally include an amount as income for the tax year in which all events have occurred that fix your right to receive the income and you can determine the amount with reasonable accuracy.

Items to include in income. You figure gross income using increases and decreases in inventory values of livestock, produce, feed, etc., between the beginning of the year and the end of the year. A complete inventory of these items is required for reporting income on an accrual method. For more information on an inventory, see *Farm Inventory*, later.

Do the following to figure gross income on an accrual method.

- 1) Add the following items.
 - a) The sales price of all livestock and other products, such as milk, held for sale and sold during the year.
 - b) Inventory value of livestock and products on hand and not sold at the end of the year.
 - c) Miscellaneous items of income you earn during the year, such as breeding fees, fees from renting or leasing animals, machinery, or land, or other incidental farm income.

- d) Subsidy or conservation payments you receive that are considered income.
- e) Your gross income from all other sources.

2) Then subtract the total of the following.

- a) Inventory value of the livestock and products you had on hand and not sold at the beginning of the year.
- b) Cost of any livestock or products you purchased during the year, including livestock held for draft, dairy, or breeding purposes if they are included in inventory.

Expenses

You generally deduct or capitalize an expense in the tax year when all the following apply.

- 1) The all-events test has been met:
 - a) All events have occurred that fix the fact of liability, and
 - b) The liability can be determined with reasonable accuracy.
- 2) Economic performance has occurred.

You generally cannot deduct or capitalize farm business expenses until economic performance occurs. If your expense is for property or services provided to you, or for your use of property, economic performance occurs as the property or services are provided or the property is used. If your expense is for property or services that you provide to others, economic performance occurs as you provide the property or services. See *Economic Performance* under *Accrual Method* in Publication 538 for more information.

Example 1. John is a farmer who uses a calendar year and an accrual method of accounting. In December 1999 John buys supplies for \$200 that are not acquired for resale and that do not become a physical part of any items held for sale. He receives the supplies and the bill in December 1999, however, he pays the bill in January 2000.

John can deduct the expense in 1999 because all events occurred to fix the liability (the supplies were received but not paid for), the liability can be determined (the unpaid bill was for \$200), and economic performance occurred in 1999 (the supplies were provided to John in December 1999).

Example 2. Jane is a farmer who uses a calendar tax year and an accrual method of accounting. She enters into a turnkey contract with Waterworks in 1999. The contract states that Jane must pay Waterworks \$200,000 in December 1999 and that they will install a complete irrigation system, including a new well, by the close of the year 2001. She pays Waterworks \$200,000 in December 1999, they start the installation in May 2001, and they complete the irrigation system in December 2001.

Economic performance for Jane's liability in the contract occurs as the property and services are provided. Jane incurs the \$200,000 cost in the year 2001.

Accrual Method Required

A C corporation or a partnership with a C corporation partner must generally use an accrual method of accounting. (This rule does not apply to S corporations.) See section 448(a) of the Internal Revenue Code.

Tax shelter. A tax shelter farm business is also required to use an accrual method of accounting unless it is excepted from the rule described later in *Accrual Method Not Required*.

A farm business is a tax shelter if it is a partnership, noncorporate enterprise, or S corporation and:

- 1) Avoidance or evasion of federal income tax is the principal purpose of the entity, **or**
- 2) It is a farming syndicate. An entity is a farming syndicate if:
 - a) Interests in the activity have ever been offered for sale in any offering required to be registered with any federal or state agency with the authority to regulate the offering of securities for sale, or
 - b) More than 35% of the losses during the tax year are allocable to limited partners or limited entrepreneurs.
 - i) A "limited partner" is one whose personal liability for partnership debts is limited to the money or other property the partner contributed or is required to contribute to the partnership.
 - ii) A "limited entrepreneur" is a person who has an interest in an enterprise other than as a limited partner and does not actively participate in the management of the enterprise.

Accrual Method Not Required

The following entities engaged in farming can generally use the cash method of accounting.

- 1) An S corporation.
- 2) A corporation whose gross receipts for each tax year are \$1 million or less.
- 3) A corporation, or partnership with corporate partners, whose trade or business is operating a nursery or sod farm or raising or harvesting trees, other than fruit and nut trees.
- 4) A **family farm corporation** whose annual gross receipts for each tax year beginning after 1985 are \$25 million or less and it qualifies as one of the following corporations in which:
 - a) Members of the same family own at least 50% of the total combined voting power of all classes of stock entitled to vote and at least 50% of the total shares of all other classes of stock of the corporation.
 - b) Members of two families owned, directly or indirectly, on October 4, 1976, and since then, at least 65% of the total combined voting power of all classes of stock entitled to vote and at least 65% of the total shares of all other classes of stock of the corporation.

- c) Members of three families owned, directly or indirectly, on October 4, 1976, and since then, at least 50% of the total combined voting power of all classes of stock entitled to vote and at least 50% of the total shares of all other classes of stock of the corporation. Also, substantially all of the remaining stock must be owned by:
 - i) Corporate employees,
 - ii) Their family members, or
 - iii) A tax-exempt employees' trust for the benefit of the corporation's employees.



A corporation (other than an S corporation) that is also engaged in a nonfarming business activity cannot use the cash method for the nonfarming activity if its average annual gross receipts for the 3 prior tax years are more than \$5 million. For this purpose, "farming business" does not include processing commodities or products beyond those activities normally incident to the growing, raising, or harvesting of the product. For example, processing grain to produce bread and cereal to sell is not a farming business.

Contested liabilities. If you use the cash method of accounting and contest an asserted liability for any of your farm business expenses, you may claim the deduction only in the year you pay the liability. If you are an accrual method taxpayer, however, you can deduct the expense either in the year you pay the contested liability (or transfer money or other property in satisfaction of it) or in the year you finally settle the contest. However, to be able to take the deduction in the year of payment or transfer, you must meet certain conditions. For more information, see *Contested Liability* under *Accrual Method* in Publication 538.

Farm Inventory

You should keep a complete record of your inventory as part of your farm records. This record should show the actual count or measurement of the inventory. It should also show all factors that enter into its valuation, including quality and weight if they are required.

Items to include in inventory. Your inventory should include all items held for sale or use as feed, seed, etc., whether raised or purchased, that are unsold at the end of the year.

Hatchery business. If you are in the hatchery business, you must include eggs in the process of incubation.

Products held for sale. All harvested and purchased farm products held for sale or for feed or seed, such as grain, hay, silage, concentrates, cotton, tobacco, etc., must be included.

Supplies. You must inventory supplies acquired for sale or that become a physical part of items held for sale. Do not include other supplies in inventory. Deduct the cost of the other supplies in the year used or consumed in operations. You can also deduct incidental supplies in the year of purchase.

Fur-bearing animals. If you are in the business of breeding and raising chinchillas, mink, foxes, or other fur-bearing animals, you are a farmer and these animals are livestock.

You can use any of the inventory and accounting methods discussed in this chapter.

Growing crops. You are generally not required to inventory growing crops. However, if the crop has a preproductive period of more than 2 years, you may have to capitalize (or include in inventory) costs associated with the crop. You cannot take a current deduction for costs incurred during the preproductive period. See *Uniform Capitalization Rules* in chapter 7.

Required to use accrual method. If you are required to use an accrual method of accounting:

- 1) The uniform capitalization rules apply to all costs of raising a plant, even if the preproductive period of raising a plant is 2 years or less.
- 2) All animals are subject to the uniform capitalization rules, regardless of age or whether held primarily for slaughter.

Inventory valuation methods. You can generally use the following methods to value your inventory:

- 1) Cost.
- 2) Lower of cost or market.
- 3) Farm-price method.
- 4) Unit-livestock-price method for livestock.

Cost and lower of cost or market methods. See Publication 538 for information on these valuation methods.

Farm-price method. Under this method, each item, whether raised or purchased, is valued at its market price less the direct cost of disposition. Market price is the **current price** at the nearest market in the quantities you usually sell. Cost of disposition includes any broker's commission, freight, hauling to market, and other marketing costs.

If you use this method, you must use it for your entire inventory, except that livestock can be inventoried on the unit-livestock-price method.

Unit-livestock-price method. This method recognizes the difficulty of establishing the exact costs of producing and raising each animal. You group or classify livestock according to type and age and use a standard unit price for each animal within a class or group. The unit price you assign should reasonably approximate the normal costs incurred in producing the animals in such classes. Unit prices and classifications are subject to approval by the IRS on examination of your return. You cannot change them without IRS approval.

If you use this method, you must include all raised livestock in inventory, regardless of whether they are held for sale or for draft, breeding, dairy, or sporting purposes. This method accounts only for the increase in cost of raising an animal to maturity. It does not provide for any decrease in the animal's market value after it reaches maturity. Also, if you raise cattle, you are not required to inventory hay you grow to feed your herd.

Do not include sold or lost animals in the year-end inventory. If your records do not show which animals were sold or lost, treat the first animals acquired as sold or lost. The animals on hand at the end of the year are considered the most recently acquired.

You must include in inventory all livestock purchased primarily for sale. You can include

in inventory livestock purchased for draft, breeding, dairy, or sporting purposes or treat them as depreciable assets. However, you must be consistent from year to year, regardless of the practice you have chosen. You cannot change your practice unless you get IRS approval.

You must inventory animals purchased after maturity or capitalize them at their purchase price. If the animals are not mature at purchase, increase the cost at the end of each tax year according to the established unit price. However, in the year of purchase, do not increase the cost of any animal purchased during the last six months of the year. This rule does not apply to tax shelters, which must make an adjustment for any animal purchased during the year.

Uniform capitalization rules. A farmer can determine costs required to be allocated under the uniform capitalization rules by using the farm-price or unit-livestock-price inventory method. This applies to any plant or animal, even if the farmer does not hold or treat the plant or animal as inventory property.

Cash Versus Accrual Method

The following examples compare the cash and accrual methods of accounting.

Example 1. You are a farmer who uses an accrual method of accounting. You keep your books on the calendar year basis. You sell grain in December 1999, but you are not paid until January 2000. You must include both the sale proceeds and your costs incurred in producing the grain on your 1999 tax return. Under an accrual method of accounting, you report your profit or loss for the year in which all events occurred that fix your right to receive income from the transaction and you can determine your profit or loss with reasonable accuracy.

Example 2. Assume the facts in *Example 1* except that you use the cash method and there was no constructive receipt of the sale proceeds in 1999. Under this method, you include the sale proceeds in income for 2000, the year you receive payment. You deduct the cost of producing the grain in the year you pay it.

Special Methods of Accounting

There are special methods of accounting for certain items of income and expense.

Crop method. If you do not harvest and dispose of your crop in the same tax year you plant it, you can, with IRS approval, use the crop method of accounting. Under this method, you deduct the entire cost of producing the crop, including the expense of seed or young plants, in the year you realize income from the crop.

You cannot use this method for timber or any commodity subject to the uniform capitalization rules.

Other special methods. Methods of accounting for depreciation, depletion, and amortization are explained in chapter 8. Accounting for an installment sale is explained in chapter 12.

Combination (Hybrid) Method

You can generally use any combination of cash, accrual, and special methods of accounting if it clearly shows your income and expenses and you use it consistently. However, the following restrictions apply.

- 1) If an inventory is necessary to account for income, you must use an accrual method for purchases and sales. You can use the cash method for all other items of income and expense. See *Farm Inventory*, earlier.
- 2) If you use the cash method for figuring your income, you must use the cash method for reporting your expenses.
- 3) If you use an accrual method for reporting your expenses, you must use an accrual method for figuring your income.

Any combination that uses the cash method is treated as the cash method.

Change in Accounting Method

When you file your first return you can choose any permitted accounting method except the crop method, discussed earlier, without IRS approval. The method must clearly show your income and be used consistently from year to year. If you want to change your accounting method after that, you must get IRS approval unless you qualify under one of the exceptions described next under *Approval not required*.

A change in your accounting method includes a change in:

- 1) Your overall method, such as from cash to an accrual method or vice versa, and
- 2) Your treatment of any material item, such as a change in your method of valuing inventory (for example, a change from the "farm-price method" to the "unit-livestock-price method").

Approval not required. You do not need IRS approval to change your accounting method in the following situations.

- 1) You value livestock inventory at cost or the lower of cost or market and you change to the unit-livestock-price method.
- 2) You are a **family farm corporation**, described earlier under *Accrual Method Not Required*, and you must change to an accrual method because your annual gross receipts are more than \$25 million. However, for tax years ending before June 9, 1997, you must establish a suspense account to reduce the section 481(a) adjustments you must include in income. In addition, you must ratably phaseout any existing suspense account over a 20-year period beginning with the first tax year after June 8, 1997. For tax years ending after June 8, 1997, you can no longer establish a suspense account to defer reporting the income that results from the change in method of accounting. Rather, you must spread the income adjustment caused by the change in accounting method over a period of 10 years beginning with the year of change. See sections 447(i)(5) and 447(f)(3) of

the Internal Revenue Code for more information.

- 3) You have certain deferred payment sales (DPS) contracts (relating to property used or produced in your trade or business of farming) and you change your method of accounting to the installment method for alternative minimum tax (ATM) purposes. See Revenue Procedure 98-59 in Internal Revenue Bulletin No. 1998-49 for more information.

Approval required. You need IRS approval to change your accounting method before you can do the following.

- 1) Change from cash to an accrual method or vice versa.
- 2) Change the method or basis used to value inventory.
- 3) Adopt any specialized method of computing net income, such as the crop method, or change the use of a specialized method.
- 4) Transfer draft, dairy, or breeding animals from inventory to a fixed asset account.
- 5) Change from reporting loan proceeds from the Commodity Credit Corporation (CCC) as income in the year received to reporting the proceeds as income in the year the crop securing the loan is forfeited or sold.

Form 3115. Generally, you must file a current Form 3115 to get IRS approval to change your accounting method. You must file the form as early as possible during the tax year for which you request the change and you must furnish the applicable information requested on the form. You are required to send a user fee with the form. However, no user fee is required for an automatic change (IRS approval not required). See the form instructions, Revenue Procedure 97-27 in Cumulative Bulletin 1997-1, Revenue Procedure 98-60 in Internal Revenue Bulletin No. 1998-51, and Publication 538 for more information.

If you want to change your method of reporting CCC loans, you must request IRS approval during the first 180 days of the tax year. See Revenue Procedure 83-77 in Cumulative Bulletin 1983-2. See *Commodity Credit Corporation (CCC) Loans* in chapter 4 for information on CCC loans.

Extension of time to file Form 3115. The IRS will grant you an extension only in unusual and compelling circumstances. See Revenue Procedure 97-27 in Cumulative Bulletin 1997-1, Revenue Procedure 99-1 in Internal Revenue Bulletin No. 1999-1, and section 301.9100-3(c)(2) of the regulations for more information. A separate user fee is required for requesting extensions.

4.

Farm Income

Important Reminder

Averaging of farm income. For tax years beginning after 1997, individual farmers can choose to average all or part of their taxable farm income. See *Farm Income Averaging*.

Introduction

You may receive income from many sources. You must report the income on your tax return, unless it is excluded by law. Where you report the income depends on its source.

This chapter discusses farm income you report on Schedule F. For information on where to report other income, see the instructions for Form 1040.

Accounting method. The rules discussed in this chapter assume you use the cash method of accounting. Under the cash method, you generally include an item of income in gross income when you receive it. See *Cash Method* in chapter 3.

If you use an accrual method of accounting, you may have to make changes to the rules in this chapter. See *Accrual Method* in chapter 3.

Topics

This chapter discusses:

- Schedule F
- Sales of livestock and produce
- Rents (including crop shares)
- Agricultural program payments
- Income from cooperatives
- Cancellation of debt
- Income from other sources
- Farm income averaging

Useful Items

You may want to see:

Publication

- 525** Taxable and Nontaxable Income
- 550** Investment Income and Expenses
- 908** Bankruptcy Tax Guide
- 925** Passive Activity and At-Risk Rules

Form (and Instructions)

- Sch E (Form 1040)** Supplemental Income and Loss
- Sch F (Form 1040)** Profit or Loss From Farming
- Sch J (Form 1040)** Farm Income Averaging
- 982** Reduction of Tax Attributes Due to Discharge of Indebtedness

(and Section 1082 Basis Adjustment)

- 1099-G** Certain Government and Qualified State Tuition Program Payments
- 1099-PATR** Taxable Distributions Received From Cooperatives
- 4797** Sales of Business Property
- 4835** Farm Rental Income and Expenses

See chapter 21 for information about getting publications and forms.

Schedule F

Report your farm income on Schedule F (Form 1040). Use this schedule to figure the net profit or loss from regular farming operations.

Income from farming reported on Schedule F includes amounts you receive from cultivating, operating, or managing a farm for gain or profit, either as owner or tenant. This includes income from operating a stock, dairy, poultry, fish, fruit, or truck farm and income from operating a plantation, ranch, range, or orchard. It also includes income from the sale of crop shares if you materially participate in producing the crop. See *Rents (Including Crop Shares)*, later.

Income reported on Schedule F does **not** include gains or losses from sales of the following.

- Land or depreciable farm equipment.
- Buildings and structures.
- Livestock held for draft, breeding, sport, or dairy purposes.

Gains and losses from the sale of farming assets, such as machinery and land, are discussed in chapters 10 and 11. Gains and losses from casualties, thefts, and condemnations are discussed in chapter 13.

Sales of Livestock and Produce

When you sell produce or livestock (including poultry) you raised for sale or bought for resale on your farm, the entire amount you receive is ordinary income. This includes money and the fair market value of any property or services you receive.

Where to report. Table 4-1 shows where to report the sale of produce and livestock on your tax return.

Schedule F. When you sell produce or livestock bought for resale, your profit or loss is the difference between your basis in the item and any money plus the fair market value of any property you receive for it. Basis usually will be your cost. See chapter 7 for information on the basis of assets. Report these amounts on Schedule F for the year you receive payment.

Example. In 1998, you bought 50 feeder calves for \$6,000. You sold them in 1999 for \$11,000. You report the \$6,000 basis, the \$11,000 sales price, and the resulting \$5,000 profit in Part 1 of your 1999 Schedule F.

Table 4-1. Where To Report Sales of Livestock and Produce

Item Sold	Schedule F	Form 4797
Livestock and produce raised for sale	X	
Livestock and produce bought for resale	X	
Livestock held for draft, breeding, dairy, or sporting purposes (bought or raised)		X
Animals not held primarily for sale		X

Form 4797. Sales of livestock held for draft, breeding, dairy, or sporting purposes may result in ordinary or capital gains or losses, depending on the circumstances. In either case, **you should always report these sales on Form 4797 instead of Schedule F.** Animals you do not hold primarily for sale are considered business assets of your farm. See *Livestock* under *Ordinary or Capital Gain or Loss* in chapter 10.

Sale by agent. If your agent sells your produce or livestock, you must include the net proceeds from the sale in gross income for the year the agent receives payment. This applies even if you arrange for the agent to pay you in a later year. See *Constructive receipt* under *Cash Method* in chapter 3.

Sales Caused by Weather-Related Conditions

If you sell more livestock, including poultry, than you normally would in a year because of a drought, flood, or other weather-related condition, you may be able to choose to include the gain from selling the additional animals in the following year's income. You must meet all the conditions below to qualify.

- Your principal trade or business is farming.
- You use the cash method of accounting.
- You can show that, under your usual business practices, you would not have sold the animals this year except for the weather-related condition.
- The weather-related condition resulted in an area being designated as eligible for assistance by the federal government.

Sales made before the area became eligible for federal assistance qualify if the weather-related condition that caused the sale also caused the area to be designated as eligible for federal assistance. The designation can be made by the President, the Department of Agriculture (or any of its agencies), or by other federal agencies.



A weather-related sale of livestock (other than poultry) held for draft, breeding, or dairy purposes also qualifies as an involuntary conversion. If you plan to replace the livestock, see Other Involuntary Conversions in chapter 13 for more information.

Usual business practice. Determine the number of animals you would have sold had you followed your usual business practice in the absence of the weather-related condition. Do this by considering all the facts and circumstances. If you have not yet established a usual business practice, rely on the usual business practices of similarly situated farmers in your general region.

Weather-related sales in successive years. If you make this choice in successive years, the following special rules prevent your choice in the first year from adversely affecting your choice in the second year.

- Do not include the amount deferred from one year to the next as received from the sale or exchange of livestock in the later year when figuring the amount to be postponed. See *Amount to be postponed*, later, which describes the computation.
- To determine your normal business practice for the later year, exclude any earlier year for which you made this choice.

Connection with area affected by weather-related condition. The livestock does not have to be raised or sold in an area affected by a weather-related condition for the postponement to apply. However, the sale must occur solely because of weather-related conditions that affected the water, grazing, or other requirements of the livestock so that the sale became necessary.

Classes of livestock. You must make the choice separately for each generic class of animals — for example, hogs, sheep, and cattle. You must also figure separately the amount to be postponed for each class of animals. Do not make a separate choice solely because of an animal's age, sex, or breed.

Amount to be postponed. Follow these steps to figure the amount to be postponed for each class of animals.

- 1) Divide the total income realized from the sale of all livestock in the class during the tax year by the total number of such livestock sold.
- 2) Multiply the result in (1) by the excess number of such livestock sold solely because of weather-related conditions.

Example. You are a calendar year taxpayer and you normally sell 100 head of beef cattle a year. As a result of drought, you sold 135 head during 1999. You realized \$35,100 from the sale. On August 9, 1999, as a result of drought, the affected area was declared a disaster area eligible for federal assistance. The income you can choose to postpone until 2000 is \$9,100 [(\$35,100 ÷ 135) × 35].

How to make the choice. To make the choice, attach a statement to your tax return for the year of the sale. The statement must include your name and address and give the following information for each class of livestock for which you make the choice.

- A statement that you are making a choice under section 451(e) of the Internal Revenue Code.
- Evidence of the weather-related conditions that forced the early sale or exchange of the livestock and the date, if known, on which an area was designated as eligible for assistance by the federal government because of weather-related conditions.
- A statement explaining the relationship of the area affected by the weather-related condition to your early sale or exchange of the livestock.
- The number of animals sold in each of the 3 preceding years.
- The number of animals you would have sold in the tax year had you followed your normal business practice.
- The total number of animals sold and the number sold because of weather-related conditions during the tax year.
- A computation, as described earlier, of the income to be postponed for each class of livestock.

You must file the statement and the return by the due date of the return, including extensions. If you timely filed your return for the year without making the choice, you can still make the choice by filing an amended return within six months of the due date of the return (excluding extensions). Attach the statement to the amended return and write "Filed pursuant to section 301.9100-2" at the top of the statement. File the amended return at the same address you filed the original return. Once you have made the choice, you can change it only with the approval of the IRS.

Rents (Including Crop Shares)

The rent you receive for the use of your farm land is generally rental income, not farm income. However, if you materially participate in farming operations on the land, the rent is farm income. See *Landlord Participation in Farming* in chapter 15.

Pasture income and rental. If you pasture someone else's cattle and take care of the livestock for a fee, the income is from your farming business. You must enter it as *Other income* on Schedule F. If you simply rent your pasture for a flat cash amount without providing services, report the income as rent in Part I of Schedule E (Form 1040).

Crop Shares

You must include rent you receive in the form of crop shares in income in the year you convert the shares to money or the equivalent of money. It does not matter whether you use the cash method of accounting or an accrual method of accounting. If you materially participate in operating a farm from which you receive rent in the form of crop shares or livestock, the rental income is subject to self-employment tax. (See *Landlord Participation in Farming* in chapter 15.) Report the rental income on Schedule F.

If you do not materially participate in operating the farm, report this income on Form 4835 and carry the net income or loss to

Schedule E (Form 1040). The income is not subject to self-employment tax.

Crop shares you use to feed livestock.

Crop shares you receive as a landlord and feed to your livestock are considered converted to money when fed to the livestock. You must include the fair market value of the crop shares in income at that time. You are entitled to a business expense deduction for the livestock feed in the same amount and at the same time you include the fair market value of the crop share as rental income. Although these two transactions would cancel each other for figuring adjusted gross income on Form 1040, they may be necessary to figure your self-employment tax. See chapter 15.

Crop shares you give to others (gift).

Crop shares you receive as a landlord and give to others are considered converted to money when you make the gift. You must report the fair market value of the crop share as income, even though someone else receives payment for the crop share.

Example. A tenant farmed part of your land under a crop-share arrangement. The tenant harvested and delivered the crop in your name to an elevator company. Before selling any of the crop, you instructed the elevator company to cancel your warehouse receipt and make out new warehouse receipts in equal amounts of the crop in the names of your children. They sell their crop shares in the following year and the elevator company makes payments directly to your children.

In this situation, you are considered to have received rental income and then made a gift of that income. You must include the fair market value of the crop shares in your income for the tax year you gave the crop shares to your children.

Crop share loss. If you are involved in a rental or crop-share lease arrangement, any loss from these activities may be subject to the limits under the passive loss rules. See Publication 925 for information on these rules.

Agricultural Program Payments

You must include in income most government payments, such as those for approved conservation practices and production flexibility contracts, whether you receive them in cash, materials, services, or commodity certificates. However, you can exclude some payments you receive under certain cost-sharing conservation programs. See *Cost-Sharing Exclusion (Improvements)*, later.

Report the agricultural program payment on the appropriate line in Part I of Schedule F. Report the full amount even if you return a government check for cancellation, refund any of the payment you receive, or the government collects all or part of the payment from you by reducing the amount of some other payment or Commodity Credit Corporation loan. However, you can deduct the amount you refund or return or that reduces some other payment or loan to you. Claim the deduction on Schedule F for the year of payment or reduction.

Refunds of Agricultural Program Expenses

Refunds of malting barley assessments.

A farmer who participates in the malting barley production program of the Commodity Credit Corporation (CCC) receives a barley subsidy benefit and pays a malting barley assessment. The barley subsidy benefit is reported to the farmer and to the IRS on Form CCC-1099-G, *Certain Government Payments*. If the farmer does not sell the barley for malting purposes, the farmer is eligible to receive a refund of the malting barley assessment. If the farmer receives the refund in a year after the assessment was paid, how the farmer reports the refund depends on whether the farmer claimed the assessment as an expense in the year it was paid. The following example shows how to report refunds of malting barley assessments.

Example. Lee White is a farmer. He uses the cash method of accounting and files his tax return on a calendar year basis. He participated in the malting barley production program and received a \$2,850 payment from the CCC in 1998. The payment was Lee's \$3,000 barley subsidy benefit less the malting barley assessment (\$150) he had to pay for the barley produced. Lee received a Form CCC-1099-G for 1998 showing the \$3,000 barley subsidy benefit. In 1999, Lee proved that he did not sell the barley for malting purposes and received a refund of the \$150 malting barley assessment. He receives a 1999 Form CCC-1099-G for the refund showing a "Barley Assessment Deficiency" of \$150.

Assessment claimed as an expense.

For 1998, Lee reported \$3,000 of farm income from the barley subsidy benefit. He claimed the \$150 malting barley assessment as a farm expense in Part II of his 1998 Schedule F (Form 1040). Lee received a tax benefit from the deduction because it reduced his 1998 tax liability. Lee includes the \$150 refund (barley assessment deficiency) as income in Part I of his 1999 Schedule F (Form 1040).

Assessment not claimed as an expense.

For 1998, Lee reported the \$3,000 barley subsidy benefit as income, but did not claim the \$150 assessment as an expense. Because Lee received no tax benefit from the payment of the assessment in 1998, he does not include the refund (barley assessment deficiency) as income for 1999. He includes the \$150 refund on line 6a of Schedule F, but does not include it as a taxable amount on line 6b.

Payments made under the Dairy Refund Payment Program (DRPP).

The DRPP, administered by the CCC, refunds the reductions in price received by eligible producers during a calendar year. Milk processors, milk handlers, and others responsible for the marketing of milk withhold the reductions in price from their payments to the producers and send the withheld amounts to the CCC. If the producer can prove that milk marketing for the current year was not more than milk marketing for the prior year, the producer is eligible for a refund of the reductions in price. Typically, an eligible producer receives a refund of the reductions in price in a year after the reductions occurred. Proper reporting of

the refund depends on whether the producer claimed the reductions in price as an expense in the year they occurred. The following example shows how to report refunds of reductions in price.

Example. Sam Brown is a milk producer. He uses the cash method of accounting and files his tax return on a calendar year basis. The marketing of Sam's milk is subject to reductions in price. In 1998, Sam had gross receipts of \$200,000 from milk sales and had \$3,000 withheld as reductions in price. Sam proved that his 1998 milk marketing was not more than his 1997 marketing. In 1999, Sam received a \$3,000 refund from the CCC of the 1998 reductions in price. Sam receives a 1999 Form CCC-1099-G for the refund showing a "Milk Marketing Fee" of \$3,000.

Reductions claimed as an expense.

For 1998, Sam reported \$200,000 of farm income from milk sales. He claimed the \$3,000 reductions in price as a farm expense in Part II of his 1998 Schedule F (Form 1040). Sam received a tax benefit from the deduction because it reduced his 1998 tax liability. Sam includes the \$3,000 refund (milk marketing fee) as income in Part I of his 1999 Schedule F (Form 1040).

Reductions not claimed as an expense.

For 1998, Sam reported milk sales income of \$200,000, but did not claim the reductions in price for his milk as an expense. Because Sam received no tax benefit from the reductions in price in 1998, he does not include the refund (milk marketing fee) as income for 1999. He includes the \$3,000 refund on line 6a of Schedule F, but does not include it as a taxable amount on line 6b.

Commodity Credit Corporation (CCC) Loans

Normally, you do not report loans you receive as income, and you report income from a crop for the year you sell it. However, if you pledge part or all of your production to secure a CCC loan, you can choose to treat the loan as if it were a sale of the crop and report the loan proceeds as income for the year you receive them. You do not need permission from the IRS to adopt this method of reporting CCC loans, even though you may have reported those received in earlier years as taxable income for the year you sold the crop.

Once you report a CCC loan as income for the year received, you must report all CCC loans in that year and later years in the same way, unless you get permission from the IRS to change to a different method. See *Change in Accounting Method* in chapter 3.

TIP You can request income tax withholding on CCC loan payments made to you. Use Form W-4V, Voluntary Withholding Request. See chapter 21 for information about ordering the form.

To make the choice to report a loan as income, include the loan as income on line 7a of Schedule F for the year you receive it. Attach a statement to your return showing the details of the loan.

When you make this choice, the amount you report as income becomes your basis in the commodity. See chapter 7 for information on the basis of assets. If you later repay the loan, redeem the pledged commodity, and sell it, you report as income at the time of sale the sale proceeds *minus* your basis in the commodity. If the sale proceeds are less than

your basis in the commodity, you can report the difference as a loss on Schedule F.

If you forfeit the pledged crops to the CCC in full payment of the loan, the forfeiture is treated for tax purposes as a sale of the crops. If you did not choose to report the loan proceeds as income for the year you received them, you must include them in your income for the year of the forfeiture. If you chose to report the loan proceeds as income for the year you received them, and the amount of the forfeited loan is less than your basis in the commodity, you can report the difference as a loss on Schedule F.

Market Gain

Under the CCC nonrecourse marketing assistance loan program, your repayment amount for a loan secured by your pledge of an eligible commodity is generally based on the lower of the loan rate or the prevailing world market price for the commodity on the date of repayment. If you repay the loan when the world price is lower, the difference between that repayment amount and the repayment amount based on the loan rate is market gain. You will receive a Form CCC-1099-G, *Certain Government Payments*, showing the market gain you realized. If you chose to include the CCC loan in income in the year you received it, do not include the amount shown on Form CCC-1099-G in income. The following examples show how to report market gain.

Example 1. Mike Green is a cotton farmer. He uses the cash method of accounting and files federal income tax returns on a calendar year basis. He has currently deducted all expenses incurred in producing the cotton and has a zero basis in the commodity. In 1998, Mike pledged 1,000 pounds of cotton as collateral for a CCC price support loan of \$500 (a loan rate of \$.50 per pound). In 1999, he repaid the loan and redeemed the cotton for \$420 when the world price was \$.42 per pound. Later in 1999, he sold the cotton for \$600.

The market gain on the redemption was \$.08 (\$.50 - \$.42) per pound. Mike received a Form CCC-1099-G from the CCC showing market gain of \$80 (\$.08 x 1,000 pounds). How he reports this market gain and figures his gain or loss from the sale of the cotton depends on whether he chose to include CCC loans in income in 1998.

With choice. Because Mike reported the \$500 CCC loan as income for 1998, he is treated as though he sold the cotton for \$500 when he pledged it and repurchased the cotton for \$420 when he redeemed it. The \$80 market gain is not recognized on the redemption. He reports it for 1999 as an "Agricultural program payment" on line 6a of Schedule F, but does not include it on line 6b as taxable income.

Mike's basis in the cotton after he redeemed it was \$420, which is the redemption (repurchase) price paid for the cotton. His gain from the sale is \$180 (\$600 - \$420). He reports it as income for 1999 on line 4 of Schedule F.

Without choice. Mike has income of \$80 from market gain in 1999. He reports it on both line 6a and line 6b of Schedule F. Because his basis in the cotton is zero, his gain from its sale is \$600. He reports the \$600 gain as income for 1999 on line 4 of Schedule F.

Example 2. The facts are the same as in Example 1 except that, instead of selling the cotton for \$600 after redeeming it, Mike entered into an option-to-purchase contract with Tom Merchant before redeeming the cotton. Under that contract, Mike authorized Tom to pay the CCC loan on Mike's behalf. In 1999, Tom repaid the loan for \$420 and immediately exercised his option, buying the cotton for \$420. How Mike reports the \$80 market gain on the redemption of the cotton and figures his gain or loss from its sale depends on whether he chose to include CCC loans in income in 1998.

With choice. As in Example 1, Mike is treated as though he sold the cotton for \$500 when he pledged it and repurchased the cotton for \$420 when Tom redeemed it for him. The \$80 market gain is not recognized on the redemption. Mike reports it for 1999 as an "Agricultural program payment" on line 6a of Schedule F, but does not include it on line 6b as taxable income.

Also as in Example 1, Mike's basis in the cotton when Tom redeemed it for him was \$420. Therefore, Mike has no gain or loss on its sale to Tom for that amount.

Without choice. As in Example 1, Mike has income of \$80 from market gain in 1999. He reports it on both line 6a and line 6b of Schedule F. Because his basis in the cotton is zero, his gain from its sale is \$420. He reports it as income for 1999 on line 4 of Schedule F.

Conservation Reserve Program (CRP)

Under the Conservation Reserve Program (CRP), if you own or operate highly erodible or other specified cropland, you may enter into a long-term contract with the USDA, agreeing to convert to a less intensive use of that cropland. You must include payments under the program in your income, whether received in cash, commodity certificates, or a combination of cash and certificates.

Crop Insurance and Crop Disaster Payments

You must include in income any crop insurance proceeds you receive as the result of crop damage. You generally include them in the year you receive them. Treat as crop insurance proceeds the crop disaster payments you receive from the federal government as the result of destruction or damage to crops, or the inability to plant crops, because of drought, flood, or any other natural disaster.



TIP You can request income tax withholding from crop disaster payments you receive from the federal government. Use Form W-4V, Voluntary Withholding Request. See chapter 21 for information about ordering the form.

Choice to postpone reporting until the following year. If you use the cash method of accounting and receive crop insurance proceeds in the same tax year in which the crops are damaged, you can choose to postpone reporting the proceeds as income until the following tax year. You can make this choice if you can show you would have included income from the damaged crops in

any tax year following the year the damage occurred.

To choose to postpone reporting crop insurance proceeds received in 1999, report the amount you received on line 8a of Schedule F, but do not include it as taxable income on line 8b. Check the box on line 8c and attach a statement to your tax return. The statement must include your name and address and contain the following information.

- A statement that you are making a choice under section 451(d) of the Internal Revenue Code and section 1.451-6 of the regulations.
- The specific crop or crops destroyed or damaged.
- A statement that under your normal business practice you would have included income from the destroyed or damaged crops in gross income for a tax year following the year the crops were destroyed or damaged.
- The cause of the destruction or damage and the date or dates it occurred.
- The total amount of payments you received from insurance carriers, itemized for each specific crop, and the date you received each payment.
- The name of each insurance carrier from whom you received payments.

One choice covers all crops representing a single trade or business. If you have more than one farming business, make a separate choice for each one. For example, if you operate two separate farms on which you grow different crops, and you keep separate books for each farm, you should make two separate choices to postpone reporting insurance proceeds you receive for crops grown on each of your farms.

A choice is binding for the year. To request IRS approval to change your choice, write to your IRS District Director giving your name, address, identification number, the year you made the choice, and your reasons for wanting to change it.

Feed Assistance and Payments

The Disaster Assistance Act of 1988 authorizes programs to provide feed assistance, reimbursement payments, and other benefits to qualifying livestock producers if the Secretary of Agriculture determines that, because of a natural disaster, a livestock emergency exists. These programs include partial reimbursement for the cost of purchased feed and for certain transportation expenses. They also include the donation or sale at a below-market price of feed owned by the Commodity Credit Corporation.

You must include these benefits in income in the year you receive them. You cannot postpone reporting them under the rules explained earlier for weather-related sales of livestock or crop insurance proceeds. Report the benefits in Part I, Schedule F, as agricultural program payments.

Include in income the market value of donated feed, the difference between the market value and the price you paid, or any cost reimbursement you receive. You can usually take a current deduction for the same amount as a feed expense.

Cost-Sharing Exclusion (Improvements)

You can exclude from your income part or all of a payment you receive under certain federal or state cost-sharing conservation, reclamation, and restoration programs. The "payment" is any economic benefit you get as a result of an improvement. However, this exclusion applies only to that part of a payment that meets all three of the following tests.

- It was for a capital expense. You cannot exclude any part of a payment for an expense you can deduct in the year you pay or incur it. You must include the payment in income and take any offsetting deduction. (See chapter 6 for information on deducting soil and water conservation expenses.)
- It does not substantially increase your annual income from the property for which it is made. An increase in annual income is substantial if it is more than the greater of 10% of the average annual income derived from the affected property before receiving the improvement or an amount equal to \$2.50 times the number of affected acres.
- The Secretary of Agriculture certified that the payment was made primarily for conserving soil and water resources, protecting or restoring the environment, improving forests, or providing a habitat for wildlife.

If the three tests above are met, you can exclude payments from the following programs.

- The rural clean water program authorized by the Federal Water Pollution Control Act.
- The rural abandoned mine program authorized by the Surface Mining Control and Reclamation Act of 1977.
- The water bank program authorized by the Water Bank Act.
- The emergency conservation measures program authorized by title IV of the Agricultural Credit Act of 1978.
- The agricultural conservation program authorized by the Soil Conservation and Domestic Allotment Act.
- The great plains conservation program authorized by the Soil Conservation and Domestic Policy Act.
- The resource conservation and development program authorized by the Bankhead-Jones Farm Tenant Act and by the Soil Conservation and Domestic Allotment Act.
- The forestry incentives program authorized by the Cooperative Forestry Assistance Act of 1978.
- Certain small watershed programs, listed below.
- Any program of a state, possession of the United States, a political subdivision of any of these, or the District of Columbia under which payments are made to individuals primarily for conserving soil, protecting or restoring the environment, improving forests, or providing a habitat for wildlife. Several state programs have

been approved. For information about the status of those programs, contact the state offices of the Farm Service Agency (FSA) and the Natural Resources and Conservation Service (NRCS).

You can exclude payments you receive under the following programs for improvements made in connection with a watershed.

- The Stewardship Incentive Program under title XII of the Food, Agriculture, Conservation, and Trade Act of 1990.
- The programs under the Watershed Protection and Flood Prevention Act of 1954.
- The flood prevention projects under the Flood Control Act of 1944.
- The Emergency Watershed Protection Program under the Flood Control Act of May 17, 1950.
- Certain programs under the Colorado Basin Salinity Act of 1974.
- The wetlands reserve program authorized by title XII of the Food Security Act of 1985 and by the Federal Agriculture Improvement and Reform Act of 1996.
- The environmental quality incentive program authorized by the Federal Agriculture Improvement and Reform Act of 1996.
- The wildlife habitat incentives program authorized by the Federal Agriculture Improvement and Reform Act of 1996.

Income realized. The gross income you realize upon getting an improvement under these cost-sharing programs is the value of the improvement reduced by the sum of the excludable portion and your share of the cost of the improvement.

Value of the improvement. You determine the value of the improvement by multiplying its fair market value (defined in chapter 12) by a fraction. The numerator of the fraction is the total cost of the improvement (all amounts paid either by you or by the government for the improvement), reduced by the sum of the following three items.

- 1) Any government payments under a program not listed earlier.
- 2) Any portion of a government payment under a program listed earlier that the Secretary of Agriculture has not certified as primarily for purposes of conservation.
- 3) Any government payment to you for rent or for your services.

The denominator of the fraction is the total cost of the improvement.

Excludable portion. The excludable portion is the present fair market value of the right to receive annual income from the affected acreage of the greater of the following amounts.

- 1) 10% of the prior average annual income from the affected acreage. The "prior average annual income" is the average of the gross receipts from the affected acreage for the last 3 tax years before the tax year in which you started to install the improvement.
- 2) \$2.50 times the number of affected acres.



The calculation of "present fair market value" is too complex to discuss in this publication. You may need to consult your tax advisor for assistance.

Example. One hundred acres of your land was reclaimed under a contract with the Natural Resources Conservation Service of the USDA. The total cost of the improvement was \$500,000. The USDA paid \$490,000. You paid \$10,000. The value of the cost-sharing improvement is \$15,000.

The present fair market value of the right to receive (1) above is \$1,380 and the value of the right to receive (2) is \$1,550. The excludable portion is the greater amount, \$1,550.

You figure the amount to include in gross income as follows:

Value of cost-sharing improvement	\$15,000
Minus: Your share	\$10,000
Excludable portion	<u>1,550</u>
Amount included in income	<u>\$3,450</u>

Effects of the exclusion. When you figure the basis of property you acquire or improve using cost-sharing payments excluded from income, subtract the excluded payments from your capital costs. Any payment excluded from income is not part of your basis.

In addition, you cannot take depreciation, amortization, or depletion deductions for the part of the cost of the property for which you receive cost-sharing payments you exclude from income.

How to report the exclusion. Attach a statement to your tax return (or amended return) for the tax year you receive the last government payment for the improvement. The statement must include the following items.

- The dollar amount of the cost funded by the government payment.
- The value of the improvement.
- The amount you are excluding.

Report the total cost-sharing payments you receive on line 6a, Schedule F, and the taxable amount on line 6b.

Recapture. If you dispose of the property within 20 years after you get it, you must treat as ordinary income part or all of the cost-sharing payments you excluded. You must report the recapture on Form 4797. See *Section 1255 property* under *Other Farm Property* in chapter 11.

Choosing not to exclude payments. You can choose **not** to exclude all or part of any payments you receive under these programs. You must make this choice by the due date, including extensions, for filing your return. If you timely filed your return for the year without making the choice, you can still make the choice by filing an amended return within six months of the due date of the return (excluding extensions). Write "Filed pursuant to section 301.9100-2" at the top of the amended return and file it at the same address you filed the original return. If you choose not to exclude these payments, none of the above restrictions and rules apply.

Other Payments

You must include other government program payments in income as explained below.

Fertilizer and Lime

Include in income the value of fertilizer or lime you received under a government program. How you claim the offsetting deduction is explained under *Fertilizer and Lime* in chapter 5.

Improvements

If government payments are based on improvements, such as a pollution control facility, you must still include them in income. You must capitalize the full cost of the improvement. Since you have included the payments in income, they do not reduce your basis. However, see *Cost-Sharing Exclusion (Improvements)* earlier, for additional information.

Payment to More Than One Person

The USDA reports program payments to the IRS. It reports a program payment intended for more than one person as having been paid to the person whose identification number is on record for that payment (payee of record). If you, as the payee of record, receive a program payment belonging to someone else, such as your landlord, the amount belonging to the other person is a nominee distribution. You should file Form 1099-G to report the identity of the actual recipient to the IRS. You should also give this information to the recipient. You can avoid the inconvenience of unnecessary inquiries about the identity of the recipient if you file this form.

See chapter 21 for information about ordering Form 1099-G.

Income From Cooperatives

If you buy farm supplies through a cooperative, you may receive income from the cooperative in the form of patronage dividends (distributions). If you sell your farm products through a cooperative, you may receive patronage dividends or a per-unit retain certificate, explained later, from the cooperative.

Form 1099-PATR. The cooperative will report the income to you on Form 1099-PATR or a similar form and send a copy to the IRS. Form 1099-PATR may also show an alternative minimum tax adjustment that you must include if you are required to file Form 6251, *Alternative Minimum Tax—Individuals*.

Patronage Dividends (Distributions)

You generally report patronage dividends you receive as income on lines 5a and 5b of Schedule F for the tax year you receive them. They include the following items.

- Money paid as a patronage dividend.
- The stated dollar value of qualified written notices of allocation.
- The fair market value of other property.

Qualified written notice of allocation. A qualified written notice of allocation is taxable at its stated dollar value in the year received. To be qualified, it must be paid as part of a patronage dividend, or a payment by a cooperative, in which 20% or more of the dividend or payment is paid in money or a qualified check. It must also meet one of the following conditions.

- 1) It must be redeemable in cash for at least 90 days after it is issued, and you must have received a written notice of your right of redemption at the same time as the written notice of allocation.
- 2) You must have agreed to include the stated dollar value in income in the year you receive the notice by doing one of the following.
 - a) Signing and giving a written agreement to the cooperative.
 - b) Getting or keeping membership in the cooperative after it adopted a bylaw providing that membership constitutes agreement. The cooperative must notify you in writing of this bylaw and give you a copy.
 - c) Endorsing and cashing a qualified check, paid as part of the written notice of allocation, by the 90th day after the close of the payment period for the tax year of the cooperative.

Loss on redemption. You can deduct in Part II of Schedule F any loss incurred on the redemption of a qualified written notice of allocation you received in the ordinary course of your farming business. The loss is the difference between the stated dollar amount of the qualified written notice you included in income and the amount you received when you redeemed it.

Nonqualified notices of allocation. Any written notices of allocation that do not meet the conditions explained earlier under *Qualified written notice of allocation* are nonqualified notices. Do not include the stated dollar value of nonqualified notices in income when you receive them. Your basis in a nonqualified notice of allocation is zero. You must include in income for the tax year of disposition any amount you receive from the sale, redemption, or other disposition of a nonqualified written notice. Include it, up to the stated dollar value of the notice, as ordinary income in Part I of Schedule F. You must include any amount that is more than the stated dollar value as the type of income it represents. For example, if it represents interest income, include it on your return as interest.

Purchase of depreciable property or capital assets. Do not include in income dividends from the purchase of capital assets or depreciable property used in your business. You must, however, reduce the basis of these assets by the dividends. If the dividends are more than your unrecovered cost, include the difference as ordinary income on Schedule F for the tax year you receive them. Include all these dividends on line 5a of Schedule F, but include only the taxable part on line 5b.

Example. On July 1, 1998, Mr. Brown, a patron of a cooperative association, bought a machine for his dairy farm business from

the association for \$2,900. The machine has a life of 7 years under MACRS (as provided in the *Table of Class Lives and Recovery Periods* in Publication 946). Mr. Brown files his return on a calendar year basis. For 1998, he claimed a depreciation deduction of \$311, using the 10.71% depreciation rate from the 150% declining balance, half-year convention table (shown in *Table A-14* in Appendix A of Publication 946). On July 1, 1999, the cooperative association paid Mr. Brown a \$300 cash patronage dividend for his purchase of the machine. Mr. Brown adjusts the basis of the machine and figures his depreciation deduction for 1999 (and later years) as follows.

Cost of machine on July 1, 1998	\$2,900
Minus: 1998 depreciation	\$311
1999 cash dividend	300
Adjusted basis for depreciation for 1999:	<u>\$2,289</u>

Depreciation rate: $1 + 6\frac{1}{2}$ (remaining recovery period as of 1/1/99) = $15.38\% \times 1.5 = 23.08\%$

Depreciation deduction for 1999 (\$2,289 \times 23.08%)	<u>\$528</u>
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Exceptions. If the dividends come from the selling or buying of capital assets or depreciable property used in your business and you did not own the property at any time during the year you received them, you must include the dividends in income unless one of the following two exceptions applies.

- If the dividends relate to a capital asset you held for more than 1 year for which a loss was or would have been deductible, treat them as gain from the sale or exchange of a capital asset held for more than 1 year.
- If the dividends relate to a capital asset for which a loss was not or would not have been deductible, do not report them as income (ordinary or capital gain).

If you receive a dividend from selling a capital asset or depreciable property used in your business in the same year the asset was sold, treat it as an additional amount received on the sale or other disposition of the asset.

If you cannot determine from which item the dividend comes, include the dividend in income as ordinary income.

Personal purchases. Omit from the taxable amount of patronage dividends on line 5b of Schedule F any dividends from buying personal, living, or family items, such as supplies, equipment, or services not related to the production of farm income. This rule also applies to amounts from the sale, redemption, or other disposition of a nonqualified written notice of allocation resulting from these purchases.

Per-Unit Retain Certificates

A per-unit retain certificate is any written notice that shows the stated dollar amount of a per-unit retain allocation made to you by the cooperative. A per-unit retain allocation is an amount paid to patrons for products sold for them that is fixed without regard to the net earnings of the cooperative. These allocations can be paid in money, other property, or qualified certificates.

Per-unit retain certificates issued by a cooperative generally receive the same tax treatment as patronage dividends, discussed earlier.

Qualified certificates. Qualified per-unit retain certificates are those issued to patrons who have agreed in writing, or in effect have agreed by getting or keeping membership in a cooperative whose bylaws or charter state that membership constitutes agreement, to include the stated dollar amount of these certificates in income in the year of receipt. If you receive qualified per-unit retain certificates, include the stated dollar amount of the certificates in income in Part I of Schedule F for the tax year you receive them.

Nonqualified certificates. All other per-unit retain certificates are nonqualified certificates. Do not include the stated dollar value of a nonqualified certificate in income when you receive it. Your basis in the certificate is zero. You must include in income any amount you receive from its sale, redemption, or other disposition. Report the amount you receive as ordinary income in Part I of Schedule F for the tax year of disposition.

Cancellation of Debt

If a federal agency, financial institution, or credit union cancels or forgives a debt you owe of \$600 or more, you will receive a Form 1099-C, *Cancellation of Debt*. The amount of the canceled debt is shown in box 2.

General Rule

Generally, if a debt you owe is canceled or forgiven, other than as a gift or bequest to you, you must include the canceled amount in gross income for tax purposes. A debt includes any debt for which you are liable or which attaches to property you hold.

Exceptions

The following discussion covers some exceptions to the general rule for canceled debt.

Price reduced after purchase. If you owe a debt to the seller for property you bought, and the seller reduces the amount you owe, generally you do not have income from the reduction. Unless you are in bankruptcy or are insolvent, treat the part of the debt reduced as a purchase price adjustment and reduce your basis in the property. The rules that apply to bankruptcy and insolvency are explained under *Exclusions*, later.

Deductible debt. You do not realize income from debt cancellation to the extent the payment of the debt would have led to a deduction.

Example. You own a business and get accounting services on credit. Later, you have trouble paying your business debts, but you are not bankrupt or insolvent. Your accountant forgives part of the amount you owe for the accounting services. How you treat the cancellation of debt depends on your method of accounting.

- Cash method – You do not include the debt cancellation in income because payment for the services would have been deductible as a business expense.
- Accrual method – You include the debt cancellation in income. Under an accrual method of accounting, the expense is

deductible when you incur the liability, not when you pay the debt.

Exclusions

Do not include canceled debt in income in the following situations. However, you may be required to file Form 982. See *Form 982*, later.

- 1) The cancellation takes place in a bankruptcy case.
- 2) The cancellation takes place when you are insolvent.
- 3) The canceled debt is a qualified farm debt.
- 4) The canceled debt is qualified real property business debt (in the case of a taxpayer other than a C corporation). For information on this type of canceled debt, see chapter 5 in Publication 334.

If a debt cancellation is excluded from income because it takes place in a bankruptcy case, items (2), (3), and (4) do not apply. If it takes place when you are insolvent, items (3) and (4) do not apply to the extent you are insolvent.

Bankruptcy and Insolvency

You can exclude the cancellation or discharge of debt from income if you are bankrupt or to the extent you are insolvent.

Bankruptcy. A bankruptcy case is a case under title 11 of the United States Code if you are under the jurisdiction of the court and the discharge of the debt is granted by the court or is the result of a plan approved by the court.

Do not include debt canceled in a bankruptcy case in your gross income in the year it is canceled. Instead, you must use the amount canceled to reduce your tax benefits, explained later under *Reduction of tax benefits*.

Insolvency. You are insolvent to the extent your liabilities are more than the fair market value of your assets immediately before the cancellation of debt.

You can exclude canceled debt from gross income up to the amount by which you are insolvent. If the canceled debt is more than the amount by which you are insolvent and you qualify, you can apply the rules for qualified farm debt to the excess. Otherwise, you include the excess in gross income. Use the amount excluded because of insolvency to reduce any tax benefits, as explained later under *Reduction of tax benefits*. You must reduce the tax benefits under the insolvency rules before applying the rules for qualified farm debt or for qualified real property business debt.

Example. You had a \$10,000 debt canceled outside of bankruptcy. Immediately before the cancellation, your liabilities totaled \$80,000 and your assets totaled \$75,000. Since your liabilities were more than your assets, you were insolvent to the extent of \$5,000 (\$80,000 – \$75,000). You can exclude this amount from income. The remaining canceled debt (\$5,000) may be subject to the qualified farm debt or qualified real property business debt rules. If not, you must include it in income.

Reduction of tax benefits. If you exclude canceled debt from income in a bankruptcy case or during insolvency, you must use the excluded debt to reduce certain tax benefits. This prevents an excessive tax benefit from the cancellation.

Order of reduction. You must use the excluded canceled debt to reduce the following tax benefits in the order listed, unless you choose to reduce the basis of depreciable property first, as explained later.

- 1) **Net operating loss (NOL).** Reduce any NOL for the tax year of the debt cancellation, and then any NOL carryover to that year. Reduce the NOL or NOL carryover one dollar for each dollar of excluded canceled debt.
- 2) **General business credit carryover.** Reduce the credit carryover to or from the tax year of the debt cancellation. Reduce the carryover 33 $\frac{1}{3}$ cents for each dollar of excluded canceled debt.
- 3) **Minimum tax credit.** Reduce the minimum tax credit available at the beginning of the tax year following the tax year of the debt cancellation. Reduce the credit 33 $\frac{1}{3}$ cents for each dollar of excluded canceled debt.
- 4) **Capital loss.** Reduce any net capital loss for the tax year of the debt cancellation, and then any capital loss carryover to that year. Reduce the capital loss or loss carryover one dollar for each dollar of excluded canceled debt.
- 5) **Basis.** Reduce the basis of the property you hold at the beginning of the tax year following the tax year of the debt cancellation in the following order.
 - a) Real property (except inventory) used in your trade or business or held for investment that secured the canceled debt.
 - b) Personal property (except inventory and accounts and notes receivable) used in your trade or business or held for investment that secured the canceled debt.
 - c) Other property (except inventory and accounts and notes receivable) used in your trade or business or held for investment.
 - d) Inventory and accounts and notes receivable.
 - e) Other property.

Reduce the basis one dollar for each dollar of excluded canceled debt. However, the reduction cannot be more than the total bases of property and the amount of money you hold immediately after the debt cancellation minus your total liabilities immediately after the cancellation.

For allocation rules that apply to basis reductions for multiple canceled debts, see section 1.1017-1(b)(2) of the regulations. Also see *Choosing to reduce the basis of depreciable property first*, later.

- 6) **Passive activity loss and credit carryovers.** Reduce the passive activity loss and credit carryovers from the tax year of the debt cancellation. Reduce the loss carryover one dollar for each dollar of excluded canceled debt. Reduce the

credit carryover 33 $\frac{1}{3}$ cents for each dollar of excluded canceled debt.

- 7) **Foreign and possession tax credits.** Reduce the credit carryover to or from the tax year of the debt cancellation. Reduce the carryover 33 $\frac{1}{3}$ cents for each dollar of excluded canceled debt.

How to make tax benefit reductions.

Always make the required reductions in tax benefits after figuring your tax for the year of the debt cancellation. In making the reductions in (1) and (4) above, first reduce the loss for the tax year of the debt cancellation. Then reduce any loss carryovers to that year in the order of the tax years from which the carryovers arose, starting with the earliest year. In making the reductions in (2) and (7) above, reduce the credit carryovers to the tax year of the debt cancellation in the order in which they are taken into account for that year.

Choosing to reduce the basis of depreciable property first. You can choose to apply any portion of the excluded canceled debt first to reduce the basis of your depreciable property you hold at the beginning of the tax year following the tax year of the debt cancellation, in the following order.

- 1) Depreciable real property used in your trade or business or held for investment that secured the canceled debt.
- 2) Depreciable personal property used in your trade or business or held for investment that secured the canceled debt.
- 3) Other depreciable property used in your trade or business or held for investment.
- 4) Real property held as inventory if you elect to treat it as depreciable property on Form 982.

The amount you apply cannot be more than the total adjusted bases of all the depreciable property. Depreciable property, for this purpose, means any property subject to depreciation, but only if a reduction of basis will reduce the depreciation or amortization otherwise allowable for the period immediately following the basis reduction.

You make this reduction before reducing the other tax benefits listed earlier. If the excluded canceled debt is more than the basis reduction you can make under this choice, use the excess to reduce the other tax benefits. In figuring the limit on the basis reduction in (5), *Basis*, use the remaining adjusted bases of your property after making this choice.

See *Form 982*, later, for information on how to make this choice. If you make this choice, you can revoke it only with the consent of the IRS.

Recapture of basis reductions. If you reduce the basis of property under these provisions and later sell or otherwise dispose of the property at a gain, the part of the gain due to this basis reduction is taxable as ordinary income under the depreciation recapture provisions. Treat any property that is not section 1245 or section 1250 property as section 1245 property. For section 1250 property, determine the straight-line depreciation adjustments as though there were no basis reduction for debt cancellation. Sections 1245 and 1250 property and the recapture of

gain as ordinary income are explained in chapter 11.

More information. For more information on debt cancellation in bankruptcy proceedings or during insolvency, see Publication 908.

Qualified Farm Debt

You can exclude from income the cancellation or discharge of qualified farm debt by a qualified person. This exclusion applies only if you were solvent when the debt was canceled or, if you were insolvent, only to the extent the canceled debt is more than the amount by which you were insolvent. Your debt is qualified farm debt if both the following requirements are met.

- You incurred it directly in operating a farming business.
- At least 50% of your total gross receipts for the 3 tax years preceding the year of debt cancellation were from your farming business. See chapter 2 for information about gross farm income and total gross income.

Qualified person. This is a person who is actively and regularly engaged in the business of lending money. A qualified person includes any federal, state, or local government, or any of their agencies or subdivisions. Therefore, these rules apply to debts discharged by the USDA.

A qualified person does not include any of the following.

- A person related to you.
- A person from whom you got the property (or a person related to this person).
- A person who receives a fee from your investment in the property (or a person related to this person).

For the definition of a related person, see *Related persons* under *At-Risk Amounts* in Publication 925.

Exclusion limit. The amount of canceled qualified farm debt you exclude from income cannot be more than the sum of your adjusted tax benefits and the total adjusted bases of the qualified property you hold at the beginning of the tax year following the tax year of the debt cancellation. Figure this limit after taking into account any reduction of tax benefits because of debt canceled during insolvency.

If the canceled debt is more than this limit, you must include the difference in gross income.

Adjusted tax benefits. Adjusted tax benefits means the sum of the following items.

- 1) Any net operating loss (NOL) for the tax year of the debt cancellation and any NOL carryover to that year.
- 2) Any general business credit carryover to or from the year of the debt cancellation, multiplied by 3.
- 3) Any minimum tax credit available at the beginning of the tax year following the tax year of the debt cancellation, multiplied by 3.
- 4) Any net capital loss for the tax year of the debt cancellation and any capital loss carryover to that year.

- 5) Any passive activity loss and credit carryovers from the tax year of the debt cancellation. Any credit carryover is multiplied by 3.
- 6) Any foreign and possession tax credit carryovers to or from the tax year of the debt cancellation, multiplied by 3.

You multiply the credits by 3 to make them comparable with the deduction benefits.

Qualified property. This is any property you use or hold for use in your trade or business or for the production of income.

Reduction of tax benefits. If you exclude canceled debt from income under the qualified farm debt rules, you must use the excluded debt to reduce tax benefits. (If you also excluded canceled debt under the insolvency rules, you reduce the amount of the tax benefits remaining after reduction for the exclusion allowed under those rules.) You generally must follow the reduction rules previously explained under *Bankruptcy and Insolvency*. However, do not follow the rules in item (5), *Basis*. Instead, follow the special rules explained next.

Special rules for reducing the basis of property. You must use special rules to reduce the basis of property for excluded canceled qualified farm debt. Under these special rules, you only reduce the basis of qualified property (defined earlier) in the following order.

- 1) Depreciable qualified property. You may choose on Form 982 to treat real property held as inventory as depreciable property.
- 2) Land that is qualified property and is used or held for use in your farming business.
- 3) Other qualified property.

Form 982

Use Form 982 to show the amounts of canceled debt excluded from income and the reduction of tax benefits in the order listed on the form. Also use it if you are making the choice to apply the excluded canceled debt to reduce the basis of depreciable property before reducing tax benefits. You make this choice by showing the amount you choose to apply on line 5 of the form.

When to file. You must file Form 982 with your timely filed income tax return (including extensions) for the tax year in which the cancellation of debt occurred. If you timely filed your return for the year without making the choice to apply the excluded canceled debt to reduce the basis of depreciable property first, you can still make the choice by filing an amended return within six months of the due date of the return (excluding extensions). Attach Form 982 to the amended return and write "Filed pursuant to section 301.9100-2" at the top of the form. File the amended return at the same address you filed the original return.

Income From Other Sources

This section discusses other types of income you may receive.

Barter income. If you do work for someone and are paid in farm products, other property, or services, you must report as income the fair market value of what you receive. The same rule applies if you trade farm products for other farm products, property, or someone else's labor. This is called barter income. For example, if you help a neighbor build a barn and receive a cow for your work, you must report the fair market value of the cow as ordinary income. Your basis for property you receive in a barter transaction is usually the fair market value that you include in income. If you pay someone with property, see the discussion on labor expense in chapter 5.

Below-market loans. A below-market loan is a loan on which no interest is charged, or interest is charged at a rate below the applicable federal rate. If you make a below-market loan, you may have to report income from the loan in addition to the stated interest you receive from the borrower. See chapter 1 of Publication 550 for more information on below-market loans.

Commodity futures and options. See *Hedging (Commodity Futures)* in chapter 10 for information on gains and losses from commodity futures and options transactions.

Easements and rights-of-way. Income you receive for granting easements or rights-of-way on your farm or ranch for flooding land, laying pipelines, constructing electric or telephone lines, etc., may result in income, a reduction in the basis of all or part of your farm land, or both.

Example. You granted a right-of-way for a gas pipeline through your property for \$1,000. Only a specific part of your farm land was affected. You reserved the right to continue farming the surface land after the pipe was laid. Treat the payment for the right-of-way in one of the following ways.

- 1) If the payment is less than the basis properly allocated to the part of your land affected by the right-of-way, reduce the basis by \$1,000.
- 2) If the payment is more than the basis of the affected part of your land, reduce the basis to zero and the rest is gain from a sale. The gain is reported on Form 4797 and is treated as section 1231 gain if you held the land for more than 1 year. See chapter 11.

If construction of the line damaged growing crops and you later receive a settlement of \$250 for this damage, the \$250 is income. It does not affect the basis of your land.

Fuel tax credit and refund. Include as income any credit or refund of federal excise tax included as part of any fuel cost claimed as an expense deduction that reduced your income tax. See chapter 18 for more information about fuel tax credits and refunds.

Illegal federal irrigation subsidy. The federal government, operating through the Bureau of Reclamation, has made irrigation water from certain reclamation and irrigation projects available for agricultural purposes. The excess of the amount required to be paid for water from these projects over the amount actually paid is an illegal subsidy.

For example, if the amount required to be paid is full cost and you paid less than full

cost, the difference is an illegal subsidy and you must include it in income. Report this on line 10 of Schedule F. You cannot take a deduction for the amount you must include in income.

For more information on reclamation and irrigation projects, contact your local Bureau of Reclamation.

Machine work (custom hire). Pay you receive for work you or your hired help perform off your farm for contract work or custom work done for others, or for the use of your property or machines, is income to you whether or not income tax was withheld. This rule applies whether you receive the pay in cash, services, or merchandise. Report this income on line 9, Part 1, of Schedule F.

Prizes. Report prizes you win on farm livestock or products at contests, exhibitions, fairs, etc., on Schedule F as *Other income*. If you receive a prize in cash, include the full amount in income. If you receive a prize in produce or other property, include the fair market value of the property. For prizes of \$600 or more, you should receive a Form 1099-MISC.

See chapter 15 for information about prizes related to 4-H Club or FFA projects. See Publication 525 for information about other prizes.

Property sold, destroyed, stolen, or condemned. You may have an ordinary or capital gain if property you own is sold or exchanged, stolen, destroyed by fire, flood, or other casualty, or condemned by a public authority. In some situations, you can postpone the tax on the gain to a later year. See chapters 10 through 13.

Recapture of certain depreciation. If you took a section 179 deduction for property used in your farming business and at any time during the property's recovery period you do not use it more than 50% in your business, you must include part of the deduction in income. See chapter 8 for information on the section 179 deduction and when to recapture that deduction.

In addition, if the percentage of business use of listed property (see chapter 8) falls to 50% or less in any tax year during the recovery period, you must include in income any excess depreciation you took on the property.

Both of these amounts are farm income. Use Part IV of Form 4797 to figure how much to include in income.

Refund or reimbursement. You should include in income a reimbursement, refund, or recovery of an item for which you took a deduction in an earlier year. Include it for the tax year you receive it. However, if any part of the earlier deduction did not decrease your income tax, you do not have to include that part of the reimbursement, refund, or recovery.

Example. A tenant farmer purchased fertilizer for \$1,000 in April 1998. He deducted \$1,000 on his 1998 Schedule F and the entire deduction reduced his tax. The landowner reimbursed him \$500 of the cost of the fertilizer in February 1999. The tenant farmer must include \$500 in income on his 1999 tax return because the entire deduction decreased his 1998 tax.

Sale of soil and other natural deposits. If you remove and sell topsoil, loam, fill dirt, sand, gravel, or other natural deposits from your property, the proceeds are ordinary income. A reasonable allowance for depletion of the natural deposit sold may be claimed as a deduction. See *Depletion* in chapter 8.

Sod. Report proceeds from the sale of sod on Schedule F. A deduction for cost depletion is allowed, but only for the topsoil removed with the sod.

Granting the right to remove deposits. If you enter into a legal relationship granting someone else the right to excavate and remove natural deposits from your property, you must determine whether the transaction is a sale or another type of transaction (for example, a lease).

If you receive a specified sum or an amount fixed without regard to the quantity produced and sold from the deposit and you retain no economic interest in the deposit, your transaction is a sale. You are considered to retain an economic interest if, under the terms of the legal relationship, you depend on the income derived from extraction of the deposit for a return of your capital investment in the deposit.

Your income from the deposit is capital gain if the transaction is a sale. Otherwise, it is ordinary income subject to an allowance for depletion. See chapter 8 for information on depletion and chapter 10 for the tax treatment of capital gains.

Timber sales. Timber sales, including sales of logs, firewood, lumber, and pulpwood, are discussed in chapter 10.

Farm Income Averaging

If you are engaged in a farming business, you may be able to average your **electd farm income (EFI)** by shifting it to the 3 prior years (base years). The term "farming business" is defined in the instructions for Schedule J (Form 1040), *Farm Income Averaging*.

Who can use farm income averaging? You can elect to use farm income averaging if, in the year of the election, you are engaged in a farming business as an individual, a partner in a partnership, or a shareholder in an S corporation. You do not have to have been engaged in a farming business in any base year.

Corporations, partnerships, S corporations, estates, and trusts cannot use farm income averaging.

Electd Farm Income (EFI)

EFI is the amount of income from your farming business that you elect to shift to the base years. You can designate as EFI any type of income attributable to your farming business. However, your EFI may not exceed your taxable income, and any EFI from a net capital gain attributable to your farming business may not exceed your total net capital gain. Income from your farming business is the sum of any farm income or gain minus any farm deductions or losses that are allowed as deductions in computing your taxable income. However, it does not include gain from the sale or other disposition of land.

Gains from the sale or other disposition of farm property. Gains from the sale or other disposition of farm property, other than land, can be designated as EFI if you (or your partnership or S corporation) use the property regularly for a substantial period in a farming business. Whether the property has been regularly used for a substantial period depends on all the facts and circumstances.

Liquidation of a farming business. If you (or your partnership or S corporation) liquidate your farming business, gains on property sold within a reasonable time after operations stop can be designated as EFI. A period of one year after stopping operations will be treated as a reasonable time. After that, what is a reasonable time depends on the facts and circumstances.

Shifting EFI to base years. If your EFI includes both ordinary income and capital gains, you must add an equal portion of each type of income to each base year. You cannot add all of the capital gains to a single base year.

How To Figure the Tax

If you elect to average your farm income, you will figure the current year's tax on Schedule J (Form 1040). You figure the tax as follows.

- 1) Subtract the EFI from your total taxable income.
- 2) Figure the tax on the result in step (1) using the current year's tax tables, tax rate schedules, or, if applicable and lower, the maximum capital gain tax rates.
- 3) For each of the base years, make the following computations.
 - a) Add one-third of the EFI to the taxable income of the base year. Do not treat the base year's taxable income as less than zero, even if your deductions exceed your income.
 - b) Figure the tax on the result in (a) using the tax rate schedule for that base year, or, if applicable and lower, the maximum capital gain tax rate for the base year. If the EFI includes a net capital gain, it does not offset any net capital loss you had in the base year. Figure the tax on the net capital gain at the maximum capital gain tax rate that would apply if an asset of the same type and with the same holding period had been sold or exchanged in the base year.
 - c) Subtract that year's actual tax from the tax in (b).
- 4) Add the results in step (3)(c) to the amount in step (2). The result is the tax for the current year.

Filing status. You are not prohibited from making a farm income averaging election solely because your filing status is not the same in an election year and the base years. For example, if you are married filing jointly in the election year, but filed as single in all of the base years, you may still elect to average farm income.

Effect on Other Tax Determinations

You subtract your EFI from your taxable income in the election year and add one-third of it to the taxable income of the base year to determine the tax rate to use for income averaging. The allocation of your EFI from the election year to the base years does not affect other tax determinations. For example, you make the following determinations **before** subtracting your EFI in the election year or adding it in the base years.

- The amount of your self-employment tax.
- Whether, in the aggregate, sales and other dispositions of business property (section 1231 transactions) produce long-term capital gain or ordinary loss.
- The amount of any net operating loss carryover or net capital loss carryover applied and the amount of any carryover to another year.
- The limit on itemized deductions based on your adjusted gross income.
- The amount of any net capital loss or net operating loss in a base year.

Tax on Investment Income of Child Under 14

If your child's investment income is more than \$1,400, part of that income may be taxed at your tax rate instead of your child's tax rate.

If you elect to use farm income averaging, figure your child's tax on investment income using your rate after shifting EFI. You cannot use any of your child's investment income as your EFI, even if it is attributable to a farming business. For information on figuring the tax on your child's investment income, see Publication 929, *Tax Rules for Children and Dependents*.

Alternative Minimum Tax

You cannot use income averaging to determine your alternative minimum tax (AMT). When figuring your AMT, the regular tax you subtract from your "tentative minimum tax" is the tax you computed using farm income averaging. This may cause you to owe AMT or increase your AMT but, generally, it will not increase your total tax.



As this publication was being prepared for print, Congress was considering legislation that would allow an individual to offset his or her regular tax (without regard to the "tentative minimum tax") by certain nonrefundable personal credits (such as the credit for child and dependent care expenses, the child tax credit, the Hope credit, or the lifetime learning credit). For more information about this and other important tax changes, see Publication 553, Highlights of 1999 Tax Changes.

Credit for base year minimum tax liability. You can use income averaging to calculate your regular tax liability for the purpose of determining the amount of the credit for a base year minimum tax liability.

Making, Revoking, or Changing an Election

You make a farm income averaging election by filing Schedule J (Form 1040), *Farm Income Averaging*, with your timely filed (including extensions) return for the election year. You can make a late election, or amend or revoke a previously made election, only if you do so in conjunction with another adjustment that affects the taxable income of the election year or any of the base years. An adjustment may be caused by a variety of things. The following are examples of situations that may result in an adjustment.

- An NOL carryback.
- A disaster loss election.
- A change made as the result of an audit.
- Any other change that results in your filing an amended return.

If you do not have an adjustment in the election year or any of the base years, you can make a late election, or amend or revoke a previously made election, only if you obtain the consent of the IRS. You can request consent by submitting a request for a private letter ruling to the IRS National Office. See Revenue Procedure 2000-1 in Internal Revenue Bulletin No. 2000-1.

5.

Farm Business Expenses

Important Changes for 1999

Standard mileage rate. The standard mileage rate for the cost of operating your car, van, pickup, or panel truck in 1999 is 32½ cents a mile for all business miles driven before April 1. The rate is 31 cents a mile for business miles driven after March 31. See *Truck and Car Expenses*.

Self-employed health insurance deduction. The part of your self-employed health insurance premiums that you can deduct as an adjustment to income increased to 60% for 1999. See *Insurance*.

Business use of your home. Beginning in 1999, you may be able to deduct expenses for your home office even if it is not where you perform your most important business activities or spend most of your business time. See *Business Use of Your Home*.

Introduction

You can generally deduct the current costs of operating your farm. Current costs are expenses you do not have to capitalize or include in inventory costs. However, your de-

duction for the cost of livestock feed and certain other supplies may be limited. If you have an operating loss, you may not be able to deduct all of it.

Topics

This chapter discusses:

- Deductible expenses
- Capital expenses
- Nondeductible expenses
- Farm operating losses
- Net operating losses
- Not-for-profit farming

Useful Items

You may want to see:

Publication

- 463** Travel, Entertainment, Gift, and Car Expenses
- 535** Business Expenses
- 536** Net Operating Losses
- 587** Business Use of Your Home
- 925** Passive Activity and At-Risk Rules

Form (and Instructions)

- 1040** U.S. Individual Income Tax Return
- Sch A (Form 1040)** Itemized Deductions
- Sch F (Form 1040)** Profit or Loss From Farming
- 1045** Application for Tentative Refund
- 5213** Election To Postpone Determination as To Whether the Presumption Applies That an Activity Is Engaged in for Profit

See chapter 21 for information about getting publications and forms.

Deductible Expenses

The ordinary and necessary costs of operating a farm for profit are deductible business expenses. Part II of Schedule F lists expenses common to farming operations. This chapter discusses many of these expenses, as well as others not listed on Schedule F.

Reimbursed expenses. If you are reimbursed, either reduce the expense or report the amount you receive as income, depending on when you receive it. See *Refund or reimbursement* under *Income From Other Sources* in chapter 4.

Prepaid Farm Supplies

There may be a limit on your deduction for prepaid farm supplies if you use the cash method of accounting to report your income and expenses. This limit will not apply, however, if you meet one of the exceptions described later.

Defined. Prepaid farm supplies are amounts you paid during the tax year for the following items.

- 1) Feed, seed, fertilizer, and similar farm supplies not used or consumed during the year.
- 2) Poultry (including egg-laying hens and baby chicks) bought for use (or for both use and resale) in your farm business that would be deductible in the following year if you had capitalized the cost and deducted it ratably (for example, monthly) over the lesser of 12 months or the useful life of the poultry.
- 3) Poultry bought for resale and not resold during the year.

Prepaid farm supplies do not include any amount paid for farm supplies on hand at the end of the tax year that you would have consumed if not for a fire, storm, flood, other casualty, disease, or drought.

Deduction limit. You can deduct an expense for prepaid farm supplies that does not exceed 50% of your **other deductible farm expenses** in the year of payment. You can deduct an expense for any excess prepaid farm supplies only for the tax year you use or consume the supplies.

The cost of poultry bought for use (or for both use and resale) in your farm business and not allowed in the year of payment is deductible in the following year. The cost of poultry bought for resale is deductible in the year you sell or otherwise dispose of that poultry.

Other deductible farm expenses. Other deductible farm expenses are any amounts allowable as deductions on Schedule F (Form 1040), including depreciation or amortization, but not prepaid farm supplies.

Example. During 1999, you bought fertilizer (\$4,000), feed (\$1,000), and seed (\$500) for use on your farm in the following year. Your total prepaid farm supplies expense for 1999 is \$5,500. Your other deductible farm expenses totaled \$10,000 for 1999. Therefore, your deduction for prepaid farm supplies may not exceed \$5,000 (50% of \$10,000) for 1999. The excess prepaid farm supplies expense of \$500 (\$5,500 – \$5,000) is deductible in the later tax year you use or consume the supplies.

Exceptions. This limit on the deduction for prepaid farm supplies expense does not apply if you are a farm-related taxpayer and either of the following apply.

- 1) Your prepaid farm supplies expense is more than 50% of your other deductible farm expenses because of a change in business operations caused by unusual circumstances.
- 2) Your total prepaid farm supplies expense for the preceding 3 tax years is less than 50% of your total other deductible farm expenses for those 3 tax years.

You are a farm-related taxpayer if any of the following tests apply.

- 1) Your main home is on a farm.
- 2) Your principal business is farming.
- 3) A member of your family meets (1) or (2).

For this purpose, your family includes your brothers and sisters, half-brothers and half-sisters, spouse, parents, grandparents, children, grandchildren, aunts, uncles, and their children.

Whether or not the deduction limit for prepaid farm supplies applies, your expenses for prepaid livestock feed may be subject to the rules for advance payment of livestock feed, discussed next.

Livestock Feed

If you report your income and expenses under the cash method, you can deduct in the year paid the cost of feed your livestock consumed in that year. However, the cost of feed not consumed in that year is subject to the advance payment for feed rules, discussed next, and the limit on prepaid farm supplies, discussed earlier.

Advance payments for feed. If you meet **all three** of the following tests, you can deduct in the year of payment (subject to the limit on prepaid farm supplies) the cost of feed your livestock will consume in a later tax year. This rule does not apply to the purchase of commodity futures contracts.

- 1) **The expense is a payment for the purchase of feed, not a deposit.**

Whether an expense is a deposit or payment depends on the facts and circumstances in each case. The expense is a payment if you can show you made it under a binding commitment to accept delivery of a specific quantity of feed at a fixed price and you are not entitled, under contract provision or business custom, to a refund or repurchase.

The following are some factors that show an expense is a deposit rather than a payment.

- a) The absence of specific quantity terms.
- b) The right to a refund of any unapplied payment credit at the end of the contract.
- c) The treatment of the expense as a deposit by the seller.
- d) The right to substitute other goods or products for those specified in the contract.

A provision permitting substitution of ingredients to vary the particular feed mix to meet current diet requirements of the livestock for which you bought the feed will not suggest a deposit. Further, adjustment to the contract price to reflect market value at the date of delivery is not, by itself, proof of a deposit.

- 2) **The prepayment has a business purpose and is not merely for tax avoidance.** You should have a reasonable expectation of receiving some business benefit from the prepayment. The following are some examples of business benefits.

- a) Fixing maximum prices and securing an assured feed supply.
- b) Securing preferential treatment in anticipation of a feed shortage.

Whether the prepayment was a condition imposed by the seller and whether the condition was meaningful will also be considered in determining the existence of a business purpose for the prepayment.

- 3) **The deduction of these costs does not result in a material distortion of**

your income. The following are some factors to consider in determining whether the deduction results in a material distortion of income.

- a) Your customary business practice in conducting your livestock operations.
- b) The expense in relation to past purchases.
- c) The time of year you made the purchase.
- d) The expense in relation to your income for the year.

If you fail any of these three tests, you cannot deduct in the year paid the cost of feed your livestock will consume in a later tax year. Deduct it in the tax years your livestock consume the feed.

Labor Hired

You can deduct reasonable wages paid for regular farm labor, piecework, contract labor, and other forms of labor hired to perform your farming operations. You may pay wages in cash or noncash items such as inventory items, capital assets, or assets used in your business. The cost of boarding farm labor is a deductible labor cost. Other deductible costs you incur for farm labor include health insurance, workers' compensation insurance, and other benefits.

If you must withhold social security, Medicare, and income taxes from your employees' cash wages, you can still deduct the full amount of wages before withholding. See chapter 16 for more information on employment taxes. Also, deduct the employer's share of the social security and Medicare taxes you must pay on your employees' wages as a farm business expense on the *Taxes* line of Schedule F (line 31). See *Taxes*, later.

Deductible Pay

The kinds of pay you can deduct include the fair market value of property you transfer to your employees and wages you pay to members of your family, as discussed below.

Property for services. If you transfer property to one of your employees in payment for services, you can deduct as wages paid the fair market value of the property on the date of transfer. If the employee pays you anything for the property, deduct as wages the fair market value of the property minus the payment by the employee for the property. Treat the deduction on your return as an amount received for the property. You may have a gain or loss to report if the property's adjusted basis on the date of transfer is different from its fair market value. Any gain or loss has the same character the exchanged property had in your hands. For more information, see chapter 10.

Child as an employee. You can deduct reasonable wages or other compensation you pay to your child for doing farm work if a **true employer-employee relationship** exists between you and your child. Include these wages in the child's income. The child may have to file an income tax return. These wages may also be subject to social security and Medicare taxes if your child is age 18 or

older. For more information, see *Family Employees* in chapter 16.

The fact that your child spends the wages to buy clothes or other necessities you normally furnish does not prevent you from deducting your child's wages as a farm expense.

Spouse as an employee. You can deduct reasonable wages or other compensation you pay to your spouse if a **true employer-employee relationship** exists between you and your spouse. Wages you pay to your spouse are subject to social security and Medicare taxes. For more information, see *Family Employees* in chapter 16.

Non deductible Pay

You cannot deduct wages paid for certain household work, construction work, and maintenance of your home. However, those wages may be subject to the employment taxes discussed in chapter 16.

Household workers. Do not deduct amounts paid to persons engaged in household work, except to the extent their services are used in boarding or otherwise caring for farm laborers.

Construction labor. Do not deduct wages paid to hired help for the construction of new buildings or other improvements. These wages are part of the cost of the building or other improvement. You must capitalize them.

Maintaining your home. If your farm employee spends time maintaining or repairing your home, the wages and employment taxes you pay for that work are nondeductible personal expenses. For example, assume you have a farm employee for the entire tax year and the employee spends 5% of the time maintaining your home. The employee devotes the remaining time to work on your farm. You cannot deduct 5% of the wages and employment taxes you pay for that employee.

Employment Credits

Reduce your deduction for wages by the amount of any employment credits you claim. The following are employment credits and their related forms.

- Empowerment zone employment credit (Form 8844).
- Indian employment credit (Form 8845).
- Welfare-to-work credit (Form 8861).
- Work opportunity credit (Form 5884).

For more information, see the forms and their instructions.

Personal and Business Expenses

Some expenses you pay during the tax year may be partly personal and partly business. These may include expenses for gasoline, oil, fuel, water, rent, electricity, telephone, automobile upkeep, repairs, insurance, interest, and taxes.

Allocation. Allocate these mixed expenses between their business and personal parts because the personal expenses are not deductible.

Example. You paid \$1,500 for electricity during the tax year. You used one-third of the electricity for personal purposes and two-thirds for farming. Under these circumstances, you can deduct two-thirds of your electricity expense (\$1,000) as a farm business expense.

Reasonable allocation. It is not always easy to determine the business and nonbusiness parts of an expense. There is no method of allocation that applies to all mixed expenses. Any reasonable allocation is acceptable. What is reasonable depends on the circumstances in each case.

Telephone expense. You cannot deduct the cost of basic local telephone service (including taxes) for the first telephone line you have in your home. However, you can deduct the cost of additional telephone service in your home if you use it for your farm business.

Tax preparation fees. You can deduct as a farm business expense on Schedule F (Form 1040) the cost of preparing that part of your tax return relating to your farm business. You may be able to deduct the remaining cost on Schedule A (Form 1040) if you itemize your deductions.

You can also deduct on Schedule F the amount you pay or incur in resolving tax issues relating to your farm business.

Repairs and Maintenance

You can deduct most expenses for the repair and maintenance of your farm property. However, repairs to depreciable property that substantially prolong the life of the property, increase its value, or adapt it to a different use are capital expenses. If you repair the barn roof, the cost is deductible. But if you replace the roof, it is a capital expense. Common items of repair and maintenance are repainting, replacing shingles and supports on farm buildings, and minor overhauls of trucks, tractors, and other farm machinery. You must, however, capitalize major overhauls that prolong the life of the property.

Interest

You can deduct as a farm business expense interest paid on farm mortgages and other obligations you incur in your farm business.

Cash method. If you use the cash method of accounting, you can deduct interest paid during the year. You cannot deduct interest paid with funds received from the original lender through another loan, advance, or other arrangement similar to a loan. You can, however, deduct the interest when you start making payments on the new loan.

Prepaid interest. Under the cash method, you generally cannot deduct any interest paid before the year it is due. Interest paid in advance may be deducted over the term of the loan.

Accrual method. You can deduct only interest that has accrued during the tax year. However, you cannot deduct interest owed to a related person who uses the cash method until payment is made and the interest is includable in the gross income of that person. For more information, see chapter 8 in Publication 535.

Allocation of interest. If you use the proceeds of a loan for more than one purpose (for example, personal and business), allocate the interest on that loan to each use.

The easiest way to allocate interest is to keep the proceeds of a particular loan separate from any other funds. You can treat a payment made from any account (or in cash) within 30 days before or after the debt proceeds are deposited (or received in cash) as being made from those debt proceeds.

You generally allocate interest on a loan the same way you allocate the loan. This is true even if the funds are paid directly to a third party. You allocate loans by tracing disbursements to specific uses. Use the following categories when allocating your interest expense.

- 1) Trade or business interest.
- 2) Passive activity interest.
- 3) Investment interest.
- 4) Personal interest.
- 5) Portfolio expenditure interest.

Secured loans. The allocation of loan proceeds and the related interest is not generally affected by the use of property that secures the loan.

Example. You secure a loan with property used in your farming business. You use the loan proceeds to buy a car for personal use. You must allocate interest expense on the loan to personal use (purchase of the car) even though the loan is secured by farm business property.

Allocation period. The period for which a loan is allocated to a particular use begins on the date the proceeds are used and ends on the earlier of the date the loan is:

- 1) Repaid, or
- 2) Reallocated to another use.

For more information, see chapter 8 in Publication 535.

Loan expenses. You prorate and deduct loan expenses, such as legal fees and commissions, you pay to get a farm loan over the term of the loan.

Breeding Fees

You can deduct breeding fees as a farm business expense. However, if you must use an accrual method of accounting, you must capitalize breeding fees and allocate them to the cost basis of the calf, foal, etc. For more information on who must use an accrual method of accounting, see *Accrual Method* in chapter 3.

Fertilizer and Lime

You can choose to deduct in the year paid or incurred the cost of fertilizer, lime, and other materials applied to farm land to enrich, neutralize, or condition it. You can also deduct the cost of applying these materials in the year you pay or incur it. However, see *Prepaid Farm Supplies*, earlier, for a rule that may limit your deduction for these materials.

If the benefits of the fertilizer, lime, or other materials last substantially more than a year, you can choose to deduct the expenses in the year paid or incurred, or you can capitalize them and deduct a part each year the benefits last. If you choose to deduct the expenses in the year paid or incurred, you can change the choice for that year only with IRS consent.

Farm land for the choice described in the preceding paragraph is land used for producing crops, fruits, or other agricultural products or for sustaining livestock. It does not include land you have never used previously for producing crops or sustaining livestock. You cannot deduct initial land preparation costs. (See *Capital Expenses*, later.)

Include government payments you receive for lime or fertilizer in income. See *Fertilizer and Lime* in chapter 4.

Taxes

You can deduct as a farm business expense the real estate and personal property taxes on farm business assets, such as farm equipment, animals, farm land, and farm buildings. You can also deduct the social security and Medicare taxes you pay to match the amount withheld from the wages of farm employees and any federal unemployment tax you pay. For information on employment taxes, see chapter 16.

The taxes on the part of your farm you use as your home (including the furnishings and surrounding land not used for farming) are nonbusiness taxes. You may be able to deduct these nonbusiness taxes as itemized deductions on Schedule A (Form 1040). To determine the nonbusiness part, prorate the taxes between the farm assets and nonbusiness assets. The proration can be done from the assessed valuations. If your tax statement does not show the assessed valuations, you can usually get them from the tax assessor.

State or local general sales taxes. State or local general sales taxes on nondepreciable farm business expense items are deductible as part of the cost of those items. Include state or local general sales taxes imposed on the purchase of assets for use in your farm business as part of the cost that you depreciate. If the taxes are imposed on the seller and passed on to you, treat them as part of your cost.

State and federal income taxes. Individuals cannot deduct state and federal income taxes as farm business expenses. Individuals can deduct state income tax only as an itemized deduction on Schedule A (Form 1040). You cannot deduct federal income tax.

Highway use tax. You can deduct the federal use tax on highway motor vehicles paid on a truck or tractor used in your farm business. For information on the tax itself, including information on vehicles subject to the tax, see the instructions for Form 2290, *Heavy Highway Vehicle Use Tax Return*.

Self-employment tax deduction. You can deduct one-half of your self-employment tax in figuring your adjusted gross income on

Form 1040. For more information, see chapter 15.

Insurance

You can generally deduct the ordinary and necessary cost of insurance for your farm business as a business expense. This includes premiums you pay for the following types of insurance.

- 1) Fire, storm, crop, theft, liability, and other insurance on farm business assets.
- 2) Health and accident insurance on your farm employees.
- 3) Workers' compensation insurance and state unemployment insurance on your farm employees.

Advance premiums. If you pay insurance premiums in advance, deduct each year only the premium that applies to that tax year. Deduct the balance in each later year to which it applies.



This treatment of advance premiums applies whether you use the cash or accrual method of accounting.

Example. On June 28, 1999, you paid a premium of \$3,000 for fire insurance on your barn. The policy will cover a period of 3 years beginning on July 1, 1999. Only the cost for the 6 months in 1999 is deductible as an insurance expense on your 1999 tax return. Deduct \$500, which is the premium for 6 months of the 36-month premium period, or $\frac{6}{36}$ of \$3,000. In both 2000 and the year 2001, deduct \$1,000 ($\frac{12}{36}$ of \$3,000). Deduct the remaining \$500 in 2002. Had the policy been effective on January 1, 1999, the deductible expense would have been \$1,000 for each of the years 1999, 2000, and 2001, based on one-third of the premium used each year.

Business interruption insurance. Business interruption insurance premiums are deductible as a business expense. This insurance pays for lost profits if your business is shut down due to a fire or other cause. Report any proceeds in full on Schedule F.

Self-employed health insurance deduction. If you are a self-employed individual, you can deduct, in figuring your adjusted gross income on your 1999 Form 1040, 60% of your payments for health insurance coverage for yourself, your spouse, and your dependents. Generally, this deduction cannot be more than the net profit from the business under which the plan was established.

If you or your spouse are also an employee of another person, you cannot take the deduction for any month in which you are eligible to participate in a subsidized health plan maintained by your employer or your spouse's employer.

Use the *Self-Employed Health Insurance Deduction Worksheet* in the Form 1040 instructions to figure your deduction. Include the remaining part of the insurance payment in your medical expenses on Schedule A, if you itemize your deductions.

For more information, see *Deductible Premiums* in chapter 10 of Publication 535.

Rent and Leasing

If you lease property for use in your business, you can generally deduct the rent you pay.

Rent

You can deduct on Schedule F rent you pay in cash. However, you cannot deduct rent you pay in crop shares because you deduct the cost of raising the crops as farm expenses.

Advance payments. Deduct advance payments of rent only in the year to which they apply, regardless of your accounting method.

Farm home. If you rent a farm, do not deduct the part of the rental expense that represents the fair rental value of the farm home in which you live.

Lease or Purchase

If you lease a farm building or equipment rather than buy it, you must determine whether or not the agreement can be treated as a lease for tax purposes. Some leases must be treated as conditional sales contracts for tax purposes. If the agreement is treated as a lease for tax purposes, you can deduct rental payments for the use of the property in your trade or business. If the agreement is treated as a conditional sales contract, the payments under the agreement (so far as they do not represent interest or other charges) are payments for the purchase of the property. Do not deduct these payments as rent, but capitalize the cost of the property and recover this cost through depreciation.

Example. You lease new farm equipment from a dealer who both sells and leases. The lease payments and the specified option price equal the sales price plus interest. Under the lease, you are responsible for maintenance, repairs, and the risk of loss. For federal income tax purposes, the lease is a sale of the equipment and you cannot deduct any of the lease costs as rent. You can deduct interest, repairs, insurance, depreciation, and other business expenses.

Intent. Whether an agreement is a conditional sales contract, rather than a lease, depends on the intent of the parties. Determine intent based on the facts and circumstances existing at the time you made the agreement. No single test, or special combination of tests, always applies. However, in the absence of compelling and persuasive factors to the contrary, treat an agreement as a conditional sales contract, rather than a lease, if **any** of the following is true.

- 1) The agreement applies part of each payment toward an equity interest you will receive.
- 2) You receive title to the property after you pay a stated amount of required payments.
- 3) You must pay, over a short period, an amount that represents a large part of the price you would pay to buy the property.
- 4) You pay much more than the current fair rental value of the property.
- 5) You have an option to buy the property at a small price compared to the value

of the property at the time you may exercise the option. Determine this value at the time of entering into the original agreement.

- 6) You have an option to buy the property at a small price compared to the total you must pay under the agreement.
- 7) The agreement designates part of the payments as interest, or part of the payments are easy to recognize as interest.

Leveraged leases. Special rules apply to leveraged leases of equipment (property financed by a nonrecourse loan from a third party). For more information, see chapter 7 of Publication 535 and the following revenue procedures.

- 1) 75–21 in Cumulative Bulletin 1975–1.
- 2) 75–28 in Cumulative Bulletin 1975–1.
- 3) 76–30 in Cumulative Bulletin 1976–2.
- 4) 79–48 in Cumulative Bulletin 1979–2.

Motor vehicle leases. Special rules apply to lease agreements that have a terminal rental adjustment clause. The clause will generally provide for a rental adjustment based upon the amount the lessor is able to sell the vehicle for at the end of the lease. If your rental agreement contains a terminal rental adjustment clause, treat the agreement as a lease if the agreement otherwise qualifies as a lease. For more information, see section 7701(h) of the Internal Revenue Code.

Depreciation

If property you acquire to use in your farm business is expected to last more than one year, you generally cannot deduct the entire cost in the year you acquire it. You must spread the cost over more than one year and deduct part of it each year on Schedule F. For most property, this deduction is depreciation. However, you may be able to deduct part or all of the cost of this property as a business expense in the year you place it in service. This is the section 179 deduction.

Depreciation and the section 179 deduction are discussed in chapter 8.

Business Use of Your Home

You can deduct expenses for the business use of your home if you use part of your home exclusively and regularly:

- 1) As the principal place of business for any trade or business in which you engage,
- 2) As a place to meet or deal with patients, clients, or customers in the normal course of your trade or business, or
- 3) In connection with your trade or business, if you are using a separate structure that is not attached to your home.

Your home office will qualify as your principal place of business for deducting expenses for its use if you meet the following requirements.

- 1) You use it exclusively and regularly for the administrative or management activities of your trade or business.

- 2) You have no other fixed location where you conduct substantial administrative or management activities of your trade or business.

If you use part of your home for business, you must divide the expenses of operating your home between personal and business use. For more information, see Publication 587.

Deduction limit. If your gross income from farming equals or exceeds your total farm expenses (including expenses for the business use of your home) you can deduct all your farm expenses. But if your gross income from farming is less than your total farm expenses, your deduction for certain expenses for the business use of your home is limited.

Your deduction for otherwise nondeductible expenses, such as utilities, insurance, and depreciation (with depreciation taken last), cannot be more than the gross income from farming minus:

- 1) The business part of expenses you could deduct even if you did not use your home for business (such as deductible mortgage interest, real estate taxes, and casualty and theft losses), and
- 2) The business expenses that relate to the business activity in the home (for example, salaries or supplies), but not to the use of the home itself.

If you are self-employed, do not include in (2) above your deduction for half of your self-employment tax.

You can carry over to your next tax year deductions over the current year's limit. These deductions are subject to the gross income limit from the business use of your home for the next tax year.

See Publication 587 for information on how to figure this limit and where to deduct the expenses on your return.

Truck and Car Expenses

You can deduct the actual cost of operating a truck or car in your farm business. Only expenses for business use are deductible. These include such items as gasoline, oil, repairs, license tags, insurance, and depreciation (subject to certain limits).

Instead of using actual costs, under certain conditions you can use a standard mileage rate. For 1999, the rate is 32½ cents a mile for all business miles driven before April 1. The rate is 31 cents a mile for all business miles driven after March 31. You can use the standard mileage rate for cars and light trucks, such as vans, pickups, and panel trucks, that you own or lease. You cannot use the standard mileage rate if you operate two or more cars or light trucks at the same time. You are **not** using two or more vehicles at the same time if you alternate using (use at different times) the vehicles for business.

Example. Maureen owns a car and a pickup truck that are both used in her farm business. Her farm employees use the truck and she uses the car for business. Maureen cannot use the standard mileage rate for the car or the truck. This is because both vehicles are used in Maureen's farm business at the same time. She must use actual expenses for both vehicles.

More information. For more information, see chapter 4 of Publication 463. If you pay your employees for the use of their truck or car in your farm business, see *Reimbursements to employees* under *Travel Expenses*, next.

Travel Expenses

You can deduct ordinary and necessary expenses you incur while traveling away from home for your farm business. You cannot deduct lavish or extravagant expenses. Usually, the location of your farm business is considered your home for tax purposes. You are traveling away from home if:

- 1) Your duties require you to be absent from your farm substantially longer than an ordinary work day, and
- 2) You need to get sleep or rest to meet the demands of your work while away from home.

If you meet these requirements and can prove the time, place, and business purpose of your travel, you can deduct your ordinary and necessary expenses for travel, meals, and lodging. You can ordinarily deduct only 50% of your business-related meal expenses.

The following are some types of travel expenses.

- 1) Air, rail, bus, and car transportation.
- 2) Meals and lodging.
- 3) Cleaning and laundry.
- 4) Telephone and fax.
- 5) Transportation between your hotel and your temporary work assignment.
- 6) Tips for any of the above expenses.

Meals. You can deduct 50% of the cost of meals only if your business trip is overnight or long enough to require you to stop for sleep or rest to properly perform your duties. You cannot deduct any of the cost of meals if it is not necessary for you to rest, unless you meet the rules for business entertainment. For information on entertainment expenses, see chapter 2 of Publication 463.

The expense of a meal includes amounts you spend for your food, beverages, taxes, and tips relating to the meal. You can deduct either the actual cost or a standard meal allowance that covers your daily meal and incidental expenses.



Recordkeeping requirements. You must be able to prove your deductions for travel by adequate records or other evidence that will support your own statement. Estimates or approximations do not qualify as proof of an expense.

You should keep an account book or similar record, supported by adequate documentary evidence, that together supports each element of an expense. Generally, it is best to record the expense and keep the documentation at the time you paid it.

If you choose to deduct a standard meal allowance you do not have to keep records to prove amounts spent for meals and incidental items. However, you must still keep records to prove the actual amount of other travel expenses, and the time, place, and business purpose of your travel.

More information. For detailed information on travel, recordkeeping, and the standard meal allowance, see Publication 463.

Reimbursements to employees. You can generally deduct reimbursements you pay to your employees for travel and transportation expenses they incur in the conduct of your business. If you reimburse these expenses under an accountable plan, deduct them as travel and transportation expenses. If you reimburse these expenses under a nonaccountable plan, you must report the reimbursements as wages on Form W-2 and deduct them as wages. For more information, see chapter 16 of Publication 535.

Marketing Quota Penalties

You can deduct on Schedule F penalties you pay for marketing crops in excess of farm marketing quotas. However, if you do not pay the penalty, but instead the purchaser of your crop deducts it from the payment to you, include in gross income only the amount you received. Do not take a separate deduction for the penalty.

Tenant House Expenses

You can deduct the costs of maintaining houses and their furnishings for tenants or hired help as farm business expenses. These costs include repairs, heat, light, insurance, and depreciation.

The value of a dwelling you furnish to a tenant under the usual tenant-farmer arrangement is not taxable income to the tenant.

Items Purchased for Resale

If you use the cash method of accounting, you can deduct the cost of livestock and other items purchased for resale in Part I of Schedule F in the year of sale. This cost includes freight charges for transporting the livestock to the farm. Ordinarily, this is the only time you can deduct the purchase price. However, see *Cost of chickens, seeds, and young plants—cash method*, later.

Example. You report on the cash method. In 1999, you buy 50 steers you will sell in 2000. You will report the sales price minus the purchase price (and any freight cost) as income in Part I of your 2000 Schedule F.

Cost of chickens, seeds, and young plants—cash method. Cash method farmers can deduct the cost of hens and baby chicks bought for commercial egg production, or for raising and resale, as an expense in the year they pay the costs, if they do it consistently and it does not distort income. You can deduct the purchase price of seeds and young plants bought for further development and cultivation before sale as an expense when paid if you do this consistently and you do not figure your income on the crop method. However, see *Prepaid Farm Supplies*, earlier, for a rule that may limit your deduction for these items.

If you deduct the purchase price of chickens and young plants as an expense, report their entire selling price as income. You cannot also deduct the purchase price from the selling price.

You cannot deduct the purchase price of seeds and young plants for Christmas trees and timber as an expense. Deduct the cost of these seeds and plants through depletion allowances. For more information, see *Depletion* in chapter 8.

The purchase price of chickens and plants used as food for your family is never deductible.

Capitalize the cost of plants with a preproductive period of more than 2 years, unless you can elect out of the uniform capitalization rules, which are discussed in chapter 7.

Example. You use the cash method of accounting. In 1999, you buy 500 baby chicks to raise for resale in 2000. You also buy 50 bushels of winter seed wheat in 1999 that you sow in the fall. You can deduct the cost of both the baby chicks and the seed wheat in 1999, unless you previously adopted the method of deducting these costs in the year you sell the chickens or the harvested crops.

Delaying deduction—crop method. You can delay deducting the purchase price of seeds and young plants until you sell them if you get IRS permission. If you follow this method, deduct the purchase price from the selling price to determine your profit. Do this in Part I of Schedule F. For more information, see *Crop method* under *Special Methods of Accounting* in chapter 3.

Choosing the method. You can adopt either of these methods for deducting the purchase price **in the first year** you buy egg-laying hens, pullets, chicks, or seeds and young plants. If you choose the crop method, however, you need IRS permission.

Although you must use the same method for egg-laying hens, pullets, and chicks, you can use a different method for seeds and young plants. Once you use a particular method for any of these items, use it for those items until you get IRS permission to change your method. For more information, see *Change in Accounting Method* in chapter 3.

Other Expenses

The following list, while not all-inclusive, shows some expenses you can deduct as other farm expenses in Part II of Schedule F. These expenses must be for business purposes and (1) paid, if you use the cash method of accounting, or (2) incurred, if you use an accrual method of accounting.

- Accounting fees.
- Advertising.
- Chemicals.
- Custom hire (machine work).
- Educational expenses (to maintain and improve farming skills).
- Farm-related attorney fees.
- Farm fuels and oil.
- Farm magazines.
- Freight and trucking.
- Ginning.
- Insect sprays and dusts.
- Litter and bedding.
- Livestock fees.
- Recordkeeping expenses.
- Service charges.

- Small tools expected to last one year or less.
- Stamps and stationery.
- Storage and warehousing.
- Subscriptions to professional, technical, and trade journals that deal with farming.
- Tying material and containers.
- Veterinary fees and medicine.

- h) Constructing earthen, masonry, or concrete tanks, reservoirs, or dams, and
- i) Building roads.

Crop production expenses. The uniform capitalization rules generally require you to capitalize expenses incurred in producing plants. However, except for certain taxpayers required to use an accrual method of accounting, the capitalization rules do not apply to plants with a preproductive period of 2 years or less. For more information, see *Uniform Capitalization Rules* in chapter 7.

Timber. Capitalize the cost of acquiring timber. Do not include the cost of land in the cost of the timber. You must generally capitalize direct costs incurred in reforestation. These costs include the following.

- 1) Site preparation costs, such as:
 - a) Girdling,
 - b) Applying herbicide,
 - c) Baiting rodents, and
 - d) Clearing and controlling brush.
- 2) The cost of seed or seedlings.
- 3) Labor and tool expenses.
- 4) Depreciation on equipment used in planting or seeding.
- 5) Costs incurred in replanting to replace lost seedlings.

You can choose to capitalize certain indirect reforestation costs.

These capitalized amounts are your basis for the timber. Recover your basis when you sell the timber or take depletion allowances when you cut the timber. However, you may recover a limited amount of your costs for forestation or reforestation before cutting the timber through amortization deductions. For more information, see *Depletion and Amortization* in chapter 8.



For more information about timber, see *Agriculture Handbook Number 708, Forest Owners' Guide to the Federal Income Tax*. Copies are \$12 each and are available from the U.S. Government Printing Office. Place your order using Stock #001-000-04621-7. The address and telephone number are:

Superintendent of Documents
U.S. Government Printing Office
P.O. Box 371954
Pittsburgh, PA 15250-7954
(202) 512-1800

Christmas tree cultivation. If you are in the business of planting and cultivating Christmas trees to sell when they are more than 6 years old, capitalize expenses incurred for planting and stump culture and add them to the basis of the standing trees. Recover these expenses as part of your adjusted basis when you sell the standing trees or as depletion allowances when you cut the trees. For more information, see *Timber depletion* under *Depletion* in chapter 8.

You can deduct as business expenses the costs incurred for shearing and basal pruning of these trees. Expenses incurred for silvicultural practices, such as weeding or cleaning, and noncommercial thinning are also deductible as business expenses.

Capitalize the cost of land improvements, such as road grading, ditching, and fire breaks, that have a useful life beyond the tax year. If the improvements do not have a determinable useful life, add their cost to the basis of the land. The cost is recovered when you sell or otherwise dispose of it. If the improvements have a determinable useful life, recover their cost through depreciation. Capitalize the cost of equipment and other depreciable assets, such as culverts and fences, to the extent you do not use them in planting Christmas trees. Recover these costs through depreciation.

Capital Expenses

A capital expense is a payment, or a debt incurred, for the acquisition, improvement, or restoration of an asset that is expected to last more than one year. You include the expense in the basis of the asset. Uniform capitalization rules also require you to capitalize or include in inventory certain other expenses. See chapters 3 and 7.

Capital expenses are generally not deductible, but they may be depreciable. However, you can elect to deduct certain capital expenses, such as the following.

- 1) The cost of fertilizer, lime, etc. (see *Fertilizer and Lime* under *Deductible Expenses*, earlier).
- 2) Soil and water conservation expenses (see chapter 6).
- 3) The cost of property that qualifies for a deduction under section 179 (see chapter 8).
- 4) The cost of qualifying clean-fuel vehicle property and clean-fuel vehicle refueling property (see chapter 15 in Publication 535).

The costs of the following items, including the costs of material, hired labor, and installation, are capital expenses.

- 1) Business start-up costs. (See *Going Into Business* in chapter 8.)
- 2) Land and buildings.
- 3) Additions, alterations, and improvements to buildings, etc.
- 4) Cars and trucks.
- 5) Equipment and machinery.
- 6) Fences.
- 7) Breeding, dairy, and draft livestock.
- 8) Reforestation.
- 9) Repairs to machinery, equipment, cars, and trucks that prolong their useful life, increase their value, or adapt them to different use.
- 10) Water wells, including drilling and equipping costs.
- 11) Land preparation, such as:
 - a) Clearing land for farming,
 - b) Leveling and conditioning land,
 - c) Purchasing and planting trees,
 - d) Building irrigation canals and ditches,
 - e) Laying irrigation pipes,
 - f) Installing drain tile,
 - g) Modifying channels or streams,

Nondeductible Expenses

You cannot deduct personal expenses and certain other items on your tax return even if they relate to your farm.

Personal, Living, and Family Expenses

You cannot deduct certain personal, living, and family expenses as business expenses. These include rent and insurance premiums paid on property used as your home, life insurance premiums on yourself or your family, the cost of maintaining cars, trucks, or horses for personal use, allowances to minor children, attorneys' fees and legal expenses incurred in personal matters, and household expenses. Likewise, the cost of purchasing or raising produce or livestock consumed by you or your family is not deductible.

Other Nondeductible Items

You cannot deduct the following items on your tax return.

Loss of growing plants, produce, and crops. Losses of plants, produce, and crops raised for sale are generally not deductible. However, you may have a deductible loss on plants with a preproductive period of more than 2 years. See chapter 13 for more information.

Repayment of loans.

Estate, inheritance, legacy, succession, and gift taxes.

Loss of livestock. You cannot deduct as a loss the value of raised livestock that die if you deducted the cost of raising them as an expense.

Losses from sales or exchanges between related persons. You cannot deduct losses from sales or exchanges of property between you and certain related persons, including your spouse, brother, sister, ancestor, or descendant. For more information, see chapter 2 of Publication 544, *Sales and Other Dispositions of Assets*.

Cost of raising unharvested crops. You cannot deduct the cost of raising unharvested crops sold with land owned more than one year if you sell both at the same time and to the same person. Add these costs to the basis of the land to determine the gain or loss on the sale. For more information, see *Section 1231 Gains and Losses* in chapter 11.

Cost of unharvested crops bought with land. Capitalize the purchase price of land, including the cost allocable to unharvested crops. You cannot deduct the cost of the crops at the time of purchase. However, you can deduct this cost in figuring net profit or loss in the tax year you sell the crops.

Cost related to gifts. You cannot deduct costs related to your gifts of agricultural products or property held for sale in the ordinary course of your business. For example, you cannot deduct as a farm business expense, in the year of the gift or any later year, the cost of raising cattle given as a gift to your child or the cost of planting and raising unharvested wheat on parcels of land given as a gift to your children.

Club dues and membership fees. Generally, you cannot deduct amounts you pay or incur for membership in any club organized for business, pleasure, recreation, or any other social purpose. This includes country clubs, athletic clubs, luncheon clubs, sporting clubs, airline clubs, and hotel clubs.

Exception. The following organizations will not be treated as clubs organized for business, pleasure, recreation, or other social purposes, unless one of its main purposes is to conduct entertainment activities for members or their guests or to provide members or their guests with access to entertainment facilities.

- 1) Boards of trade.
- 2) Business leagues.
- 3) Chambers of commerce.
- 4) Civic or public service organizations.
- 5) Professional associations.
- 6) Trade associations.

Fines and penalties. You cannot deduct fines and penalties, except penalties for exceeding marketing quotas, discussed earlier.

Losses From Operating a Farm

If your deductible farm expenses are more than your farm income, you have a loss from the operation of your farm. The amount of that loss you can deduct when figuring your taxable income may be limited. To figure your deductible loss, you must apply the following limits.

- 1) The at-risk limits.
- 2) The passive activity limits.

The following discussions explain these limits. If your deductible loss after applying these limits is more than your other income for the year, you may have a net operating loss. See *Net Operating Losses*, later.



If you do not carry on your farming activity to make a profit, your loss deduction may be limited by the not-for-profit rules. See Not-for-Profit Farming, later.

At-Risk Limits

The at-risk rules limit your deduction for losses from most business or income-producing activities, including farming. The at-risk rules limit the losses you can deduct when figuring your taxable income. The deductible loss from an activity is limited to the amount you have at risk in the activity.

You are at risk in any activity for:

- 1) The money and adjusted basis of property you contribute to the activity, and
- 2) Amounts you borrow for use in the activity if:
 - a) You are personally liable for repayment, or
 - b) You pledge property (other than property used in the activity) as security for the loan.

You are not at risk, however, for amounts you borrow for use in a farming activity from a person who has an interest in the activity (other than as a creditor) or a person related to someone (other than you) having such an interest.

For more information, see Publication 925.

Passive Activity Limits

A *passive activity* is generally any activity involving the conduct of any trade or business in which you do not materially participate. Generally, a rental activity is a passive activity.

If you have a passive activity, special rules limit the loss you can deduct in the tax year. You generally can deduct losses from passive activities only from income from passive activities. Credits are similarly limited.

For more information, see Publication 925.

Net Operating Losses

If your deductible loss from operating your farm (after applying the at-risk and passive activity limits explained in the preceding discussion) is more than your other income for the year, you may have a net operating loss (NOL). You may also have an NOL if you had a personal or business-related casualty or theft loss that was more than your income.

If you have an NOL this year, you can carry it to other years and deduct it. You may be able to get a refund of all or part of the income tax you paid for past years, or you may be able to reduce your tax in future years.

To determine if you have an NOL, complete your tax return for the year. You may have an NOL if a negative figure appears on the line shown below.

- 1) Individuals—line 37 of Form 1040.
- 2) Estates and trusts—line 22 of Form 1041.
- 3) Corporations—line 30 of Form 1120 or line 26 of Form 1120-A.

If the amount on that line is zero or more, you do not have an NOL.

There are rules that limit what you can deduct from gross income when figuring an NOL. These rules are discussed in detail under *How To Figure an NOL* in Publication 536.

In general, these rules do not allow the following items.

- 1) Personal exemptions.
- 2) Capital losses in excess of capital gains. (Nonbusiness capital losses may only offset nonbusiness capital gains.)
- 3) The section 1202 exclusion of 50% of the gain from the sale or exchange of qualified small business stock.
- 4) Nonbusiness deductions in excess of nonbusiness income.
- 5) Net operating loss deduction.

Example. Glenn Johnson is a dairy farmer. He is single and has the following income and deductions on his Form 1040 for 1999.

INCOME	
Wages from part-time job	\$1,225
Interest on savings	425
Net long-term capital gain on sale of farm acreage	2,000
Glenn's total income	<u>\$3,650</u>

DEDUCTIONS	
Net loss from farming business (income of \$67,000 minus expenses of \$72,000)	\$5,000
Net short-term capital loss on sale of stock	1,000
Standard deduction	4,300
Personal exemption	2,750
Glenn's total deductions	<u>\$13,050</u>

Glenn's deductions exceed his income by \$9,400 (\$13,050 – \$3,650). However, to figure whether he has an NOL, he must modify certain deductions. He can use **Schedule A (Form 1045)** to figure his NOL.

Glenn cannot deduct the following items.

Nonbusiness net short-term capital loss	\$1,000
Nonbusiness deductions (standard deduction, \$4,300) minus nonbusiness income (interest, \$425)	3,875
Personal exemption	2,750
Total adjustments to net loss	<u>\$7,625</u>

When these items are eliminated, Glenn's net loss is reduced to \$1,775 (\$9,400 – \$7,625). This is his NOL for 1999.

Carrybacks. Generally, you carry an NOL back to the 2 tax years before the NOL year and deduct it from income you had in those years. You can choose not to carry back an NOL and only carry it forward. See *Waiving the carryback period*, later. There are rules for figuring how much of the NOL is used in each tax year and how much is carried to the next tax year. These rules are explained in Publication 536.

Unless you choose to waive the carryback period, as discussed later, you must first carry the entire NOL to the earliest carryback year. If your NOL is not used up, you can carry the rest to the next earliest carryback year, and so on.

Refigure your deductions, credits, and tax for each of the years to which you carried back an NOL. If your refigured tax is less than the tax you originally paid, you can apply for a refund by filing Form 1040X, *Amended U.S. Individual Income Tax Return*, for each year affected, or by filing Form 1045. You will usually get a refund faster by filing Form 1045, and generally you can use one Form 1045 to apply an NOL to all carryback years.

Exceptions to 2-year carryback rule. Eligible losses and farming losses qualify for longer carryback periods.

Eligible loss. The carryback period for an eligible loss is 3 years. An eligible loss is any part of an NOL that:

- 1) Is from a casualty or theft, or
- 2) Is attributable to a Presidentially declared disaster for a qualified small business or a farming business.

An eligible loss does not include a farming loss (explained next) unless you choose to treat the farming loss as if it were not a farming loss.

Farming loss. The carryback period for a farming loss is 5 years. A farming loss is the **smaller** of:

- 1) The amount which would be the NOL for the tax year if only income and deductions attributable to farming businesses were taken into account, or
- 2) The NOL for the tax year.

You can choose to treat a farming loss as if it were not a farming loss. For more information, see Publication 536.

Carryovers. If you do not use up the NOL in the carryback years, carry forward what remains of it to the 20 tax years following the NOL year. Start by carrying it to the first tax year after the NOL year. If you do not use it up, carry over the unused part to the next year. Continue to carry over any unused part of the NOL until you use it up or complete the 20-year carryforward period.



For an NOL occurring in a tax year beginning before August 6, 1997, the carryforward period is 15 years.

Waiving the carryback period. You can choose not to carry back your NOL. If you make this choice, you use your NOL only in the carryforward period.

To make this choice, attach a statement to your tax return for the NOL year filed on or before the due date of the return (including extensions). This statement must show that you are choosing to waive the carryback period under section 172(b)(3) of the Internal Revenue Code. Also, if you filed your return timely without making that election, you may still make the election by filing an amended return within 6 months of the due date of the return (excluding extensions). Attach the election to the amended return and write "Filed pursuant to section 301.9100-2" on the election statement. File the amended return at the same address that you filed the original return. Once made, the election is irrevocable and the carryforward is limited to 20 years.

Partnerships and S corporations. Partnerships and S corporations cannot use an NOL. But partners or shareholders can use their separate shares of the partnership's or S corporation's business income and business deductions to figure their individual NOLs.

Not-for-Profit Farming

If you operate a farm for profit you can deduct all the ordinary and necessary expenses of carrying on the business of farming on Schedule F. However, if you do not carry on your farming activity, or other activity you engage or invest in, to make a profit, you report the income from the activity on line 21 of Form 1040 and you can deduct expenses of

carrying on the activity only if you itemize your deductions on Schedule A (Form 1040). Also, there is a limit on the deductions you can take. You cannot use a loss from that activity to offset income from other activities.

Activities you do as a hobby, or mainly for sport or recreation, come under these rules. So does an investment activity intended only to produce tax losses for the investors.

The limit on not-for-profit losses applies to individuals, partnerships, estates, trusts, and S corporations. It does not apply to corporations other than S corporations.

In determining whether you are carrying on your farming activity for profit, all the facts are taken into account. No one factor alone is decisive. Among the factors to consider are whether:

- 1) You operate your farm in a businesslike manner,
- 2) The time and effort you spend on farming indicates you intend to make it profitable,
- 3) You depend on income from farming for your livelihood,
- 4) Your losses are due to circumstances beyond your control or are normal in the start-up phase of farming,
- 5) You change your methods of operation in an attempt to improve profitability,
- 6) You, or your advisors, have the knowledge needed to carry on the farming activity as a successful business,
- 7) You made a profit in similar activities in the past,
- 8) You make a profit from farming in some years and how much profit you make, and
- 9) You can expect to make a future profit from the appreciation of the assets used in the farming activity.

Limit on deductions and losses. If your activity is not carried on for profit, take deductions only in the following order, only to the extent stated in the three categories, and, if you are an individual, only if you itemize them on Schedule A (Form 1040).

Category 1. Deductions you can take for personal as well as for business activities are allowed in full. For individuals, all nonbusiness deductions, such as those for home mortgage interest, taxes, and casualty losses (see chapter 13), belong in this category. For the limits that apply to mortgage interest, see Publication 936, *Home Mortgage Interest Deduction*.

Category 2. Deductions that do not result in an adjustment to the basis of property are allowed next, but only to the extent your gross income from the activity is more than the deductions you take (or could take) for it under the first category. Most business deductions, such as those for fertilizer, feed, insurance premiums, utilities, wages, etc., belong in this category.

Category 3. Business deductions that decrease the basis of property are allowed last, but only to the extent the gross income from the activity is more than deductions you take (or could take) for it under the first two categories. The deductions for depreciation, amortization, and the part of a casualty loss an individual could not deduct in category (1) belong in this category. Where more than one asset is involved, divide depreciation and

these other deductions proportionally among those assets.



Individuals must claim the amounts in categories (2) and (3) above as miscellaneous deductions on Schedule A (Form 1040). They are subject to the 2%-of-adjusted-gross-income limit. See Publication 529 for information on this limit.

Partnerships and S corporations. If a partnership or S corporation carries on a not-for-profit activity, these limits apply at the partnership or S corporation level. They are reflected in the individual shareholder's or partner's distributive shares.

Presumption of profit. Your farming or other activity is presumed to be carried on for profit if it produced a profit in at least 3 of the last 5 tax years, including the current year. Activities that consist primarily of breeding, training, showing, or racing horses are presumed to be carried on for profit if they produced a profit in at least 2 out of the last 7 tax years, including the current year. The activity must be the same for each year within this period. You have a profit when the gross income from an activity is more than the deductions for it.

If a taxpayer dies before the end of the 5-year (or 7-year) period, the period ends on the date of the taxpayer's death.

If your business or investment activity passes this 3- (or 2-) years-of-profit test, it is presumed to be carried on for profit. This means the limits discussed here do not apply. You can take all your business deductions from the activity on Schedule F, even for the years that you have a loss. You can rely on this presumption unless the IRS shows it is not valid.

If you fail the 3- (or 2-) years-of-profit test, you may still be considered to operate your farm for profit by considering the factors listed earlier.

Using the presumption later. If you are starting out in farming and do not have 3 (or 2) years showing a profit, you may want to take advantage of this presumption later, after you have had the 5 (or 7) years of experience allowed by the test.

You can choose to do this by filing **Form 5213**. Filing this form postpones any determination that your farming activity is not carried on for profit until 5 (or 7) years have passed since you first started farming. Form 5213 must be filed within 3 years after the due date of your return for the year you first started farming. However, if you receive a notice from the Internal Revenue Service proposing to disallow your farm loss, file this form within 60 days after receiving the notice.

The benefit gained by making this choice is that the IRS will not immediately question whether your farming activity is engaged in for profit. Accordingly, it will not limit your deductions. Rather, you will gain time to earn a profit in 3 (or 2) out of the first 5 (or 7) years you carry on the farming activity. If you show 3 (or 2) years of profit at the end of this period, your deductions are not limited under these rules. If you do not have 3 (or 2) years of profit (and cannot otherwise show that you operated your farm for profit), the limit applies retroactively to any year in the 5- (or 7-) year period with a loss.

Filing Form 5213 automatically extends the period of limitations on any year in the 5- (or 7-) year period to 2 years after the due date of the return for the last year of the pe-

riod. The period is extended only for deductions of the activity and any related deductions that might be affected.

For more information on not-for-profit activities, see *Not-for-Profit Activities* in chapter 1 of Publication 535.

6. Soil and Water Conservation Expenses

Introduction

If you are in the business of farming, you can choose to currently deduct your expenses for soil or water conservation or for the prevention of erosion of land used in farming. Otherwise, these are capital expenses that must be added to the basis of the land. (See chapter 7 for information on determining basis.) Conservation expenses for land in a foreign country do not qualify for this special treatment.

The deduction cannot be more than 25% of your gross income from farming. See *Limit on Deduction*, later.

Ordinary and necessary expenses that are otherwise deductible are not soil and water conservation expenses. These include interest and taxes, the cost of periodically clearing brush from productive land, the annual removal of sediment from a drainage ditch, and expenses paid or incurred primarily to produce an agricultural crop that may also conserve soil.



To get the full deduction to which you are entitled, you should maintain your records in a way that will clearly distinguish between your ordinary and necessary farm business expenses and your soil and water conservation expenses.

Topics

This chapter discusses:

- Business of farming
- Plan certification
- Conservation expenses
- Assessment by conservation district
- Limit on deduction
- Choosing to deduct
- Sale of a farm

Business of Farming

For purposes of soil and water conservation expense, you are in the business of farming if you cultivate, operate, or manage a farm for profit, either as owner or tenant. You are not farming if you cultivate or operate a farm for

recreation or pleasure, rather than for profit. You are not farming if you are engaged only in forestry or the growing of timber.

Farm defined. A farm includes stock, dairy, poultry, fish, fruit, and truck farms. It also includes plantations, ranches, ranges, and orchards. A fish farm is an area where fish and other marine animals are grown or raised and artificially fed, protected, etc. It does not include an area where they are merely caught or harvested. A plant nursery is a farm for purposes of deducting soil and water conservation expenses.

Farm rental. If you own a farm and receive farm rental payments based on farm production, either in cash or crop shares, you are in the business of farming. If you receive a fixed rental payment not based on farm production, you are in the business of farming only if you materially participate in operating or managing the farm. See *Landlord Participation in Farming* in chapter 15.

If you get cash rental for a farm you own that is not used in farm production, you cannot claim soil and water conservation expenses for that farm.

Example. You own a farm in Iowa and live in California. You rent the farm for \$125 in cash per acre and do not materially participate in producing or managing production of the crops grown on the farm. You cannot deduct your soil conservation expenses for this farm. You must capitalize the expenses and add them to the basis of the land.

Plan Certification

You can deduct your expenses for soil and water conservation only if they are consistent with a plan approved by the Natural Resources Conservation Service (NRCS) of the Department of Agriculture. If no such plan exists, the expenses must be consistent with a soil conservation plan of a comparable state agency to be deductible. Keep a copy of the plan with your books and records as part of the support for your deductions.

Conservation plans. A conservation plan includes the farming conservation practices approved for the area where your farm land is located. There are three types of approved plans.

- **NRCS individual site plans.** These plans are issued individually to farmers who request assistance from NRCS to develop a conservation plan designed specifically for their farm land.
- **NRCS county plans.** These plans include a listing of farm conservation practices approved for the county where the farm land is located. Expenses for conservation practices not included on the NRCS county plans are deductible only if the practice is a part of an individual site plan.
- **Comparable state agency plans.** These plans are approved by state agencies and can be approved individual site plans or county plans. Individual site plans can be obtained from NRCS offices and comparable agencies.

Conservation Expenses

Deductible conservation expenses are those made for land that you or your tenant are using, or have used in the past, for farming. They include, but are not limited to expenses for the following.

- 1) The treatment or movement of earth, such as:
 - a) Leveling,
 - b) Conditioning,
 - c) Grading,
 - d) Terracing,
 - e) Contour furrowing, and
 - f) Restoration of soil fertility.
- 2) The construction, control, and protection of:
 - a) Diversion channels,
 - b) Drainage ditches,
 - c) Irrigation ditches,
 - d) Earthen dams, and
 - e) Watercourses, outlets, and ponds.
- 3) The eradication of brush.
- 4) The planting of windbreaks.



If you choose to deduct soil and water conservation expenses, you cannot exclude from gross income any cost-sharing payments you receive for those expenses. See chapter 4 for information about excluding cost-sharing payments.

New farm or farm land. If you acquire a new farm or new farm land from someone who was using it in farming immediately before you acquired the land, soil and water conservation expenses you make on it will be treated as made on land used in farming at the time the expenses were paid. You can deduct soil and water conservation expenses for this land if your use of it is substantially a continuation of its use in farming. The new farming activity does not have to be the same as the old farming activity. For example, if you buy land that was used for grazing cattle and then prepare it for use as an apple orchard, the expenses will qualify.

Land not used for farming. If your conservation expenses benefit both land that does not qualify as land used for farming and land that does qualify, you must allocate the expenses. For example, if the expenses benefit 200 acres of your land, but only 120 acres of this land are used for farming, then 60% (120 ÷ 200) of the expenses are deductible. You can use another method to allocate these expenses if you can clearly show that your method is more reasonable.

Wetlands. Expenses to drain or fill wetlands are **not** deductible as soil and water conservation expenses. These expenses are added to the basis of the land.

Center pivot irrigation. Expenses to prepare land for center pivot irrigation systems are **not** deductible as soil and water conser-

Table 6–1. Limits on Deducting an Assessment for Depreciable Property

Total Limit on Deduction for Assessment	Yearly Limit on Deduction for Assessment	Yearly Limit for All Conservation Expenses
10% of:	10% of:	25% of:
Total assessment against all members of the district for the property.	Your deductible share of the cost to the district for the property + \$500.	Your gross income from farming.
<ul style="list-style-type: none"> No one taxpayer can deduct more than 10% of the total assessment. Any amount over 10% is a capital expense and is added to the basis of your land. If an assessment is over 10% and payable in installments, each payment must be prorated between the deductible amount and the capital expense. 	<ul style="list-style-type: none"> If the assessment is greater than the amount paid, the limit for that year is 10% of your deductible share of the cost. The remainder is included in equal amounts over the next 9 tax years. 	<ul style="list-style-type: none"> Limit for all conservation expenses, including assessments for depreciable property. Amounts greater than 25% can be carried to the following year and added to that year's expenses. The total is then subject to the 25% of gross income from farming limit in that year.

vation expenses. These expenses are added to the basis of the land.

Depreciable conservation assets. You cannot deduct your expenses for depreciable conservation assets. There is, however, an exception for an assessment for depreciable property that a soil and water conservation or drainage district levies against your farm. See *Assessment for Depreciable Property*, later.

You must capitalize direct expenses for structures or facilities subject to an allowance for depreciation, such as depreciable nonearthen items made of masonry or concrete. Expenses for depreciable property include those for materials, supplies, wages, fuel, hauling, and moving dirt when making structures such as tanks, reservoirs, pipes, conduits, canals, dams, wells, or pumps composed of masonry, concrete, tile, metal, or wood. You recover your capital investment through annual allowances for depreciation.

However, soil and water conservation expenses for nondepreciable earthen items such as earthen terraces and dams are deductible.

Water well. The cost of drilling a water well for irrigation and other agricultural purposes is a capital expense and **not** deductible as a soil and water conservation expense. You recover your cost through depreciation. You must also capitalize your cost for drilling a test hole. If the test hole produces no water and you continue drilling, the cost of the test hole is added to the cost of the producing well. You can recover the total cost through depreciation deductions.

If a test hole, dry hole, or dried-up well (resulting from prolonged lack of rain, for instance) is abandoned, you can deduct your unrecovered cost in the year of abandonment. Abandonment means that all economic benefits from the well are terminated. For example, filling or sealing a well excavation or casing so that all economic benefits from the well are terminated would be abandonment.

Assessment by Conservation District

In some localities, a soil or water conservation or drainage district incurs the expenses for soil or water conservation and levies an assessment against the farmers who benefit from the expenses. You can include as a deductible conservation expense the part of an assessment that:

- You would have included if you had paid it directly, or
- Covers expenses for depreciable property used in the district's business.

You include the amount in the year you pay or incur the assessment, depending on your method of accounting, not the year the expenses are paid or incurred by the district.

Assessment for Depreciable Property

You can include as a deductible conservation expense part of an assessment levied against you by a soil and water conservation or drainage district to pay for depreciable property. This includes items such as pumps, locks, concrete structures including dams and weir gates, draglines, and similar equipment. The depreciable property must be used in the district's soil and water conservation activities. Special limits, discussed next, apply to these assessments.

Amount to include. The amount you can include for any conservation district assessment for depreciable property is subject to the following limits.

- The total amount you can include for the assessment (whether one payment or paid in installments) cannot exceed 10% of the total assessment against all members of the district for the property.
- The maximum amount you can include each year is 10% of your deductible share of the cost + \$500.

The amount you can include is added to your other conservation expenses for the year. The total for these expenses is then subject to the limit on the deduction discussed later. See *Table 6–1* for information on the limits.

Total limit. You cannot include more than 10% of the total amount assessed to all members of the conservation district for the depreciable property. This applies whether you pay the assessment in one payment or in installments. If your assessment is more than 10% of the total assessment, both the following rules apply.

- The amount over 10% is a capital expense and is added to the basis of your land.
- If the assessment is paid in installments, each payment must be prorated between

the deductible amount and the capital expense.

Yearly limit. The maximum amount you can include in one year is the total of 10% of your deductible share of the cost as explained earlier, plus \$500. If the assessment is equal to or less than the maximum amount, you can include the entire assessment in the year it is paid. If the assessment is more, the maximum amount you can include in one year is 10% of your deductible share of the cost. The remainder of the assessment is included in equal amounts (subject to the yearly limit) over the next 9 tax years.

Example 1. This year, the soil conservation district levies an assessment of \$2,400 against your farm. Of the assessment, \$1,500 is for digging drainage ditches. It is includible as a soil or conservation expense as if you had paid it directly. The remaining \$900 is for depreciable equipment to be used in the district's irrigation activities. The total amount assessed by the district against all its members for the depreciable equipment is \$7,000.

The total amount you can include for the depreciable equipment is limited to 10% of the total amount assessed by the district against all its members for depreciable equipment, or \$700. The \$200 excess (\$900 – \$700) is a capital expense you must add to the basis of your farm.

To figure the maximum amount to include for this year, multiply your deductible share of the total assessment (\$700) by 10%. Add \$500 to the result for a total of \$570. Since the assessment, \$700, is greater than the maximum amount deductible in one year, you can include only \$70 of the assessment for depreciable property this year (10% of \$700). The balance is included at the rate of \$70 a year over the next 9 years.

You add \$70 to the \$1,500 portion of the assessment for drainage ditches. You can include \$1,570 of the \$2,400 assessment as a soil and water conservation expense this year, subject to the limit on deduction discussed later.

Example 2. Assume the same facts in *Example 1* except that \$1,850 of the \$2,400 assessment is for digging drainage ditches and \$550 is for depreciable equipment. The total assessed by the district against all its members for depreciable equipment is \$5,500. Your total deductible assessment for the depreciable equipment is limited to 10% of this amount, or \$550.

The maximum deductible this year for the depreciable equipment is \$555 (10% of your total deductible assessment, \$55, plus \$500).

Since the assessment for depreciable property is less than the maximum deductible, you can include the entire \$550. The entire assessment, \$2,400, is deductible as a soil and water conservation expense this year, subject to the limit on deduction, discussed later.

Sale or disposal of land during 9-year period. If you sell or dispose of the land during the 9-year period for deducting conservation expenses, any remaining assessment not yet included is added to the basis of the property.

Death of farmer during 9-year period. If the farmer dies during the 9-year period, any remaining assessment not yet included is included in the year of death.

Limit on Deduction

The total deduction for conservation expenses in any tax year is limited to 25% of your gross income from farming for the year.

Gross income from farming. Gross income from farming is the income you derive in the business of farming from the production of crops, fish, fruits, other agricultural products, or livestock. Gains from sales of livestock held for draft, breeding, or dairy are included. Gains from sales of assets such as farm machinery, or from the disposition of land, are not included.

Carryover of deduction. If your deductible conservation expenses in any year are more than 25% of your gross income from farming for that year, you can carry the unused deduction over to later years. However, the deduction in any later year is limited to 25% of the gross income from farming for that year, as well.

Example. In 1999, you have gross income of \$16,000 from two farms. During the year, you incurred \$5,300 of deductible soil and water conservation expenses for one of the farms. However, your deduction is limited to 25% of \$16,000, or \$4,000. The \$1,300 (\$5,300 – \$4,000) is carried over to 2000 and added to deductible soil and water conservation expenses made in that year. The total of the 1999 carryover plus 2000 expenses is deductible in 2000, subject to the limit of 25% of your gross income from farming in 2000. Any expenses over the limit in that year are carried to 2001 and later years.

Net operating loss. The deduction for soil and water conservation expenses is included when figuring a net operating loss (NOL) for the year. If the NOL is carried to another year, the soil and water conservation deduction included in the NOL is not subject to the 25% limit in the year to which it is carried.

Choosing To Deduct

You can choose to deduct soil and water conservation expenses on your tax return for the first year you pay or incur these expenses. If you choose to deduct them, you must deduct the total allowable amount in the year they are paid or incurred. If you do not deduct the expenses, you must capitalize them.

Change of method. If you want to change your method of treating soil and water conservation expenses, or you want to treat the expenses for a particular project or a single farm in a different manner, you must get the approval of the IRS. To get this approval, submit a written request by the due date of your return for the first tax year you want the new method to apply. You or your authorized representative must sign the request.

The request must include the following information.

- Your name and address.
- The first tax year the method or change of method is to apply.
- Whether the method or change of method applies to all your soil and water conservation expenses or only to those for a particular project or farm. If the method or change of method does not apply to all your expenses, identify the project or farm to which the expenses apply.
- The total expenses you paid or incurred in the first tax year the method or change of method is to apply.
- A statement that you will account separately in your books for the expenses to which this method or change of method relates.

Sale of a Farm

If you sell your farm, you cannot adjust the basis of the land at the time of the sale for any unused carryover of soil and water conservation expenses (except for deductions of assessments for depreciable property, discussed earlier). However, if you acquire another farm and return to the business of farming, you can start taking deductions again for the unused carryovers.

Gain on disposition of farm land. If you held the land 5 years or less before you sold or disposed of it, gain on the sale or other disposition of the land is treated as ordinary income up to the amount you previously deducted for soil and water conservation expenses. If you held the land less than 10 but more than 5 years, the gain is treated as ordinary income up to a specified percentage of the previous deductions. See *Section 1252 property* in chapter 11.

7.

Basis of Assets

Introduction

Basis is the amount of your investment in property for tax purposes. Use the basis of property to figure the amount of gain or loss on the sale, exchange, or other disposition of property. Also use it to figure the deduction for depreciation, amortization, depletion, and casualty losses. If you use property for both

business and personal purposes, you must allocate the basis based on the use. Only the basis allocated to the business use of the property can be depreciated.

Your original basis in property is adjusted (increased or decreased) by certain events. If you make improvements to the property, increase your basis. If you take deductions for depreciation or casualty losses, reduce your basis.



It is important to keep an accurate record of your basis. For information on keeping records, see chapter 1.

Generally, the higher your basis for an asset, the less gain you will have to report on its sale. The higher your basis in a depreciable asset, the higher your depreciation deductions.

Topics

This chapter discusses:

- Cost basis
- Adjusted basis
- Basis other than cost

Useful Items

You may want to see:

Publication

- 504** Divorced or Separated Individuals
- 535** Business Expenses
- 537** Installment Sales
- 544** Sales and Other Dispositions of Assets
- 551** Basis of Assets

Form (and Instructions)

- 706–A** United States Additional Estate Tax Return

See chapter 21 for information about getting publications and forms.

Cost Basis

The basis of property you buy is usually its cost. However, in some cases, such as inherited property or property received as a gift, your basis will be figured differently. (See *Basis Other Than Cost*, later.) The cost is the amount you pay in cash, debt obligations, other property, or services. Your cost also includes amounts you pay for sales tax, freight, installation, and testing. In addition, the basis of real estate and business assets will include other items. Basis generally does not include interest payments.

You may also have to capitalize (add to basis) certain other costs related to buying or producing property. Under the uniform capitalization rules, discussed later, you may have to capitalize certain indirect costs of producing property.

Loans with low or no interest. If you buy property on any time-payment plan that charges little or no interest, the basis of your property is your stated purchase price minus the amount considered to be unstated interest. You generally have unstated interest if your interest rate is less than the applicable

federal rate. See the discussion of unstated interest in Publication 537.

Real Property

Real property, also called real estate, is land and generally anything built on, growing on, or attached to land.

If you buy real property, certain fees and other expenses you pay are part of your cost basis in the property.

You must allocate your cost basis between land and improvements, such as buildings, to figure the basis for depreciation of the improvements. Allocate the costs according to the fair market values of the land and improvements at the time of purchase.

Real estate taxes. If you pay real estate taxes that the seller owed on real property you bought, and the seller did not reimburse you, treat those taxes as part of your basis. You cannot deduct them as taxes.

If you reimburse the seller for taxes the seller paid for you, you usually can deduct that amount as an expense in the year of purchase. Do not include that amount in the basis of property. If you did not reimburse the seller, you must reduce your basis by the amount of those taxes.

Settlement costs. You can include in the basis of property you buy the settlement fees and closing costs that are for buying the property. (A fee for buying property is a cost that must be paid even if you bought the property for cash.) You cannot include fees and costs for getting a loan on the property.

The following items are some of the settlement fees or closing costs you can include in the basis of your property.

- Abstract fees (abstract of title fees).
- Charges for installing utility services.
- Legal fees (including title search and preparing the sales contract and deed).
- Recording fees.
- Surveys.
- Transfer taxes.
- Owner's title insurance.
- Any amounts the seller owes that you agree to pay, such as back taxes or interest, recording or mortgage fees, charges for improvements or repairs, and sales commissions.

Settlement costs **do not include** amounts placed in escrow for the future payment of items such as taxes and insurance.

The following items are some settlement fees and closing costs you **cannot** include in the basis of the property.

- 1) Fire insurance premiums.
- 2) Rent for occupancy of the property before closing.
- 3) Charges for utilities or other services related to occupancy of the property before closing.
- 4) Fees for refinancing a mortgage.
- 5) Charges connected with getting a loan. The following items are examples of these charges.
 - a) Mortgage insurance premiums.
 - b) Loan assumption fees.

- c) Cost of a credit report.
- d) Fees for an appraisal required by a lender.

If these costs relate to business property, items (1) through (3) are deductible as business expenses. Items (4) and (5) must be capitalized as costs of getting a loan and can be deducted over the period of the loan.

Points. If you pay points to get a loan (including a mortgage, second mortgage, line-of-credit, or a home equity loan), do not add the cost to the basis of the related property. Generally, you deduct points over the term of the loan. For more information about deducting points, see *Points* in chapter 8 of Publication 535.

Points on home mortgage. Special rules may apply to points you and the seller pay when you get a mortgage to buy your main home. If certain requirements are met, you can deduct the points in full for the year in which they are paid. Reduce the basis of your home by the amount of any seller-paid points. For more information, see *Points* in Publication 936, *Home Mortgage Interest Deduction*.

Assumption of a mortgage. If you buy property and assume (or buy subject to) an existing mortgage on the property, your basis includes the amount you pay for the property plus the amount to be paid on the mortgage.

Example. If you buy a farm for \$100,000 cash and assume a mortgage of \$400,000 on it, your basis is \$500,000.

Constructing assets. If you build property or have assets built for you, your expenses for this construction are part of your basis. Some of these expenses include the following items.

- The cost of purchased land.
- The cost of labor and materials.
- Architect's fees.
- Building permit charges.
- Payments to contractors.
- Payments for rental equipment.
- Inspection fees.

In addition, if you use your employees or farm materials and equipment to build an asset, your basis would also include the following costs.

- 1) Employee wages paid for the construction work.
- 2) Depreciation on equipment you own while it is used in the construction.
- 3) Operating and maintenance costs for equipment used in the construction.
- 4) The cost of business supplies and materials used in the construction.

Do not deduct these expenses. You **must** capitalize them (include them in the asset's basis). Also, reduce your basis by any work opportunity credit, welfare-to-work credit, Indian employment credit, or empowerment zone employment credit allowable on the wages you pay in (1). For information about these credits, see Publication 954, *Tax Incentives for Empowerment Zones and Other Distressed Communities*.



Do not include the value of your own labor, or any other labor you did not pay for, in the basis of any property you construct.

Allocating the Basis

If you buy multiple assets for a lump sum, allocate the amount you pay among the assets you receive. Make this allocation to figure your basis for depreciation and gain or loss on a later disposition of any of these assets.

Group of assets acquired. If you buy multiple assets for a lump sum, you and the seller may agree to a specific allocation of the purchase price among the assets in the sales contract. If this allocation is based on the value of each asset and you and the seller have adverse legal interests, the allocation generally will be accepted.

Example. In March you bought property for the lump-sum price of \$30,000. In the sales contract, you and the seller (not a related person) agree to allocate the purchase price among the assets based on their fair market value (FMV). An inventory of the property at its FMV on the date of purchase is as follows:

	FMV
Tractor	\$15,000
Plow	5,000
Mower	6,000
Manure spreader	4,000
Total purchase price	<u>\$30,000</u>

Your basis in each of the assets is its FMV. The FMV of property is defined later under *Basis Other Than Cost*.

Farming business acquired. If you buy a group of assets that is a farming business, there are rules you must use to allocate the purchase price among the assets. See *Trade or Business Acquired* in Publication 551 for more information.

Transplanted embryo. If you buy a cow that is pregnant with a transplanted embryo, allocate to the basis of the cow the part of the purchase price equal to the FMV of the cow. Allocate the rest of the purchase price to the basis of the calf. Neither the cost allocated to the cow nor the cost allocated to the calf is deductible as a current business expense.

Quotas and allotments. Certain areas of the country have quotas or allotments for commodities such as milk, tobacco, and peanuts. The cost of the quota or allotment is its basis. If you acquire a right to a quota with the purchase of land or a herd of dairy cows, allocate part of the purchase price to that right.

Uniform Capitalization Rules

The uniform capitalization rules specify the costs you add to basis in certain circumstances. You are subject to the uniform capitalization rules if you do any of the following in your trade or business or activity carried on for profit.

- Produce real or tangible personal property for use in the business or activity.
- Produce real or tangible personal property for sale to customers.

- Acquire property for resale. However, you generally do not have to use the uniform capitalization rules for personal property acquired if your average annual gross receipts are \$10 million or less for the 3 prior tax years.

You produce property if you construct, build, install, manufacture, develop, improve, create, raise, or grow the property.



You are not required to capitalize the costs of producing animals and certain plants. See Exceptions, later.

Examples of real property you might produce (build) for use in your farming business are barns, chicken houses, and storage sheds. Examples of tangible personal property you might produce for use in your farming business or for sale to customers include crops raised for sale or as animal feed. Other examples are animals raised for sale (beef cattle, hogs, etc.) or animals used in your farming business for breeding or production purposes (dairy cows).

Under the uniform capitalization rules, you must capitalize all direct costs and an allocable part of most indirect costs you incur due to your production or resale activities. The term **capitalize** means to include certain expenses in the basis of property you produce or in your inventory costs, rather than deduct them as current expenses. You can recover these costs through depreciation, amortization, or cost of goods sold when you use, sell, or otherwise dispose of the property.

Costs that are allocable to property being produced include variable costs, such as feed and labor, and fixed costs, such as depreciation on machinery and buildings.

For more information about these rules, see the regulations under section 263A of the Internal Revenue Code.

Exceptions. The uniform capitalization rules do not apply to the following.

- 1) Any animal.
- 2) Any plant with a preproductive period of 2 years or less.
- 3) Costs of replanting certain plants lost or damaged due to casualty.

Exceptions (1) and (2) do not apply to a corporation, partnership, or tax shelter required to use an accrual method of accounting. See *Accrual Method Required* in chapter 3.

In addition, you can choose not to use the uniform capitalization rules in the case of plants with a preproductive period of more than 2 years. If you make this choice, special rules apply. This choice cannot be made by a corporation, partnership, or tax shelter required to use an accrual method of accounting. This choice also does not apply to any costs incurred for the planting, cultivation, maintenance, or development of any citrus or almond grove (or any part thereof) within the first 4 years that the trees were planted.

For more information, see section 1.263A-4T of the regulations.

Adjusted Basis

Before figuring any gain or loss on a sale, exchange, or other disposition of property or figuring allowable depreciation, depletion, or amortization, you must usually make certain

adjustments to the basis of the property. The result of these adjustments to the basis is the adjusted basis.

Increases to Basis

Increase the basis of any property by all items properly added to a capital account. These include the cost of any improvements having a useful life of more than 1 year and amounts spent after a casualty to restore the damaged property.

The following are items that increase the basis of property.

- The cost of extending utility service lines to property.
- Legal fees, such as the cost of defending and perfecting title.
- Legal fees for obtaining a decrease in a government charge levied against property to pay for local improvements.

If you make additions or improvements to business property, keep separate accounts for them. Also, depreciate the basis of each according to the depreciation rules in effect when you placed the addition or improvement in service. See chapter 8.

Government charges for local improvements. Increase the basis of property by government charges for items such as paving roads and building ditches that increase the value of the property assessed. Do not deduct them as taxes. However, you can deduct as taxes charges that are for maintenance, repairs, or interest charges related to the improvements.

Deducting vs. capitalizing costs. Do not add to your basis costs you can deduct as current expenses. For example, amounts paid for incidental repairs or maintenance that are deductible as business expenses, cannot be added to basis. However, you can choose either to deduct or to capitalize certain other costs. If you capitalize these costs, include them in your basis. If you deduct them, do not include them in your basis. See chapter 11 in Publication 535.

Decreases to Basis

All the following reduce the basis of your property.

- The section 179 deduction.
- The deduction for clean-fuel vehicles and clean-fuel vehicle refueling property.
- Investment credit (part or all of credit) taken.
- Casualty and theft losses and insurance reimbursements.
- Amounts you receive for granting an easement.
- Deductions previously allowed or allowable for amortization, depreciation, and depletion.
- Exclusion from income of subsidies for energy conservation measures.
- Credit for qualified electric vehicles.
- Gain on the sale of your home on which tax was postponed.
- Certain canceled debt excluded from income.

- Rebates received from a manufacturer or seller.
- Patronage dividends received as a result of a purchase of property. See *Patronage Dividends (Distributions)* in chapter 4.
- Gas-guzzler tax.

Some of these decreases to basis are discussed next.

Section 179 deduction. If you choose to take the section 179 deduction for all or part of the cost of property, decrease the basis of the property by the deduction. For more information, see *Section 179 Deduction* in chapter 8.

Deduction for clean-fuel vehicle and clean-fuel vehicle refueling property. If you take the deduction for clean-fuel vehicles or clean-fuel vehicle refueling property, decrease the basis of the property by the amount of the deduction. For more information about these deductions, see chapter 15 in Publication 535.

Casualties and thefts. If you have a casualty or theft loss, decrease the basis of your property by the amount of any insurance or other reimbursement. Also, decrease it by any deductible loss not covered by insurance. However, increase your basis for amounts you spend after a casualty to restore the damaged property. See chapter 13 for information about figuring your casualty or theft loss.

Easements. The amount you receive for granting an easement is usually considered to be from the sale of an interest in your real property. It reduces the basis of the affected part of the property. If the amount received is more than the basis of the part of the property affected by the easement, reduce your basis in that part to zero and treat the excess as a recognized gain. See *Easements and rights-of-way* in chapter 4.

Depreciation. Decrease the basis of your property by the depreciation you deducted, or could have deducted, on your tax returns under the method of depreciation you chose. If you took less depreciation than you could have under the method you chose, decrease the basis by the amount you could have taken under that method. If you did not take a depreciation deduction, figure the amount of depreciation you could have taken. If you deducted more depreciation than you should have, decrease your basis as follows. Decrease it by the amount you should have deducted plus the part of the excess depreciation you deducted that actually reduced your tax liability for any year.

See chapter 8 for information on figuring the depreciation you should have claimed. See also *Changing Your Accounting Method* in chapter 8 for information that may benefit you if you deducted the wrong amount of depreciation.

In decreasing your basis for depreciation, take into account the amount deducted on your tax returns as depreciation and any depreciation you must capitalize under the uniform capitalization rules.

Exclusion from income of subsidies for energy conservation measures. If you received a subsidy from a utility company for the purchase or installation of any energy

conservation measure for a dwelling unit, you can exclude it from income. Reduce the basis of the property for which you received the subsidy by the excluded amount. For more information about this subsidy, see Publication 525, *Taxable and Nontaxable Income*.

Credit for qualified electric vehicle. If you claim the credit for a qualified electric vehicle, you must reduce your basis in that vehicle by the lesser of the following amounts.

- \$4,000.
- 10% of the vehicle's cost.

This reduction amount applies even if the credit allowed is less than that amount. For more information on this credit, see chapter 15 in Publication 535.

Canceled debt excluded from income. If a debt you owe is canceled or forgiven, other than as a gift or bequest, you generally must include the canceled amount in your gross income for tax purposes. A debt includes indebtedness for which you are liable or which attaches to property you hold.

You can exclude your canceled debt from income if the debt is included in any of the following categories.

- 1) Debt that is canceled in a bankruptcy case or when you are insolvent.
- 2) Qualified farm debt.
- 3) Qualified real property business debt (provided you are not a C corporation).

If you exclude from income canceled debt described in (1) or (2), you may have to reduce the basis of your depreciable and non-depreciable property. However, for canceled debt described in (3) that you exclude from income, you **must** reduce the basis of your depreciable property by the excluded amount.

For more information about canceled debt in a bankruptcy case, see Publication 908. For more information about insolvency and canceled debt that is qualified farm debt, see chapter 4. For more information about qualified real property business debt, see chapter 5 in Publication 334.

Basis Other Than Cost

There are many times when you cannot use cost as basis. In these cases, the fair market value of the property or the adjusted basis of certain property may be used. Adjusted basis is discussed earlier. Fair market value is discussed next.

Fair market value (FMV). Fair market value (FMV) is the price at which property would change hands between a buyer and a seller, neither having to buy or sell, and both having reasonable knowledge of all necessary facts. Sales of similar property on or about the same date may help in figuring the FMV of the property.

Property changed to business use. When you hold property for personal use and change it to business use or use it to produce rent, you must figure its basis for depreciation. An example of changing property held for personal use to business use would be renting out your former personal residence.

Basis for depreciation. The basis for depreciation is the lesser of the following two amounts.

- The FMV of the property on the date of the change.
- Your adjusted basis on the date of the change.

Property received for services. If you receive property for services, include the property's FMV in income. The amount you include in income becomes your basis. If the services were performed for a price agreed on beforehand, it will be accepted as the FMV of the property if there is no evidence to the contrary.

Taxable Exchanges

A taxable exchange is one in which the gain is taxable, or the loss is deductible. A taxable gain or deductible loss also is known as a **recognized** gain or loss. If you receive property in exchange for other property in a taxable exchange, the basis of the property you receive is usually its FMV at the time of the exchange. A taxable exchange occurs when you receive cash or get property that is not similar or related in use to the property exchanged.

Example. You trade a tract of farm land with an adjusted basis of \$3,000 for a tractor that has an FMV of \$6,000. You must report a taxable gain of \$3,000 for the land. The tractor has a basis of \$6,000.

Nontaxable Exchanges

A nontaxable exchange is an exchange in which you are not taxed on any gain and you cannot deduct any loss. If you receive property in a nontaxable exchange, its basis is usually the same as the basis of the property you transferred. A nontaxable gain or loss also is known as an **unrecognized** gain or loss.

Example. You traded a truck you used in your farming business for a new smaller truck to use in farming. The adjusted basis of the old truck was \$10,000. The FMV of the new truck was \$14,000. If this was a taxable exchange, you would recognize gain of \$4,000 (\$14,000 FMV of the new truck minus the \$10,000 adjusted basis of the old truck), and your basis in the new truck would be \$14,000. Because this is a nontaxable exchange, you do not recognize the gain, and your basis in the new truck is \$10,000, the same as the adjusted basis of the old truck you traded.

Like-Kind Exchanges

The exchange of property for the same kind of property is the most common type of nontaxable exchange.

For an exchange to qualify as a like-kind exchange, you must hold for business or investment purposes both the property you transfer and the property you receive. There must also be an exchange of like-kind property. For more information, see *Like-Kind Exchanges*, in chapter 10.

The basis of the property you receive is the same as the basis of the property you gave up.

Example. You traded a machine (adjusted basis \$8,000) for another like-kind machine (FMV \$9,000). You used both ma-

chines in your farming business. The basis of the machine you received is \$8,000, the same as the machine traded.

Exchange expenses. Exchange expenses generally are the closing costs that you pay. They include such items as brokerage commissions, attorney fees, deed preparation fees, etc. Add them to the basis of the like-kind property you received.

Property plus cash. If you trade property in a nontaxable exchange and also pay money, the basis of the property you receive is the basis of the property you gave up plus the money you paid.

Example. You trade in a truck (adjusted basis \$3,000) for another truck (FMV \$7,500) and pay \$4,000. Your basis in the new truck is \$7,000 (the \$3,000 basis of the old truck plus the \$4,000 paid).

Special rules for related persons. If a like-kind exchange takes place directly or indirectly between related persons and either party disposes of the property within 2 years after the exchange, the exchange no longer qualifies for like-kind exchange treatment. Each person must report any gain or loss not recognized on the original exchange. Each person reports it on the tax return filed for the year in which the later disposition occurred. If this rule applies, the basis of the property received in the original exchange will be its FMV. For more information, see chapter 10.

Exchange of business property. Exchanging the property of one business for the property of another business is a multiple property exchange. For information on figuring basis, see *Multiple Property Exchanges* in chapter 1 of Publication 544.

Partially Nontaxable Exchange

A partially nontaxable exchange is an exchange in which you receive unlike property or money in addition to like property. The basis of the property you receive is the same as the basis of the property you gave up with the following adjustments.

- 1) Decrease the basis by both the following amounts.
 - a) Any money you receive.
 - b) Any loss you recognize on the exchange.
- 2) Increase the basis by both the following amounts.
 - a) Any additional costs you incur.
 - b) Any gain you recognize on the exchange.

If the other party to the transaction assumes, or takes property subject to, your liabilities (including a nonrecourse obligation), treat the debt assumption as money you received in the exchange.

Example 1. You traded farm land (basis \$10,000) for another tract of farm land (FMV \$11,000). You also received \$3,000 cash. You realized a gain of \$4,000. This is the FMV of the land received plus the cash minus the basis of the land you traded (\$11,000 + \$3,000 - \$10,000). Include your gain in income (recognize gain) only to the extent of the cash you received. Your basis in the land you received is figured as follows.

Basis of land traded	\$10,000
Minus: Cash received (adjustment 1(a))	<u>-3,000</u>
	\$7,000
Plus: Gain recognized (adjustment 2(b))	<u>+3,000</u>
Basis of land received	<u>\$10,000</u>

Example 2. You traded a truck (adjusted basis \$22,750) for another truck (FMV \$20,000). You also received \$10,000 cash. You realized a gain of \$7,250. This is the FMV of the truck received plus the cash minus the adjusted basis of the truck you traded (\$20,000 + \$10,000 - \$22,750). You include all the gain in your income (recognize gain) because the gain is less than the cash you received. Your basis in the truck you received is figured as follows.

Adjusted basis of truck traded	\$22,750
Minus: Cash received (adjustment 1(a))	<u>-10,000</u>
	\$12,750
Plus: Gain recognized (adjustment 2(b))	<u>+7,250</u>
Basis of truck received	<u>\$20,000</u>

Allocation of basis. Allocate the basis first to the unlike property, other than money, up to its FMV on the date of the exchange. The rest is the basis of the like property.

Example. You had an adjusted basis of \$15,000 in a tractor you traded for another tractor that had an FMV of \$12,500. You also received \$1,000 in cash and a truck that had an FMV of \$3,000. The truck is unlike property. You realized a gain of \$1,500. This is the FMV of the tractor received plus the FMV of the truck received plus the cash minus the adjusted basis of the tractor you traded (\$12,500 + \$3,000 + \$1,000 - \$15,000). You include in your income (recognize) all \$1,500 of the gain because it is less than the FMV of the unlike property plus the cash received. Your basis in the properties you received is figured as follows.

Adjusted basis of old tractor	\$15,000
Minus: Cash received (adjustment 1(a))	<u>-1,000</u>
	\$14,000
Plus: Gain recognized (adjustment 2(b))	<u>+1,500</u>
Total basis of properties received	<u>\$15,500</u>

Allocate the total basis of \$15,500 first to the unlike property—the truck (\$3,000). The rest (\$12,500) is the basis of the tractor.

Sale and Purchase

If you sell property and buy similar property in two mutually dependent transactions, you may have to treat the sale and purchase as a single nontaxable exchange.

Example. You used a tractor on your farm for 3 years. Its adjusted basis is \$2,000 and its FMV is \$4,000. You are interested in a new tractor, which sells for \$15,500. Ordinarily, you would trade your old tractor for the new one and pay the dealer \$11,500. Your basis for depreciation for the new tractor would then be \$13,500 (\$11,500 plus the \$2,000 basis of your old tractor). However, you want a higher basis for depreciating the new tractor, so you agree to pay the dealer \$15,500 for the new tractor if he will pay you \$4,000 for your old tractor. Because the two transactions are dependent on each other, you are treated as having exchanged your old tractor for the new one and paid \$11,500 (\$15,500 minus \$4,000). Your basis for the new tractor is \$13,500, the same as if you traded the old tractor.

Involuntary Conversions

If you get property as a result of an involuntary conversion, such as a casualty, theft, or condemnation, you may figure the basis of the replacement property you get using the basis of the property destroyed, stolen, or condemned (old property).

Similar or related property. If the replacement property is similar or related in service or use to the old property, the replacement property's basis is the same as the old property's basis on the date of the involuntary conversion. However, make the following adjustments.

- 1) Decrease the basis by both the following amounts.
 - a) Any loss you recognize on the involuntary conversion.
 - b) Any money you receive that you do not spend on similar property.
- 2) Increase the basis by both the following amounts.
 - a) Any gain you recognize on the involuntary conversion.
 - b) Any cost of acquiring the replacement property.

Money or property that is not similar or related. If you receive money or property not similar or related in service or use to the old property and you buy replacement property similar or related in service or use to the old property, the basis of the replacement property is its cost decreased by the gain not recognized on the involuntary conversion.

For more information about involuntary conversions, see chapter 13.

Property Received as a Gift

To figure the basis of property you receive as a gift, you must know its adjusted basis (defined earlier) to the donor just before it was given to you. You also must know its FMV at the time it was given to you and any gift tax paid on it.

FMV equal to or more than donor's adjusted basis. If the FMV of the property is equal to or more than the donor's adjusted basis, your basis is the donor's adjusted basis when you received the gift. Increase your basis by all or part of any gift tax paid, depending on the date of the gift.

Also, for figuring gain or loss from a sale or other disposition of the property, or for figuring depreciation, depletion, or amortization deductions on business property, you must increase or decrease your basis (the donor's adjusted basis) by any required adjustments to basis while you held the property. See *Adjusted Basis*, earlier.

Gift received before 1977. If you received a gift before 1977, increase your basis in the gift (the donor's adjusted basis) by any gift tax paid on it. However, do not increase your basis above the FMV of the gift when it was given to you.

Example 1. You were given a house in 1976 with an FMV of \$21,000. The donor's adjusted basis was \$20,000. The donor paid a gift tax of \$500. Your basis is \$20,500, the donor's adjusted basis plus the gift tax paid.

Example 2. If, in Example 1, the gift tax paid had been \$1,500, your basis would be \$21,000. This is the donor's adjusted basis plus the gift tax paid, limited to the FMV of the house at the time you received the gift.

Gift received after 1976. If you received a gift after 1976, increase your basis in the gift (the donor's adjusted basis) by the part of the gift tax paid on it that is due to the net increase in value of the gift. Figure the increase by multiplying the gift tax paid by the following fraction.

$$\frac{\text{Net increase in value of the gift}}{\text{Amount of the gift}}$$

The net increase in value of the gift is the FMV of the gift minus the donor's adjusted basis. The amount of the gift is its value for gift tax purposes after reduction by any annual exclusion and marital or charitable deduction that applies to the gift. For information on the gift tax, see Publication 950, *Introduction to Estate and Gift Taxes*.

Example. In 1999, you received a gift of property from your mother that had an FMV of \$50,000. Her adjusted basis was \$20,000. The amount of the gift for gift tax purposes was \$40,000 (\$50,000 minus the \$10,000 annual exclusion). She paid a gift tax of \$9,000. Your basis, \$26,750, is figured as follows:

Fair market value	\$50,000
Minus: Adjusted basis	<u>-20,000</u>
Net increase in value	<u>\$30,000</u>
Gift tax paid	\$9,000
Multiplied by (\$30,000 ÷ \$40,000)	<u>× .75</u>
Gift tax due to net increase in value	\$6,750
Adjusted basis of property to your mother	<u>+20,000</u>
Your basis in the property	<u>\$26,750</u>

FMV less than donor's adjusted basis. If the FMV of the property at the time of the gift was less than the donor's adjusted basis, your basis depends on whether you have a gain or a loss when you dispose of the property. Your basis for figuring gain is the donor's adjusted basis plus or minus any required adjustment to basis while you held the property. (See *Adjusted Basis*, earlier.) Your basis for figuring loss is its FMV when you received the gift plus or minus any required adjustment to basis while you held the property. (See *Adjusted Basis*, earlier.)

If you use the donor's adjusted basis for figuring a gain and get a loss, and then use the FMV for figuring a loss and get a gain, you have neither gain nor loss on the sale or other disposition of the property.

Example. You received farm land as a gift from your parents when they retired from farming. At the time of the gift, the land had an FMV of \$80,000. Your parents' adjusted basis was \$100,000. After you received the land, no events occurred that would increase or decrease your basis in it.

If you sell the land for \$120,000, you will have a \$20,000 gain because you must use the donor's adjusted basis at the time of the gift (\$100,000) to report a gain. If you sell the land for \$70,000, you will have a \$10,000 loss because you must use the FMV at the time of the gift (\$80,000) to figure a loss.

If the sales price is between \$80,000 and \$100,000, you have neither gain nor loss. For instance, if the sales price was \$90,000 and you tried to figure a gain using the donor's adjusted basis (\$100,000), you would get a \$10,000 loss. If you then tried to figure a loss

using the FMV (\$80,000), you would get a \$10,000 gain.

Business property. If you hold the gift as business property, your basis for figuring any depreciation, depletion, or amortization deductions is the same as the donor's adjusted basis plus or minus any required adjustments to basis while you hold the property.

Property Transferred From a Spouse

The basis of property transferred to you or transferred in trust for your benefit by your spouse is the same as your spouse's adjusted basis. The same rule applies to a transfer by your former spouse if the transfer is incident to divorce. However, adjust your basis for any gain recognized by your spouse on property transferred in trust. This rule applies only to a transfer of property in trust in which the liabilities assumed plus the liabilities to which the property is subject are more than the adjusted basis of the property transferred.

The transferor must give you records needed to determine the adjusted basis and holding period of the property as of the date of the transfer.

For more information, see Publication 504.

Inherited Property

Your basis in property you inherit from a decedent is generally one of the following.

- 1) The FMV of the property at the date of the individual's death.
- 2) The FMV on the alternate valuation date, if the personal representative for the estate chooses to use alternate valuation. For information on the alternate valuation date, see the instructions for Form 706.
- 3) The value under the special-use valuation method for real property used in farming or other closely held business, if chosen for estate tax purposes. This method is discussed next.
- 4) The decedent's adjusted basis in land to the extent of the value that is excluded from the decedent's taxable estate as a qualified conservation easement.

If a federal estate tax return does not have to be filed, your basis in the inherited property is its appraised value at the date of death for state inheritance or transmission taxes.

Special farm real property valuation. Under certain conditions, when a person dies the executor or personal representative of that person's estate may choose to value the qualified real property on other than its FMV. If so, the executor or personal representative values the qualified real property based on its use as a farm. If the executor or personal representative chooses this method of valuation for estate tax purposes, this value is the basis of the property for the heirs. The qualified heirs should be able to get the necessary value from the executor or personal representative of the estate.

If you are a qualified heir who received special-use valuation property, increase your basis by any gain recognized by the estate or trust because of post-death appreciation. Post-death appreciation is the property's FMV on the date of distribution minus the property's FMV either on the date of the individual's death or on the alternate valuation date. Figure all FMVs without regard to the special-use valuation.

You can choose to increase your basis in special-use valuation property if it becomes subject to the additional estate tax. This tax is assessed if, within 10 years after the death of the decedent, you transfer the property to a person who is not a member of your family or the property stops being used as a farm. This tax may apply if you dispose of the property in a like-kind exchange or involuntary conversion.

To increase your basis in the property, you must make an irrevocable choice and pay the interest on the additional estate tax figured from the date 9 months after the decedent's death until the date of payment of the additional estate tax. If you meet these requirements, increase your basis in the property to its FMV on the date of the decedent's death or the alternate valuation date. The increase in your basis is considered to have occurred immediately before the event that results in the additional estate tax.

You make the choice by filing with Form 706-A a statement that does all the following.

- Contains your (and the estate's) name, address, and taxpayer identification number.
- Identifies the choice as a choice under section 1016(c) of the Internal Revenue Code.
- Specifies the property for which you are making the choice.
- Provides any additional information required by the Form 706-A instructions.

Community property. In community property states (Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin), husband and wife are each usually considered to own half the community property. When either spouse dies, the total value of the community property, even the part belonging to the surviving spouse, generally becomes the basis of the entire property. For this rule to apply, at least half the value of the community property interest must be includible in the decedent's gross estate, whether or not the estate must file a return.

For example, you and your spouse owned community property that had a basis of \$80,000. When your spouse died, at least half the FMV of the community interest was includible in your spouse's estate. The FMV of the community interest was \$100,000. The basis of your half of the property after the death of your spouse is \$50,000 (half of the \$100,000 FMV). The basis of the other half to your spouse's heirs is also \$50,000.

For more information about community property, see Publication 555.

8.

Depreciation, Depletion, and Amortization

Important Changes for 1999

Depreciation limits on business cars. The total section 179 deduction and depreciation you can take on a car you use in your business and first place in service in 1999 is \$3,060. Special rules apply to certain clean-fuel vehicles. See *Special Rules for Passenger Automobiles*.

Section 179 deduction. For 1999, the total cost you can elect to deduct under section 179 of the Internal Revenue Code is increased to \$19,000. See *Maximum dollar limit*.

Important Change for 2000

Section 179 deduction. For 2000, the total cost you can elect to deduct under section 179 of the Internal Revenue Code is increased to \$20,000. See *Maximum dollar limit*.

Introduction

If you buy farm property such as machinery, equipment, or a structure with a useful life of more than a year, you generally cannot deduct its entire cost in one year. Instead, you must spread the cost over more than one year and deduct part of it each year. For most types of property, this is called depreciation.

This chapter gives information on depreciating property placed in service after 1986. For information on depreciating property placed in service before 1987, see Publication 534, *Depreciating Property Placed in Service Before 1987*.



CAUTION You must use the 150% declining balance method for property used in a farming business rather than the 200% declining balance method, or you can elect an alternative method. The methods you can use are discussed later under Depreciation Methods.



TIP To help you understand depreciation and how to complete Form 4562, Depreciation and Amortization, see the filled-in Form 4562 in chapter 20.

This chapter also provides information on figuring both cost depletion (including timber depletion) and percentage depletion.

The last section of this chapter discusses amortization of section 197 intangibles, reforestation costs, pollution control facilities, and the costs of going into business.

Topics

This chapter discusses:

- General information on depreciation
- Section 179 deduction
- Modified Accelerated Cost Recovery System (MACRS)
- Listed property rules
- Basic information on depletion and amortization

Useful Items

You may want to see:

Publication

- 463** Travel, Entertainment, Gift, and Car Expenses
- 534** Depreciating Property Placed in Service Before 1987
- 535** Business Expenses
- 544** Sales and Other Dispositions of Assets
- 551** Basis of Assets
- 946** How To Depreciate Property

Form (and Instructions)

- T** Forest Activities Schedules
- 1040X** Amended U.S. Individual Income Tax Return
- 4562** Depreciation and Amortization
- 4797** Sales of Business Property

See chapter 21 for information about getting publications and forms.

General Information on Depreciation

The first part of this chapter gives you basic information on what property can and cannot be depreciated, when to begin and end depreciation, and how to claim depreciation.

What Can Be Depreciated

You can depreciate property only if it meets all the following requirements.

- 1) It is used in business or held for the production of income.
- 2) It must be expected to last more than one year. In other words, it must have a useful life that extends substantially beyond the year it is placed in service.
- 3) It is property that wears out, decays, gets used up, becomes obsolete, or loses value from natural causes.

Depreciable property may be tangible or intangible.

Tangible Property

Tangible property is property you can see or touch and it includes both real and personal property. Tangible personal property includes machinery or equipment and anything else you can see or touch except real property. Real property is land, buildings, and generally anything built or constructed on land, growing on land, or attached to land. However, land itself is never depreciable.

Livestock. Livestock purchased for draft, breeding, or dairy purposes that is not kept in an inventory account may be depreciated.

Raised livestock. Livestock you raise usually has no depreciable basis because the costs of raising them are deducted and are not added to their basis. However, if you purchase immature livestock for draft, dairy, or breeding purposes, you can depreciate your initial costs when the livestock reach the age when they can be worked, milked, or bred.

Dams, ponds, and terraces. In general, you cannot depreciate earthen dams, ponds, and terraces unless the structures have a determinable useful life.

Irrigation systems and water wells. You can depreciate irrigation systems and wells composed of masonry, concrete, tile, metal, or wood. In addition, you can depreciate costs for moving dirt to make irrigation systems and water wells composed of these materials.

Partial business use. If you use tangible property (including your car) for business or investment purposes and for personal purposes, you can deduct depreciation on the part used for business or investment.

For example, if you use your car for farm business, you can deduct depreciation for the part you use it in farming. If you also use it for investment purposes, you can depreciate the part used for investment.

If you use part of your home for business, you may be able to take a depreciation deduction for its business use. For more information, see *Business Use of Your Home* in chapter 5.

Intangible Property

Intangible property is generally any property that has value but that you cannot see or touch. It includes items such as computer software, copyrights, patents, franchises, trademarks, and trade names.

Computer software. Computer software includes any program used to cause a computer to perform a desired function. It also includes any data base or similar item in the public domain and incidental to the operation of qualifying software.

Generally, you can depreciate software over 36 months. However, if you acquired the software in connection with the acquisition of a substantial portion of a business, you can depreciate it over 36 months only if it meets the following requirements.

- It is readily available for purchase by the general public.
- It is not subject to an exclusive license.
- It has not been substantially modified.

If you acquire software in connection with the acquisition of a substantial portion of a

business and it does **not** meet the previous requirements, you must amortize it over 15 years (rather than depreciate it). For more information on amortization, see *Amortization*, later.

Year 2000 costs. Year 2000 costs are costs of converting or replacing computer software to recognize dates beginning in the year 2000. They include costs of the following.

- Manually converting existing software.
- Developing new software.
- Purchasing or leasing new software to replace existing software.
- Developing or purchasing software tools to assist you in converting your existing software.

Treat year 2000 costs as computer software for depreciation purposes.

Any change in the treatment of year 2000 costs to allow them to be treated as computer software for depreciation purposes is a change in accounting method. If you want to make this type of change, follow the automatic change procedures in Revenue Procedure 98-60 in Internal Revenue Bulletin No. 1998-51.

Leased software. If you lease software, treat the rental payments the same as any other rental payments.

What Cannot Be Depreciated

To determine if you can depreciate any item, you must know not only what you can depreciate but what you cannot depreciate.

Property placed in service and disposed of in the same year. You cannot depreciate property you place in service and dispose of in the same year. Determining when property is placed in service is explained later.

Land. You can never depreciate the cost of land because land does not wear out, become obsolete, or get used up. The cost of land generally includes the cost of clearing, grading, planting, and landscaping because these expenses are all part of the cost of the land itself. You may be able to depreciate some land preparation costs. For information on these costs, see chapter 1 of Publication 946.

Inventory. You can never depreciate property you hold primarily for sale to customers in the ordinary course of your business.

Equipment used to build capital improvements. You cannot deduct depreciation on equipment used to build your own capital improvements. You must add the depreciation allowed on equipment used during the period of construction to the basis of your improvements. See *Uniform Capitalization Rules* in chapter 7.

Leased property. You can depreciate leased property only if you retain the incidents of ownership for the property (explained later). This means you bear the burden of exhaustion of the capital investment in the property. Therefore, if you lease property to use in your trade or business or for the production of income, you cannot depreciate its cost. You can, however, depreciate any cap-

ital improvements you make to the leased property. See *Additions or improvements to property* in chapter 3 of Publication 946.

If you lease property to someone, you generally can depreciate its cost even if the lessee (the person leasing from you) has agreed to preserve, replace, renew, and maintain the property. However, you cannot depreciate the cost of the property if the lease provides that the lessee is to maintain the property and return to you the same property or its equivalent in value at the expiration of the lease in as good condition and value as when leased.

Incidents of ownership. Incidents of ownership include the following.

- The legal title.
- The legal obligation to pay for it.
- The responsibility to pay its maintenance and operating expenses.
- The duty to pay any taxes.
- The risk of loss if the property is destroyed, condemned, or diminished in value through obsolescence or exhaustion.

Intangible property. The following are two types of intangible property that you can never depreciate.

Goodwill. You can never depreciate goodwill because its useful life cannot be determined.

However, if you acquired a business after August 10, 1993 (July 25, 1991, if elected), and part of the price included goodwill, you may be able to amortize the cost of the goodwill over 15 years. For more information, see *Amortization*, later.

Trademark and trade name. In general, you must capitalize trademark and trade name expenses. This means that you cannot deduct the full amount in the current year. You can neither depreciate nor amortize the costs for trademarks and trade names you acquired before August 11, 1993 (before July 26, 1991, if elected). You may be able to amortize over 15 years the costs of trademarks and trade names acquired after August 10, 1993 (after July 25, 1991, if elected). For more information, see *Amortization*, later.

When Depreciation Begins and Ends

You begin to depreciate your property when you place it in service for use in your trade or business or for the production of income. You stop depreciating property either when you have fully recovered your cost or other basis or when you retire it from service, whichever happens first.

Placed in Service

For depreciation purposes, property is placed in service when it is ready and available for a specific use, whether in a trade or business, the production of income, a tax-exempt activity, or a personal activity. Even if you are not using the property, it is in service when it is ready and available for its specific use.

Example 1. You bought a home and used it as your personal home for several years before you converted it to rental property. Although its specific use was personal and no depreciation was allowable, you placed the

home in service when you began using it as your home. You can claim a straight line depreciation deduction in the year you converted it to rental property because its use changed to an income-producing use at that time.

Example 2. You bought a planter for your farm business late in the year after harvest was over. You can take a depreciation deduction for the planter for that year because it was ready and available for its specific use.

Cost or other basis fully recovered. You have fully recovered your cost or other basis when you have taken section 179 and depreciation deductions that are equal to your cost or investment in the property.

Retired From Service

You stop depreciating property when you retire it from service. You retire property from service when you permanently withdraw it from use in a trade or business or in the production of income.

You can retire property from service in any of the following ways.

- Sale or exchange.
- Abandonment.
- Destruction.

Incorrect Amount of Depreciation Deducted

If you deducted an incorrect amount of depreciation in any year, you may be able to make a correction by filing an amended return. See *Amended Return*, later. If you are not allowed to make the correction on an amended return, you can change your accounting method to claim the correct amount of depreciation. See *Changing Your Accounting Method*, later.

Basis adjustment. Even if you do not claim depreciation you are entitled to deduct, you must reduce the basis of the property by the full amount of depreciation you were entitled to deduct. If you deduct more depreciation than you should, you must decrease your basis by any amount deducted from which you received a tax benefit.

Amended Return

If you deducted an incorrect amount of depreciation, you can file an amended return to correct the following.

- A mathematical error made in any year.
- A posting error made in any year (for example, omitting an asset from the depreciation schedule).
- The amount of depreciation for property for which you have not adopted a method of accounting.

If you deducted an incorrect amount of depreciation for the property on two or more consecutively filed tax returns, you have adopted a method of accounting for that property. If you have adopted a method of accounting, you cannot change the method by filing amended returns. See *Changing Your Accounting Method*, later.

If an amended return is allowed, you must file it by the later of the following.

- 3 years from the date you filed your original return for the year in which you deducted the incorrect amount.
- 2 years from the time you paid your tax for that year.

A return filed early is considered filed on the due date.

Changing Your Accounting Method

If you deducted an incorrect amount of depreciation for the property on two or more consecutively filed tax returns, you have adopted a method of accounting for that property.

TIP You can claim the correct amount of depreciation only by changing your method of accounting for depreciation. You will then be able to take into account any unclaimed or excess depreciation from years before the year of change.

Approval required. You must get IRS approval to change your method of accounting. File **Form 3115, Application for Change in Accounting Method**, to request a change to a permissible method of accounting for the depreciation. Revenue Procedure 97-27 in Cumulative Bulletin 1997-1 gives general instructions for getting approval. Cumulative Bulletins are available at many libraries and IRS offices. There is a user fee for changing your method of accounting under Revenue Procedure 97-27.

Automatic approval. You may be able to get automatic approval from the IRS to change your method of accounting if you used an unallowable method of accounting for depreciation in at least the 2 years immediately before the year of change and the property for which you are changing the method meets the following conditions.

- 1) It is property for which, under your unallowable method of accounting, you claimed either no depreciation or an incorrect amount of depreciation.
- 2) It is property for which you figured depreciation using one of the following.
 - a) Pre-1981 rules.
 - b) Accelerated Cost Recovery (ACRS).
 - c) Modified Accelerated Cost Recovery (MACRS).
- 3) It is property you owned at the beginning of the year of change.

File Form 3115 to request a change to a permissible method of accounting for depreciation. Revenue Procedure 98-60 and section 2.01 of its Appendix, which can be found in Internal Revenue Bulletin No. 1998-51, have instructions for getting automatic approval and list exceptions to the automatic approval procedures.

Exceptions. You generally cannot use the automatic approval procedure in any of the following situations.

- You are under examination by the IRS.
- You are before a federal court or an IRS appeals office for any income tax issue and the method of accounting for depreciation to be changed is an issue under

consideration by the federal court or appeals office.

- You are correcting a mathematical or posting error. See *Amended Return*, earlier.
- During the last five years (including the year of change), you changed the same method of accounting for depreciation (with or without obtaining IRS approval).
- During the last five years (including the year of change), you filed a Form 3115 to change the same method of accounting for depreciation but did not make the change because the Form 3115 was withdrawn, not perfected, denied, or not granted.

Also, see other exceptions listed in section 2.01(2)(b) of the Appendix of Revenue Procedure 98-60.

How To Claim Depreciation

Use Form 4562 to claim depreciation and amortization deductions and to elect the section 179 deduction, discussed next. Amortization is discussed later. For more information on completing Form 4562, refer to its instructions.



It is important to keep good records for property you depreciate. Do not file these records with your return. Instead, you should keep them as part of the records of the depreciated property. They will help you verify the accuracy of the information on Form 4562. For general information on recordkeeping, see Publication 583, *Starting a Business and Keeping Records*. For specific information on keeping records for section 179 property (discussed next) and listed property (discussed later), see Publication 946.

Section 179 Deduction

This part of the chapter explains the rules for the section 179 deduction. It explains what a section 179 deduction is, the costs that can be deducted, what property qualifies for the deduction, limits that may apply, and how to claim the deduction. You can recover through depreciation certain costs that you do not recover through the section 179 deduction.

Section 179 Deduction Defined

Section 179 of the Internal Revenue Code allows you to elect to deduct all or part of the cost of certain qualifying property in the year you place it in service. You can do this instead of recovering the cost by taking depreciation deductions.

What Costs Can and Cannot Be Deducted

You can claim the section 179 deduction for the cost of qualifying property acquired for use in your trade or business. You cannot claim the deduction for the cost of property you hold only for the production of income.

For information on property held for the production of income, see *Production of income*, later.

Acquired by Purchase

Only the cost of property you acquired by purchase for use in your business qualifies for the section 179 deduction. The cost of property acquired from a related person or group may not qualify. See *Nonqualifying Property*, later.

Acquired by Trade

If you buy an asset with cash and a trade-in, you can claim a section 179 deduction based only on the amount of cash you pay. For example, if you buy (for cash and a trade-in) a new tractor for use in your business, your cost for the section 179 deduction does not include the adjusted basis of the old tractor you trade for the new tractor. See *Adjusted Basis* in chapter 7.

Example. J-Bar Farms traded two cultivators having a total adjusted basis of \$6,800 for a new cultivator costing \$13,200. They received an \$8,000 trade-in for the old cultivators and paid \$5,200 cash for the new cultivator. J-Bar also traded a used pickup truck with an adjusted basis of \$8,000 for a new pickup truck costing \$15,000. They received a \$5,000 trade-in and paid \$10,000 cash for the new pickup truck.

J-Bar Farms' basis in the new property includes both the adjusted basis of the property traded and the cash paid. However, only the cash paid by J-Bar qualifies for the section 179 deduction. J-Bar's business costs that qualify for a section 179 deduction are \$15,200 (\$5,200 + \$10,000), the part of the cost of the new property not determined by the property traded.

Qualifying Property

Qualifying section 179 property is depreciable property and includes the following.

- 1) Tangible personal property.
- 2) Other tangible property (except most buildings and their structural components) listed below.
 - a) Property used as an integral part of manufacturing, production, or extraction, or of furnishing transportation, communications, electricity, gas, water, or sewage disposal services.
 - b) A research facility used in connection with any of the activities in (a).
 - c) A facility used in connection with any of the activities in (a) for the bulk storage of fungible commodities (including commodities in a liquid or gaseous state).
- 3) Single purpose agricultural (livestock) or horticultural structures (defined later).
- 4) Storage facilities (excluding buildings and their structural components) used in connection with distributing petroleum or any primary product of petroleum.

Tangible personal property. Tangible personal property is any tangible property that is not real property. Machinery and equipment are examples of tangible personal property.

Land and land improvements are not tangible personal property and they do not qualify as section 179 property. Items such as buildings and other permanent structures and their components are real property. Non-

agricultural fences, swimming pools, paved parking areas, wharfs, docks, bridges, and fences are examples of land improvements. However, **agricultural fences** do qualify as section 179 property.

Business property. All business property, other than structural components, contained in or attached to a building is tangible personal property. Milk tanks, automatic feeders, barn cleaners, and office equipment are tangible personal property.

Livestock. Livestock is qualifying property. For this purpose, livestock includes horses, cattle, hogs, sheep, goats, and mink and other furbearing animals.

Single purpose agricultural (livestock) or horticultural structures. A single purpose agricultural (livestock) or horticultural structure is qualifying property for purposes of the section 179 deduction. For purposes of determining whether a structure is a single purpose agricultural structure, poultry is considered livestock.

Agricultural structure. A single purpose agricultural (livestock) structure is any building or enclosure specifically designed, constructed, and used for both of the following purposes.

- 1) To house, raise, and feed a particular type of livestock and its produce.
- 2) To house the equipment, including any replacements, needed to house, raise, or feed the livestock.

Single purpose structures are qualifying property if used, for example, to breed chickens or hogs, produce milk from dairy cattle, or produce feeder cattle or pigs, broiler chickens, or eggs. The facility must include, as an integral part of the structure or enclosure, equipment necessary to house, raise, and feed the livestock.

Horticultural structure. A single purpose horticultural structure is either of the following.

- 1) A greenhouse specifically designed, constructed, and used for the commercial production of plants.
- 2) A structure specifically designed, constructed, and used for the commercial production of mushrooms.

Use of structure. A structure must be used only for the purpose that qualified it. For example, a hog barn will not be eligible property if you use it to house poultry. Similarly, using part of your greenhouse to sell plants will make the greenhouse ineligible.

If a structure includes work space, that structure is a single purpose agricultural or horticultural structure if the work space is used only for the following.

- 1) Stocking, caring for, or collecting livestock or plants or their produce.
- 2) Maintaining the enclosure or structure.
- 3) Maintaining or replacing the equipment or stock enclosed or housed in the structure.

Partial business use. When you use property for business and nonbusiness purposes, you can elect the section 179 deduction only if you use it more than 50% for your business in the year you place it in service. You figure the part of the cost of the property that is for

business use by multiplying the cost of the property by the percentage of business use. The result is your business cost, which you use to figure your section 179 deduction.

Nonqualifying Property

Generally, the section 179 deduction cannot be claimed on the cost of any of the following.

- Property you hold only for the production of income.
- Real property, including buildings and their structural components.
- Property you acquired from certain groups or persons.
- Air conditioning or heating units.
- Certain property used predominately outside the U.S.
- Property used predominately to furnish lodging or in connection with the furnishing of lodging.
- Property used by foreign persons or entities.
- Certain property you lease to others (if you are a noncorporate lessor).

For more information on nonqualifying property, see *Nonqualifying Property* in chapter 2 of Publication 946.

For the kind of leased property on which you can claim the section 179 deduction, see *Qualifying Property* in chapter 2 of Publication 946.

Production of income. Property you hold for the production of income includes investment property, rental property (if renting property is not your trade or business), and property that produces royalties. If you use property in the active conduct of a trade or business, you do not hold it **only** for the production of income.

Acquired from certain groups or persons. Property does not qualify for the section 179 deduction if any of the following apply.

- 1) The property is acquired by one member of a controlled group from another member of the same group.
- 2) The property's basis is determined in either of the following ways.
 - a) In whole or in part by its adjusted basis in the hands of the person from whom it was acquired.
 - b) Under stepped-up basis rules for property acquired from a decedent.
- 3) The property is acquired from a related person. A "related person" generally means a member of your immediate family (including your spouse, an ancestor, and a lineal descendant) or a partnership or corporation in which you hold an interest.

For more information on related persons, see Publication 946.

How To Make the Election

You make the election by taking your deduction on Form 4562. You attach and file Form 4562 with either of the following.

- Your original tax return filed for the year the property was placed in service (whether or not you filed it timely).

- An amended return filed by the due date (including extensions) for your return for the year the property was placed in service. In other words, you cannot make an election for the section 179 deduction on an amended return filed after the due date (including extensions) of the original return.

However, if you timely filed your return for the year without making the election, you can still make the election by filing an amended return within six months of the due date of the return (excluding extensions). Attach the election to the amended return and write "Filed pursuant to section 301.9100-2" on the election statement. File the amended return at the same address you filed the original return.

How To Figure the Deduction

The total business cost you can elect to deduct under section 179 for 1999 cannot be more than \$19,000. This maximum dollar limit applies to each taxpayer, not to each business. You do not have to claim the full \$19,000. You can decide how much of the business cost of your qualifying property you want to deduct under section 179. You may be able to depreciate any cost you do not deduct under section 179. To figure depreciation, see *MACRS*, later.

If you acquire and place in service more than one item of qualifying property during the year, you can divide the deduction among the items in any way, as long as the total deduction is not more than \$19,000.

If you have only one item of qualifying property and it does not cost more than \$19,000, your deduction is limited to the lesser of the following.

- Your taxable income from your trade or business (the taxable income limit is discussed later).
- The cost of the item.

You must figure your section 179 deduction before figuring your depreciation deduction.

You must subtract the amount you elect to deduct under section 179 from the business/investment cost of the qualifying property. The result is your unadjusted basis and it is the amount you use to figure any depreciation deduction.



You cannot take depreciation on the cost of property you deduct under section 179.

Example. This year, you bought and placed in service a tractor for \$16,000 and a mower for \$6,200 for use in your farming business. You elect to deduct the entire \$6,200 for the mower and \$12,800 for the tractor, a total of \$19,000. This is the most you can deduct. Your \$6,200 deduction for the mower completely recovered its cost. The cost of your tractor is reduced by \$12,800. Its remaining basis for depreciation is \$3,200. You figure this by subtracting the amount of your section 179 deduction, \$12,800, from the cost of the tractor, \$16,000.

Deduction Limits

Your section 179 deduction cannot be more than the business cost of the qualifying property. In addition, in figuring your section 179 deduction, you must apply the following limits.

- Maximum dollar limit.
- Investment limit.
- Taxable income limit.

Maximum dollar limit. The total cost you can elect to deduct for 1999 cannot be more than \$19,000. This maximum dollar limit is reduced if you go over the investment limit (discussed later) in any year.



The total deductible cost of section 179 property increases in future years as shown next.

Tax Year	Maximum Deduction
2000	\$20,000
2001 – 2002	24,000
After 2002	25,000

Passenger automobiles. For passenger automobiles placed in service in 1999, your total section 179 deduction and depreciation cannot be more than \$3,060. For more information, see *Maximum deductions for 1999* under *Special Rules for Passenger Automobiles*, later.

Joint returns. If you file a joint return, you and your spouse are treated as one taxpayer in determining any reduction to the maximum dollar limit, regardless of which of you purchased the property or placed it in service.

Married taxpayers filing separate returns. If you and your spouse file separate returns, you both are treated as one taxpayer for the maximum dollar limit and for the \$200,000 investment limit. Unless you elect otherwise, 50% of the maximum dollar limit (after applying the investment limit) will be allocated to each of you. If the percentages elected by each of you do not total 100%, 50% will be allocated to each of you.

Joint return after filing separate returns. If you and your spouse elect to file a joint return after the due date for filing the return, the maximum dollar limit on the joint return is the lesser of the following.

- The maximum dollar limit (after the investment limit).
- The total cost of section 179 property you and your spouse elected to expense on your separate returns.

Investment limit. If the cost of your qualifying section 179 property placed in service in a year is over \$200,000, reduce the maximum dollar limit for each dollar over \$200,000 (but not below zero). If your business cost of section 179 property placed in service during 1999 is \$219,000 or more, you cannot take a section 179 deduction and you cannot carry over the cost that is more than \$219,000.

Example. In 1999, James Smith placed in service machinery costing \$207,000. Because this cost is \$7,000 more than \$200,000, he must reduce the maximum dollar limit of \$19,000 by \$7,000. If his taxable income is at least \$12,000, James can claim a \$12,000 section 179 deduction for this year.

Taxable income limit. The total cost you can deduct each year is limited to the taxable income from the active conduct of any trade or business during the year. Generally, you are

considered to actively conduct a trade or business if you meaningfully participate in the management or operations of the trade or business.

Figure taxable income for this purpose by totaling the net income (or loss) from all trades and businesses you actively conducted during the year. Items of income derived from a trade or business actively conducted by you include the following.

- Section 1231 gains (or losses) as discussed in chapter 11.
- Interest from working capital of your trade or business.
- Wages, salaries, tips, or other pay earned as an employee.

When figuring taxable income, do not take into account any unreimbursed employee business expenses you may have as an employee.

In addition, figure taxable income without regard to any of the following.

- The section 179 deduction.
- The self-employment tax deduction.
- Any net operating loss carryback or carryforward.

Carryover of disallowed deduction.

You can carry over the cost of any section 179 property you elected to expense but were unable to because of the taxable income limit.

The amount you carry over is used in determining your section 179 deduction in the next year; however, it is subject to the limits in that year. You may select the properties for which all or a part of the cost will be carried forward, provided the reasons for your decisions are shown in your books and records.

Example. Last year, Joyce Jones placed in service a machine that cost \$8,000. The taxable income from her business (determined without a section 179 deduction for the cost of the machine and without the self-employment tax deduction) was \$6,000. Her section 179 deduction is limited to \$6,000. The \$2,000 cost that is not allowed as a current section 179 deduction (because of the taxable income limit) is carried to this year.

This year, Joyce placed another machine in service that cost \$9,000. Her taxable income from business (determined without a section 179 deduction for the cost of the machine and without the self-employment tax deduction) is \$10,000. Joyce can deduct the full cost of the machine (\$9,000) but only \$1,000 of the carryover from last year because of the taxable income limit. She can carry over the balance of \$1,000 to next year.

See *Carryover of disallowed deduction* in chapter 2 of Publication 946 for information on figuring the carryover.

Two different taxable income limits.

The section 179 deduction is subject to a taxable income limit. You also may have to figure another deduction (for example, charitable contributions) that has a limit based on taxable income. If you have to figure the limit for this other deduction taking into account the section 179 deduction, complete the steps discussed next.

Step 1. Figure taxable income without the section 179 deduction or the other deduction.

Step 2. Figure a hypothetical section 179 deduction using the taxable income figured in Step 1.

Step 3. Subtract the hypothetical section 179 deduction figured in Step 2 from the taxable income figured in Step 1.

Step 4. Figure a hypothetical amount for the other deduction using the amount figured in Step 3 as taxable income.

Step 5. Subtract the hypothetical other deduction figured in Step 4 from the taxable income figured in Step 1.

Step 6. Now figure your actual section 179 deduction using the taxable income figured in Step 5.

Step 7. Subtract your actual section 179 deduction figured in Step 6 from the taxable income figured in Step 1.

Step 8. Figure your actual other deduction using the taxable income figured in Step 7.

Example. During the year, the XYZ farm corporation purchased and placed in service qualifying section 179 property that cost \$10,000. It elects to expense as much as possible under section 179. The XYZ corporation also gave a charitable contribution of \$1,000 during the year. A corporation's deduction for charitable contributions cannot be more than 10% of its taxable income, figured after subtracting any section 179 deduction. The taxable income limit for the section 179 deduction is figured after subtracting any allowable charitable contributions. XYZ's taxable income figured without the section 179 deduction or the deduction for charitable contributions is \$12,000. XYZ figures its section 179 deduction and its deduction for charitable contributions as follows.

Step 1. Taxable income figured without either deduction is \$12,000.

Step 2. Using \$12,000 as taxable income, XYZ's hypothetical section 179 deduction is \$10,000.

Step 3. \$12,000 (from Step 1) minus \$10,000 (from Step 2) equals \$2,000.

Step 4. Using \$2,000 (from Step 3) as taxable income, XYZ's hypothetical charitable contribution (limited to 10% of taxable income) is \$200.

Step 5. \$12,000 (from Step 1) minus \$200 (from Step 4) equals \$11,800.

Step 6. Using \$11,800 (from Step 5) as taxable income, XYZ figures the actual section 179 deduction. Because the taxable income is at least \$10,000, XYZ can take a \$10,000 section 179 deduction.

Step 7. \$12,000 (from Step 1) minus \$10,000 (from Step 6) equals \$2,000.

Step 8. Using \$2,000 (from Step 7) as taxable income, XYZ's actual charitable contribution (limited to 10% of taxable income) is \$200.

Partnerships and S corporations. The section 179 deduction limits apply both to the partnership or S corporation and to each partner or shareholder. The partnership or S corporation determines its section 179 deduction subject to the limits. It then allocates the deduction among its partners or shareholders.

If you are a partner or shareholder, you add the amount allocated from the partnership or S corporation to any 179 costs that are not related to the partnership or S corporation and then apply the maximum dollar limit to this total. To determine if you exceed the

\$200,000 investment limit, you do not include any of the cost of section 179 property placed in service by the partnership or S corporation. After you apply the maximum dollar limit and investment limit, you apply the taxable income limit to any remaining section 179 costs. For more information see chapter 2 of Publication 946.

Section 179 Recapture

Section 179 recapture occurs when you are required to add back to income the section 179 deduction you took in an earlier year.

When To Recapture the Deduction

You may have to recapture the section 179 deduction if, in any year during the property's recovery period, the percentage of business use drops to 50% or less or you sell or otherwise dispose of the property. Recovery periods are discussed later.

Dispositions of property. You may have to treat any gain you realize from the sale, exchange, or other disposition of business property as ordinary income up to the depreciation allowed or allowable on the property. The section 179 deduction is treated as depreciation for purposes of the recapture rule. See *Depreciation Recapture* in chapter 11.

How To Figure the Recapture

To figure the amount to recapture (include in income) take the following steps.

- 1) Figure the depreciation that would have been allowable on the section 179 deduction you claimed. Begin with the year the property was placed in service and include the year of recapture.
- 2) Subtract the depreciation figured in (1) from the section 179 deduction you claimed.
- 3) The result in (2) is the amount you must recapture.

Example. Paul Lamb, a calendar year taxpayer, bought and placed in service on August 1, 1997, an item of 3-year property costing \$10,000. The property is not listed property. He elected a \$5,000 section 179 deduction for the property. He used the property only for business in 1997 and 1998. During 1999, he used the property 40% for business and 60% for personal use. He figures his recapture amount as follows.

Section 179 deduction claimed (1997)	\$5,000
Allowable depreciation (instead of section 179):	
1997 —	
\$5,000 × 25.00%*	\$1,250
1998 —	
\$5,000 × 37.50%*	1,875
1999 —	
\$5,000 × 25.00%*	
× 40% (business)	500
1999 —	3,625
Recapture amount	\$1,375

*Rates from the 150% table, later.

Paul must include \$1,375 in income for 1999.

Where To Report Recapture

Report any recapture of the section 179 deduction on Form 4797 and Schedule F (Form 1040).

MACRS

MACRS consists of two systems that determine how you depreciate your property. The main system is called the **General Depreciation System (GDS)**. The second system is called the **Alternative Depreciation System (ADS)**. The main difference between the two systems is that ADS generally provides for a longer recovery period.

Unless you are specifically required by law to use ADS or you elect it, you must generally use GDS to figure your depreciation deduction. Property for which you are required by law to use ADS and how to elect ADS are discussed later.

What Can Be Depreciated Under MACRS

MACRS applies to most tangible depreciable property placed in service after 1986. Property for which you cannot use MACRS is discussed later under *What Cannot Be Depreciated Under MACRS*.

Use of real property changed. You must use MACRS to depreciate all real property you acquired before 1987 that you changed from personal use to business or income-producing use after 1986.

When To Use GDS

Most tangible depreciable property falls within the general rule of MACRS, also called the General Depreciation System (GDS). Because GDS permits use of the declining balance method over a shorter recovery period, the deduction is greater in the earlier years.

However, the law requires you to use ADS for certain property, as discussed next.

Although your property may qualify for GDS, you can elect on a property-by-property or class of assets basis to use ADS. If you make this election, you can never revoke it. How to make this election is discussed later under *ADS election*.

When To Use ADS

You must use ADS for the following property.

- Any property used predominately in a farming business and placed in service during any tax year in which you make an election not to apply the uniform capitalization rules to certain farming costs.
- Any tax-exempt use property.
- Any tax-exempt bond-financed property.
- Any imported property covered by an executive order of the President of the United States.
- Any tangible property used predominately outside the United States during the year.

What Cannot Be Depreciated Under MACRS

You cannot use MACRS to depreciate the following property.

- Intangible property.
- Any motion picture film or video tape.
- Any sound recording.
- Certain real and personal property placed in service before 1987.

You can elect to exclude from MACRS any property that you can properly depreciate under a method of depreciation not based on a term of years.

Election To Exclude Property From MACRS

If you properly depreciate any property under a method not based on a term of years, such as the unit-of-production method, you can elect to exclude that property from MACRS. You make the election by reporting your depreciation for the property on line 18 of Part III of Form 4562 and attaching a statement as described in the Instructions for Form 4562. You must make this election by the return due date (including extensions) for the year you place your property in service. However, if you timely filed your return for the year without making the election, you can still make the election by filing an amended return within six months of the due date of the return (excluding extensions). Attach the election to the amended return and write "Filed pursuant to section 301.9100-2" on the election statement. File the amended return at the same address you filed the original return.

Standard mileage rate. If you use the standard mileage rate to figure your tax deduction for your business automobile, you are treated as having made an election to exclude the automobile from MACRS. See Publication 463 for a discussion of the standard mileage rate.

Property Placed in Service Before 1987

There are special rules that may prevent you from using MACRS for property placed in service by anyone (for any purpose) before 1987 (before August 1, 1986, if MACRS was elected). These rules apply to both personal and real property. However, the rules for personal property are more restrictive.



Do not treat either real or personal property as owned before you placed it in service. If you owned property in 1986 but did not place it in service until 1987, you do not treat it as owned in 1986.

Personal property. You cannot use MACRS for most personal property (section 1245 property) that you acquired after 1986 (after July 31, 1986, if MACRS was elected) if any of the following apply.

- 1) You or someone related to you owned or used the property in 1986.

- 2) You acquired the property from a person who owned it in 1986 and as part of the transaction the property user did not change.
- 3) You leased the property to a person (or someone related to this person) who owned or used the property in 1986.
- 4) You acquired the property in a transaction in which:
 - a) The property user did not change, and
 - b) The property was not MACRS property in the hands of the person from whom you acquired it because of (2) or (3).

Real property. You cannot use MACRS for certain real property. This includes property acquired after 1986 (after July 31, 1986, if MACRS was elected) if any of the following apply.

- You or someone related to you owned the property in 1986.
- You leased the property back to the person (or someone related to this person) who owned the property in 1986.
- You acquired the property in a transaction in which part of your gain or loss was not recognized. MACRS applies only to that part of your basis in the acquired property that represents cash paid or unlike property given up. It does not apply to the substituted portion of the basis. For more information on transactions in which part of your gain or loss was not recognized, see *Partially Nontaxable Exchanges* in chapter 1 of Publication 544.

Exceptions. These rules do not apply to the following.

- 1) Residential rental property or nonresidential real property.
- 2) Any property, if in the first tax year it is placed in service, the deduction under ACRS is more than the deduction under MACRS using the half-year convention.
- 3) Property placed in service after 1980 and before 1987 if it was transferred to you from a related person or converted from personal to business use after 1986 and the deduction under ACRS is more than the deduction under MACRS.

Property placed in service before 1981.

For property placed in service before 1981 that was transferred to you from a related person or converted from personal to business use after 1986, use the straight line or declining balance method. These methods are based on salvage value and useful life.

More information. See Publication 534 for information on how to figure ACRS and other methods of depreciation.

Related Persons

For the preceding rules, a related person includes members of your immediate family (including your spouse, ancestors, and lineal descendants).

For more information on related persons, see Publication 946.

How To Figure the Deduction Using Percentage Tables

Once you determine your property can be depreciated under MACRS and whether it falls under GDS or ADS, you are ready to figure your deduction. To help you figure your deduction, the IRS has established percentage tables. To use these percentage tables to figure your MACRS deduction each year, you need to know the following information about your property.

- Its basis.
- The date it was placed in service.
- Its property class and recovery period.
- Which convention to use.
- Which depreciation method to use.

Basis

To figure your depreciation deduction, you must determine the basis of your property. To determine basis, you need to know the cost or other basis of your property. If you bought the property, your basis is the amount you paid for the property plus amounts you paid for other items such as sales tax, freight charges, and installation and testing fees. Other basis (not cost) refers to basis that is determined by the way you received the property. For example, you may have received the property through a taxable or nontaxable exchange, for services you performed, as a gift, or as an inheritance. If you received property in this or some other way, see chapter 7 to determine your basis.

Property changed from personal use. If you held property for personal use and later change it to business use or use in the production of income, your basis is the lesser of the following.

- 1) The fair market value (FMV) of the property on the date you change it from personal use to business use.
- 2) Your original cost or other basis adjusted as follows.
 - a) Increased by the cost of any permanent improvements or additions and other additions to basis.
 - b) Decreased by any tax deductions you claimed for casualty and theft losses and other items that reduced your basis.

Adjusted basis. After you determine your basis, you may have to make certain adjustments (increases and decreases) for events occurring between the time you acquired the property and the time you placed it in service. These events could include the costs of the following.

- Installation of utility lines.
- Legal fees for perfecting the title.
- Removal of barriers.
- Settlement of zoning issues.
- Receiving rebates.

For a discussion of items that may affect the basis of your property, see *Adjusted Basis* in chapter 7.

Table 8-1. Farm Property Recovery Periods

Assets	Recovery Period in Years	
	GDS	ADS
Agricultural structures (single purpose)	10	15
Airplanes (including helicopters) ¹	5	6
Automobiles	5	5
Calculators and copiers	5	6
Cattle (dairy or breeding)	5	7
Communication equipment ²	7	10
Computers and peripheral equipment	5	5
Cotton ginning assets	7	12
Drainage facilities	15	20
Farm buildings ³	20	25
Farm machinery and equipment	7	10
Fences (agricultural)	7	10
Goats and sheep (breeding)	5	5
Grain bin	7	10
Hogs (breeding)	3	3
Horses (age when placed in service)		
Breeding and working (12 years or less)	7	10
Breeding and working (more than 12 years)	3	10
Racing horses (more than 2 years)	3	12
Horticultural structures (single purpose)	10	15
Logging machinery and equipment ⁴	5	6
Nonresidential real property	39 ⁵	40
Office equipment (not calculators, copiers, or typewriters)	7	10
Office furniture or fixtures	7	10
Residential rental property	27.5	40
Tractor units (over-the-road)	3	4
Trees or vines bearing fruit or nuts	10	20
Truck (heavy duty, unloaded weight 13,000 lbs. or more)	5	6
Truck (weight less than 13,000 lbs.)	5	5
Typewriter	5	6
Water wells	15	20

¹ Not including airplanes used in commercial or contract carrying of passengers.

² Not including communication equipment listed in other classes.

³ Not including single purpose agricultural or horticultural structures.

⁴ Used by logging and sawmill operators for cutting of timber.

⁵ For property placed in service after May 12, 1993; for property placed in service before May 13, 1993, the recovery period is 31.5 years.

Placed in Service

For depreciation purposes, property is placed in service when it is ready and available for a specific use, whether in a trade or business, the production of income, a tax-exempt activity, or a personal activity. Even if you are not using the property, it is in service when it is ready and available for its specific use.

Example 1. A corn planter that is delivered to the farm ready to be used in December 1999 is placed in service in 1999 even though it will not be used until the spring of 2000.

Example 2. If the planter comes unassembled in December 1999 and is put together in February 2000, it is not placed in service until 2000.

Example 3. If the planter was delivered and assembled in February 2000 but not used until April 2000, it is placed in service in February 2000, since this is when the planter was in a condition of readiness for its specified use.

Fruit or nut trees and vines. If you acquire an orchard, grove, or vineyard and the trees or vines have not yet reached the income-

producing stage, your depreciation begins when they reach the income-producing stage.

Immature livestock. If you acquire immature livestock for draft, dairy, or breeding purposes, your depreciation begins when they reach maturity. This means depreciation begins when the livestock reach the age when they can be worked, milked, or bred. When this occurs, your basis for depreciation is your initial cost for the immature livestock.

Property Classes and Recovery Periods

Each item of property depreciated under MACRS is assigned to a property class. The property class establishes the number of years over which you recover the basis of your property. This period of time is called a recovery period.

Property classes. Under MACRS, tangible property you place in service after 1986, or after July 31, 1986, if elected, falls into one of the following classes.

- 1) 3-year property.
- 2) 5-year property.
- 3) 7-year property.
- 4) 10-year property.
- 5) 15-year property.
- 6) 20-year property.
- 7) Residential rental property.
- 8) Nonresidential real property.

Recovery periods. See *Table 8-1* for recovery periods under both GDS and ADS for some commonly used assets. For a complete list of class lives and recovery periods, see the *Table of Class Lives and Recovery Periods* in Appendix B of Publication 946.

House trailers for farm laborers. Use one of the following recovery periods to depreciate a house trailer you supply as housing for those who work on your farm. Whether the house trailer is mobile or not determines which recovery period you can use.

- 1) If the house trailer is mobile and has wheels and a history of movement, depreciate its cost over a 10-year recovery period under ADS or a 7-year recovery period under GDS.
- 2) If the house trailer is not mobile, its wheels removed, and permanent utilities and pipes are attached to it, depreciate its cost over a 25-year recovery period under ADS or a 20-year recovery period under GDS.

Water wells. Depreciable water wells used to provide water for raising poultry and livestock are land improvements and have a 15-year recovery period under GDS and a 20-year recovery period under ADS.

The types of water wells that can be depreciated are discussed earlier under *Irrigation systems and water wells*.

Conventions

To figure your depreciation deduction for both the year in which you place property in service and the year in which you dispose of the property, use one of the following conventions.

- The half-year convention.
- The mid-month convention.
- The mid-quarter convention.

Half-year convention. Generally, you use this convention for property other than nonresidential real and residential rental property. Under the half-year convention, you treat all property placed in service or disposed of during a year as placed in service or disposed of at the midpoint of that year. This means that no matter when in the year you begin or end the use of the property, you treat it as if you began or ended its use in the middle of the year.

Mid-month convention. You use the mid-month convention for the following types of property.

- Nonresidential real property.
- Residential rental property.

Under this convention, you treat all property placed in service (or disposed of) during a month as placed in service (or disposed of) at the midpoint of the month. This means that regardless of when during a month you place property in service or dispose of it, you treat it as being placed in service (or disposed of) in the middle of that month.

Mid-quarter convention. You must use this convention when the total depreciable bases of MACRS property you placed in service during the last 3 months of the year are more than 40% of the total depreciable bases of all MACRS property you placed in service during the entire year. When this happens, you must use the mid-quarter convention for all MACRS property you placed in service during the year. Under the mid-quarter convention, you treat all property placed in service or disposed of during the year as placed in service in the middle of the quarter.

Total bases. To determine the total bases of property, do not include the following.

- Residential rental property.
- Nonresidential real property.
- Property you placed in service and disposed of in the same tax year.

Depreciable basis. To determine whether you must use the mid-quarter convention, the depreciable basis of property is your basis multiplied by the percentage of business/investment use and then reduced by the following.

- Any amortization taken on the property.
- Any section 179 deduction claimed on the property.
- Any deduction claimed for clean-fuel vehicles or for clean-fuel vehicle refueling property.

Depreciation Methods

For personal property placed in service in a farming business after 1988 you must use the 150% declining balance method over a GDS recovery period or you can elect one of the following methods.

- The straight line method over a GDS recovery period.
- The straight line method over an ADS recovery period.



For property placed in service before 1999, you could elect to use the 150% declining balance method using the ADS recovery periods. If you made this election, continue to use the same method and recovery period for that property.

You can depreciate real property using the straight line method under either GDS or ADS.

Under MACRS, there are four methods you can use to figure depreciation. The following table lists the types of property you can depreciate under each method. You can use this table to help you determine the method to use for a specific property class. The declining balance method is abbreviated as DB and the straight line method is abbreviated as SL.

Depreciation Methods

Method	Type of Property
200% DB using GDS	• Nonfarm 3-, 5-, 7-, and 10-year property
150% DB using GDS	• All farm property (except real property) • All 15- and 20-year property • Nonfarm 3-, 5-, 7-, and 10-year property*
SL using GDS	• Nonresidential real property • Residential rental property • Trees or vines bearing fruit or nuts • All 3-, 5-, 7-, 10-, 15-, and 20-year property*
SL using ADS	• Property used predominantly outside the U.S. • Tax-exempt property • Tax-exempt bond-financed property • Imported property** • Any property for which you elect to use this method*

*Elective method

**See section 168(g)(6) of the Internal Revenue Code



You cannot use the 200% declining balance method for farm property placed in service after 1988.

If you use a declining balance method, you switch to the straight line method when that method provides a greater deduction.



If you use the MACRS percentage tables, you do not need to determine in which year your deduction is greater using the straight line method. The tables have the switch to the straight line method built into their rates.

Fruit or nut trees and vines. Depreciate trees and vines bearing fruit or nuts under GDS using the straight line method over a 10-year recovery period.

ADS required for some farmers. If you elect not to apply the uniform capitalization rules to any plant produced in your farming business, you must use ADS for all property you place in service in any year the election is in effect. See chapter 7 for a discussion of the application of the uniform capitalization rules to farm property.

Farming business. A farming business is any trade or business involving cultivating land or raising or harvesting any agricultural or horticultural commodity. A farming business includes any of the following.

- Operating a nursery or sod farm.
- Raising or harvesting crops.
- Raising or harvesting trees bearing fruit, nuts, or other crops.
- Raising ornamental trees. (An evergreen tree is not considered an ornamental tree if it is more than 6 years old when it is severed from its roots.)
- Raising, shearing, feeding, caring for, training, and managing animals.

Processing. In general, a farming business includes processing activities that are normally part of the growing, raising, or harvesting of agricultural products. However, a farming business generally does not include the processing of commodities or products

beyond those activities that are normally part of the growing, raising, or harvesting of such products.

Example 1. If you are in the trade or business of growing fruits and vegetables, you can harvest, wash, inspect, and package the fruits and vegetables for sale. Such activities are normally part of the raising of these crops by farmers. You will be considered to be in the business of farming with respect to the growing of fruits and vegetables and the processing activities that are part of their harvest.

Example 2. You are in the business of growing and harvesting wheat and other grains. You also process grain you have harvested in order to produce breads, cereals, and other similar food products. You then sell these products to customers in the course of your business. Although you are in the farming business with respect to the growing and harvesting of grain, you are not in the farming business with respect to the processing of the grain to produce the food products.

Electing a method. As shown in the table, *Depreciation Methods*, you can elect a different method for depreciation for certain types of property. The election must be made by the due date of the return (including extensions) for the year you place the property in service. However, if you timely filed your return for the year without making the election, you can still make the election by filing an amended return within six months of the due date of your return (excluding extensions). Attach the election to the amended return and write "Filed pursuant to section 301.9100-2" on the election statement. File the amended return at the same address you filed the original return.



If you elect to use a different method for one item in a property class, you must apply the same method to all property in that class placed in service during the year of the election. However, you can make the election on a property-by-property basis for residential rental and nonresidential real property. Once you make the election, you cannot change it.

Straight line election. Instead of using the declining balance method, you can elect to use the straight line method over the GDS recovery period.

ADS election. Although your property may come under GDS, you can elect to use ADS. ADS uses the straight line method of depreciation over fixed ADS recovery periods. The ADS recovery periods for many assets used in the business of farming are listed in *Table 8-1*. Additional ADS recovery periods for other classes of property may be found in the *Table of Class Lives and Recovery Periods* in Appendix B of Publication 946.

Make the election by completing line 16, Part II of Form 4562.

Figuring the MACRS Deduction

You can determine your MACRS depreciation deduction in one of two ways.

- 1) You can use the percentage tables shown in Appendix A of Publication 946.
- 2) You can figure your own deduction. See *How To Figure the Deduction Without*

Table 8-2. 150% Declining Balance Method

Year	3-Year	5-Year	7-Year	20-Year
1	25.0%	15.00%	10.71%	3.750%
2	37.5	25.50	19.13	7.219
3	25.0	17.85	15.03	6.677
4	12.5	16.66	12.25	6.177
5		16.66	12.25	5.713
6		8.33	12.25	5.285
7			12.25	4.888
8			6.13	4.522

Using the Tables in chapter 3 of Publication 946.



Figuring your own MACRS deduction will generally result in a slightly different amount than using the tables.

Rules for using the tables. The following rules cover the use of the percentage tables.

- 1) You must apply the rates in the percentage tables to your property's **unadjusted basis** (defined later).
- 2) You cannot use the percentage tables for a short tax year. See chapter 3 of Publication 946 for information on how to figure the deduction in a short tax year.
- 3) You must continue to use the tables for the entire recovery period even if there are adjustments to the basis of your property for the reasons listed below.
 - a) Depreciation allowed or allowable.
 - b) An addition or improvement to the property. (An addition or improvement is depreciated as a separate property.)
- 4) You must stop using the tables if there is an adjustment to the basis of your property for any reason other than those listed in (3) above.

Figuring unadjusted basis. You must apply the table rates to your property's unadjusted basis each year of the recovery period. **Unadjusted basis** is the amount you would use to figure gain on a sale but figured without taking into account any depreciation taken in earlier years. However, you do reduce your original basis by any of the following items that apply.

- Amortization taken on the property.
- Section 179 deduction claimed on the property.
- Deduction claimed for clean-fuel vehicle or clean-fuel vehicle refueling property.
- Electric vehicle credit. (The lesser of \$4,000 or 10% of the cost of the vehicle, even if the credit is less than that amount.)

For business property you purchase during the year the unadjusted basis is its cost minus these adjustments.

If you trade property, your unadjusted basis in the property received is the cash paid plus the adjusted basis of the property traded minus these adjustments.

The clean-fuel vehicle and clean-fuel vehicle refueling property deductions and the credit for electric vehicles are discussed in chapter 15 of Publication 535.

Adjustment due to casualty loss. If you reduce the basis of your property because of a casualty, you cannot continue to use the tables. For the year of adjustment and the rest of the recovery period, figure the depreciation using the property's adjusted basis at the end of the year of adjustment.

150% table applying the half-year convention. *Table 8-2* has the percentages for 3-, 5-, 7-, and 20-year property. The percentages are based on the 150% declining balance method with a change to the straight line method. This table covers only the half-year convention and the first 8 years for 20-year property. See Appendix A in Publication 946 for complete MACRS tables, including tables for the mid-quarter and mid-month convention.

Example 1. This year, you buy and place in service an item of 7-year property for \$10,000. You do not elect a section 179 deduction for this property. The unadjusted basis of the property is \$10,000. You use the percentage tables to figure your deduction.

Since this is 7-year property, you multiply \$10,000 by 10.71% to get this year's depreciation of \$1,071. For next year, you figure your depreciation deduction by multiplying \$10,000 by 19.13% to get \$1,913.

Example 2. You have a barn constructed on your farm at a cost of \$20,000. You place the barn in service this year. The barn is 20-year property and you use the table percentages to figure your deduction. You figure this year's depreciation by multiplying \$20,000 (unadjusted basis) by 3.75% to get \$750. For next year, your depreciation will be \$20,000 multiplied by 7.219%, or \$1,443.80.

Straight line table applying the half-year convention. The following table has the straight line percentages for 3-, 5-, 7-, and 20-year property using the half-year convention. The table covers only the first 8 years for 20-year property. See Appendix A in Publication 946 for complete MACRS tables, including tables for the mid-quarter and mid-month convention.

Year	Straight Line Percentages			
	3-Year	5-Year	7-Year	20-Year
1	16.67%	10%	7.14%	2.5%
2	33.33	20	14.29	5.0
3	33.33	20	14.29	5.0
4	16.67	20	14.28	5.0
5		20	14.29	5.0
6		10	14.28	5.0
7			14.29	5.0
8			7.14	5.0

Figuring MACRS deductions without the tables. If you are required to or would prefer to figure your own depreciation without using the tables, see *How To Figure the Deduction Without Using the Tables* in chapter 3 of Publication 946.

Dispositions

If you dispose of depreciable property at a gain, you may have to report, as ordinary income, all or part of the gain. See chapter 11.

General Asset Accounts

To make it easier to figure MACRS depreciation, you can group separate properties into one or more general asset accounts. You can then depreciate all of the properties in each account as a single item of property. Each account can include only property with similar characteristics, such as asset class and recovery period. Some property cannot be included in a general asset account. There are additional rules for passenger automobiles, disposing of property, converting property to personal use, and property that generates foreign source income.

After you have set up a general asset account, you generally figure the amount of depreciation for each account by using the depreciation method, recovery period, and convention that applies to the property in the account. For each general asset account, record the depreciation allowance in a separate depreciation reserve account.

Property you cannot include. You cannot include property in a general asset account if you use it in both a trade or business (or for the production of income) and in a personal activity in the year in which you first place it in service.

How To Group Property in General Asset Accounts

Each general asset account must include only property you placed in service in the same year and that has the following in common.

- Asset class.
- Recovery period.
- Depreciation method.
- Convention.

The following rules also apply when you establish a general asset account.

- **No asset class.** Property without an asset class, but with the same depreciation method, recovery period, and convention, which you place in service in the same year, can be grouped into the same general asset account.
- **Mid-quarter convention.** Property subject to the mid-quarter convention can only be grouped into a general asset account with property that is placed in service in the same quarter.
- **Mid-month convention.** Property subject to the mid-month convention can only be grouped into a general asset account with property that is placed in service in the same month.
- **Passenger automobiles.** Passenger automobiles subject to the limits on passenger automobile depreciation must be grouped into a separate general asset account.

Dispositions and Conversions

It is considered a disposition of property in a general asset account when you do any of the following.

- Permanently withdraw it from use in your trade or business or from the production of income.
- Transfer it to a supplies, scrap, or similar account.
- Sell, exchange, retire, physically abandon, or destroy it.

The retirement of a structural component of real property is not a disposal.

The unadjusted depreciable basis and the depreciation reserve of the general asset account are not affected by your disposition of property from the general asset account.

You must remove from the general asset account any property you change to personal use.

Unadjusted depreciable basis. The unadjusted depreciable basis of an item of property in a general asset account is the amount you would use to figure gain on the sale of the property but figured without taking into account any depreciation taken in earlier years.

The unadjusted depreciable basis of a general asset account is the total of the unadjusted depreciable bases of all of the property in the account.

For more information on general asset accounts, see chapter 3 in Publication 946.

- Bucket trucks (cherry pickers), dump trucks, flatbed trucks, and refrigerated trucks.
- Combines, cranes and derricks, and forklifts.
- Passenger buses with a capacity of at least 20 passengers that are used as passenger buses.

Predominant Use Test

If you do not use listed property predominantly (more than 50%) in a qualified business use, you cannot take a section 179 deduction for the property and you must depreciate the property using ADS (straight line method) over the ADS recovery period.

Listed property meets the predominant use test for any year if its business use is more than 50% of its total use. You must allocate the use of any item of listed property used for more than one purpose during the year among its various uses. You cannot use the percentage of investment use of listed property as part of the percentage of qualified business use to meet the predominant use test. However, you do use the combined total of business and investment use to figure your depreciation deduction for the property.

TIP Property does not stop being predominantly used in a qualified business use because of a transfer at death.

Special Rules for Passenger Automobiles

For passenger automobiles, the total depreciation deduction (including the section 179 deduction) you can claim is limited.

Passenger automobile defined. A passenger automobile is any four-wheeled vehicle made primarily for use on public streets, roads, and highways and rated at 6,000 pounds or less of unloaded gross vehicle weight (6,000 pounds or less of gross vehicle weight for trucks and vans). It includes any part, component, or other item physically attached to the automobile or usually included in the purchase price of an automobile.

Maximum deductions for 1999. Determine the maximum depreciation deduction (including section 179) you can claim for a passenger automobile based on the date you place it in service. The maximum deductions for 1999, based on the year the automobile is placed in service, are shown in the following table.

Maximum Depreciation Deduction for Passenger Automobiles

Year Placed In Service	1st Year	2nd Year	3rd Year	4th Year and Later
1999	\$3,060	\$5,000	\$2,950	\$1,775
1998		5,000	2,950	1,775
1997			3,050	1,775
1996				1,775
1995				1,775
1994				1,675
Pre-1994				1,675

You must reduce these limits further if your business/investment use is less than 100%.

Listed Property

Listed property includes property used for transportation or entertainment and certain computers and cellular phones. There are additional rules and recordkeeping requirements you must follow when depreciating listed property.

Listed Property Defined

Listed property is any of the following.

- Any passenger automobile (defined later).
- Any other vehicle used for transportation.
- Any property of a type generally used for entertainment, recreation, or amusement.
- Any computer and related peripheral equipment **unless** it is used only at a regular business establishment and owned or leased by the person operating the establishment.
- Any cellular telephone (or similar telecommunication equipment).

Other vehicles used for transportation. This includes trucks, buses, boats, airplanes, motorcycles, and other vehicles used for transporting persons or goods.

Vehicles that are not listed property. The following vehicles, because of their design, are unlikely to be used very often for personal purposes. They are **not** listed property.

- Tractors and other special purpose farm vehicles.

Exceptions for clean-fuel vehicles.

There are two exceptions to the depreciation limits for passenger automobiles. These exceptions are effective after August 5, 1997, for automobiles that run on clean fuel.

The **first exception** is a higher depreciation deduction for clean-fuel vehicles. The maximum deductions for 1999, based on the year the clean-fuel vehicle is placed in service, are shown in the following table.

Maximum Depreciation Deduction for Clean-Fuel Vehicles

Year Placed in Service	1st Year	2nd Year	3rd Year	4th Year and Later
1999	\$9,280	\$14,900	\$8,950	\$5,325
1998		15,000	8,950	5,425
1997			9,050	5,425

The **second exception** is for any costs you pay to retrofit parts and components to modify an automobile to run on clean fuel. These costs are **not subject** to the limits on depreciation for automobiles. Only the cost of the automobile, excluding this modification, is subject to the limit.

For more information on clean-fuel vehicles, see chapter 15 in Publication 535, *Business Expenses*.

Fully depreciated automobile. If you have fully depreciated a car you are still using in your business, you can continue to claim your other operating expenses for the business use of your car. Continue to keep records, as explained next.

More information. For more information about deducting expenses for the business use of your passenger automobile, see chapter 4 in Publication 463.

What Records Must Be Kept



You cannot take any depreciation or section 179 deduction for the use of listed property (including passenger automobiles) unless you can prove business and investment use with adequate records or sufficient evidence to support your own statements.

Adequate records. To meet the adequate records requirement, you must maintain an account book, diary, log, statement of expense, trip sheet, or similar record or other documentary evidence that, together with the receipt, is sufficient to establish each element of an expenditure or use. You do not have to record information in an account book, diary, or similar record if the information is already shown on the receipt. However, your records should back up your receipts in an orderly manner.

How long to keep records. For listed property, you must keep records for as long as any excess depreciation can be recaptured (included in income). Recapture can occur in any tax year of the ADS recovery period.

For more information on records, see chapter 4 in Publication 946.

Depletion

Depletion is the using up of natural resources by mining, quarrying, drilling, or felling. The depletion deduction allows an owner or oper-

ator to account for the reduction of a product's reserves.

Who Can Claim Depletion

If you have an economic interest in mineral property or standing timber, you can take a deduction for depletion. More than one person can have an economic interest in the same mineral deposit or timber.

You have an economic interest if both of the following apply.

- 1) You have acquired by investment a legal interest in mineral deposits or standing timber.
- 2) You have the right to income from the extraction of the mineral or the cutting of the timber to which you must look for a return of your capital investment.

A contractual relationship you have that allows you an economic or monetary advantage from products of the mineral deposit or standing timber is not, in itself, an economic interest. A production payment carved out of, or retained on the sale of, mineral property is not an economic interest.

The term "mineral property" means each separate interest you own in each mineral deposit in each separate tract or parcel of land. You can treat mineral properties separately or as a group. See section 614 of the Internal Revenue Code for rules on how to treat separate properties.

The term "timber property" means your economic interest in standing timber in each tract or block representing a separate timber account.

Figuring Depletion

There are two ways of figuring depletion.

- Cost depletion.
- Percentage depletion.

For mineral property, you generally must use the method that gives you the larger deduction. For standing timber, you must use cost depletion.

Cost Depletion

To figure cost depletion you must first determine the following.

- The property's basis for depletion.
- The total recoverable units in the property's natural deposit.
- The number of units sold during the tax year.

You must estimate or determine recoverable units (tons, barrels, board feet, or other measure) using the current industry method and the most accurate and reliable information you can obtain.

Basis for depletion and recoverable units are explained in chapter 13 of Publication 535.

Number of units sold. The number of units sold during the tax year is one of the following.

- 1) The units sold based on your inventories, during the tax year, if you use the accrual method of accounting.
- 2) The units sold for which you receive payment, during the year (regardless of

the year of sale), if you use the cash method of accounting.

The number of units sold during the tax year does not include any units on which depletion deductions were allowed or allowable in earlier years.

Figuring the cost depletion deduction.

Once you have figured your property's basis for depletion, the total recoverable units, and the number of units sold during the tax year, you can figure your cost depletion deduction by taking the following steps.

Step	Action	Result
1	Divide your property's basis for depletion by total recoverable units.	Rate per unit.
2	Multiply the rate per unit by units sold during the tax year.	Cost depletion deduction.

Cost depletion on ground water of Ogallala Formation.

Farmers who extract ground water from the Ogallala Formation for irrigation are allowed cost depletion. Cost depletion is allowed when it can be demonstrated the ground water is being depleted and the rate of recharge is so low that, once extracted, the water is lost to the taxpayer and immediately succeeding generations.

To figure your cost depletion deduction, use the guidance provided in Revenue Procedure 66-11 in Cumulative Bulletin 1966-1.

For tax years ending before December 13, 1982, those extracting ground water for irrigation farming from areas in the Ogallala Formation outside the Southern High Plains were not required to reduce their basis in ground water by any allowable cost depletion that was not claimed.

Timber depletion. You can take depletion on timber (including Christmas trees) only if you cut it yourself or have it cut for you. To figure timber depletion, you multiply the number of units of standing timber cut by your depletion unit.

Timber units. When you acquire timber property, you must make an estimate of the quantity of marketable timber that exists on the property. You measure the timber using board feet, log scale, cords, or other units. If you later determine that you have more or less units of timber, you must adjust the original estimate.

Depletion units. You figure your depletion unit each year by taking the following steps.

- 1) Determine your cost or the adjusted basis of the timber on hand at the beginning of the year.
- 2) Add to the amount determined in (1) the cost of any units acquired during the year and any additions to capital.
- 3) Figure the number of units to take into account by adding the units acquired during the year to the units on hand in the account at the beginning of the year and then adding (or subtracting) any correction to the estimate of the units remaining in the account.
- 4) Divide the result of (2) by the result of (3). This is your depletion unit.

When to claim timber depletion. Claim your depletion allowance as a deduction in the year of sale or other disposition of the

products cut from the timber, unless you elect to treat the cutting of timber as a sale or exchange as explained in chapter 10. Include allowable depletion for timber products not sold during the tax year the timber is cut as a cost item in the closing inventory of timber products for the year. The inventory is your basis for determining gain or loss in the tax year that you sell the timber products.

Form T. Attach Form T to your income tax return if you are claiming a deduction for timber depletion or electing to treat the cutting of timber as a sale or exchange.

Example. Sam Brown bought a farm that included standing timber. This year Sam determined that the standing timber could produce 300,000 units when cut. At that time, the adjusted basis of the standing timber was \$24,000. Sam then cut and sold 27,000 units. Sam did not elect to treat the cutting of the timber as a sale or exchange. Sam's depletion for each unit for the year is \$.08 ($\$24,000 \div 300,000$). His deduction for depletion is \$2,160 ($27,000 \times \$.08$). If Sam had cut 27,000 units but sold only 20,000 units during the year, his depletion for each unit would have remained at \$.08. However, his depletion deduction would have been \$1,600 for this year and he would have included the balance of \$560 ($7,000 \times \$.08$) in the closing inventory for the year.

Percentage Depletion

You can use percentage depletion on certain mines, wells, and other natural deposits. You cannot use the percentage method to figure depletion for standing timber, soil, sod, dirt, or turf.

Figure percentage depletion by multiplying the percentage for each mineral by your gross income from the property during the year. See *Mines and other natural deposits* in chapter 13 of Publication 535 for a list of the percentages.

Taxable income limit. The percentage depletion deduction cannot be more than **50%** (100% for oil and gas property) of your taxable income from the property figured without the depletion deduction. This taxable income limit may not apply to percentage depletion on the marginal production of oil or natural gas. For information on marginal production, see section 613A(c)(6) of the Internal Revenue Code.

The following rules apply when figuring your taxable income from the property for purposes of the taxable income limit.

- Do not deduct any net operating loss deduction from the gross income from the property.
- Corporations do not deduct charitable contributions from the gross income from the property.
- If, during the year, you disposed of an item of section 1245 property which was used in connection with the mineral property, reduce any allowable deduction for mining expenses by the part of any gain you must report as ordinary income that is allocable to the property. See section 1.613-5(b)(1) of the regulations for information on how to figure the ordinary gain allocable to the property.

More Information

For more information on depletion, see chapter 13 in Publication 535.

Amortization

Amortization is a method of recovering certain capital costs over a fixed period of time. It is similar to the straight line method of depreciation. See chapter 12 in Publication 535 for more information on the following topics.

Section 197 Intangibles

You must amortize over 15 years the capitalized costs of "section 197 intangibles" you acquired after August 10, 1993. Section 197 intangibles are defined later. You must amortize these costs if you hold the section 197 intangible in connection with your trade or business or in an activity engaged in for the production of income. Your deduction each year is the part of the adjusted basis (for purposes of determining gain) of the intangible amortized ratably over a 15-year period, beginning with the month acquired. You are not allowed any other depreciation or amortization deduction for a section 197 intangible.

Section 197 Intangibles Defined

The following assets are section 197 intangibles.

- 1) Goodwill.
- 2) Going concern value.
- 3) Workforce in place, including its composition and the terms and conditions (contractual or otherwise) of its employment.
- 4) Business books and records, operating systems, or any other information base, including lists or other information concerning current or prospective customers.
- 5) A patent, copyright, formula, process, design, pattern, know-how, format, or similar item.
- 6) A customer-based intangible.
- 7) A supplier-based intangible.
- 8) Any item similar to items (3) through (7).
- 9) A license, permit, or other right granted by a governmental unit or agency (including renewals).
- 10) A covenant not to compete entered into in connection with the acquisition of an interest in a trade or business.
- 11) A franchise, trademark, or trade name (including renewals).



You cannot amortize any intangible listed in items (1) through (8) that you created, unless you created it in connection with the acquisition of assets constituting a trade or business or a substantial part of a trade or business.

Assets that are not section 197 intangibles. The following assets are not section 197 intangibles.

- 1) Any interest in land.
- 2) Most computer software (see *Computer software*, next).

- 3) An interest under either:
 - a) An existing lease or sublease of tangible property, or
 - b) A debt that was in existence when the interest was acquired.

Computer software. Section 197 intangibles do not include computer software that is:

- 1) Readily available for purchase by the general public,
- 2) Subject to a nonexclusive license, and
- 3) Not substantially changed.

Software not acquired in the acquisition of a substantial part of a business is not a section 197 intangible.

If you are allowed to depreciate any computer software that is not a section 197 intangible, use the straight line method with a useful life of 36 months.

For more information on depreciating computer software, see *Computer software* under *Intangible Property*, earlier.

Costs associated with non-section 197 intangibles. Amounts you take into account in determining the cost of non-section 197 property are not considered section 197 intangibles. These amounts are added to the basis of the property. For example, none of the costs of acquiring real property held for the production of rental income are considered goodwill, going concern value, or any other section 197 intangible.

Anti-Churning Rules

Anti-churning rules prevent you from converting section 197 intangibles that do not qualify for amortization into property that would qualify for amortization.

You cannot use 15-year amortization for goodwill, going concern value, or any other intangible for which you cannot claim a depreciation or amortization deduction that would not have been allowable before August 10, 1993, to amortizable property.

Anti-Abuse Rule

You cannot amortize any section 197 intangible acquired in a transaction in which either of the following was a principal purpose of the transaction.

- 1) To avoid the requirement that the intangible be acquired after August 10, 1993.
- 2) To avoid any of the anti-churning rules.

Dispositions

A section 197 intangible is treated as depreciable property used in your trade or business. If you dispose of property held for more than one year, any gain on the disposition, up to the allowable amortization, is ordinary income (section 1245 gain). Any remaining gain or loss is a section 1231 gain or loss. If you held the property one year or less, any gain or loss on its disposition is an ordinary gain or loss. For more information, see chapter 3 in Publication 544.

Non deductible loss. If you acquire more than one section 197 intangible in a transaction (or series of related transactions) and later dispose of one of them or one of them becomes worthless, you cannot deduct any

loss on the intangible. Instead, increase the adjusted basis of each remaining amortizable section 197 intangible by part of the non-deductible loss.

Reforestation Costs

You can elect to amortize part of your qualified timber property reforestation costs. Qualifying expenses you have during the year are amortizable over an 84-month period.

Annual limit. Each year you can elect to amortize up to \$10,000 (\$5,000 if you are married filing separate returns) of qualified costs you pay or incur during the year. You cannot carry over or carry back qualifying costs over the annual limit. If you incur more than \$10,000 in costs for more than one piece of timber property, you can divide the annual limit among the properties in any manner you wish.

Qualifying costs. Qualifying costs include only those costs you must capitalize and include in the adjusted basis of the property. Costs you can deduct currently are not qualifying expenses. Qualifying costs include costs for the following items.

- Site preparation.
- Seeds or seedlings.
- Labor.
- Tools.
- Depreciation on equipment used in planting and seeding.

If the government reimburses you under a cost-sharing program, you can amortize these costs only if you include the reimbursement in your income.

Qualified timber property. Qualified timber property can be a woodlot or other site that you own or lease. The property qualifies only if it meets all of the following requirements.

- 1) It is located in the United States.
- 2) It is held for the growing and cutting of timber you will either use in, or sell for use in, the commercial production of timber products.
- 3) It consists of at least one acre planted with tree seedlings in the manner normally used in forestation or reforestation.

Qualified timber property does not include property on which you have planted shelter belts and ornamental trees, such as Christmas trees.

Maximum annual amortization. The maximum annual deduction for costs incurred in any year is \$1,428.57 ($\$10,000 \div 7$). The maximum deduction in the first and last year of the 84-month period is one half ($1/2$) of \$1,428.57 or \$714.29.

Estates. The reforestation deduction is available to estates in the same manner as to individuals. The deduction is divided between the income beneficiary and the estate based on the income of the estate allocable to each. A beneficiary must include any allocated amount as part of his or her annual limit.

Trusts. Trusts are not allowed the reforestation deduction.

Investment credit. Reforestation costs eligible to be amortized qualify for the investment credit, whether or not they are amortized. See *Investment Credit* in chapter 9.

How to make the election. To elect to amortize qualified reforestation costs, enter your deduction in Part VI of Form 4562. Attach a statement containing the following information.

- A description of the costs and the dates you incurred them.
- A description of the type of timber being grown and the purpose for which it is grown.

Attach a separate statement for each property for which you amortize reforestation costs. You can make the election only on a timely filed return (including extensions) for the year in which you incurred the costs. However, if you timely filed your return for the year without making the election, you can still make the election by filing an amended return within six months of the due date of your return (excluding extensions). Attach the election to the amended return and write "Filed pursuant to section 301.9100-2" on the election statement. File the amended return at the same address you filed the original return.

Recapture. If you dispose of qualified timber property within 10 years after the tax year you create an amortizable basis in the property, report any gain as ordinary income up to the amount of the amortization taken.

Pollution Control Facilities

You can elect to amortize over 60 months the cost of a certified pollution control facility.

Certified pollution control facility. A certified pollution control facility is a new identifiable treatment facility used in connection with a plant or other property in operation before 1976 to reduce or control water or atmospheric pollution or contamination. The facility must do so by removing, changing, disposing, storing, or preventing the creation or emission of pollutants, contaminants, wastes, or heat. The facility must be certified by the state and federal certifying authorities. Examples of such a facility include septic tanks and manure-control facilities.

For information regarding certification procedures, see section 1.169-2(c) of the regulations.

The federal certifying authority will not certify your property to the extent it appears you will recover (over the property's useful life) all or part of its cost from the profit based on its operation (such as through sales of recovered wastes). You must reduce the amortizable basis of the facility by this potential recovery. For more information, see section 169 of the Internal Revenue Code and the related regulations.

Example. This year, you purchase a new \$7,500 manure control facility for use on your dairy farm. The farm has been in operation since you bought it in 1976 and all of the dairy plant was in operation before that date. You have no intention of recovering the cost of the facility through sale of the waste and a federal certifying authority has so certified.

Your manure control facility qualifies for amortization. You can elect to amortize its

cost over 60 months. Otherwise, you can capitalize the cost and depreciate the facility.

Going Into Business

When you go into business, treat all costs you incur to get your business started as capital expenses. Capital expenses are a part of your basis in the business. Generally, you recover costs for particular assets through depreciation deductions. However, you generally cannot recover other costs until you sell the business or otherwise go out of business.

Business start-up costs. Start-up costs are costs for setting up an active trade or business or investigating the possibility of creating or acquiring an active trade or business. Start-up costs include any amounts paid or incurred in connection with any activity engaged in for profit and for the production of income before the trade or business begins, in anticipation of the activity becoming an active trade or business.

For more information, see *Going Into Business* in chapter 12 of Publication 535.

9.

General Business Credit

Introduction

Your general business credit for the year consists of your carryforward of business credits from prior years plus your total current year business credits. Current year business credits include the following credits.

- Credit for alcohol used as fuel (Form 6478).
- Credit for contributions to selected community development corporations (Form 8847).
- Credit for employer social security and Medicare taxes paid on certain employee tips (Form 8846).
- Disabled access credit (Form 8826).
- Empowerment zone employment credit (Form 8844).
- Enhanced oil recovery credit (Form 8830).
- Indian employment credit (Form 8845).
- Investment credit (Form 3468).
- Low-income housing credit (Form 8586).
- Orphan drug credit (Form 8820).
- Renewable electricity production credit (Form 8835).
- Research credit (Form 6765).
- Welfare-to-work credit (Form 8861).
- Work opportunity credit (Form 5884).

In addition, your general business credit for the current year may be increased later by the carryback of business credits from later years.

If you need more information about these credits than you find in this chapter, see the instructions for the forms listed above.

Topics

This chapter discusses:

- How to claim the credit
- Carrybacks and carryforwards
- Investment credit

Useful Items

You may want to see:

Form (and Instructions)

- 1040X** Amended U.S. Individual Income Tax Return
- 1045** Application for Tentative Refund
- 1120X** Amended U.S. Corporation Income Tax Return
- 1139** Corporation Application for Tentative Refund
- 3468** Investment Credit
- 3800** General Business Credit
- 4255** Recapture of Investment Credit
- 4626** Alternative Minimum Tax—Corporations
- 6251** Alternative Minimum Tax—Individuals
- 8582-CR** Passive Activity Credit Limitations

See chapter 21 for information about getting publications and forms.

How To Claim the Credit

To claim a general business credit, you will first need to get the form or forms you need to claim your current year business credits. The introduction to this chapter contains a list of current year business credits. The form to claim each credit is shown in parentheses.

In addition to the credit form, you may also need to file Form 3800. See the next discussion to decide whether you need to file Form 3800.

Who must file Form 3800? You must file Form 3800 if any of the following apply.

- You have more than one of the credits listed in the introduction (other than the empowerment zone employment credit).
- You have a carryback or carryforward of any of these credits (other than the empowerment zone employment credit).
- Any of these credits (other than the low-income housing credit or the empowerment zone employment credit) is from a passive activity. (For information about passive activity credits, see Form 8582-CR.)

Claiming the empowerment zone employment credit. The empowerment zone employment credit is subject to different rules. The credit is figured separately on Form 8844 and is not carried to Form 3800. For more information, see the instructions for Form 8844.

Carrybacks and Carryforwards



The following discussion does not apply to the empowerment zone employment credit.

There is a limit on how much general business credit you can take in any one tax year. If your credit is more than this limit, you can generally carry the difference to another tax year and subtract it from your income tax for that year. See *Rule for carrybacks and carryforwards*, later.

Credit limit. Your general business credit is limited to your **net income tax** minus the **greater** of the following amounts.

- Your **tentative minimum tax**.
- 25% of your **net regular tax liability** that is more than \$25,000.

Net income tax. Your net income tax is your net regular tax liability plus any alternative minimum tax.

Tentative minimum tax. You must figure your tentative minimum tax before you figure your general business credit. Use Form 6251 (Form 4626 for a corporation) to figure your tentative minimum tax.

Net regular tax liability. Your net regular tax liability is your regular tax liability minus certain credits. For more information, see Form 3800 or any of the credit forms listed under *Introduction*, earlier.

Example. Your general business credit for the year is \$30,000. Your net income tax is \$27,500. Your tentative minimum tax, figured on Form 6251, is \$18,487. The general business credit you can take for the tax year is limited to \$9,013. This is your net income tax, \$27,500, minus the greater of your tentative minimum tax, \$18,487, or 25% of your net regular tax liability that is more than \$25,000 (25% of \$2,500 = \$625).

Married persons filing separate returns. If you are married and file a separate return, you and your spouse must each figure your credit limit separately. In figuring your separate limit, use \$12,500 instead of \$25,000. However, if one spouse has no credit for the tax year and no carryforwards or carrybacks of any credit to that year, the other spouse can use the full \$25,000 in figuring the limit based on the separate tax.

Rule for carrybacks and carryforwards. In general, you can carry the unused portion of your credit back one tax year and then forward to your next 20 tax years to reduce your tax in those years. First, carry the unused portion to your last tax year. Any unused credit that you could not take in the prior tax year can be carried forward to the next 20 tax years until it is used up.

There are generally limits on the carryback of a new credit to periods before the enactment of the credit provision. See the

instructions for Form 3800 for more information on these limits.

Credits must be used in the order in which they are earned.

- 1) First, for any tax year, use your credit carryforward (earliest year first).
- 2) Next, use the current year's credit.
- 3) Finally, use your credit carrybacks (earliest year first).



For a credit earned in a tax year before 1998, the carryforward period is 15 years. No part of your carryforward to 1999 should be from a tax year before 1984.

Unused carryforward. If you have any unused credit carryforward in the year following the end of the 20-year (15 years for pre-1998 credits) carryforward period, you can generally deduct the unused amount. If an individual dies or a corporation, trust, or estate ceases to exist, the deduction is generally allowed for the tax year in which the death or cessation occurs. The deduction may not be allowed to certain corporations whose assets are acquired by another corporation.

Claiming carryforwards. Use Form 3800 to claim a carryforward of an unused credit from a previous tax year. The carryforward becomes part of your general business credit for the tax year to which it is carried.

Claiming carrybacks. You can make a claim for refund based on your general business credit carryback to a prior tax year by filing an amended return for the tax year to which you carry the unused credit. Use Form 1040X if your original return was a Form 1040. Use Form 1120X if your original return was a Form 1120 or 1120-A. Attach Form 3800 to your amended return.

Generally, you must file the amended return for the carryback year within 3 years after the due date, including extensions, for filing the return for the year that resulted in the credit carryback.

Quick refunds. You can apply for a quick refund of taxes for a prior year by filing **Form 1045 (Form 1139** for a corporation) to claim a tentative adjustment of tax from a general business credit carryback. The application should be filed on or after the date of filing the tax return for the carryback year, but must be filed within 12 months after the end of the tax year in which you earn the credit.

Investment Credit

The investment credit is the total of the following credits.

- Reforestation credit.
- Rehabilitation credit.
- Energy credit.

Reforestation credit. The 10% reforestation credit applies to up to \$10,000 (\$5,000 if you are married filing a separate return) of the costs you incur each year to forest or reforest property you hold for growing trees for sale or use in the commercial production of timber products. These costs must qualify for amortization. You can take the investment credit for reforestation costs whether you

choose to amortize them or add them to the basis of your property. There is no carryforward or carryback of costs exceeding the dollar limit. For more information about these costs, see *Amortization* in chapter 8.

Example. You incurred \$9,000 of qualified reforestation costs during the year. You may take a reforestation credit of \$900 (10% of \$9,000) for the year.

Rehabilitation credit. The rehabilitation credit applies to costs you incur for rehabilitation and reconstruction of certain buildings. Rehabilitation includes renovation, restoration, or reconstruction. It does not include enlargement or new construction. Generally, the percentage of costs you can take as a credit is 10% for buildings placed in service before 1936 and 20% for certified historic structures. See the instructions for Form 3468 for more information.

Energy credit. The 10% energy credit applies to certain costs for solar or geothermal energy property you placed in service during your tax year. See the instructions for Form 3468 for more information.

Basis adjustment. You generally must reduce the basis of assets on which you take an investment credit. The reduction is 100% of the rehabilitation credit and 50% of the reforestation and energy credits. See the instructions for Form 3468.

Example. You amortized qualified reforestation costs of \$9,000 incurred during the year. You are also taking a \$900 reforestation credit. You must reduce your amortizable basis by \$450 (50% of \$900). As a result, your amortizable basis will be \$8,550 (\$9,000 – \$450).

How to take the investment credit. Use **Form 3468** to figure your credit. You may also need to file Form 3800. See *How To Claim the Credit*, earlier.

Carrybacks and carryforwards. Even if you cannot take an investment credit for the year, you may have unused credits from earlier years that may reduce your tax. These unused credits are carried to your current tax year as general business credit carryforwards and the rules for the general business credit, discussed earlier, apply.

Recapture of Investment Credit

At the end of each tax year, you must determine whether you disposed of or stopped using in your business (either partially or entirely) any property for which you claimed an investment credit in a prior year. If you dispose of property before the end of the recapture period, you must recapture a percentage of the credit by adding it to your tax. See *Recapture Rule*, later, for a discussion of recapture period.

Use **Form 4255** to figure the recapture tax or attach a detailed statement to your return for the year you dispose of the asset showing the computation of the recapture tax and the decrease in any investment credit carryforward.

Dispositions

An outright sale of property is the clearest example of a disposition. Another type of disposition occurs when you exchange or trade worn-out or obsolete business assets for new ones. If the property ceases to be qualifying property, it is considered to be disposed of for investment credit recapture purposes. For example, the conversion of business property to personal use is considered a disposal for investment credit recapture purposes.

Certain transactions result in dispositions for investment credit recapture purposes. The following illustrate those that are and those that are not dispositions.

Mortgaging and foreclosure. There is no disposition if title to property is transferred as security for a loan. However, a disposition does occur if there is a transfer of property by foreclosure.

Leased property. The leasing of investment credit property by the lessor who took the credit is generally not a disposition. However, if the lease is treated as a sale for income tax purposes, it is a disposition. A disposition also occurs if property ceases to be investment credit property in the hands of the lessor, the lessee, or any sublessee.

Decrease in basis. If the basis of investment credit property decreases, the decrease is considered to be a disposition of part of the property. This occurs, for example, if you buy property and later receive a refund of part of the original purchase price. You must then refigure the credit as if the decrease in basis was never part of the original basis. If your refigured credit is less than the credit you originally took, you must add the difference to your tax.

Retirement or abandonment. You dispose of property if you abandon it or otherwise retire it from use. Normal retirements are also dispositions.

Transfer by reason of death. There is no disposition of investment credit property if the property is transferred because the owner-taxpayer died.

Gifts. You are considered to have disposed of property that you transferred by gift.

Transfers between spouses. If you transfer investment credit property to your spouse, or you transfer the property to your former spouse incident to a divorce, you generally are not considered to have disposed of the property. This also applies if the transfer is made in trust for the benefit of your spouse or former spouse. However, if your spouse or former spouse later transfers the property, your spouse or former spouse will receive the same tax treatment that would have applied to you if you had made the transfer.

Casualty, theft, or involuntary conversion. You are considered to have disposed of property that was destroyed by casualty or lost by theft or other involuntary conversion.

Disposition of assets by S corporation, partnership, estate, or trust. If you are a shareholder of an S corporation that disposes

of assets on which you figured the investment credit, you are treated as having disposed of the share of the investment on which you figured your credit. This same rule applies if you are a member of a partnership or a beneficiary of an estate or trust.

Change in form of doing business. A disposition does not occur because of a change in the form of doing business if certain conditions are met. For more information, see section 1.47–3(f) of the regulations.

Choosing S corporation status. The choice by a corporation to become an S corporation generally will not cause the recapture of investment credit previously claimed by the corporation. The choice is treated as a change in the form of doing business and not as a disposition of property. No disposition occurs when an S corporation terminates or revokes its choice not to be taxed as a corporation.

Sale and leaseback. There is no disposition when investment credit property is sold by the taxpayer who claimed the credit and it is then leased back to that taxpayer as part of the same transaction.

Recapture Rule

If you dispose of investment credit property before the end of the recapture period, you must recapture, as an additional tax, part of the original credit you claimed. You may also have to recapture part or all of the credit if you change the use of investment credit property to one that would not have originally qualified for the credit.

Recapture period. The credit you must recapture depends on when during the recapture period you dispose of, or change the use of, the property. The recapture period is the length of time the property must be used to get the full investment credit. The recapture period for investment credit property is 5 full years from the date it was placed in service. If you dispose of the property during the first full year of service, you must recapture the full amount of the credit that was used to reduce your tax. The recapture amount decreases for each year the property remains in qualified service.

Form 4255. Use Form 4255 to figure the recapture amount. The credit recapture is figured by multiplying the original investment credit taken by the recapture percentage from the tables shown on Form 4255. The result of this computation is the recapture amount. See Form 4255 for more information.

If the refigured credit is less than the credit you originally took, you must add the difference to your tax.

Net operating loss carrybacks. If you have a net operating loss carryback from the recapture year or a later year that reduces your tax for the recapture year or an earlier year, you may have to refigure your recapture. See section 1.47–1(b)(3) of the regulations.

At-risk reduction. If your investment credit property is subject to the at-risk limits, you may have to recapture part of the credit if the amount at risk is decreased. See the instructions for Form 3468 for more information.

10.

Gains and Losses

Introduction

During the year, you may have sold or exchanged property. This chapter explains how to figure your gain or loss on the sale or exchange and determine the effect it has on your taxes.

Topics

This chapter discusses:

- Sales and exchanges
- Ordinary or capital gain or loss

Useful Items

You may want to see:

Publication

- 504** Divorced or Separated Individuals
- 523** Selling Your Home
- 544** Sales and Other Dispositions of Assets
- 547** Casualties, Disasters, and Thefts (Business and Nonbusiness)
- 550** Investment Income and Expenses
- 551** Basis of Assets

Form (and Instructions)

- Sch D (Form 1040)** Capital Gains and Losses
- Sch F (Form 1040)** Profit or Loss From Farming
- 4684** Casualties and Thefts
- 4797** Sales of Business Property
- 8824** Like-Kind Exchanges

See chapter 21 for information about getting publications and forms.

Sales and Exchanges

If you sell, exchange, or otherwise dispose of your property, you usually have a gain or a loss. This section explains some of the rules for determining whether any gain you have is taxable, and whether any loss you have is deductible.

A sale is a transfer of property for money or a mortgage, note, or other promise to pay money. An exchange is a transfer of property for other property or services.

Determining Gain or Loss

You usually realize a gain or loss when you sell or exchange property. A gain is the amount you realize from a sale or exchange of property that is more than its adjusted basis. A loss is the adjusted basis of the property that is more than the amount you realize.

See chapter 7 for the definition of basis, adjusted basis, and fair market value.

Amount realized. The amount you realize from a sale or exchange is the total of all money you receive plus the fair market value of all property or services you receive. The amount you realize also includes any of your liabilities that were assumed by the buyer and any liabilities to which the property you transferred is subject, such as real estate taxes or a mortgage.

If the liabilities relate to an exchange of multiple properties, see *Treatment of Liabilities* under *Multiple Property Exchanges* in chapter 1 of Publication 544.

Amount recognized. Your gain or loss realized from a sale or exchange of property is usually a recognized gain or loss for tax purposes. A recognized gain is a gain that you must include in gross income and report on your income tax return. However, depending on your other income and losses for the year, this amount may or may not be taxed. A recognized loss is a loss that you deduct from gross income. For example, if your recognized gain from the sale of your tractor is \$5,300, you include that amount in gross income on Form 1040. However, your gain or loss realized from certain exchanges of property is not recognized for tax purposes. See *Like-Kind Exchanges*, next. Also, a loss from the disposition of property held for personal use is not deductible.

Like-Kind Exchanges

Certain exchanges of property are not taxable. This means that any gain from the exchange is not taxed, and any loss cannot be deducted. Your gain or loss will not be recognized until you sell or otherwise dispose of the property you receive.

The exchange of property for the same kind of property is the most common type of nontaxable exchange. To be a like-kind exchange, the property traded and the property received must be both of the following.

- Qualifying property.
- Like property.

These two requirements are discussed later.

Additional requirements apply to exchanges in which the property received is not received immediately upon the transfer of the property given up. See *Deferred exchanges*, later.

If the like-kind exchange involves the receipt of money or unlike property or the assumption of your liabilities, you may have a recognized gain. See *Partially nontaxable exchange*, later.

Multiple-party transactions. The like-kind exchange rules also apply to property exchanges that involve three- and four-party transactions. Any part of these multiple-party transactions can qualify as a like-kind exchange if it meets all of the requirements described in this section.

Receipt of title from third party. If you receive property in a like-kind exchange and the other party who transfers the property to you does not give you the title but a third party does, you may still treat this transaction as a like-kind exchange if it meets all the requirements.

Basis of property received. If you acquire property in a like-kind exchange, the basis of that property is the same as the basis of the property you transferred. See chapter 7 for more information about basis.

Money paid. If, in addition to giving up like property, you pay money in a like-kind exchange, you still have no recognized gain or loss. The basis of the property received is the basis of the property given up, increased by the money paid.

Example. Bill Smith trades an old tractor for a new one. The new tractor costs \$10,800. He is allowed \$2,000 for the old tractor and pays \$8,800 cash. He has no recognized gain or loss on the transaction regardless of the adjusted basis of his old tractor. If Bill sold the old tractor to a third party for \$2,000 and bought a new one, he would have a recognized gain or loss on the sale of his old tractor equal to the difference between the amount realized and the adjusted basis of the old tractor.

Reporting the exchange. Report the exchange of like-kind property on **Form 8824**. The instructions for the form explain how to report the details of the exchange. Report the exchange even though no gain or loss is recognized.

If you have any taxable gain because you received money or unlike property, report it on Schedule D (Form 1040) or Form 4797, whichever applies. You may also have to report the taxable gain as ordinary income because of depreciation recapture on Form 4797. See chapter 11 for more information.

Qualifying property. In a like-kind exchange, both the property you give up and the property you receive must be held by you for investment or for productive use in your trade or business. Machinery, buildings, land, trucks, and rental houses are examples of property that may qualify.

The rules for like-kind exchanges do not apply to exchanges of the following property.

- Property you use for personal purposes, such as your home and your family car.
- Stock in trade or other property held primarily for sale, such as crops and produce.
- Stocks, bonds, notes, or other securities or evidences of indebtedness, such as accounts receivable.
- Partnership interests.

However, you might have a nontaxable exchange under other rules. See *Other Nontaxable Exchanges* in chapter 1 of Publication 544.

Like property. To qualify as a nontaxable exchange, the properties exchanged must be of "like kind" as defined in the income tax regulations. Generally, real property exchanged for real property qualifies as an exchange of like-kind property. Depreciable tangible personal property can be either "like

kind" or "like class" to qualify for nontaxable exchange treatment. See *Personal property*, next.

Personal property. Like-class properties are depreciable tangible personal properties within the same General Asset Class or Product Class.

General Asset Classes. General Asset Classes describe the types of property frequently used in many businesses. They include the following property.

- 1) Office furniture, fixtures, and equipment (asset class 00.11).
- 2) Information systems, such as computers and peripheral equipment (asset class 00.12).
- 3) Data handling equipment except computers (asset class 00.13).
- 4) Airplanes (airframes and engines), except planes used in commercial or contract carrying of passengers or freight, and all helicopters (airframes and engines) (asset class 00.21).
- 5) Automobiles and taxis (asset class 00.22).
- 6) Buses (asset class 00.23).
- 7) Light general purpose trucks (asset class 00.241).
- 8) Heavy general purpose trucks (asset class 00.242).
- 9) Railroad cars and locomotives except those owned by railroad transportation companies (asset class 00.25).
- 10) Tractor units for use over the road (asset class 00.26).
- 11) Trailers and trailer-mounted containers (asset class 00.27).
- 12) Vessels, barges, tugs, and similar water-transportation equipment, except those used in marine construction (asset class 00.28).
- 13) Industrial steam and electric generation or distribution systems (asset class 00.4).

Product Classes. Product Classes include property listed in a 4-digit product class (except any ending in "9," a miscellaneous category) in Division D of the Standard Industrial Classification codes of the Executive Office of the President, Office of Management and Budget, Industrial Classification Manual. Copies of the manual may be obtained from the National Technical Information Service, an agency of the U.S. Department of Commerce. To order the manual, call 1-800-553-NTIS (1-800-553-6847). Or visit their web site at www.ntis.gov. The cost of the manual is \$30 and the order number is PB87-100012INQ.

Examples. An exchange of a truck for a tractor is an exchange of like-kind property, and so is an exchange of timber land for crop acreage. An exchange of a tractor for acreage, however, is not an exchange of like-kind property. Neither is the exchange of livestock of one sex for livestock of the other sex. An exchange of the assets of a business for the assets of a similar business cannot be treated as an exchange of one property for another property. Whether you engaged in a like-kind exchange depends on an analysis of each asset involved in the exchange.

Partially nontaxable exchange. If you exchange your property for like-kind property and also receive money or unlike property, or both, in an exchange in which you realize gain, you have a partially nontaxable exchange. You are taxed on the gain realized to the extent of the money and the fair market value of the unlike property you receive. A loss is not deductible.

Example 1. You trade farm land that cost you \$30,000 for \$10,000 cash and other land to be used in farming with a fair market value of \$50,000. You have a gain of \$30,000, but only \$10,000, the cash received, is recognized.

Example 2. Assume the same facts as in *Example 1*, except that, instead of money, you received a tractor with a fair market value of \$10,000. Your recognized gain is still limited to \$10,000, the value of the tractor (the unlike property).

Example 3. Assume in *Example 1* that the fair market value of the land you received was only \$15,000. Your \$5,000 loss is not deductible.

Unlike property given up. If you trade property for like-kind property and also give up unlike property in the exchange, you have a recognized gain or loss on the unlike property you give up. This gain or loss is the difference between the fair market value of the unlike property and its adjusted basis.

Like-kind exchanges between related persons. Special rules apply to like-kind exchanges made between related persons. These rules affect both direct and indirect exchanges. Under these rules, if either person disposes of the property within 2 years after the exchange, the exchange is disqualified from nonrecognition treatment. The gain or loss on the original exchange must be recognized as of the date of that later disposition. The 2-year holding period begins on the date of the last transfer of property that was part of the like-kind exchange.

Related persons. Under these rules, a related person generally includes: a member of your family (spouse, brother, sister, parent, child, etc.), a corporation in which you have more than 50% ownership, a partnership in which you directly or indirectly own more than a 50% interest of the capital or profits, and two partnerships in which you directly or indirectly own more than 50% of the capital interests or profits.

For the list of related persons, see *Non-deductible Loss under Sales and Exchanges Between Related Persons* in chapter 2 of Publication 544.

Example. You used a truck in your farming business. Your sister used a station wagon in her landscaping business. In December 1997, you exchanged your truck, plus \$200, for your sister's station wagon. At that time, the fair market value (FMV) of your truck was \$7,000 and its adjusted basis was \$6,000. The FMV of your sister's station wagon was \$7,200 and its adjusted basis was \$1,000. You realized a gain of \$1,000 (the \$7,200 FMV of the station wagon minus the \$200 you paid, minus the \$6,000 adjusted basis of the truck). Your sister realized a gain of \$6,200 (the \$7,000 FMV of your truck plus the \$200 you paid, minus the \$1,000 adjusted basis of the station wagon).

However, because this was a like-kind exchange, you recognized no gain. Your basis in the station wagon was \$6,200 (the \$6,000 adjusted basis of the truck plus the \$200 you paid). Your sister recognized gain only to the extent of the money she received, \$200. Her basis in the truck was \$1,000 (the \$1,000 adjusted basis of the station wagon minus the \$200 received, plus the \$200 gain recognized).

In 1999, you sold the station wagon to a third party for \$7,000. Because you sold it within 2 years after the exchange, the exchange is disqualified from nonrecognition treatment. On your tax return for 1999, you must report your \$1,000 gain on the exchange in 1998. You also report a loss on the sale of \$200 (the adjusted basis of the station wagon, \$7,200 (its \$6,200 basis plus the \$1,000 gain recognized), minus the \$7,000 amount realized from the sale).

In addition, your sister must report on her tax return for 1999 the \$6,000 balance of her gain on the 1998 exchange. Her adjusted basis in the truck is increased to \$7,000 (its \$1,000 basis plus the \$6,000 gain recognized).

Exceptions to the rules for related persons. The following kinds of property dispositions are excluded from these rules.

- Dispositions due to the death of either related person.
- Involuntary conversions.
- Dispositions if it is established to the satisfaction of the IRS that neither the exchange nor the disposition has as a main purpose the avoidance of federal income tax.

Exchanges of multiple properties. Under the like-kind exchange rules, you must generally make a property-by-property comparison to figure your recognized gain and the basis of the property you receive in the exchange. However, for exchanges of multiple properties, you do not make a property-by-property comparison if you do either of the following.

- Transfer and receive properties in two or more exchange groups.
- Transfer or receive more than one property within a single exchange group.

For more information, see *Multiple Property Exchanges* in chapter 1 of Publication 544.

Deferred exchanges. A deferred exchange is one in which you transfer property you use in business or hold for investment and, at a later time, you receive like-kind property you will use in business or hold for investment. The property you receive is replacement property. The transaction must be an exchange (that is, property for property) rather than a transfer of property for money that is used to buy replacement property.

A deferred exchange for like-kind property may qualify for nonrecognition of gain or loss if the like-kind property is identified and transferred within the following time limits.

- 1) You must identify the property to be received within 45 days after the date you transfer the property given up in the exchange.

Table 10–1. **Worksheet for Foreclosures and Repossessions**
(Keep for your records)



Part 1. Figure your income from cancellation of debt. (<i>Note: If you are not personally liable for the debt, you do not have income from cancellation of debt. Skip Part 1 and go to Part 2.</i>)	
1. Enter amount of debt canceled by the transfer of property	_____
2. Enter the fair market value of the transferred property	_____
3. Income from cancellation of debt.* Subtract line 2 from line 1. If less than zero, enter zero	_____
Part 2. Figure your gain or loss from foreclosure or repossession.	
4. Enter the smaller of line 1 or line 2. Also include any proceeds you received from the foreclosure sale. (If you are not personally liable for the debt, enter the amount of debt canceled by the transfer of property.)	_____
5. Enter the adjusted basis of the transferred property	_____
6. Gain or loss from foreclosure or repossession. Subtract line 5 from line 4	_____

*The income may not be taxable. See *Cancellation of debt*.

- 2) The property must be received by the earlier of the following dates.
- a) The 180th day after the date on which you transfer the property given up in the exchange.
 - b) The due date, including extensions, for your tax return for the tax year in which the transfer of the property given up occurs.

For more information, see *Deferred Exchanges* in chapter 1 of Publication 544.

Transfers Between Spouses

No gain or loss is recognized (included in gross income) on a transfer of property from an individual to (or in trust for the benefit of) a spouse, or a former spouse if incident to divorce. This rule does not apply if the recipient is a nonresident alien. Nor does this rule apply to a transfer in trust to the extent the liabilities assumed and the liabilities on the property are more than the property's adjusted basis.

Any transfer of property to a spouse or former spouse on which gain or loss is not recognized is not considered a sale or exchange. The recipient's basis in the property will be the same as the adjusted basis of the giver immediately before the transfer. This carryover basis rule applies whether the adjusted basis of the transferred property is less than, equal to, or greater than either its fair market value at the time of transfer or any consideration paid by the recipient. This rule applies for determining loss as well as gain. Any gain recognized on a transfer in trust increases the basis.

For more information on transfers of property incident to divorce, see *Property Settlements* in Publication 504.

Foreclosures and Repossessions

If you do not make payments you owe on a loan secured by property, the lender may foreclose on the loan or repossess the property. The foreclosure or repossession is

treated as a sale or exchange from which you may realize gain or loss. This is true even if you voluntarily return the property to the lender. You may also realize ordinary income from cancellation of debt if the loan balance is more than the property's fair market value.

Buyer's (borrower's) gain or loss. You figure and report gain or loss from a foreclosure or repossession in the same way as gain or loss from a sale or exchange. The gain or loss is the difference between your adjusted basis in the transferred property and the amount realized. See *Determining Gain or Loss*, earlier.

TIP You can use Table 10–1 to figure your gain or loss from a foreclosure or repossession.

Amount realized on a nonrecourse debt. If you are not personally liable for repaying the debt (nonrecourse debt) secured by the transferred property, the amount you realize includes the full amount of the debt canceled by the transfer. The full amount of the canceled debt is included even if the property's fair market value is less than the canceled debt.

Example 1. Ann paid \$200,000 for farm land. She paid \$15,000 down and borrowed the remaining \$185,000 from a bank. Ann is not personally liable for the loan (nonrecourse debt), but pledges the land as security. The bank foreclosed on the loan when Ann stopped making payments. At the time of the foreclosure, the balance due on the loan was \$180,000 and the fair market value of the land was \$170,000. The amount Ann realized on the foreclosure was \$180,000, the debt canceled by the foreclosure. She figures her gain or loss by comparing the amount realized (\$180,000) with her adjusted basis (\$200,000). She has a \$20,000 deductible loss.

Example 2. Assume the same facts as in *Example 1* except the fair market value of the land was \$210,000. The result is the same. The amount Ann realized on the

foreclosure is \$180,000, the debt canceled by the foreclosure. Because her adjusted basis is \$200,000, she has a deductible loss of \$20,000.

Amount realized on a recourse debt. If you are personally liable for repaying the debt (recourse debt), the amount realized on the foreclosure or repossession does not include the amount of the canceled debt that is income from cancellation of debt. However, if the fair market value of the transferred property is less than the canceled debt, the amount realized includes the canceled debt up to the fair market value of the property. You are treated as receiving ordinary income from the canceled debt for the part of the debt that is more than the fair market value. See *Cancellation of debt*, later.

Example 3. Assume the same facts as in *Example 1* earlier except that Ann is personally liable for the loan (recourse debt). In this case, the amount she realizes is \$170,000. This is the amount of the canceled debt (\$180,000) up to the farm land's fair market value (\$170,000). Ann figures her gain or loss on the foreclosure by comparing the amount realized (\$170,000) with her adjusted basis (\$200,000). She has a \$30,000 deductible loss. She is also treated as receiving ordinary income from cancellation of debt. That income is \$10,000 (\$180,000 – \$170,000). This is the part of the canceled debt not included in the amount realized.

Example 4. Assume the same facts as in *Example 2* earlier except that Ann is personally liable for the loan (recourse debt). She realizes \$180,000, the amount of the canceled debt (\$180,000) up to the fair market value of the land (\$210,000). She compares the amount realized (\$180,000) with her adjusted basis (\$200,000) and figures a \$20,000 deductible loss. She has no ordinary income from cancellation of debt because all the canceled debt was included in the amount realized.

Seller's (lender's) gain or loss on repossession. If you finance a buyer's purchase of property and later acquire an interest in it through foreclosure or repossession, you may have a gain or loss on the acquisition. For more information, see *Repossession* in Publication 537.

Cancellation of debt. If property that is repossessed or foreclosed upon secures a debt for which you are personally liable (recourse debt), you generally must report, as ordinary income, the amount by which the canceled debt is more than the fair market value of the property. This income is separate from any gain or loss realized from the foreclosure or repossession. Report the income from cancellation of a business debt on Schedule F, line 10. Report the income from cancellation of a nonbusiness debt as miscellaneous income on line 21, Form 1040.

TIP You can use Table 10–1 to figure your income from cancellation of debt.

However, income from cancellation of debt is not taxed if any of the following apply.

- The cancellation is intended as a gift.
- The debt is qualified farm debt (see chapter 4).

- The debt is qualified real property business debt (see chapter 5 of Publication 334, *Tax Guide for Small Business*).
- You are insolvent or bankrupt (see Publication 908, *Bankruptcy Tax Guide*).

Forms 1099-A and 1099-C. A lender who acquires an interest in your property in a foreclosure or repossession should send you Form 1099-A showing information you need to figure your gain or loss. However, if the lender also cancels part of your debt and must file Form 1099-C, the lender may include the information about the foreclosure or repossession on that form instead of on Form 1099-A. The lender must file Form 1099-C and send you a copy if the amount of debt canceled is \$600 or more and the lender is a financial institution, credit union, or federal government agency. For foreclosures or repossessions occurring in 1999, these forms should be sent to you by January 31, 2000.

Ordinary or Capital Gain or Loss

You must classify your gains and losses as either ordinary or capital gains or losses (and your capital gains or losses as either short-term or long-term gains or losses). You must do this to figure your net capital gain or loss.

Your net capital gains may be taxed at a lower tax rate than ordinary income. See *Capital Gain Tax Rates*, later. Your deduction for a net capital loss may be limited. See *Treatment of Capital Losses*, later.

Capital gain or loss. Generally, you will have a capital gain or loss if you sell or exchange a capital asset. You may also have a capital gain if your section 1231 transactions result in a net gain.

Section 1231 transactions. Section 1231 transactions are sales and exchanges of property held longer than 1 year and either used in a trade or business or held for the production of rents or royalties. They also include certain involuntary conversions of business or investment property, including capital assets. See *Section 1231 Gains and Losses* in chapter 11 for more information.

Capital Assets

For the most part, all property you own and use for personal purposes or investment is a capital asset.

The following items are some examples of capital assets:

- 1) A home owned and occupied by you and your family.
- 2) Household furnishings.
- 3) A car used for pleasure. If your car is used both for pleasure and for farm business, it is partly a capital asset and partly a noncapital asset, defined later.
- 4) Stocks and bonds. However, there are special rules for gains and losses on qualified small business stock. For more information on this subject, see *Losses on Small Business Investment Company Stock* in chapter 4 of Publication 550.

Personal-use property. Property held for personal use is a capital asset. Gain from a sale or exchange of that property is a capital gain and is taxable. Loss from the sale or exchange of that property is not deductible. You can deduct a loss relating to personal-use property only if it results from a casualty or theft. For information about casualties and thefts, see chapter 13.

Long and Short Term

Where you report a capital gain or loss depends on how long you own the asset before you sell or exchange it. The time you own an asset before disposing of it is the holding period.

If you hold a capital asset 1 year or less, the gain or loss resulting from its disposition is short term. Report it in Part I of Schedule D. If you hold a capital asset longer than 1 year, the gain or loss resulting from its disposition is long term. Report it in Part II of Schedule D.

Holding period. To figure if you held property longer than 1 year, start counting on the day after the day you acquired the property. This same date of each following month is the beginning of a new month regardless of the number of days in the preceding month. The day you disposed of the property is part of your holding period.

Example. If you bought an asset on June 18, 1998, you should start counting on June 19, 1998. If you sold the asset on June 18, 1999, your holding period is not longer than 1 year, but if you sold it on June 19, 1999, your holding period is longer than 1 year.

Inherited property. If you inherit property, you are considered to have held the property longer than 1 year even if you dispose of it within 1 year after the decedent's death. This rule does not apply to livestock used in a farm business. See *Holding period* under *Livestock*, later.

Bad debt. A nonbusiness bad debt is always treated as a short-term capital loss. See chapter 4 of Publication 550.

Nontaxable exchange. If you acquire an asset in exchange for another asset and your basis for the new asset is determined, in whole or in part, by your basis in the old property, the holding period of the new property includes the holding period of the old property. That is, it begins on the same day as your holding period for the old property.

Gift. If you receive a gift of property and your basis in it is figured using the donor's basis, your holding period includes the donor's holding period.

Real property. To figure how long you held real property, start counting on the day after you received title to it, or, if earlier, on the day after you took possession of it and assumed the burdens and privileges of ownership.

However, taking possession of real property under an option agreement is not enough to start the holding period. The holding period cannot start until there is an actual contract of sale. The holding period of the seller cannot end before that time.

Figuring Net Gain or Loss

The totals for short-term capital gains and losses and the totals for long-term capital gains and losses must be figured separately.

Net short-term capital gain or loss. Combine your short-term capital gains and losses. Do this by adding all your short-term capital gains. Then add together all your short-term capital losses. Subtract the lesser total from the other. The result is your net short-term capital gain or loss.

Net long-term capital gain or loss. Follow the same steps to combine your long-term capital gains and losses. The result is your net long-term capital gain or loss.

Net gain. If the total of your capital gains is more than the total of your capital losses, the difference is taxable. However, the part that is not more than your net capital gain may be taxed at a rate that is lower than the rate of tax on your ordinary income. See *Capital Gain Tax Rates*, later.

Net loss. If the total of your capital losses is more than the total of your capital gains, the difference is deductible. But there are limits on how much loss you can deduct, and when you can deduct it. See *Treatment of Capital Losses*, next.

Treatment of Capital Losses

If your capital losses are more than your capital gains, you must claim the difference even if you do not have ordinary income to offset it. The yearly limit on the amount of the capital loss you can deduct is \$3,000 (\$1,500 if you are married and file a separate return). If your other income is low, you may not be able to use the full \$3,000. The part of the \$3,000 you cannot use becomes part of your capital loss carryover.

Capital loss carryover. Generally, you have a capital loss carryover if either of the following situations applies to you.

- Your net capital loss on line 17 of Schedule D is more than the yearly limit.
- The amount shown on line 37, Form 1040 (your taxable income without your deduction for exemptions), is less than zero.

If either of these situations applies to you for 1999, complete the *Capital Loss Carryover Worksheet* provided in the instructions to Schedule D (Form 1040) to figure the amount you can carry over to 2000.

Capital Gain Tax Rates

The 31%, 36%, and 39.6% income tax rates for individuals do not apply to a net capital gain. In most cases, the 15% and 28% rates do not apply either. Instead, your net capital gain is taxed at lower capital gain rates.

Net capital gain is the net long-term capital gain for the year that is more than the net short-term capital loss for the year.

You will need to use Part IV of Schedule D (Form 1040) to figure your tax using the capital gain rates if both of the following are true.

- Both lines 16 and 17 of Schedule D are gains.
- Your taxable income on Form 1040, line 39, is more than zero.

The rate may be 10%, 20%, 25%, or 28%, or a combination of two or more of those rates as shown in *Table 10-2*.

Table 10–2. What Is Your Capital Gain Tax Rate?

IF your net capital gain is from . . .	THEN your capital gain rate is . . .
Collectibles gain	28% ¹
Gain on qualified small business stock equal to the section 1202 exclusion	28% ¹
Unrecaptured section 1250 gain	25% ¹
Other gain, and your regular tax rate would be 28% or higher	20%
Other gain, and your regular tax rate would be 15%	10% ²

¹ The rate is 15% if your regular tax rate would be 15%.

² The 10% rate applies only to the part of your net capital gain that would be taxed at 15% if there were no capital gain rates.

Using the capital gain rates. The part of a net capital gain that is subject to each rate is determined by first netting long-term capital gains with long-term capital losses in the following tax rate groups.

- 1) A 28% group, consisting of all the following gains and losses.
 - a) Collectibles gains and losses.
 - b) The part of your gain on qualified small business stock that is equal to the section 1202 exclusion.
 - c) Any long-term capital loss carry-over.
- 2) A 25% group, consisting of unrecaptured section 1250 gain.
- 3) A 20% group, consisting of gains and losses not in the 28% or 25% group.

If any group has a net loss, the following rules apply.

- A net loss from the 28% group reduces any gain from the 25% group, and then any net gain from the 20% group.
- A net loss from the 20% group reduces any net gain from the 28% group, and then any gain from the 25% group.

If you have a net short-term capital loss, it reduces any net gain from the 28% group, then any gain from the 25% group, and finally any net gain from the 20% group.

The resulting net gain (if any) from each group is subject to the tax rate for that group. (The 10% rate applies to a net gain from the 20% group to the extent that, if there were no capital gain rates, the net capital gain would be taxed at the 15% regular tax rate.)

Collectibles gain or loss. This is gain or loss from the sale or exchange of a work of art, rug, antique, metal, gem, stamp, coin, or alcoholic beverage held longer than 1 year. Collectibles gain includes gain from the sale of an interest in a partnership, S corporation, or trust attributable to unrealized appreciation of collectibles.

Gain on qualified small business stock. If you realized a gain from qualified small business stock that you held longer than 5 years, you exclude up to one-half of your gain from your income. The taxable part of your gain equal to your section 1202 exclusion is a 28% rate gain. See *Sales of Small Business Stock* in chapter 1 of Publication 544.

Unrecaptured section 1250 gain. This is the part of any long-term capital gain on section 1250 property (real property) that is

due to straight-line depreciation minus any net loss in the 28% group. Unrecaptured section 1250 gain cannot be more than the net section 1231 gain or include any gain that is otherwise treated as ordinary income. Use the worksheet in the Schedule D instructions to figure your unrecaptured section 1250 gain. For more information about section 1250 property and net section 1231 gain, see chapter 3 of Publication 544.

Changes after 2000. After 2000, there will be changes to the capital gain rates.

2001. Beginning in 2001, the 10% capital gain rate will be lowered to 8% for “qualified 5-year gain.”

2006. Beginning in 2006, the 20% capital gain rate will be lowered to 18% for qualified 5-year gain from property with a holding period that begins after 2000.

Taxpayers who own certain stock on January 1, 2001, can choose to treat the stock as sold and repurchased on January 2, 2001, if they pay tax for 2001 on any resulting gain.

Qualified 5-year gain. This is long-term capital gain from the sale of property you held for longer than 5 years that would otherwise be subject to the 10% or 20% capital gain rate.

Net capital gain from disposition of investment property. If you choose to include any part of a net capital gain from a disposition of investment property in investment income for figuring your investment interest deduction, you must reduce the net capital gain eligible for the capital gain tax rates by the same amount. You make this choice on **Form 4952, Investment Interest Expense Deduction**, line 4e. For information on making this choice, see the instructions to Form 4952. For information on the investment interest deduction, see chapter 3 in Publication 550.

Noncapital Assets

Noncapital assets include property such as inventory and depreciable property used in a trade or business. A list of properties that are not capital assets is provided in the Schedule D Instructions.

Property held for sale in the ordinary course of your farm business. Property you hold mainly for sale to customers, such as livestock, poultry, livestock products, and crops, is a noncapital asset. Gain or loss from sales or other dispositions of this property is reported on Schedule F (not on Schedule D or Form 4797). The treatment of this property is discussed in chapter 4.

Land and depreciable properties. Non-capital assets include land and depreciable property you use in farming. They also include livestock held for draft, breeding, dairy, or sporting purposes. However, your gains and losses from sales and exchanges of your farm land and depreciable properties must be considered together with certain other transactions to determine whether the gains and losses are treated as capital or ordinary gains and losses. The sales of these business assets are reported on Form 4797. See chapter 11 for more information.

Hedging (Commodity Futures)

Hedging transactions are transactions that you enter into in the normal course of business primarily to reduce the risk of interest rate or price changes or currency fluctuations with respect to borrowings, ordinary property, or ordinary obligations. (Ordinary property or obligations are those that cannot produce capital gain or loss if sold or exchanged.)

A commodity futures contract is a standardized, exchange-traded contract for the sale or purchase of a fixed amount of a commodity at a future date for a fixed price. The holder of an option on a futures contract has the right (but not the obligation) for a specified period of time to enter into a futures contract to buy or sell at a particular price. A forward contract is generally similar to a futures contract except that the terms are not standardized and the contract is not exchange traded.

Businesses may enter into commodity futures contracts or forward contracts and may acquire options on commodity futures contracts as either of the following.

- Hedging transactions.
- Transactions that are not hedging transactions.

Futures transactions that are not hedging transactions generally result in capital gain or loss. There is a limit on the amount of capital losses you can deduct each year.

If, as a farmer-producer, to protect yourself from the risk of unfavorable price fluctuations, you enter into commodity forward contracts, futures contracts, or options on futures contracts **and** the contracts cover an amount of the commodity within your range of production, the transactions are generally considered hedging transactions. They can take place at any time you have the commodity under production, have it on hand for sale, or reasonably expect to have it on hand.

The gain or loss on the termination of these hedges is generally ordinary gain or loss. Farmers who file their income tax returns on the cash method report any profit or loss on the hedging transaction on line 10 of Schedule F.

The gain or loss on transactions that hedge the purchase of a noninventory supply (for example, animal feed) may be ordinary. If a business sells only a negligible amount of a noninventory supply, a transaction to hedge the purchase of that supply is treated as a hedging transaction.



If you have numerous transactions in the commodity futures market during the year, you must be able to show which transactions are hedging transactions. Clearly identify a hedging transaction on your books and records before the end of the day

you entered into the transaction. It may be helpful to have separate brokerage accounts for your hedging and speculation transactions.

The identification must not only be on, and retained as part of, your books and records but must specify both the hedging transaction and the item, items, or aggregate risk that is being hedged. Although the identification of the hedging transaction must be made before the end of the day it was entered into, the identification of the hedged item, items, or risk must be made no more than 35 days after entering into the hedging transaction.

For more information on the tax treatment of futures and options contracts, see *Commodity Futures* and Section 1256 *Contracts Marked to Market* in Publication 550.

Accounting methods for hedging transactions. Hedging transactions must be accounted for under special rules if you use an accounting method other than the following methods.

- 1) Cash method.
- 2) Farm-price method.
- 3) Unit-livestock-price method.

Under these rules, the accounting method you use for a hedging transaction must clearly reflect income. This means that your accounting method must reasonably match the timing of income, deduction, gain, or loss from a hedging transaction with the timing of income, deduction, gain, or loss from the item or items being hedged. There are requirements and limitations on the method you can use for certain hedging transactions. See section 1.446-4(e) of the regulations for those requirements and limitations.

Once you adopt a method, you must apply it consistently and must have IRS approval before changing it.

Your books and records must describe the accounting method used for each type of hedging transaction. They must also contain any additional identification necessary to verify the application of the accounting method you used for the transaction. You must make the additional identification no more than 35 days after entering into the hedging transaction.

Example of a hedging transaction. You file your income tax returns on the cash method. On July 2, 1999, you anticipate a yield of 50,000 bushels of corn this crop year. The present December futures price is \$2.75 a bushel, but there are indications that by harvest time the price will drop. To protect yourself against a drop in the sales price of your corn inventory, you enter into the following hedging transaction. You sell 10 December futures contracts of 5,000 bushels each for a total of 50,000 bushels of corn at \$2.75 a bushel.

The price did not drop as anticipated but rose to \$3 a bushel. In November, you sell your crop at a local elevator for \$3 a bushel. You also close out your futures position by buying 10 December futures contracts for \$3 a bushel. You paid a broker's commission of \$700 (\$70 per contract) for the complete in and out position in the futures market.

The result is that the price of corn rose 25 cents a bushel and the actual selling price is \$3 a bushel. Your loss on the hedge is 25

cents a bushel. In effect, the net selling price of your corn is \$2.75 a bushel.

Report the results of your futures transactions and your sale of corn separately on Schedule F.

The loss on your futures transactions is \$13,200, figured as follows.

July 2, 1999—Sold Dec. corn futures 50,000 bu. @ \$2.75	\$137,500
Nov. 6, 1999—Bought Dec. corn futures 50,000 bu. @ \$3 (plus broker's commission)	150,700
Futures loss	(\$13,200)

This loss is reported as a negative figure on line 10, Part I of Schedule F.

The proceeds from your corn sale at the local elevator are \$150,000 (50,000 bu. × \$3). Report it on line 4, Part I of Schedule F.

Assume you were right and the price went down 25 cents a bushel. In effect, you would still net \$2.75 a bushel, figured as follows.

Sold cash corn, per bushel	\$2.50
Gain on hedge, per bushel25
	\$2.75

The gain on your futures transactions would have been \$11,800, figured as follows.

July 2, 1999—Sold Dec. corn futures 50,000 bu. @ \$2.75	\$137,500
Nov. 6, 1999—Bought Dec. corn futures 50,000 bu. @ \$2.50 (plus broker's commission)	125,700
Futures gain	\$11,800

The \$11,800 is reported on line 10, Part I of Schedule F.

The proceeds from the sale of your corn at the local elevator, \$125,000, are reported on line 4, Part I of Schedule F.

Livestock

This part discusses the sale or exchange of livestock used in your farm business. Gain or loss from the sale or exchange of this livestock may qualify as a section 1231 transaction. However, any part of the gain that is ordinary income from the recapture of depreciation is not included as section 1231 gain. See chapter 11 for more information on section 1231 gains and losses and the recapture of depreciation under section 1245.



The rules discussed here do not apply to the sale of livestock held primarily for sale to customers. The sale of livestock is reported on Schedule F. See chapter 4.

Holding period. The sale or exchange of livestock used in your farm business qualifies as a section 1231 transaction if you held the livestock for 12 months or more (24 months or more for horses and cattle).

Livestock. For section 1231 transactions, livestock includes cattle, hogs, horses, mules, donkeys, sheep, goats, fur-bearing animals (such as mink), and other mammals. Livestock does not include chickens, turkeys, pigeons, geese, emus, ostriches, rheas, or other birds, fish, frogs, reptiles, etc.

Livestock used in farm business. If livestock is held primarily for draft, breeding, dairy, or sporting purposes, it is used in your farm business. The purpose for which an animal is held ordinarily is determined by a farmer's actual use of the animal. An animal is not held for draft, breeding, dairy, or sporting purposes merely because it is suitable for that purpose, or because it is held for sale to

other persons for use by them for that purpose.

Example 1. You discover an animal that you intend to use for breeding purposes is sterile. You dispose of it within a reasonable time. This animal was held for breeding purposes.

Example 2. You retire and sell your entire herd, including young animals that you would have used for breeding or dairy purposes had you remained in business. These young animals were held for breeding or dairy purposes. Also, if you sell young animals to reduce your breeding or dairy herd because of, for example, drought, these animals are treated as having been held for breeding or dairy purposes.

Example 3. You are in the business of raising hogs for slaughter. Customarily, before selling your sows, you obtain a single litter of pigs that you will raise for sale. You sell the brood sows after obtaining the litter. Even though you hold these brood sows for ultimate sale to customers in the ordinary course of your business, they are considered to be held for breeding purposes.

Example 4. You are in the business of raising registered cattle for sale to others for use as breeding cattle. It is the business practice to breed the cattle before sale to establish their fitness as registered breeding cattle. Your use of the young cattle for breeding purposes is ordinary and necessary for selling them as registered breeding cattle. Such use does not demonstrate that you are holding the cattle for breeding purposes. However, those cattle you held as additions or replacements to your own breeding herd to produce calves are considered to be held for breeding purposes, even though they may not actually have produced calves. The same applies to hog and sheep breeders.

Example 5. You are in the business of breeding and raising mink that you pelt for the fur trade. You take breeders from the herd when they are no longer useful as breeders and pelt them. Although these breeders are processed and pelted, they are still considered to be held for breeding purposes. The same applies to breeders of other fur-bearing animals.

Example 6. You breed, raise, and train horses for racing purposes. Every year you cull some horses from your racing stable. In 1999, you decided that to prevent your racing stable from getting too large to be effectively operated, you must cull six horses from it. All six of these horses had been raced at public tracks in 1998. These horses are all considered held for sporting purposes.

Figuring gain or loss on the cash method. Farmers or ranchers who use the cash method of accounting figure their gain or loss on the sale of livestock used in their farming business as follows.

Raised livestock. Gain on the sale of raised livestock is generally the gross sales price reduced by any expenses of the sale is gain. Expenses of sale include sales commissions, freight or hauling from farm to commission company, and other similar expenses. The basis of the animal sold is zero if the costs of raising it were deducted during the years the animal was being raised. However, see *Uniform Capitalization Rules* in chapter 7.

Purchased livestock. The gross sales price minus your adjusted basis and any expenses of sale is the gain or loss.

Example. A farmer sold a breeding cow on January 6, 1999, for \$1,250. Expenses of the sale were \$125. The cow was bought July 2, 1996, for \$1,300. Depreciation (not less than the amount allowable) was \$759.

Gross sales price	\$1,250	
Cost (basis)	\$1,300	
Minus: Depreciation deduction	<u>759</u>	
Unrecovered cost (adjusted basis)	\$541	
Expense of sale	<u>125</u>	<u>666</u>
Gain realized		<u>\$584</u>

Converted Wetland and Highly Erodible Cropland

Special rules apply to dispositions of land converted to farming use after March 1, 1986. Any gain realized on the disposition of converted wetland or highly erodible cropland is treated as ordinary income. Any loss on the disposition of such property is treated as a long-term capital loss.

Converted wetland. This is generally land that must have been drained or filled to make the production of agricultural commodities possible. It includes converted wetland held by the person who originally converted it or held by any other person who used the converted wetland at any time after conversion for farming purposes.

A wetland (before conversion) is land that meets all of the following conditions.

- 1) It is mostly soil that, in its undrained condition, is saturated, flooded, or ponded long enough during a growing season to develop an oxygen-deficient state that supports the growth and regeneration of plants growing in water.
- 2) It is saturated by surface or groundwater at a frequency and duration sufficient to support mostly plants that are adapted for life in saturated soil.
- 3) It supports under normal circumstances mostly plants that grow in saturated soil.

Highly erodible cropland. This is cropland subject to erosion that you used at any time for farming purposes other than the grazing of animals. Generally, highly erodible cropland is land that is currently classified by the Department of Agriculture as Class IV, VI, VII, or VIII under its classification system. Highly erodible cropland also includes land that would have an excessive average annual erosion rate in relation to the soil loss tolerance level, as determined by the Department of Agriculture.

Successors. Converted wetland or highly erodible cropland is also land held by any person whose basis in the land is figured by reference to the adjusted basis of a person in whose hands the property was converted wetland or highly erodible cropland.

Timber

Standing timber you held as investment property is a capital asset. Gain or loss from its sale is capital gain or loss reported on Schedule D (Form 1040). If you held the timber primarily for sale to customers, it is not a capital asset. Gain or loss on its sale is or-

dinary business income or loss. It is reported on the gross receipts or sales and cost of goods sold lines of Schedule F.

Farmers who cut timber on their land and sell it as logs, firewood, or pulpwood usually have no cost or other basis for that timber. These sales constitute a very minor part of their farm businesses. Amounts realized from these sales, and the expenses incurred in cutting, hauling, etc., are ordinary farm income and expenses reported on Schedule F (Form 1040).

Different rules apply if you owned the timber longer than 1 year and choose to treat timber cutting as a sale or exchange or you enter into a cutting contract, discussed later. Depletion on timber is discussed in chapter 8.

Timber considered cut. Timber is considered cut on the date when, in the ordinary course of business, the quantity of felled timber is first definitely determined. This is true whether the timber is cut under contract or whether you cut it yourself.

Christmas trees. Evergreen trees, such as Christmas trees, that are more than 6 years old when severed from their roots and sold for ornamental purposes are included in the term "timber." They qualify for both rules, discussed below.

Choice to treat cutting as a sale or exchange. Under the general rule, the cutting of timber results in no gain or loss. It is not until a sale or exchange occurs that gain or loss is realized. But if you owned or had a contractual right to cut timber, you may choose to treat the cutting of timber as a section 1231 transaction in the year it is cut. Even though the cut timber is not actually sold or exchanged, you report your gain or loss on the cutting for the year the timber is cut. Any later sale results in ordinary business income or loss.

To choose this treatment, you must:

- 1) Own or hold a contractual right to cut the timber for a period of more than 1 year before it is cut, and
- 2) Cut the timber for sale or use it in your trade or business.

Making the choice. You make the choice on your return for the year the cutting takes place by including in income the gain or loss on the cutting and including a computation of your gain or loss. You do not have to make the choice in the first year you cut the timber. You may make it in any year to which the choice would apply. If the timber is partnership property, the choice is made on the partnership return. This choice cannot be made on an amended return.

Once you have made the choice, it remains in effect for all later years unless you cancel it.

Canceling a post-1986 choice. You can cancel a choice you made for a tax year beginning after 1986 only if you can show undue hardship and you get the approval of the Internal Revenue Service (IRS). Thereafter, you may not make any new choice unless you have the approval of the IRS.

Canceling a pre-1987 choice. You can cancel a choice you made for a tax year beginning before 1987 without the approval of the IRS. You can cancel the choice by attaching a statement to your tax return for the year the choice is to be effective. If you make

this cancellation, which can be made only once, you can make a new choice without the approval of the IRS. Any further cancellation will require the approval of the IRS.

The statement must include all of the following information.

- Your name, address, and taxpayer identification number.
- The year the cancellation is effective and the timber to which it applies.
- That the cancellation being made is of the choice to treat the cutting of timber as a sale or exchange under section 631(a) of the Internal Revenue Code.
- That the cancellation is being made under section 311(d) of Public Law 99-514.
- That you are entitled to make the cancellation under section 311(d) of Public Law 99-514 and section 301.9100-7T of the regulations.

Gain or loss. Your gain or loss on the cutting of standing timber is the difference between its adjusted basis for depletion and its fair market value on the first day of your tax year in which it is cut.

Your adjusted basis for depletion of cut timber is based on the number of units (feet board measure, log scale, or other units) of timber cut during the tax year and considered to be sold or exchanged. Your adjusted basis for depletion is also based on the depletion unit of timber in the account used for the cut timber, and should be figured in the same manner as shown in section 611 of the Internal Revenue Code and section 1.611-3 of the regulations.

Example. In April 1999, you owned 4,000 MBF (1,000 board feet) of standing timber longer than 1 year. It had an adjusted basis for depletion of \$40 per MBF. You are a calendar year taxpayer. On January 1, 1999, the timber had a fair market value (FMV) of \$120 per MBF. It was cut in April for sale. On your 1999 tax return, you choose to treat the cutting of the timber as a sale or exchange. You report the difference between the FMV and your adjusted basis for depletion as a gain. This amount is reported on Form 4797 along with your other section 1231 gains and losses to figure whether it is treated as a capital gain or as ordinary gain. You figure your gain as follows.

FMV of timber January 1, 1999	\$480,000
Minus: Adjusted basis for depletion	<u>160,000</u>
Section 1231 gain	<u>\$320,000</u>

The FMV becomes your basis in the cut timber, and a later sale of the cut timber, including any by-product or tree tops, will result in ordinary business income or loss.

Cutting contract. You must treat the disposal of standing timber under a cutting contract as a section 1231 transaction if all of the following apply to you.

- You are the owner of the timber.
- You held the timber longer than 1 year before its disposal.
- You kept an economic interest in the timber.

The difference between the amount realized from the disposal of the timber and its adjusted basis for depletion is treated as gain or loss on its sale. Include this amount on Form 4797 along with your other section 1231

gains and losses to figure whether it is treated as capital or ordinary gain or loss.

Date of disposal. The date of disposal is the date the timber is cut. However, if you receive payment under the contract before the timber is cut, you may elect to treat the date of payment as the date of disposal. This election is effective only to figure the holding period of the timber. It has no effect on the time for reporting gain or loss (generally when the timber is sold or exchanged). To make this election, attach a statement to the tax return filed by the due date (including extensions) for the year payment is received. The statement must identify the advance payments subject to the election and the contract under which they were made. If you timely filed your return for the year you received payment without making the election, you can still make the election by filing an amended return within 6 months after the due date for that year's return (excluding extensions). Attach the statement to the amended return and write "Filed pursuant to section 301.9100-2" at the top of the statement. File the amended return at the same address the original return was filed.

Owner. An owner is any person who owns an interest in the timber, including a sublessor and the holder of a contract to cut the timber. You own an interest in timber if you have the right to cut it for sale on your own account or for use in your business.

Economic interest. You have kept an economic interest in standing timber if, under the cutting contract, the expected return on your investment is based on the cutting of the timber.

Tree stumps. Tree stumps are a capital asset if they are on land held by an investor who is not in the timber or stump business, either as a buyer, seller, or processor. Gain from the sale of stumps sold in one lot by such a holder is taxed as a capital gain. However, tree stumps held by timber operators, after the saleable standing timber was cut and removed from the land are considered by-products. Gain from the sale of stumps in lots or tonnage by such operators is taxed as ordinary income.

Sale of a Farm

The sale of your farm will usually involve the sale of both nonbusiness property (your home) and business property (the land and buildings used in the farm operation and perhaps machinery and livestock). If you have a gain from the sale, you may be allowed to exclude the gain on your home. The gain on the sale of your business property is taxable. A loss on the sale of your business property to an unrelated person is deducted as an ordinary loss. Losses from nonbusiness property, other than casualty or theft losses, are not deductible. If you receive payments for your farm in installments, your gain is taxed over the period of years the payments are received, unless you choose not to use the installment method of reporting the gain. See chapter 12 for information about installment sales.

When you sell your farm, the gain or loss on each asset is figured separately. The tax treatment of gain or loss on the sale of each asset is determined by the classification of the asset. Each of the assets sold must be classified as one of the following.

- Capital asset held 1 year or less.

- Capital asset held longer than 1 year.
- Property (including real estate) used in your business and held 1 year or less (including draft, breeding, dairy, and sporting animals held less than the holding periods discussed earlier under *Live-stock*).
- Property (including real estate) used in your business and held longer than 1 year (including draft, breeding, dairy, and sporting animals held for the holding periods discussed earlier).
- Property held primarily for sale or which is of the kind that would be included in inventory if on hand at the end of your tax year.

Allocation of consideration paid for a farm.

The sale of a farm for a lump sum is considered a sale of each individual asset rather than a single asset. Except for assets exchanged under the like-kind exchange rules (discussed earlier), both the buyer and seller of a farm must use the residual method to allocate the consideration to each business asset transferred. This method determines gain or loss from the transfer of each asset. It also determines the buyer's basis in the business assets.

Residual method. The residual method provides for the consideration to be reduced first by the cash, demand deposits, and similar accounts transferred by the seller. The consideration remaining after this reduction must be allocated among the various business assets in a certain order.

The allocation must be made among the following assets in the following order in proportion to (but not more than) their fair market value on the purchase date.

- 1) Certificates of deposit, U.S. government securities, readily marketable stock or securities, and foreign currency.
- 2) All other assets except section 197 intangibles.
- 3) Section 197 intangibles (other than goodwill and going concern value) (discussed in chapter 8).
- 4) Section 197 intangibles in the nature of goodwill and going concern value.

For more information about the residual method and how to report the allocation of the sales price on Form 1040, see chapter 2 in Publication 544.

Property used in farm operation. The rules for excluding the gain on the sale of your home, described later under *Sale of your home*, do not apply to the property used for your farming business. Recognized gains and losses on business property must be reported on your return for the year of the sale. If the property was held longer than 1 year, it may qualify for section 1231 treatment (see chapter 11).

Example. You sell your farm, including your main home, which you have owned since December 1994. You realize gain on the sale as follows.

	Farm With Home	Home Only	Farm Without Home
Selling price	\$182,000	\$58,000	\$124,000
Cost (or other basis) .	40,000	10,000	30,000
Gain	\$142,000	\$48,000	\$94,000

You must report the \$94,000 gain from the sale of the property used in your farm business. All or a part of that gain may have to be reported as ordinary income from the recapture of depreciation or soil and water conservation expenses. Treat the balance as section 1231 gain.

The \$48,000 gain from the sale of your home is not taxable as long as you meet the requirements explained later under *Gain on sale of your main home*.

Partial sale. If you sell only part of your farm, you must report any recognized gain or loss on the sale of that part on your tax return for the year of the sale. You cannot wait until you have sold enough of the farm to recover its entire cost before reporting gain or loss.

Adjusted basis of the part sold. This is the properly allocated part of your original cost or other basis of the entire farm, plus or minus necessary adjustments for improvements, depreciation, etc., on the part sold.

Example. You bought a 600-acre farm for \$700,000. The farm included land and buildings. The purchase contract designated \$600,000 of the purchase price to the land. You later sold 60 acres of land on which you had installed a fence. Your adjusted basis for the part of your farm sold is \$60,000 (1/10 of \$600,000), plus any unrecovered cost (cost not depreciated) of the fence on the 60 acres at the time of sale. Use this amount to determine your gain or loss on the sale of the 60 acres.

Assessed values for local property taxes. If you paid a flat sum for the entire farm and no other facts are available for properly allocating your original cost or other basis between the land and the buildings, you can use the assessed value for local property taxes for the year of purchase to allocate the costs.

Example. Assume that in the preceding example there was no breakdown of the \$700,000 purchase price between land and buildings. However, in the year of purchase, local taxes on the entire property were based on assessed valuations of \$420,000 for land and \$140,000 for improvements, or a total of \$560,000. The assessed valuation of the land is 3/4 (75%) of the total assessed valuation. Multiply the \$700,000 total purchase price by 75% to figure basis of \$525,000 for the 600 acres of land. The unadjusted basis of the 60 acres you sold would then be \$52,500 (1/10 of \$525,000). If your home is on the farm, you must properly adjust the basis to exclude those costs from your farm asset costs, as discussed next.

Sale of your home. Your home is a capital asset and not property used in the trade or business of farming. If you sell a farm that includes a house you and your family occupy, you must determine the part of the selling price and the part of the cost or other basis allocable to your home. Your home includes the immediate surroundings and outbuildings relating to it.

If you use part of your home for business, you must make an appropriate adjustment to the basis for depreciation allowed or allowable. For more information on basis, see *Allocating the Basis* in chapter 7.

Gain on sale of your main home. If you sell your main home at a gain, you may qualify to exclude from income all or part of

the gain. To qualify, you must meet the ownership and use tests.

You can claim the exclusion if, during the 5-year period ending on the date of the sale, you meet both the following requirements.

- You owned the home for at least 2 years (the ownership test).
- You lived in the home as your main home for at least 2 years (the use test).

You can exclude the entire gain on the sale of your main home up to:

- 1) \$250,000, or
- 2) \$500,000, if all of the following are true.
 - a) You are married and file a joint return for the year.
 - b) Either you or your spouse meets the ownership test.
 - c) Both you and your spouse meet the use test.
 - d) Neither you nor your spouse excluded gain from the sale of another home after May 6, 1997.

The exclusion may be reduced under certain circumstances. See Publication 523 for more information.

Gain from condemnation. If you have a gain from a condemnation or sale under threat of condemnation, you may use the preceding rules for excluding the gain, rather than the rules discussed under *Postponing Gain* in chapter 13. However, any gain that cannot be excluded (because it is more than the limit) may be postponed under the rules discussed under *Postponing Gain* in chapter 13.

Loss on your home. You cannot deduct a loss on your home from a voluntary sale, a condemnation, or a sale under threat of condemnation.

More information. For more information on selling your home, see Publication 523.

Abandonments

You abandon property when you voluntarily give up possession of the property with the intention of ending your ownership, but without passing it on to anyone else.

Business or investment property. Loss from abandonment of business or investment property is deductible as an ordinary loss, even if the property is a capital asset. The loss is the amount of the property's adjusted basis when abandoned. This rule also applies to leasehold improvements the lessor made for the lessee that were abandoned. However, if the property is later foreclosed on or repossessed, gain or loss is figured as discussed earlier under *Foreclosures and Repossessions*.

The abandonment loss is taken in the tax year in which the loss is sustained. Report the loss on Form 4797, Part II, line 10.

Example. Ann lost her contract with the local poultry processor and abandoned poultry facilities that she built for \$100,000. At the time she abandoned the facilities, her mortgage balance was \$85,000. She has a deductible loss of \$66,554 (her adjusted basis). If the bank later forecloses on the loan or repossesses the facilities, she will have to figure her gain or loss as discussed earlier under *Foreclosures and Repossessions*.

Personal-use property. You cannot deduct any loss from abandonment of your home or other property held for personal use.

Canceled debt. If the abandoned property secures a debt for which you are personally liable and the debt is canceled, you will realize ordinary income equal to the amount of canceled debt. This income is separate from any loss realized from abandonment of the property. Report income from cancellation of a debt related to a business or rental activity as business or rental income. Report income from cancellation of a nonbusiness debt as miscellaneous income on line 21, Form 1040.

However, income from cancellation of debt is not taxed in the following circumstances.

- The cancellation is intended as a gift.
- The debt is qualified farm debt (see chapter 4).
- The debt is qualified real property debt (see chapter 5 of Publication 334, *Tax Guide for Small Business*).
- You are insolvent or bankrupt (see Publication 908, *Bankruptcy Tax Guide*).

Forms 1099-A and 1099-C. If your abandoned property secures a loan and the lender knows the property has been abandoned, the lender should send you Form 1099-A showing the information you need to figure your loss from the abandonment. However, if your debt is canceled and the lender must file Form 1099-C, the lender may include the information about the abandonment on that form instead of Form 1099-A. The lender must file Form 1099-C and send you a copy if the canceled debt is \$600 or more and the lender is a financial institution, credit union, or federal government agency. For abandonments of property and debt cancellations occurring in 1999, these forms should be sent to you by January 31, 2000.

11.

Dispositions of Property Used in Farming

Introduction

When you dispose of property used in your farm business, your taxable gain or loss is usually a section 1231 gain or loss. Its treatment as ordinary income, which is taxed at the same rates as wages and interest income, or capital gain, which is generally taxed at lower rates, is determined under the rules for section 1231 transactions.

When you dispose of depreciable property (section 1245 property or section 1250 property) at a gain, you may have to recognize all or part of the gain as ordinary income under the depreciation recapture rules. Any remaining gain is a section 1231 gain, which may be taxed as a capital gain.

Gains and losses from property used in farming are reported on Form 4797. *Table 11-1* shows examples of items reported on Form 4797 and refers to the part of that form on which they first should be reported. Chapter 20, *Sample Return*, shows a sample filled-in Form 4797.

Topics

This chapter discusses:

- Section 1231 gains and losses
- Depreciation recapture
- Other farm property

Useful Items

You may want to see:

Publication

- 544** Sales and Other Dispositions of Assets

Form (and Instructions)

- 4797** Sales of Business Property

See chapter 21 for information about getting publications and forms.

Section 1231 Gains and Losses

Section 1231 gains and losses are the taxable gains and losses from section 1231 transactions — generally, dispositions of property used in your business. Their treatment as ordinary or capital depends on whether you have a net gain or a net loss from all your section 1231 transactions.



If you have a gain from a section 1231 transaction, first determine whether any of the gain is ordinary income under the depreciation recapture rules (explained later). Do not take that gain into account as section 1231 gain.

Section 1231 transactions. The following transactions result in gain or loss subject to section 1231 treatment.

- **Sale or exchange of cattle and horses.** The cattle and horses must be held for draft, breeding, dairy, or sporting and held for 2 years or longer.
- **Sale or exchange of other livestock.** This livestock must be held for draft, breeding, dairy, or sporting and held for 1 year or longer. Other livestock includes hogs, mules, sheep, and goats, but does not include poultry.
- **Sale or exchange of depreciable personal property.** This property must be used in your business and held longer than 1 year. Generally, property held for the production of rents or royalties is considered to be used in a trade or business. Examples of depreciable personal property are farm machinery and trucks. It also includes amortizable section 197 intangibles.
- **Sale or exchange of real estate.** This property must be used in your business

Table 11–1. Where To Report Items on Form 4797

Type of property	Held one year or less	Held more than one year
1 Depreciable trade or business property: a Sold or exchanged at a gain b Sold or exchanged at a loss	Part II Part II	Part III (1245, 1250) Part I
2 Depreciable residential rental property: a Sold or exchanged at a gain b Sold or exchanged at a loss	Part II Part II	Part III (1250) Part I
3 Farm land held less than 10 years upon which soil, water, or land clearing expenses were deducted: a Sold at a gain b Sold at a loss	Part II Part II	Part III (1252) Part I
4 Disposition of cost-sharing payment property described in section 126.	Part II	Part III (1255)
5 Cattle and horses used in a trade or business for draft, breeding, dairy, or sporting purposes: a Sold at a gain b Sold at a loss c Raised livestock sold at a gain	Held less than 24 mos. Part II Part II Part II	Held 24 mos. or more Part III (1245) Part I Part I
6 Livestock other than cattle and horses used in a trade or business for draft, breeding, dairy, or sporting purposes: a Sold at a gain b Sold at a loss c Raised livestock sold at a gain	Held less than 12 mos. Part II Part II Part II	Held 12 mos. or more Part III (1245) Part I Part I

and held longer than 1 year. Examples are your farm or ranch (including barns and sheds).

- **Sale or exchange of unharvested crops.** The crop and land must be sold, exchanged, or involuntarily converted at the same time and to the same person, and the land must have been held longer than 1 year. The taxpayer cannot keep any right or option to reacquire the land directly or indirectly (other than a right customarily incident to a mortgage or other security transaction). Growing crops sold with a lease on the land, though sold to the same person in a single transaction, are not included.
- **Distributive share of partnership gains and losses.** Your distributive share must be from the sale or exchange of property listed earlier held longer than 1 year, or for the required period for certain livestock.
- **Timber.** The cutting or disposal of timber must be treated as a sale, as described in chapter 10 under *Timber*.
- **Condemnation.** The condemned property (described in chapter 13) must have been held longer than 1 year. It must be business property or a capital asset held in connection with a trade or business or a transaction entered into for profit, such as investment property. It cannot be property held for personal use.
- **Casualty or theft.** It must have been a casualty to or theft of business property, property held for the production of rents and royalties, or investment property (such as notes and bonds). You must have held the property longer than 1 year. However, if your casualty or theft losses are more than your casualty or theft gains, neither the gains nor losses are taken into account in the section 1231 computation. Section 1231 does not ap-

ply to personal casualty gains and losses. See chapter 13 for information on how to treat these gains and losses.

Property held for sale to customers. A sale, exchange, or involuntary conversion of property held mainly for sale to customers is not a section 1231 transaction. If you will get back all, or nearly all, of your investment in the property by selling it rather than by using it up in your business, it is property held mainly for sale to customers.

Treatment as ordinary or capital. To determine the treatment of section 1231 gains and losses, combine all your section 1231 gains and losses for the year.

- If you have a net section 1231 loss, it is an ordinary loss.
- If you have a net section 1231 gain, it is ordinary income up to the amount of your nonrecaptured section 1231 losses from previous years, explained next. The rest, if any, is long-term capital gain.

Nonrecaptured section 1231 losses. Your nonrecaptured section 1231 losses are your net section 1231 losses for the previous 5 years that have not been applied against a net section 1231 gain by treating the gain as ordinary income. These losses are applied against your net section 1231 gain beginning with the earliest loss in the 5-year period.

Example. In 1995, you had a net section 1231 loss of \$2,500. For tax years 1998 and 1999, you had net section 1231 gains of \$1,800 and \$2,000, respectively. In 1994, 1995, and 1997, you had no section 1231 gains or losses. In figuring taxable income for 1998, you treated your net section 1231 gain of \$1,800 as ordinary income by recapturing \$1,800 of your \$2,500 net section 1231 loss. For 1999, you apply your remaining \$700 net section 1231 loss (\$2,500 – \$1,800) against

your net section 1231 gain of \$2,000. For 1999, you report \$700 as ordinary income and \$1,300 (\$2,000 – \$700) as long-term capital gain.

Depreciation Recapture

If you dispose of depreciable or amortizable property at a gain, you may have to treat all or part of the gain (even if it is otherwise nontaxable) as ordinary income.

Section 1245 Property

A gain on the disposition of section 1245 property is treated as ordinary income to the extent of depreciation allowed or allowable. See *Gain Treated as Ordinary Income*, later.

Any gain recognized that is more than the part that is ordinary income because of depreciation is a section 1231 gain. See *Treatment as ordinary or capital* under *Section 1231 Gains and Losses*, earlier.

Defined. Section 1245 property includes any property that is or has been subject to an allowance for depreciation or amortization and is any of the following types of property.

- 1) Personal property (either tangible or intangible).
- 2) Other tangible property (except buildings and their structural components) used as any of the following.
 - a) An integral part of manufacturing, production, or extraction or of furnishing transportation, communications, electricity, gas, water, or sewage disposal services.
 - b) A research facility in any of the activities in (a).
 - c) A facility in any of the activities in (a) for the bulk storage of fungible commodities.
- 3) That part of real property (not included in (2)) with an adjusted basis that was reduced by certain amortization deductions (including those for certified pollution control facilities, child-care facilities, removal of architectural barriers to persons with disabilities and the elderly, or reforestation expenses) or a section 179 deduction.
- 4) Single purpose agricultural (livestock) or horticultural structures.
- 5) Storage facilities (except buildings and their structural components) used in distributing petroleum or any primary product of petroleum.

Buildings and structural components.

Section 1245 property does not include buildings and structural components. The term “building” includes a house, barn, warehouse, or garage. The term “structural component” includes walls, floors, windows, doors, central air conditioning systems, light fixtures, etc.

A structure that is essentially machinery or equipment is not considered a building or structural component. Also, a structure that houses property used as an integral part of an activity is not considered a building or structural component if the structure’s use is

so closely related to the property's use that the structure can be expected to be replaced when the property it initially houses is replaced.

The fact that the structure is specially designed to withstand the stress and other demands of the property and the fact that the structure cannot be used economically for other purposes indicate that it is closely related to the use of the property it houses. Structures such as oil and gas storage tanks, grain storage bins, and silos are not treated as buildings, but as section 1245 property.

Storage facility. This is a facility used mainly for the bulk storage of fungible commodities. Bulk storage means storage of a commodity in a large mass before it is used. For example, if a facility is used to store oranges that have been sorted and boxed, it is not used for bulk storage. To be fungible, a commodity must be such that one part may be used in place of another.

Gain Treated as Ordinary Income

The gain treated as ordinary income on the sale, exchange, or involuntary conversion of section 1245 property, including a sale and leaseback transaction, is the **lesser** of the following amounts.

- 1) The depreciation and amortization allowed or allowable on the property.
- 2) The gain realized on the disposition (the amount realized from the disposition minus the adjusted basis of the property).

For any other disposition of section 1245 property, ordinary income is the lesser of (1) above or the amount by which its fair market value is more than its adjusted basis. See chapter 3 of Publication 544.

Use Part III of Form 4797 to figure the ordinary income part of the gain.

Depreciation on other property or taken by other taxpayers. Depreciation and amortization include not only the amounts you claimed on the section 1245 property but also the following depreciation and amortization amounts.

- Amounts you claimed on property you exchanged for, or converted to, your section 1245 property in a like-kind exchange or involuntary conversion.
- Amounts a previous owner of the section 1245 property claimed if your basis is determined with reference to that person's adjusted basis (for example, the donor's depreciation deductions on property you received as a gift would be included).

Depreciation and amortization. Depreciation and amortization deductions that must be recaptured as ordinary income include (but are not limited to) the following items.

- 1) Ordinary depreciation deductions.
- 2) Amortization deductions for all the following costs.
 - a) The cost of acquiring a lease.
 - b) The cost of lessee improvements.
 - c) Pollution control facilities.
 - d) Reforestation expenses.
 - e) Section 197 intangibles.

- f) Child care facility expenses before 1982.
- g) Franchises, trademarks, and trade names acquired before August 11, 1993.
- 3) The section 179 expense deduction.
- 4) Deductions for all the following costs.
 - a) The cost of removing barriers to the disabled and the elderly.
 - b) Tertiary injectant expenses.
 - c) Depreciable clean-fuel vehicles and refueling property (minus any recaptured deduction).
- 5) Any basis reduction for the investment credit (minus any basis increase for a credit recapture).
- 6) Any basis reduction for the qualified electric vehicle credit (minus any basis increase for a credit recapture).

Example. You file your returns on a calendar year basis. In February 1997, you bought and placed in service for 100% use in your farming business a light-duty truck (5-year property) that cost \$10,000. You used the half-year convention and your MACRS deductions for the truck were \$1,500 in 1997 and \$2,550 in 1998. You did not take the section 179 deduction on it. You sold the truck in May 1999 for \$7,000. The MACRS deduction in 1999, the year of sale, is \$893 (1/2 of \$1,785). Figure the gain treated as ordinary income as follows.

1) Amount realized	\$7,000
2) Cost (Feb. 1997)	\$10,000
3) Depreciation allowed or allowable (MACRS deductions: \$1,500 + \$2,550 + \$893)	4,943
4) Adjusted basis (subtract line 3 from line 2)	\$5,057
5) Gain realized (subtract line 4 from line 1)	1,943
6) Gain treated as ordinary income (lesser of line 3 or line 5)	<u>\$1,943</u>

Depreciation allowed or allowable. You generally use the greater of the depreciation allowed or allowable when figuring the part of gain to report as ordinary income. If, in prior years, you have consistently taken proper deductions under one method, the amount allowed for your prior years will not be increased even though a greater amount would have been allowed under another proper method. If you did not take any deduction at all for depreciation, your adjustments to basis for depreciation allowable are figured by using the straight line method.

This treatment applies only when figuring what part of gain is treated as ordinary income under the rules for section 1245 depreciation recapture.

Disposition of plants and animals. If you made the choice not to apply the uniform capitalization rules, you must treat any plant or animal you produce (if the animals were produced in 1987 or 1988) as section 1245 property. You must recapture the preproductive expenses you would have capitalized if you had not made the choice by treating these expenses as ordinary income when determining your gain on selling or disposing of the property. For section 1231 transactions, show these expenses as depreciation on line 22, Part III, of Form 4797. For plant sales that

are reported on Schedule F (Form 1040), this recapture rule does not change the reporting of income because the gain is already ordinary income. You can use the farm-price method or the unit-livestock-price method discussed in chapter 3 to figure these expenses.

Example. Janet Maple sold her apple orchard in 1999 for \$80,000. Her adjusted basis at the time of sale was \$60,000. She bought the orchard in 1992, but the trees did not produce a crop until 1995. Her preproductive expenses were \$6,000. She chose not to apply the uniform capitalization rules. Janet must treat the \$6,000 preproductive expenses as ordinary income when figuring the gain on the sale.

Livestock costs incurred before 1989. For livestock costs incurred before 1989, the IRS provided two safe-harbor choices. These safe-harbor choices were not available to corporations, partnerships, or tax shelters that were required to use an accrual method of accounting. For information on these choices, see Notice 88-24 in Cumulative Bulletin 1988-1 and Notice 88-113 modifying Notice 88-24 in Cumulative Bulletin 1988-2.

For information on the uniform capitalization rules, see chapter 7.

Section 1250 Property

A gain on the disposition of section 1250 property is treated as ordinary income to the extent of additional depreciation allowed or allowable. To determine the additional depreciation on section 1250 property, see *Additional Depreciation*, later.

You will not have additional depreciation if any of the following apply.

- You figured depreciation for the property using the straight line method or any other method that does not result in depreciation that is more than the amount figured by the straight line method, and you have held the property longer than a year.
- You chose the alternate ACRS (straight line) method for the types of 15-, 18-, or 19-year real property covered by the section 1250 rules.
- You dispose of residential rental property or nonresidential real property placed in service after 1986 (or after July 31, 1986, if the choice to use MACRS was made). These properties are depreciated using the straight line method.

Defined. Section 1250 property includes all real property subject to an allowance for depreciation that is not and never has been section 1245 property. It includes a leasehold of land or section 1250 property subject to an allowance for depreciation. A fee simple interest in land is not section 1250 property because it is not depreciable.

Gain Treated as Ordinary Income

To find what part of the gain from the disposition of section 1250 property is treated as ordinary income, follow these steps.

- 1) In a sale, exchange, or involuntary conversion of the property, figure the amount realized that is more than the adjusted basis of the property (in any other disposition of the property, figure

the amount of the fair market value that is more than the adjusted basis).

- 2) Figure the additional depreciation for the periods after 1975.
- 3) Multiply the lesser of (1) or (2) by the applicable percentage, discussed later. Stop here if this is residential rental property, or if (2) is equal to or more than (1). This is the gain that is treated as ordinary income because of additional depreciation.
- 4) Subtract (2) from (1).
- 5) Figure the additional depreciation for periods after 1969 but before 1976.
- 6) Add the lesser of (4) or (5) to the result in (3). This is the gain treated as ordinary income because of additional depreciation.

Use Part III, Form 4797, to figure the ordinary income part of the gain.

Additional Depreciation

If you hold section 1250 property longer than 1 year, the additional depreciation is the amount of actual depreciation adjustments that is more than the depreciation figured using the straight line method. For a list of items treated as depreciation adjustments, see *Depreciation and amortization* under *Section 1245 Property*, earlier.

If you hold section 1250 property for 1 year or less, all of the depreciation is additional depreciation.

Figure straight line depreciation for ACRS real property by using its 15-, 18-, or 19-year recovery period as the property's useful life.

The straight line method is applied without any basis reduction for the investment credit.

You will have additional depreciation if you use the regular ACRS method, the declining balance method, the sum-of-the-years-digits method, the units-of-production method, or any other method of rapid depreciation. You also have additional depreciation if you choose amortization, other than amortization on real property that qualifies as section 1245 property, discussed earlier.

Depreciation taken by other taxpayers or on other property. Additional depreciation includes all depreciation adjustments to the basis of section 1250 property whether allowed to you or another person (as for carry-over basis property).

Depreciation allowed or allowable. You generally use the greater of depreciation allowed or allowable (to any person who held the property if the depreciation was used in figuring its adjusted basis in your hands) when figuring the part of the gain to be reported as ordinary income. If you can show that the deduction allowed for any tax year was less than the amount allowable, the lesser figure will be the depreciation adjustment for figuring additional depreciation.

Applicable Percentage

The applicable percentage used to figure the ordinary income because of additional depreciation depends on whether the real property you disposed of is nonresidential real property, residential rental property, or low-income housing. The applicable percentages for nonresidential real property and residential

rental property are explained next. The applicable percentage for low-income housing is explained in chapter 3 of Publication 544.

Nonresidential real property. For real property that is not residential rental property, the applicable percentage for periods after 1969 is 100%. For periods before 1970, the percentage is zero and no ordinary income will result on its disposition because of additional depreciation before 1970.

Residential rental property. For residential rental property (80% or more of the gross income is from dwelling units) other than low-income housing, the percentage for periods after 1975 is 100%. The applicable percentage for periods before 1976 is zero. No ordinary income will result from a disposition of residential rental property because of additional depreciation before 1976.

More information. For more information about depreciation recapture on section 1250 property, see chapter 3 of Publication 544.

Installment Sales

If you report the sale of property under the installment method, any depreciation recapture under section 1245 or 1250 is taxable as ordinary income in the year of sale. This applies even if no payments are received in that year. If the gain is more than the depreciation recapture income, report the rest of the gain using the rules of the installment method. For this purpose, add the recapture income to the property's adjusted basis.

If you dispose of more than one asset in a single transaction, you must separately figure the gain on each asset so that it may be properly reported. To do this, allocate the selling price and the payments you receive in the year of sale to each asset. Report any depreciation recapture income in the year of sale before using the installment method for any remaining gain.

For more information on installment sales, see chapter 12.

Other Dispositions

Chapter 3 of Publication 544 discusses the tax treatment of the following transfers of depreciable property.

- By gift.
- At death.
- In like-kind exchanges.
- In involuntary conversions.

Publication 544 also explains how to handle a single transaction involving multiple properties.

Other Farm Property

This section discusses gain on the disposition of farm land for which you were allowed either of the following.

- Deductions for soil and water conservation expenditures (section 1252 property).
- Exclusions from income for certain cost sharing payments (section 1255 property).

Section 1252 property. If you disposed of farm land you held less than 10 years at a gain and you were allowed deductions for soil and water conservation expenses for the land discussed in chapter 6, you must treat part of the gain as ordinary income and treat the balance as section 1231 gain.

Amount to report as ordinary income. You report as ordinary income the lesser of the following amounts.

- The total deductions allowed for soil and water conservation expenditures multiplied by the applicable percentage, discussed next.
- Your gain (determined by subtracting the adjusted basis from the amount realized from a sale, exchange, or involuntary conversion, or the fair market value for all other dispositions).

Applicable percentage. The applicable percentage is based on the length of time you held the land. If you dispose of your farm land within 5 years after the date you got it, the percentage is 100%. If you dispose of the land within the 6th through 9th year after you got it, the applicable percentage is reduced by 20% a year for each year you hold the land after the 5th year. If you dispose of the land 10 or more years after you got it, the percentage is zero (0), and the entire gain is a section 1231 gain.

Example. You acquired farm land on January 19, 1992. On October 3, 1999, you sold the land at a \$30,000 gain. Between January 1 and October 3, 1999, you make soil and water conservation expenditures of \$15,000 for the land that are fully deductible in 1999. The applicable percentage is 40% since you sold the land within the 8th year after you got it. You treat \$6,000 (40% of \$15,000) of the \$30,000 gain as ordinary income and the \$24,000 balance as a section 1231 gain.

Section 1255 property. If you receive certain cost-sharing payments on property and you exclude those payments from income (discussed in chapter 4), you may have to treat part of any gain as ordinary income and treat the balance as a section 1231 gain. If you chose not to exclude these payments, you will not have to recognize ordinary income under this provision.

Amount to report as ordinary income. You report as ordinary income the lesser of the following amounts.

- The applicable percentage of the total excluded cost-sharing payments.
- The gain on the disposition of the property.

You do not report ordinary income under this rule to the extent the gain is recognized as ordinary income under sections 1231 through 1254, 1256, and 1257 of the Internal Revenue Code. However, you do report as ordinary income under this rule a gain or a part of a gain regardless of any contrary provisions (including nonrecognition provisions) under any other section of the Internal Revenue Code.

Applicable percentage. The applicable percentage of the excluded cost-sharing payments to be reported as ordinary income is based on the length of time you hold the property after receiving the payments. If the property is held less than 10 years, the per-

centage is 100%. After 10 years, the percentage is reduced by 10% a year or part of a year until the rate is 0%.

Form 4797, Part III. Use Form 4797, Part III to figure the ordinary income portion of a gain from the sale, exchange, or involuntary conversion of section 1252 property and section 1255 property.

12.

Installment Sales

Introduction

An installment sale is a sale of property where you receive at least one payment after the close of the tax year of the sale. If you dispose of property in an installment sale, you report part of your gain or profit when you receive each installment payment. You cannot use the installment method to report a loss.

The buyer's "installment obligation" to make future payments to you can be in the form of a deed of trust, note, land contract, mortgage, or other evidence of the buyer's debt to you. The rules discussed in this chapter generally apply regardless of the form of the installment obligation.

Topics

This chapter discusses:

- Installment method
- Figuring installment income
- Payments received
- Installment sale of a farm

Useful Items

You may want to see:

Publication

- 523** Selling Your Home
- 537** Installment Sales

Form (and Instructions)

- 4797** Sale of Business Property
- 6252** Installment Sale Income

See chapter 21 for information about getting publications and forms.

Installment Method

An installment sale is a sale of property, except for inventory, where you receive at least one payment after the close of the tax year of the sale. A cash basis farmer who is not required to maintain an inventory can use the installment method to report gain from the sale of property used or produced in farming.



If you finance the buyer's purchase of your property, instead of having the buyer get a loan or mortgage from a third party, you probably have an installment sale. It is not an installment sale if the buyer borrows the money from a third party and then pays you the total selling price.

You generally report your gain on an installment sale as you actually receive payment. Each payment usually consists of the following three parts.

- 1) Interest income.
- 2) Return of your adjusted basis in the property.
- 3) Gain on the sale.

You are taxed only on the part of each payment that represents interest and your gain on the sale. In this way, the installment method of reporting income relieves you of paying tax on income you have not yet collected. However, when reporting a sale of **depreciable or amortizable property**, you must include in income for the year of the sale, any depreciation or amortization recapture income (up to the amount of gain). Report any remaining gain on the installment method.

Sale at a loss. If your sale results in a loss, you cannot use the installment method. If the loss is on an installment sale of business assets, you can deduct it only in the tax year of sale. You cannot deduct a loss on the sale of property owned for personal use.

Form 6252. Each year, including the year of sale, report your income from an installment sale on Form 6252. Attach this form to your tax return.

Disposition of installment obligation. If you sell or discount an installment obligation, you generally have a gain or loss to report. It is considered gain or loss on the sale of the property for which you received the installment obligation. If this takes place during the year of sale, report your entire gain on your return for that year. You do not have an installment sale. If it takes place in a later year, you may have a disposition of an installment obligation.

Cancellation. If an installment obligation is canceled or otherwise becomes unenforceable, it is treated as a disposition other than a sale or exchange. Your gain or loss is the difference between your basis in the obligation and its fair market value at the time you cancel it. Fair market value (FMV) is discussed later under *Payment of property*. (A reduction in the selling price changes the gross profit and gross profit percentage.)

Transfer due to death. The transfer of an installment obligation (other than to a buyer) as a result of the death of the seller (or other holder of the obligation) is not a disposition. Any unreported gain from the installment obligation is not treated as gross income to the decedent. No income is reported on the decedent's return due to the transfer. This means whoever receives the obligation as a result of the seller's death is taxed on the installment payments the same as the seller would have been if the seller had lived to receive the payments.

However, if the installment obligation is canceled, becomes unenforceable, or is transferred to the buyer because of the death

of the holder of the obligation, it is a disposition. The estate must figure gain or loss on the disposition.

More information. For more information on the disposition of an installment obligation, see Publication 537.

Inventory. The sale of farm inventory items cannot be reported on the installment method. All gain or loss on their sale must be reported in the year of sale, even if you are paid in later years. However, if you are a cash basis farmer and are not required to maintain an inventory, you may be able to use the installment method to report the sale of property you use or produce in your farming business. For a definition of farm inventory, see *Farm Inventory* in chapter 3.

If inventory items are included in an installment sale, you may have an agreement stating which payments are for inventory and which are for the other assets being sold. If you do not, each payment must be allocated between the inventory and the other assets sold.

Electing out. You must use the installment method to report an installment sale **unless** you elect not to use that method. If you make the election, you generally report the entire gain in the year of sale, even though you will not be paid all of the selling price in that year. You then do not report any gain from the payments you receive in later years.

To make this election, do not report your sale on Form 6252. Instead, report it on Schedule D (Form 1040) or Form 4797, whichever applies.

When to elect out. Make this election by the due date, including extensions, for filing your tax return for the year the sale takes place. However, if you timely filed your return for the year the sale took place you may still make the election by filing an amended return within six months of the due date of the return (excluding extensions). Attach the election to the amended return and write "Filed pursuant to section 301.9100-2" on the election statement. File the amended return at the same address the original return was filed. Once made, the election generally cannot be revoked.

More information. See *Electing Out of Installment Method* in Publication 537 for more information on electing out of the installment method.



You must continue to report the interest income on payments you receive for subsequent years.

Figuring Installment Income

Each payment on an installment sale usually consists of the following three parts.

- 1) Interest income.
- 2) Return of your adjusted basis in the property.
- 3) Gain on the sale.

In each year you receive a payment, you include the interest part in income, as well as the part that is your gain on the sale. You do not include in income the part that is the return of your adjusted basis in the property.

Interest income. You must report interest as ordinary income. Interest is generally not included in a down payment. However, you may have to treat part of each later payment as interest, even if it is not called interest in your agreement with the buyer. See *Unstated interest*, later.

Return of basis and gain on sale. The rest of each payment is treated as if it were made up of two parts. One part is a tax-free return of your adjusted basis in the property. The other part is your gain.

 **Figuring gain part of payment.** To figure what part of any payment is gain, multiply the payment (less interest) by the gross profit percentage. Use the following worksheet to figure the gross profit percentage.

1) Selling price	_____
2) Installment sale basis:	
Adjusted basis of property ...	_____
Selling expenses	_____
Depreciation recapture	_____
3) Gross profit (line 1 – line 2)	_____
4) Contract price	_____
5) Gross profit percentage	
(line 3 ÷ line 4)	=====

Selling price. The selling price is the total cost of the property to the buyer. It includes any money and the FMV of any property you are to receive. It also includes any debt the buyer pays, assumes, or takes, to which the property is subject. The debt could be a note, mortgage, or any other liability, such as a lien, accrued interest, or taxes you owe on the property. If the buyer pays any of your selling expenses for you, that amount is also included in the selling price. The selling price does not include interest, whether stated or unstated.

Installment sale basis. This chapter refers to the adjusted basis plus selling expenses and depreciation recapture income as the installment sale basis.

Adjusted basis. Basis is a way of measuring your investment in the property you are selling. The way you figure basis depends on how you first acquired the property. The basis of property you bought is generally its cost. The basis of property you inherited, received as a gift, built yourself, or received in a tax-free exchange is figured differently. See chapter 7 for information on determining basis.

While you own personal-use property, various events may change your original basis in the property. Some events, such as adding rooms or making permanent improvements, increase basis. Others, such as deductible casualty losses or depreciation previously allowed or allowable, decrease basis. The result is adjusted basis.

Selling expenses. Selling expenses are any expenses that relate to the sale of the property. They include commissions, attorney fees, and any other expenses paid on the sale. Selling expenses are added to the basis of the sold property.

Depreciation recapture. If you took depreciation deductions on the asset, part of the gain on the sale of the asset may be recaptured as ordinary income. See *Sale of depreciable property*, later.

Gross profit. For an installment sale, gross profit is the total gain you report on the installment method.

To figure your gross profit, subtract your installment sale basis from the selling price. If the property you sold was your home, subtract from the gross profit any gain you can exclude. See Publication 523 for information on excluding gain on the sale of your home.

Contract price. The contract price is the total of all principal payments you are to receive on the installment sale. It includes payments you are considered to receive, even though you are not paid anything directly. See *Payments Received*, later.

If part of the selling price is paid in cash and you hold a mortgage payable from the buyer to you for the remainder, then the contract price equals the selling price.

Gross profit percentage. A certain percentage of each payment (after subtracting interest) is reported as gain from the sale. It is called the "gross profit percentage" and is figured by dividing your gross profit from the sale by the contract price.

The gross profit percentage generally remains the same for each payment you receive. However, see *Selling price reduced*, later, for an example of changing the gross profit percentage.

Example. You sell property at a contract price of \$200,000. The property has an adjusted basis of \$150,000. Your gross profit is \$50,000. Your gross profit percentage is 25% (\$50,000 ÷ \$200,000). After subtracting interest, you report 25% of each payment, including the down payment, as gain from the sale for the tax year you receive the payment.

Amount to include in income. Each year you receive a payment on the installment sale, multiply the payment (after subtracting interest) by the gross profit percentage to determine the amount you must include in income for the tax year.

Sale of depreciable property. You cannot use the installment method to report any depreciation recapture income up to the gain on the sale. Report any remaining gain on the installment method.

However, you generally cannot report gain from the sale of depreciable property to a related person on the installment method. See *Sale to Related Person* in Publication 537.

Figure your depreciation recapture income (including the section 179 deduction and the section 179A deduction recapture) in Part III of Form 4797. Report the depreciation recapture income in Part II of Form 4797 as ordinary income in the year of sale.

 **TIP** If you sell depreciable business property, prepare Form 4797 first in order to figure the amount to enter on line 12 of Part I, Form 6252.

For more information on the section 179 deduction, see *Section 179 Deduction* in

chapter 8. For more information on the section 179A deductions, see chapter 15 in Publication 535. For more information on depreciation recapture, see *Depreciation Recapture* in chapter 11.

Selling price reduced. If the selling price is reduced at a later date, the gross profit on the sale will also change. You must then refigure your gross profit percentage for the remaining payments. Refigure your gross profit using the reduced sale price and then subtract the gain already reported. Spread the remaining gain over the remaining installments. You cannot go back and refigure the gain you reported in earlier years.

Example. In 1997, you sold land with a basis of \$40,000 for \$100,000. Your gross profit was \$60,000. You received a \$20,000 down payment and the buyer's note for \$80,000. The note provides for four annual payments of \$20,000 each, plus 12% interest, beginning in 1998. Your gross profit percentage is 60%. You reported a gain of \$12,000 on each payment received in 1997 and 1998. In 1999, you and the buyer agreed to reduce the purchase price to \$85,000 and the payments for 1999, 2000, and 2001 are reduced to \$15,000 for each year.

The new gross profit percentage, 46.67%, is figured as follows. You will report a gain of \$7,000 (46.67% of \$15,000) on each of the \$15,000 installments due in 1999, 2000, and 2001.

1) Reduced selling price	\$85,000
2) Minus: Basis	40,000
3) Adjusted gross profit	\$45,000
4) Minus: Gain reported in 1997 & 1998 ..	24,000
5) Gain to be reported	\$21,000
6) Selling price to be received:	
Reduced selling price	\$85,000
Minus: Payments received	
in 1997 and 1998	40,000
	\$45,000
7) New gross profit percentage	
(line 5 ÷ line 6)	<u>46.67%</u>

Sale to related person. Special rules apply to an installment sale between related persons. Spouses, children, grandchildren, brothers, sisters, and parents are all considered related persons. A partnership or corporation in which you have an interest, or an estate or trust with which you have a connection, can also be considered a related person.

For information on these rules, see *Sale to Related Person* in Publication 537.

Trading property for like-kind property. If you trade business or investment property for the same kind of property, you can postpone reporting part of the gain. See *Like-Kind Exchanges* in chapter 10 for a discussion of like-kind property.

If the trade includes an installment obligation, the following rules apply.

- 1) The contract price is reduced by the FMV of the like-kind property received in the trade.
- 2) The gross profit is reduced by any gain on the trade that can be postponed.
- 3) Like-kind property received in the trade is not considered payment on the installment obligation.

Payments Received Including Payments Considered Received

You must figure your gain each year on the payments you receive, or are treated as receiving, from an installment sale. These payments include the down payment and each later payment of principal on the buyer's debt to you.

In certain situations, you are considered to have received a payment, even though the buyer does not pay you directly. These situations arise if the buyer assumes or pays any of your debts, such as a loan, or pays any of your expenses, such as a sales commission.

Buyer pays seller's expenses. If the buyer pays any of your expenses related to the sale of your property, it is considered a payment to you in the year of sale. Include these expenses in the selling and contract prices when figuring the gross profit percentage.

Buyer assumes mortgage. If the buyer assumes or pays off your mortgage, or otherwise takes the property subject to the mortgage, the following rules apply.

Mortgage less than basis. If the buyer assumes a mortgage that is less than your installment sale basis in the property, it is not considered a payment to you. The contract price equals the selling price minus the mortgage. This difference is all you will directly collect from the buyer.

Example. You sell property with an adjusted basis of \$19,000. You have selling expenses of \$1,000. The buyer assumes your existing mortgage of \$15,000 and agrees to pay you \$10,000 (a cash down payment of \$2,000 and \$2,000 (plus 12% interest) in each of the next 4 years).

The selling price is \$25,000 (\$15,000 + \$10,000). Your gross profit is \$5,000 (\$25,000 - \$20,000 installment sale basis). The contract price is \$10,000 (\$25,000 - \$15,000 mortgage). Your gross profit percentage is 50% (\$5,000 ÷ \$10,000). You report half of each \$2,000 payment received as gain from the sale. You also report all interest you receive as ordinary income.

Mortgage more than basis. If the buyer assumes a mortgage that is more than your installment sale basis in the property, you recover your entire basis. You are also relieved of the obligation to repay the amount borrowed. The part of the mortgage greater than your basis is treated as a payment received in the year of sale. This is in addition to the buyer's other payments.

To figure the contract price, subtract the mortgage from the selling price. This is the total you will actually receive from the buyer. Add to this amount the "payment" you are considered to receive (the difference between the mortgage and your installment sale basis). The contract price is then the same as your gross profit from the sale.

If the mortgage the buyer assumes is equal to or more than your installment sale basis, the gross profit percentage will always be 100%.

Example. The selling price for your property is \$9,000. The buyer will pay you \$1,000 annually (plus 8% interest) over the next 3 years and assumes an existing mort-

gage of \$6,000. Your basis in the property is \$4,400. You have selling expenses of \$600, for a total installment sale basis of \$5,000. The part of the mortgage that is more than your installment sale basis is \$1,000 (\$6,000 - \$5,000). This amount is included in the contract price and treated as a payment received in the year of sale. The contract price is \$4,000:

Selling price	\$9,000
Minus: Mortgage	(6,000)
Amount actually received	\$3,000
Add difference:	
Mortgage	\$6,000
Minus: Installment sale basis ...	5,000
Contract price	\$4,000

Your gross profit on the sale is also \$4,000:

Selling price	\$9,000
Minus: Installment sale basis	(5,000)
Gross profit	\$4,000

Your gross profit percentage is 100%. Report 100% of each payment as gain from the sale. You also treat the \$1,000 difference between the mortgage and your installment sale basis as a payment and report 100% of it as gain in the year of sale.

Buyer assumes other debts. If the buyer assumes your other debts, such as a loan or back taxes, it may be considered a payment to you in the year of sale.

If the buyer assumes the debt instead of paying it off, only part of it may have to be treated as a payment. Compare the debt to your installment sale basis in the property being sold. If the debt is less than your installment sale basis, none of it is treated as a payment. If it is more, only the difference is treated as a payment. If the buyer assumes more than one debt, any part of the total that is more than your installment sale basis is considered a payment. These rules are the same as the rules discussed earlier under *Buyer assumes mortgage*. However, they apply to only the following two types of debts the buyer assumes.

- 1) Those acquired from ownership of the property you are selling, such as a mortgage, lien, overdue interest, or back taxes.
- 2) Those acquired in the ordinary course of your business, such as a balance due for inventory you purchased.

If the buyer assumes any other type of debt, such as a personal loan, it is treated as if the buyer had paid off the debt at the time of the sale. The value of the assumed debt is considered a payment to you in the year of sale.

Payment of property. If you receive property rather than money from the buyer, it is still considered a payment. However, see *Trading property for like-kind property*, discussed earlier. The value of the payment is the property's FMV on the date you receive it.

Fair market value (FMV). This is the price at which property would change hands between a buyer and a seller, neither being required to buy or sell, and both having reasonable knowledge of all the necessary facts. If your installment sale fits this description, the value assigned to property in your agreement with the buyer is good evidence of its FMV.

Third-party note. If the property the buyer gives you is a third-party note (or other obligation of a third party), you are considered to have received a payment equal to the note's FMV. Because the note is itself a payment on your installment sale, any payments you later receive from the third party are not considered payments on your sale.

Example. You sold real estate in an installment sale. As part of the down payment, the buyer assigned to you a \$5,000, 8% note of a third party. The FMV of the third-party note at the time of your sale was \$3,000. This amount, not \$5,000, is a payment to you in the year of sale. Because the third-party note had an FMV equal to 60% of its face value (\$3,000 ÷ \$5,000), 60% of each payment of principal you receive on this note is a non-taxable return of capital. The remaining 40% is ordinary income. Report the interest you receive in full as ordinary income.

Bond. A bond or other evidence of debt you receive from the buyer that is payable on demand is treated as a payment in the year you receive it. If you receive a government or corporate bond that has interest coupons attached or that can be readily traded in an established securities market, you are considered to have received payment equal to the bond's FMV. Accrual basis taxpayers should see section 15A.453-1(e)(2) of the regulations.

Buyer's note. The buyer's note (unless payable on demand) is not considered payment on the sale. Its full face value is included when figuring the selling price and the contract price. Payments you receive on the note are used to figure your gain in the year you receive them.

Guarantee. If a third party or government agency guarantees the buyer's payments to you on an installment obligation, the guarantee itself is not considered payment.

Unstated interest. An installment sale contract generally provides that each deferred payment on the sale will include interest or that there will be an interest payment in addition to the principal payment. Interest provided in the contract is called **stated interest**.

If an installment sale contract with some or all payments due more than one year after the date of sale does not provide for interest, part of each payment due more than 6 months after the date of sale may be treated as interest. The amount treated as interest is referred to as **unstated interest**.

When the stated interest rate in the contract is lower than the applicable federal rate, unstated interest is the difference between interest figured at the federal rate and any interest figured at the rate specified in the sales contract.

 The applicable federal rates are published monthly in the Internal Revenue Bulletin (IRB). You can get this information by contacting an IRS office. IRBs are also available on the Internet at www.irs.gov.

Generally, the unstated interest rules do not apply to a debt given in consideration for a sale or exchange of personal-use property. Personal-use property is any property in which substantially all of its use by the buyer is not in connection with a trade or business or an investment activity.

Unstated interest reduces the stated selling price of the property and the buyer's basis in the property. It increases the seller's interest income and the buyer's interest expense.

More information. For more information, see *Unstated Interest* in Publication 537.

Installment Sale of a Farm

The installment sale of a farm for one overall price under a single contract is not the sale of a single asset. It generally includes the sale of real and personal property that can be reported on the installment method. It may also include the sale of farm inventory, which cannot be reported on the installment method. See *Inventory*, earlier. The selling price must be allocated to determine the amount received for each class of asset.

The tax treatment of the gain or loss on the sale of each class of assets is determined by its classification as capital asset or property used in the business, and by the length of time held. Separate computations must be made to figure the gain or loss for each class of asset sold. See *Sale of a Farm* in chapter 10.

If you report the sale of property on the installment method, any depreciation recapture under section 1245 or 1250 of the Internal Revenue Code is taxable as ordinary income in the year of sale. This applies even if no payments are received in that year.

Example

On January 3, 1999, you sold your farm, including the equipment and livestock (cattle used for breeding). You received \$50,000 down and the buyer's note for \$200,000. In addition, the buyer assumed an outstanding \$50,000 mortgage on the farm land. The total selling price was \$300,000. The note payments of \$25,000 each, plus adequate interest, are due every July 1 and January 1, beginning in July 1999. Your selling expenses were \$15,000.

Adjusted basis and depreciation. The adjusted basis and depreciation claimed on each asset sold are as follows:

Asset	Depreciation Claimed	Adjusted Basis
Home*	-0-	\$30,000
Land	-0-	61,250
Buildings	\$31,500	28,500
Truck	3,001	1,499
Equipment	15,811	9,189
Tractor	15,811	9,189
Cattle**	1,977	2,023
Cattle***	19,167	833

* Owned and used as main home for at least 2 of the 5 years prior to the sale

** Held less than 2 years

***Held 2 years or more

Gain on each asset. The following schedule shows the assets included in the sale, each asset's selling price based on its respective value, the selling expense allocated to each asset, the adjusted basis of each asset, and the gain on each asset. The selling expense for each asset is 5% of the selling price (\$15,000 selling expense ÷ \$300,000 selling

price). The livestock and produce held for sale were sold before the end of 1998 in anticipation of selling the farm. There was no section 179 deduction claimed on any asset.

	Selling Price	Selling Expense	Adjusted Basis	Gain
Home*	\$50,000	\$2,500	\$30,000	\$17,500
Land	125,000	6,250	61,250	57,500
Buildings	55,000	2,750	28,500	23,750
Truck	5,000	250	1,499	3,251
Equip.	17,000	850	9,189	6,961
Tractor	23,000	1,150	9,189	12,661
Cattle**	5,000	250	2,023	2,727
Cattle***	20,000	1,000	833	18,167
	\$300,000	\$15,000	\$142,483	\$142,517

* Owned and used as main home for at least 2 of the 5 years prior to the sale

** Held less than 2 years

***Held 2 years or more

Depreciation recapture. The buildings are section 1250 property. There is no depreciation recapture income for them because they were depreciated using the straight line method. See chapter 11 for more information on depreciation recapture.

The truck used for hauling is section 1245 property. The entire depreciation of \$3,001 is recapture income because it is less than the gain on the truck. The remaining gain of \$250 is reported on the installment method.

The equipment and tractor are section 1245 property. The entire gain on each (\$6,961 and \$12,661, respectively) is depreciation recapture income.

The cattle used for breeding and held for less than 2 years are section 1245 property. The gain of \$2,727 is depreciation recapture income to the extent of the depreciation claimed (\$1,977). The remaining gain of \$750 is reported on the installment method.

The cattle used for breeding and held for more than 2 years are also section 1245 property. Since the gain on the cattle of \$18,167 is less than the depreciation claimed (\$19,167), the total gain is depreciation recapture income.

The total depreciation recapture income figured in Part III of Form 4797 is \$42,767. (This is the sum of: \$3,001 + \$6,961 + \$12,661 + \$1,977 + \$18,167.) Depreciation recapture income is reported as ordinary income in the year of sale even if no payments were received.

The part of the gains reported as depreciation recapture income on the truck and the cattle held less than 2 years (\$3,001 and \$1,977) is added to their adjusted basis when making the installment sale computations.

Assets not reported on installment method. In the year of sale, the gain on the cattle held 2 years or more, the equipment, and the tractor is reported in full. Because the entire gain on the home can be excluded from income, the installment method does not apply to the sale of the home. See *Sale of your home* in chapter 10. The selling price of these assets (\$110,000) is subtracted from the total selling price (\$300,000). The selling price for the assets included in the installment sale is \$190,000.

Installment sale basis and gross profit. The following table shows each asset reported on the installment method, its selling price, "installment sale basis," and gross profit.

	Selling Price	Installment Sale Basis	Gross Profit
Farm land	\$125,000	\$67,500	\$57,500
Buildings	55,000	31,250	23,750
Truck	5,000	4,750	250
Cattle*	5,000	4,250	750
	\$190,000	\$107,750	\$82,250

* Held less than 2 years

Section 1231 gains. Since the ordinary income part of the gain on the truck is reported in the year of sale, the remaining gain (\$250) and the gain on the land and buildings are reported as section 1231 gains. The cattle held for less than 2 years do not qualify for section 1231 treatment. The \$750 gain on their sale is reported as ordinary gain in Part II of Form 4797 as payments are received. See *Section 1231 Gains and Losses* in chapter 11.

Contract price and gross profit percentage. The contract price is \$140,000 for the part of the sale reported on the installment method. This is the selling price (\$300,000) minus the mortgage assumed (\$50,000) minus the selling price of the assets with gains fully reported in the year of sale or excluded from income (\$110,000).

Gross profit percentage for the sale is 58.75% (\$82,250 gross profit ÷ \$140,000 contract price). The gross profit percentage for each asset is figured as follows:

	Percent
Farm land (\$57,500 ÷ \$140,000)	41.0714
Buildings (\$23,750 ÷ \$140,000)	16.9643
Truck (\$250 ÷ \$140,000)	0.1786
Cattle* (\$750 ÷ \$140,000)	0.5357
Total	58.75

* Held less than 2 years

Figuring the gain to report on the installment method. Only 56% of each payment is reported on the installment method [\$140,000 contract price ÷ \$250,000 to be received on the sale (\$300,000 selling price - \$50,000 mortgage assumed)]. The total amount received on the installment sale in 1999 is \$75,000 (\$50,000 down payment + \$25,000 payment on July 1). The installment sale part of the total 1999 payments is \$42,000 (\$75,000 × .56). Figure the gain to report for each asset by multiplying its gross profit percentage times \$42,000.

	Income
Farm land—41.0714% × \$42,000	\$17,250
Buildings—16.9643% × \$42,000	7,125
Truck—0.1786% × \$42,000	75
Cattle*—0.5357% × \$42,000	225
Total installment income for 1999	\$24,675

* Held less than 2 years

Reporting the sale. Report the installment sale on Form 6252. Then report the amounts from Form 6252 on Form 4797 and Schedule D (Form 1040). Attach a separate page to Form 6252 that shows the computations in the example.

Section 1231 gains. The gains on the land, buildings, and truck are section 1231 gain and may be reported as capital or ordinary gain when combined with certain other gains and losses.

Depreciation recapture and gain on cattle. In the year of sale, you must report the total depreciation recapture income on Form 4797. The \$225 gain on the cattle held

less than 2 years is ordinary income reported in Part II of Form 4797. See *Table 11-1* in chapter 11.

Installment income for years after 1999. You figure installment income for the years after 1999 by applying the same gross profit percentages to the payments you receive each year. If you receive \$50,000 during the year, \$28,000 is considered received on the installment sale (56% × \$50,000). You realize income as follows:

	<u>Income</u>
Farm land—41.0714% × \$28,000	\$11,500
Buildings—16.9643% × \$28,000	4,750
Truck—0.1786% × \$28,000	50
Cattle*—0.5357% × \$28,000	150
Total installment income	<u>\$16,450</u>

* Held less than 2 years

For each year you receive payments on the sale, you can exclude the gain on the sale of your home from your income. You will report the gain on cattle held less than 2 years as ordinary gain in Part II of Form 4797. You will combine your section 1231 gains with certain other gains and losses in each of the later years to determine whether to report them as ordinary or capital gains. The interest received with each payment will be included in full as ordinary income.

Summary. The installment income (rounded to the nearest dollar) from the sale of the farm is reported as follows:

Selling price	\$190,000
Minus: Installment basis	<u>107,750</u>
Gross profit	<u>\$82,250</u>
Gain reported in 1999 (year of sale)	\$24,675
Gain reported in 2000:	
\$28,000 × 58.75%	16,450
Gain reported in 2001:	
\$28,000 × 58.75%	16,450
Gain reported in 2002:	
\$28,000 × 58.75%	16,450
Gain reported in 2003:	
\$14,000 × 58.75%	<u>8,225</u>
Total gain reported	<u>\$82,250</u>

13.

Casualties, Thefts, and Condemnations

Introduction

This chapter explains the tax treatment of casualties, thefts, and condemnations. A **casualty** occurs when property is damaged, destroyed, or lost due to a sudden, unexpected, or unusual event. A **theft** occurs when property is stolen. A **condemnation** occurs when private property is legally taken for public use without the owner's consent. A casualty, theft, or condemnation may result in a deductible loss or taxable gain on your federal income tax return. You may have a deductible loss or a taxable gain even if only a portion of your property was affected by a casualty, theft, or condemnation.

An **involuntary conversion** occurs when you receive money or other property as reimbursement for a casualty, theft, condemnation, disposition of property under threat of condemnation, or certain other events discussed in this chapter.

If an involuntary conversion results in a gain, you can postpone reporting of the gain on your income tax return if you buy qualified replacement property within the specified replacement period. For more information, see *Postponing Gain*, later.

Topics

This chapter discusses:

- Casualties and thefts
- How to figure gain or loss
- Other involuntary conversions
- Postponing gain
- Reporting gains and losses

Useful Items

You may want to see:

Publication

- 536** Net Operating Losses
- 544** Sales and Other Dispositions of Assets
- 547** Casualties, Disasters, and Thefts (Business and Nonbusiness)
- 584** Casualty, Disaster, and Theft Loss Workbook (Personal-Use Property)

Form (and Instructions)

- Sch A (Form 1040)** Itemized Deductions
- Sch D (Form 1040)** Capital Gains and Losses
- Sch F (Form 1040)** Profit or Loss From Farming
- 4684** Casualties and Thefts
- 4797** Sales of Business Property

See chapter 21 for information about getting publications and forms.

Casualties and Thefts

If your property is destroyed, damaged, or stolen, you may have a deductible loss. If the insurance or other reimbursement is more than the adjusted basis of the destroyed, damaged, or stolen property, you may have a taxable gain.

Casualty. A casualty is the damage, destruction, or loss of property resulting from an identifiable event that is sudden, unexpected, or unusual.

Deductible losses. Deductible casualty losses can result from a number of different causes, including the following.

- Airplane crashes.
- Car or truck accidents not resulting from your willful act or willful negligence.
- Earthquakes.

- Fires.
- Floods.
- Freezing.
- Hurricanes.
- Lightning.
- Shipwrecks.
- Storms.

Nondeductible losses. A casualty loss is not deductible if the damage or destruction is caused by the following.

- Accidentally breaking articles such as glassware or china under normal conditions.
- A family pet.
- A fire if you willfully set it, or pay someone else to set it.
- A car or truck accident if your willful negligence or willful act caused it. The same is true if the willful act or willful negligence of someone acting for you caused the accident.
- Progressive deterioration (explained next).

Progressive deterioration. Loss of property due to progressive deterioration is not deductible as a casualty loss. This is because the damage results from a steadily operating cause or a normal process, rather than from a sudden event. Examples of damage due to progressive deterioration include damage from rust, corrosion, or termites. However, weather-related conditions or disease may cause another type of involuntary conversion. See *Other Involuntary Conversions*, later.

Theft. A theft is the taking and removing of money or property with the intent to deprive the owner of it. The taking of your property must be illegal under the law of the state where it occurred and it must have been done with criminal intent.

Theft includes the taking of money or property by the following means.

- Blackmail.
- Burglary.
- Embezzlement.
- Extortion.
- Kidnapping for ransom.
- Larceny.
- Robbery.
- Threats.

The taking of money or property through fraud or misrepresentation is theft if it is illegal under state or local law.

Mislaid or lost property. The simple disappearance of money or property is not a theft. However, an accidental loss or disappearance of property can qualify as a casualty if it results from an identifiable event that is sudden, unexpected, or unusual.

Example. A car door is accidentally slammed on your hand, breaking the setting of your diamond ring. The diamond falls from the ring and is never found. The loss of the diamond is a casualty.

Farming Losses

Certain casualty or theft losses that occur in the business of farming are deductible losses. The following is a discussion of some losses you can deduct and some you cannot deduct.

Livestock or produce purchased for sale.

Casualty or theft losses of livestock or produce bought for sale are deductible if you report your income on the cash method. If you report your income on an accrual method, take casualty and theft losses on property bought for sale by omitting the item from the closing inventory for the year of the loss. You cannot take a separate deduction.

Livestock, plants, produce, and crops raised for sale.

Losses of livestock, plants, produce, and crops raised for sale are generally not deductible if you report your income on the cash method. You have already deducted the cost of raising these items as farm expenses.

For plants with a preproductive period of more than 2 years, you may have a deductible loss if you have a tax basis in the plants. You usually have a tax basis if you capitalized the expenses associated with these plants under the uniform capitalization rules. The uniform capitalization rules are discussed in chapter 7.

If you report your income on an accrual method, casualty or theft losses **are deductible only if** you included the items in your inventory at the beginning of your tax year. You get the deduction by omitting the item from your inventory at the close of your tax year. You cannot take a separate casualty or theft deduction.

Income loss. A loss of future income is not deductible.

Example. An ice storm damaged your standing timber by reducing its rate of growth and its quality. The storm did not cause any physical damage, but you determined that the timber will sell for less than you anticipated because of the reduced growth rate and quality. The loss of future income is not deductible.

Loss of timber. If you sell timber downed by a casualty, treat the proceeds from the sale as a reimbursement. If you use the proceeds to buy qualified replacement property, you can postpone reporting the gain. See *Postponing Gain*, later.

Property used in farming. Casualty and theft losses of property used in the farm business usually result in deductible losses. If a fire or storm destroyed your barn, or you lose by casualty or theft an animal you bought for draft, breeding, dairy, or sport, you may have a deductible loss. See *How To Figure a Loss*, discussed later.

Raised draft, breeding, dairy, or sporting animals. Generally, losses of raised, draft, breeding, dairy, or sporting animals do not result in deductible casualty or theft losses because you have no basis in the animals. However, you may be able to claim a deduction if either of the following situations applies to you.

- 1) You use inventories to determine your income and you included the animals in your inventory.

- 2) You capitalized the expenses associated with the animals under the uniform capitalization rules and therefore have a tax basis in the animals that were subject to a casualty or theft.

When you include livestock in inventory, its last inventory value is its basis. When an inventoried animal held for draft, breeding, dairy, or sport is lost by casualty or theft during the year, decrease ending inventory by the value at which you included the animal in inventory. You cannot take a separate deduction.

How To Figure a Loss

How you figure a deductible casualty or theft loss depends on whether the loss was to farm or personal-use property and whether the property was stolen or partly or completely destroyed.

Farm property. Farm property is the property you use in your farming business. If your farm property was **completely destroyed or stolen**, your loss is figured as follows:

Your adjusted basis in the property

MINUS

Any salvage value

MINUS

Any insurance or other reimbursement you receive or expect to receive

If your farm property was **partially damaged**, use the steps shown under *Personal-use property*, next, to figure your casualty loss. But do **not** apply the deduction limits.

Personal-use property. Personal-use property is property used by you or your family members for personal use. You figure the amount of your casualty or theft loss on this property by using the following steps.

- 1) Determine your **adjusted basis** in the property before the casualty or theft.
- 2) Determine the **decrease in fair market value** of the property as a result of the casualty or theft.
- 3) From the smaller of the amounts you determined in (1) and (2) subtract any **insurance or other reimbursement** you receive or expect to receive.

You must apply the deduction limits, discussed later, to determine your deductible loss.

TIP *Publication 584 is available to help you make a list of your stolen or damaged property and figure your loss. It includes schedules to help you figure the loss on your home and its contents, and on your motor vehicles.*

Adjusted basis. Adjusted basis is your basis (usually cost) increased or decreased by various events, such as improvements and casualty losses. For more information about adjusted basis, see chapter 7.

Decrease in fair market value (FMV).

The decrease in FMV is the difference between the property's value immediately before the casualty or theft and its value immediately afterwards. FMV is defined in chapter 12.

Cost of cleaning up or making repairs.

The cost of repairing damaged property is not part of a casualty loss. Neither is the cost of cleaning up after a casualty. But you can use the cost of cleaning up or of making repairs after a casualty as a measure of the decrease in FMV if you meet all the following conditions.

- The repairs are necessary to bring the property back to its condition before the casualty.
- The amount spent for repairs is not excessive.
- The repairs fix only the damage.
- The value of the property after the repairs is not, due to the repairs, more than the value of the property before the casualty.

Related expenses. The incidental expenses due to a casualty or theft, such as expenses for the treatment of personal injuries, for temporary housing, or for a rental car, are not part of your casualty or theft loss. However, they may be deductible as farm business expenses if the damaged or stolen property is farm property.

Separate computations for more than one item of property. Generally, if a single casualty or theft involves more than one item of property, you must figure your loss separately for each item of property. Then combine the losses to determine your total loss.

CAUTION *There is an exception for personal-use real property. See Exception for personal-use real property, later.*

Example. A fire on your farm damaged a tractor and the barn in which it was stored. The tractor had an adjusted basis of \$3,300. Its FMV was \$2,800 just before the fire and \$1,000 immediately afterward. The barn had an adjusted basis of \$8,000. Its FMV was \$25,000 just before the fire and \$15,000 immediately afterward. You received insurance reimbursements of \$600 on the tractor and \$6,000 on the barn. Figure your deductible casualty loss separately for the two items of property.

	Tractor	Barn
1) Adjusted basis	\$3,300	\$8,000
2) FMV before fire	\$2,800	\$25,000
3) FMV after fire	1,000	15,000
4) Decrease in FMV (2 minus 3) ..	\$1,800	\$10,000
5) Loss (lesser of 1 or 4)	\$1,800	\$8,000
6) Minus: Insurance	600	6,000
7) Deductible casualty loss	\$1,200	\$2,000
8) Total loss	\$3,200	

Exception for personal-use real property. In figuring a casualty loss on personal-use real property, the entire property (including any improvements, such as buildings, trees, and shrubs) is treated as one item. Figure the loss using the smaller of the following.

- The decrease in FMV of the entire property.
- The adjusted basis of the entire property.

Example. You bought a farm in 1960 for \$20,000. The adjusted basis of the residential part is \$6,000. In 1999, a windstorm blew

down shade trees and three ornamental trees planted at a cost of \$600 on the residential part. The adjusted basis of the residential part includes the \$600. The fair market value (FMV) of the residential part immediately before the storm was \$30,000, and \$26,000 immediately after the storm. The trees were not covered by insurance.

1) Adjusted basis	\$6,000
2) FMV before the storm	\$30,000
3) FMV after the storm	26,000
4) Decrease in FMV (line 2 minus line 3) ..	\$4,000
5) Loss before insurance (lesser of line 1 or line 4)	\$4,000
6) Minus: Insurance	0
7) Amount of loss	<u>\$4,000</u>

Insurance and other reimbursements. If you receive an insurance or other type of reimbursement, you must subtract the reimbursement when you figure your loss. You do not have a casualty or theft loss to the extent you are reimbursed.

 **Do not subtract insurance payments for living expenses from your loss.** You may have to include these payments in your income. See Publication 547 for details.

If you expect to be reimbursed for part or all of your loss, you must subtract the expected reimbursement when you figure your loss. You must reduce your loss even if you do not receive payment until a later tax year.

Reimbursement in a later year. If you figured your casualty or theft loss using your expected reimbursement, you may have to adjust the tax return for the tax year in which you get your actual reimbursement.

Actual reimbursement less than expected. If you later receive less reimbursement than you expected, include that difference as a loss with your other losses (if any) on your return for the year in which you can reasonably expect no more reimbursement.

Actual reimbursement more than expected. If you later receive more reimbursement than you expected after you have claimed a deduction for the loss, you may have to include the extra reimbursement in your income for the year you receive it. However, if any part of your original deduction did not reduce your tax for the earlier year, do not include that part of the reimbursement in your income. You do not refigure your tax for the year you claimed the deduction. See *Recoveries* in Publication 525 to find out how much extra reimbursement to include in income.

 **If the total of all the reimbursements you receive is more than your adjusted basis in the destroyed or stolen property, you will have a gain on the casualty or theft.** If you have already taken a deduction for a loss and you receive the reimbursement in a later year, you may have to include the gain in your income for the later year. Include the gain as ordinary income up to the amount of your deduction that reduced your tax for the earlier year. See Publication 547 for more information on how to treat a gain from the reimbursement of a casualty or theft.

Actual reimbursement same as expected. If you receive exactly the reimbursement you expected to receive, you do not have any amount to include in your income or any loss to deduct.

Lump-sum reimbursement. If you have a casualty or theft loss of several assets at the same time without an allocation of reimbursement to specific assets, divide the lump-sum reimbursement among the assets according to the fair market value of each asset at the time of the loss. Figure the gain or loss separately for each asset that has a separate basis.

Adjustments to basis. If you have a casualty or theft loss, you must decrease your basis in the property by any insurance or other reimbursement you receive and by any deductible loss. The result is your adjusted basis in the property. Amounts you spend to restore your property after a casualty increase your adjusted basis. See *Adjusted Basis* in chapter 7 for more information.

Deduction Limits on Losses of Personal-Use Property

Casualty and theft losses of property held for personal use may be deductible if you itemize deductions on Schedule A (Form 1040).

There are two limits on the amount you can deduct for your casualty or theft loss of personal-use property. You figure these limits on Form 4684.

\$100 rule. You must reduce each casualty or theft loss on personal-use property by \$100. This \$100 rule applies after you have subtracted any reimbursement.

10% rule. You must further reduce the total of all your casualty or theft losses on personal-use property by 10% of your adjusted gross income. Apply this rule after you reduce each loss by \$100. Adjusted gross income is on line 33 of Form 1040.

Example. In June, you discovered that your house had been burglarized. Your loss after insurance reimbursement was \$2,000. Your adjusted gross income is \$29,500. Figure your theft loss as follows:

1. Loss after insurance	\$2,000
2. Subtract \$100	100
3. Loss after \$100 rule	\$1,900
4. Subtract 10% of \$29,500 AGI	\$2,950
5. Theft loss deduction	<u>0</u>

You do not have a theft loss deduction because your loss (\$1,900) is less than 10% of your adjusted gross income (\$2,950).

 **If you have a casualty or theft gain in addition to a loss, you will have to make a special computation to figure your 10% limit.** See 10% Rule in Publication 547.

When Loss Is Deductible

Casualty losses are generally deductible only in the year in which they occur. Theft losses are generally deductible only in the year they are discovered. However, see *Disaster Area Losses*, later.

Leased property. If you lease property from someone else, you can deduct a loss on the property in the year your liability for the loss is fixed. This is true even if the loss occurred or the liability was paid in a different year. You are not entitled to a deduction until your liability under the lease can be determined with reasonable accuracy. Your liability can be ascertained with reasonable accuracy when

a claim for recovery is settled, adjudicated, or abandoned.

Example. Robert leased a tractor from First Implement, Inc. for use in his farm business. The tractor was destroyed by a tornado in June 1999. The loss was not insured. First Implement billed Robert for the fair market value of the tractor on the date of the loss. Robert disagreed with the amount of the liability. First Implement later filed a suit in court against Robert. In 2000, Robert and First Implement agreed to settle the suit for \$20,000, and the court entered a judgement in favor of First Implement. Robert paid \$20,000 in June 2000. He can claim the \$20,000 as a loss on his 2000 tax return.

Net operating loss (NOL). If your deductions, including casualty or theft loss deductions, are more than your income for the year, you may have an NOL. An NOL can be carried back or carried forward and deducted from income in other years. See chapter 5 for more information on NOLs.

Proof of Loss

To deduct a casualty or theft loss, you must be able to prove that there was a casualty or theft. You must be able to support the amount you claim for the loss.

Casualty. For a casualty loss, your records should show all of the following.

- The type of casualty (car accident, fire, storm, etc.) and when it occurred.
- That the loss was a direct result of the casualty.
- That you were the owner of the property or, if you leased the property from someone else, that you were contractually liable to the owner for the damage.

Theft. For a theft, your records should show all of the following.

- When you discovered that your property was missing.
- That your property was stolen.
- That you were the owner of the property.

Figuring a Gain

If you receive insurance or other reimbursement that is more than your adjusted basis in the destroyed, damaged, or stolen property, you have a gain from the casualty or theft. You generally report your gain as income in the year you receive the reimbursement. However, depending on the type of property you receive, you may not have to report your gain. See *Postponing Gain*, later.

Your gain is figured as follows:

- The amount you receive, minus
- Your adjusted basis in the property at the time of the casualty or theft.

Even if the decrease in FMV of your property is smaller than the adjusted basis of your property, use your adjusted basis to figure the gain.

Amount you receive. The amount you receive includes any money plus the value of any property you receive, minus any expenses you have in obtaining reimbursement.

It also includes any reimbursement used to pay off a mortgage or other lien on the damaged, destroyed, or stolen property.

Example. A tornado severely damaged your barn. The adjusted basis of the barn was \$2,500. Your insurance company reimbursed you \$4,000 for the damaged barn. However, you had legal expenses of \$200 to collect that insurance. Since your insurance minus your expenses to collect the insurance is more than your adjusted basis in the barn, you have a gain.

1) Insurance reimbursement	\$4,000
2) Legal expenses	200
3) Amount received.	
Subtract line 2 from line 1	\$3,800
4) Adjusted basis	2,500
5) Gain on casualty (line 3 – line 4)	<u>\$1,300</u>

Other Involuntary Conversions

In addition to casualties and thefts, there are other events that cause involuntary conversions of property. Some of these are described in the following paragraphs.

Gain or loss from an involuntary conversion of your property is usually recognized for tax purposes. You report the gain or deduct the loss on your tax return for the year you realize it. However, depending on the type of property you receive, you may not have to report your gain on the involuntary conversion. See *Postponing Gain*, later.

Condemnation

Condemnation is the process by which private property is legally taken for public use without the owner's consent. The property may be taken by the federal government, a state government, a political subdivision, or a private organization that has the power to legally take property. The owner receives a condemnation award (money or property) in exchange for the property taken. A condemnation is like a forced sale, the owner being the seller and the condemning authority being the buyer.

For information on how to figure the gain or loss on condemned property, see chapter 1 in Publication 544. Also see *Postponing Gain*, later, to find out if you can postpone reporting the gain.

Threat of condemnation. Treat the sale of your property under threat of condemnation as a condemnation.

Main home condemned. If you have a gain because your main home is condemned, you generally can exclude the gain from your income as if you had sold or exchanged your home. For information on this exclusion, see Publication 523, *Selling Your Home*. If your gain is more than the amount you can exclude, but you can buy replacement property, you may be able to postpone the excess gain. See *Postponing Gain*, later. (You cannot deduct a loss from the condemnation of your main home.)

Irrigation Project

Property located within an irrigation project and sold or otherwise disposed of to conform to the acreage limits of federal reclamation laws is an involuntary conversion.

Livestock Losses

Diseased livestock. If livestock die from disease, or are destroyed, sold, or exchanged because of disease, even though the disease is not of epidemic proportions, treat these occurrences as involuntary conversions. If the livestock was raised or purchased for resale, follow the rules for livestock discussed earlier under *Farming Losses*. Otherwise, figure the gain or loss from these conversions using the rules discussed under *Determining Gain or Loss* in chapter 10. If you replace the livestock, you may be able to postpone reporting the gain. See *Postponing Gain*, later.

Reporting dispositions of diseased livestock. If you choose to postpone gain on the disposition of diseased livestock, you must attach a statement to your return explaining that the livestock was disposed of because of disease. You must also include other information on this statement. See *How To Postpone Gain*, later under *Postponing Gain*.

Weather-related sales of livestock. If solely because of drought, flood, or other weather-related conditions you sell or exchange livestock (other than poultry) held for draft, breeding, or dairy purposes, treat the sale or exchange as an involuntary conversion. Only livestock sold in excess of the number you normally would sell under usual business practice, in the absence of weather-related conditions, are considered involuntary conversions. Figure the gain or loss using the rules discussed under *Determining Gain or Loss* in chapter 10. If you replace the livestock, you may be able to postpone reporting the gain. See *Postponing Gain*, later.

Example. Under your usual business practice you sell five of your dairy animals during the year. This year you sold 20 dairy animals because of drought. The sale of 15 animals is treated as an involuntary conversion.

TIP *If you do not replace the livestock, you may be able to report the gain in the following year's income. This rule also applies to poultry. See Sales Caused by Weather-Related Conditions in chapter 4.*

Reporting weather-related sales of livestock. If you choose to postpone the gain on weather-related sales of livestock, show all of the following information on a statement attached to your return for the tax year in which you first realize any of the gain.

- Evidence of the weather-related conditions that forced the sale or exchange of the livestock.
- The gain realized on the sale or exchange.
- The number and kind of livestock sold or exchanged.
- The number of livestock of each kind you would have sold or exchanged under your usual business practice.

Show all of the following information on the return for the year in which you replace the livestock.

- The date you bought replacement livestock.
- The cost of the replacement livestock.
- The number and kind of the replacement livestock.

Tree Seedlings

If, because of an abnormal drought, the failure of planted tree seedlings is greater than normally anticipated, you may have a deductible loss. The loss equals the previously capitalized reforestation costs you had to duplicate on replanting. You deduct the loss on the return for the year the seedlings died.

Postponing Gain

Do not report a gain if you receive reimbursement in the form of property similar or related in service or use to the destroyed, stolen, or other involuntarily converted property. Your basis in the new property is the same as your adjusted basis in the property it replaces.

You must ordinarily report the gain on your stolen, destroyed, or other involuntarily converted property if you receive money or unlike property as reimbursement. But you can choose to postpone reporting the gain if you purchase replacement property that is similar or related in service or use to your destroyed, stolen, or other involuntarily converted property within a specific replacement period.

To postpone all the gain, the cost of your replacement property must be at least as much as the reimbursement you receive. If the cost of the replacement property is less than the reimbursement, you must include the gain in your income up to the amount of the unspent reimbursement.

Replacement Property

You must buy replacement property for the specific purpose of replacing your property. Your replacement property must be similar or related in service or use to the property it replaces. You do not have to use the same funds you receive as reimbursement for your old property to acquire the replacement property. If you spend the money you receive for other purposes, and borrow money to buy replacement property, you can still choose to postpone the gain if you meet the other requirements. Property you acquire as a gift or inheritance does not qualify as replacement property.

Buying replacement property from a related person. You cannot postpone reporting a gain from a casualty, theft, or other involuntary conversion if you buy the replacement property from a related person (discussed later). This rule applies to involuntary conversions occurring **after** the following dates.

- 1) February 5, 1995, for C corporations and partnerships in which more than 50% of the capital or profits interest is owned by C corporations.

- 2) June 8, 1997, for individuals, partnerships—other than those in (1) above—and S corporations if the total realized gain for the tax year on all involuntarily converted properties on which there are realized gains is more than \$100,000.

For involuntary conversions described in (2) above, gains cannot be offset with any losses when determining whether the total gain is more than \$100,000. If the property is owned by a partnership, the \$100,000 limit applies to the partnership and each partner. If the property is owned by an S corporation, the \$100,000 limit applies to the S corporation and each shareholder.

Exception. This rule does not apply if the related persons acquired the property from an unrelated person within the period of time allowed for replacing the involuntarily converted property.

Related persons. Under this rule, related persons include, for example, a corporation and an individual who owns more than 50% of its outstanding stock, and two partnerships in which the same C corporations own more than 50% of the capital or profits interests. For more information on related persons, see *Nondeductible Loss* under *Sales and Exchanges Between Related Persons* in chapter 2 of Publication 544.

Owner-user. If you are an owner-user, “similar or related in service or use” means that replacement property must function in the same way as the property it replaces. Examples of property that functions in the same way as the property it replaces are a home that replaces another home, a dairy cow that replaces another dairy cow, and farm land that replaces other farm land. A passenger automobile that replaces a tractor does not qualify. Neither does a breeding cow that replaces a dairy cow.

Soil or environmental contamination. If, because of soil or environmental contamination, it is not practical for you to reinvest your insurance money from destroyed livestock in property similar or related in service or use to the livestock, you can treat other property, including real property used for farming purposes, as property similar or related in service or use to the destroyed livestock.

Standing crop destroyed by casualty. If a storm or other casualty destroyed your standing crop and you use the insurance money to acquire either another standing crop or a harvested crop, this purchase qualifies as replacement property. The cost of planting a new crop does not qualify as a replacement for the destroyed crop, unless you use the crop method of accounting (discussed in chapter 3). In this case, the costs of bringing the new crop to the same level of maturity as the destroyed crop qualify as replacement costs.

Timber loss. Standing timber you bought with the proceeds from the sale of timber downed by a casualty, such as high winds, earthquakes, or volcanic eruptions, qualifies as replacement property. If you bought the standing timber within the replacement period, you can postpone reporting the gain.

Business or income-producing property located in a federal disaster area. If your destroyed business or income-producing property was located in a federally declared disaster area, **any** tangible replacement property you acquire for use in a business is treated as similar or related in service or use to the destroyed property. For more information, see *Disaster Area Losses* in Publication 547.

Substituting replacement property. Once you have acquired qualified replacement property that you designate as replacement property, you cannot substitute other qualified replacement property. The designation is made by the statement with your return reporting that you have acquired replacement property. However, if you discover that the original replacement property was not qualified replacement property, you can, within the replacement period, substitute the new qualified replacement property.

Taxpayer's death. If a taxpayer dies after having a gain, but before buying replacement property, the gain must be reported for the year in which the decedent realized the gain. The executor of the estate or the person succeeding to the funds from the casualty or theft cannot postpone the gain by buying replacement property.

Replacement Period

To postpone reporting your gain, you must buy replacement property within a specified period of time. This is the replacement period.

The replacement period begins on the date your property was damaged, destroyed, stolen, sold, or exchanged. The replacement period **ends 2 years** after the close of the first tax year in which you realize any part of your gain from the involuntary conversion.

Condemnation. The replacement period for a condemnation begins on the earlier of the following dates.

- The date on which you disposed of the condemned property.
- The date on which the threat of condemnation began.

The replacement period **ends 2 years** after the close of the first tax year in which any part of the gain on the condemnation is realized.

If real property held for use in a trade or business or for investment (not including property held primarily for sale) is condemned, the replacement period **ends 3 years** after the close of the first tax year in which any part of the gain on the condemnation is realized.

Extension. You may get an extension of the replacement period if you apply to the District Director of the Internal Revenue Service for your area. Include all the details about your need for an extension. Make your application before the end of the replacement period. However, you can file an application within a reasonable time after the replacement period ends if you can show a good reason for the delay. You will get an extension of the replacement period if you can show reasonable cause for not making the replacement within the regular period.

How To Postpone Gain

You postpone your gain by reporting your choice on your tax return for the year you have the gain. You have the gain in the year you receive insurance proceeds or other reimbursements that result in a gain.

Required statement. You should attach a statement to your return for the year you have the gain. This statement should include all of the following information.

- The date and details of the casualty, theft, or other involuntary conversion.
- The insurance or other reimbursement you received.
- How you figured the gain.

Replacement property acquired before return filed. If you acquire replacement property before you file your return for the year you have the gain, your statement should also include detailed information about all of the following.

- The replacement property.
- The postponed gain.
- The basis adjustment that reflects the postponed gain. (Reduce the basis of the replacement property by the amount of postponed gain.)
- Any gain you are reporting as income.

Replacement property acquired after return filed. If you intend to buy replacement property after you file your return for the year you realize gain, your statement should also say that you are choosing to replace the property within the required replacement period.

You then attach another statement to your return for the year in which you buy the replacement property. Show in this statement detailed information on the replacement property. If you acquire part of your replacement property in one year and part in another year, you must make a statement for each year. Include in the statement detailed information on the replacement property bought in that year.

Amended return. You must file an amended return (Form 1040X) for the tax year of the gain in either of the following situations.

- You do not acquire replacement property within the replacement period. On this amended return, you must report the gain and pay any additional tax due.
- You acquire replacement property within the required replacement period but at a cost less than the amount you receive from the casualty, theft or other involuntary conversion. On this amended return you must report the portion of the gain that cannot be postponed and pay any additional tax due.

Disaster Area Losses

There are special rules that apply to Presidentially declared disaster area losses. A **Presidentially declared disaster** is a disaster that occurred in an area declared by the President to be eligible for federal assistance

under the Disaster Relief and Emergency Assistance Act.

This part discusses the special rules for when to deduct a disaster area loss and the abatement of interest on tax underpayments. For other special rules, see Publication 547.

When to deduct disaster area losses. If you have a deductible loss from a Presidentially declared disaster area, you can elect to deduct that loss on your return or amended return for the immediately preceding tax year. If you make this election, the loss is treated as having occurred in the preceding year.

TIP *Claiming a qualifying disaster loss on the previous year's return may result in a lower tax for that year, often producing or increasing a cash refund.*

You must make this election to take your casualty loss for the disaster in the preceding year by the latest of the following dates.

- The due date (without extensions) for filing your tax return for the tax year in which the disaster actually occurred.
- The due date (with extensions) for the return for the preceding tax year.
- If you timely filed the return for the preceding tax year, the date that is 6 months after the due date of the return (without extensions). (If you use this date to make the election, write, "Filed pursuant to section 301.9100-2" at the top of the amended return and file it at the same address you used for your original return.)

Interest abatement on underpayments in disaster areas. The IRS will abate interest for the length of the extension period granted to all taxpayers who meet both of the following requirements.

- 1) They were located in an area declared a disaster area by the President.
- 2) They were granted extensions to file income tax returns and pay income tax.

Reporting Gains and Losses

You will have to file one or more of the following forms to report your gains or losses from involuntary conversions.

Form 4684. Use this form to report your gains and losses from casualties and thefts.

Form 4797. Use this form to report involuntary conversions (other than from casualty or theft) of property used in your trade or business and capital assets held in connection with a trade or business or a transaction entered into for profit.

Schedule A (Form 1040). Use this form to deduct your losses from casualties and thefts of personal-use property that you reported on Form 4684.

Schedule D (Form 1040). Use this form to report gain from an involuntary conversion (other than from casualty or theft) of

personal-use property. Also, carry over from Form 4797 any net gain from an involuntary conversion of business property held for more than 1 year.

Schedule F (Form 1040). Use this form to deduct your losses from casualty or theft of livestock or produce bought for sale under *Other expenses* in Part II, line 34, if you use the cash method of accounting and have not otherwise deducted these losses.

14.

Alternative Minimum Tax

Important Reminder

Deferred payment (installment) sales and alternative minimum tax (AMT). For tax years beginning after December 31, 1986, the installment method is allowed for both the regular tax and the AMT for deferred payment sales of property used or produced in a farming business and held primarily for sale to customers. You may choose to begin applying the installment method for the AMT to sales entered into in the 1999 tax year. No adjustment should be made on Form 6251 for these sales. Any income you reported in 1999 for regular tax purposes from a prior year installment sale, and that was reported for AMT purposes in a prior tax year, should be reported as a negative amount on Form 6251. Alternatively, if you wish to make this change in a prior tax year, you may file Form 1040X, *Amended U.S. Individual Income Tax Return*, to amend the return for any earlier open tax year after which there is no closed tax year.

If you choose to file an amended return to take advantage of the retroactive change, you should not apply the installment method for the AMT to sales entered into prior to the earliest tax year for which you are filing an amended return. You should apply the installment method for the AMT only to installment sales entered into in the earliest tax year for which you are filing an amended return and all subsequent tax years. You should report as a negative AMT adjustment on the earliest year amended return any income reported in such tax year for regular tax purposes from an installment sale that was reported in an earlier tax year for AMT purposes. No adjustment should be made for any tax year subsequent to the earliest year for which an amended return was filed. Additionally, if you file an amended return, you must recalculate the AMT credit earned for the year.

Introduction

The tax laws give special treatment to some types of income, allow special deductions for some types of expenses, and allow credits for certain taxpayers. These laws enable some

taxpayers with substantial economic income to significantly reduce their regular tax. The alternative minimum tax (AMT) ensures that these taxpayers pay at least a minimum amount of tax on their economic income.

This chapter discusses the AMT for individuals. For information about the AMT for corporations, see Publication 542, *Corporations*.

Topics

This chapter discusses:

- Whether to fill in Form 6251
- What records you must keep
- When you can take a credit for prior year minimum tax

Useful Items

You may want to see:

Form (and Instructions)

- 1040** U.S. Individual Income Tax Return
- Sch A (Form 1040)** Itemized Deductions
- 6251** Alternative Minimum Tax—Individuals
- 8801** Credit for Prior Year Minimum Tax—Individuals, Estates, and Trusts

See chapter 21 for information about getting publications and forms.

Do You Need To Fill In Form 6251?

Individuals use Form 6251 to figure the amount, if any, of their AMT, and to figure any credit limitations. If you claimed or received any of the following items, fill in Form 6251.

- 1) Accelerated depreciation.
- 2) Income or (loss) from tax-shelter farm activities or passive activities.
- 3) Net operating loss deduction.
- 4) Income from incentive stock options.
- 5) Tax-exempt interest from private activity bonds.
- 6) Intangible drilling, circulation, research, experimental, or mining costs.
- 7) Amortization of pollution-control facilities or depletion.
- 8) Percentage-of-completion income from long-term contracts.
- 9) Interest paid on a home mortgage *not* used to buy, build, or substantially improve your home.
- 10) Investment interest expense reported on **Form 4952**.
- 11) AMT adjustments from an estate, trust, electing large partnership, or a cooperative.
- 12) Section 1202 exclusion.

After you fill in Form 6251, see *Who Must File* in the form instructions to see if you need to attach it to your tax return.

Table 14-1. **Worksheet To See If You Should Fill In Form 6251**

(Keep for your records)

Before you begin: ✓ Be sure you have read *Do You Need To Fill In Form 6251?* before using this worksheet.



1. Enter the amount from Form 1040, line 37.	1. _____
2. Are you filing Schedule A? <input type="checkbox"/> Yes. Leave line 2 blank and go to line 3. <input type="checkbox"/> No. Enter your standard deduction from Form 1040, line 36, and go to line 5	2. _____
3. Enter the smaller of the amount on Schedule A, line 4, or 2.5% (.025) of the amount on Form 1040, line 34	3. _____
4. Add lines 9 and 26 of Schedule A and enter the total	4. _____
5. Add lines 1 through 4 above	5. _____
6. Enter the amount shown below for your filing status: <ul style="list-style-type: none"> • Married filing jointly or qualifying widow(er)—\$45,000 • Married filing separately—\$22,500 • Single or head of household—\$33,750 	6. _____
7. Is the amount on line 5 more than the amount on line 6? <input type="checkbox"/> No. You do not need to fill in Form 6251. <input type="checkbox"/> Yes. Subtract line 6 from line 5	7. _____
8. Enter the amount shown below for your filing status: <ul style="list-style-type: none"> • Married filing jointly or qualifying widow(er)—\$150,000 • Married filing separately—\$75,000 • Single or head of household—\$112,500 	8. _____
9. Is the amount on line 5 more than the amount on line 8? <input type="checkbox"/> No. Enter -0- here and on line 10 and go to line 11. <input type="checkbox"/> Yes. Subtract line 8 from line 5.	9. _____
10. Multiply line 9 by 25% (.25) and enter the result but do not enter more than line 6 above	10. _____
11. Add lines 7 and 10	11. _____
12. Is the amount on line 11 more than the amount shown below for your filing status? <ul style="list-style-type: none"> • Single, married filing jointly, head of household, or qualifying widow(er)—\$175,000 • Married filing separately—\$87,500 <input type="checkbox"/> Yes. Fill in Form 6251 to see if you owe the alternative minimum tax. <input type="checkbox"/> No. Multiply line 11 by 26% (.26)	12. _____
13. Enter the amount from Form 1040, line 40, minus the total of any tax from Form 4972 and any amount on Form 1040, line 46.	13. _____
Next: Is the amount on line 12 more than the amount on line 13? <input type="checkbox"/> Yes. Fill in Form 6251 to see if you owe the alternative minimum tax. <input type="checkbox"/> No. Do not fill in Form 6251.	

Child under age 14. Fill in Form 6251 for a child under age 14 if the child's adjusted gross income from Form 1040, line 34, exceeds the child's earned income by more than \$5,100.

Worksheet. Even if your return is not affected by any of the items listed above, you may have to complete Form 6251. Fill in the *Table 14-1* worksheet to see if you should complete Form 6251.

Earned income credit. If you have an earned income credit, you must reduce it by any AMT.

What Records Must You Keep?



Because of AMT adjustments, you may have a different AMT basis in certain property or activities. Because your AMT basis may affect the computation of AMT in future tax years, you may need to figure the adjustments that affect basis, even though you do not owe AMT this year. You should keep a separate record of your AMT adjusted basis, including an AMT depreciation schedule.

Carrybacks and carryovers of certain deductions and credits may have to be refigured for AMT purposes. You should keep a separate record of these AMT carrybacks and carryovers to assist you in preparing your return in other years.

When Can You Take a Credit for Prior Year Minimum Tax?

You may be able to take a credit against your regular tax on your 1999 tax return if any of the following apply.

- 1) You paid AMT in 1998.
- 2) You had a minimum tax credit carryforward from 1998 to 1999.
- 3) You had an unallowed nonconventional source fuel credit or qualified electric vehicle credit not allowed for 1998.

Individuals use **Form 8801** to figure the amount, if any, of their minimum tax credit, and to figure any minimum tax credit carryforward.

Reduction for canceled debt. You may have to reduce the credit if you exclude from income a canceled debt from any of the following.

- 1) A bankruptcy case.
- 2) Insolvency.
- 3) Qualified farm debt.

You must reduce the amount available at the beginning of the year after the debt was canceled before preparing Form 8801 for that year. For more information, see *Cancellation of Debt* in chapter 4.

15.

Self-Employment Tax

Important Change for 1999

Tax rates and maximum net earnings for self-employment tax. The maximum net self-employment earnings subject to the social security part (12.4%) of the self-employment tax increased to \$72,600 for 1999. There is no maximum limit on earnings subject to the Medicare part (2.9%).

Important Change for 2000

Tax rates and maximum net earnings for self-employment tax. The maximum net self-employment earnings subject to the social security part of the self-employment tax will be published in Publications 533 and 553. There is no maximum limit on earnings subject to the Medicare part.

Introduction

The self-employment tax (SE tax) is a social security and Medicare tax for individuals who work for themselves. It is similar to the social security and Medicare taxes withheld from the pay of wage earners.

You usually have to pay SE tax if you are self-employed. You are usually self-employed if you operate your own farm on land you either own or rent. You have to figure SE tax on Schedule SE (Form 1040).

Farmers who have employees may have to pay the employer's share of social security tax, as well. See chapter 16 for information on employment taxes.

Topics

This chapter discusses:

- Who must pay self-employment tax
- Self-employment income

- Landlord participation in farming
- Figuring self-employment tax
- Reporting self-employment tax

Useful Items

You may want to see:

Publication

- 533** Self-Employment Tax
- 541** Partnerships

Form (and Instructions)

- SS-5** Application for a Social Security Card
- 1040** U.S. Individual Income Tax Return
- Sch F (Form 1040)** Profit or Loss From Farming
- Sch SE (Form 1040)** Self-Employment Tax
- 1065** U.S. Partnership Return of Income
- Sch K-1 (Form 1065)** Partner's Share of Income, Credits, Deductions, etc.

See chapter 21 for information about getting publications and forms.

General Information

Social security benefits. Social security coverage provides you with retirement benefits, disability benefits, survivor benefits, and hospital insurance (Medicare) benefits. Your payments of self-employment tax (SE tax) contribute to your coverage under the social security system. Social security benefits are available to self-employed persons just as they are to wage earners.

Credits. You must be insured under the social security system before you begin receiving social security benefits. You are insured if you have the required number of credits (quarters of coverage).

For 1999, you received one credit for each \$740 of income subject to social security tax. It does not matter whether the income is earned in one quarter or is spread over two or more quarters. The maximum number of credits you can receive for the year is four. Therefore, for 1999, if you had income (self-employment and wages) of \$2,960 that was subject to social security taxes, you received four credits ($\$2,960 \div 740$).

For an explanation of the number of credits you must have to be insured and the benefits available to you and your family under the social security program, consult your nearest Social Security Administration (SSA) office.



You may be subject to penalties for making false statements to get or increase social security benefits.

Social security number. You must have a social security number to pay SE tax. If you do not have a number, apply for one on Form SS-5, *Application for a Social Security Card*. You can get this form at any Social Security office or by calling **1-800-772-1213**.

If you have a social security number from the time you were an employee, do not apply again.

If you have a number but lost your card, file Form SS-5. You will get a new card showing your original number, not a new number.

If your name has changed since you received your social security card, complete Form SS-5 to report a name change.

Social Security Administration (SSA) time limit for posting self-employment income.

Generally, the SSA will give you credit only for self-employment income reported on a tax return filed within 3 years, 3 months, and 15 days after the year you earned the income. If you file your tax return or report a change in your self-employment income after this time limit, the SSA may change its records, but only to remove or reduce the amount. The SSA will not change its records to increase the amount of your self-employment income.

Estimated tax. You may have to pay estimated tax. This depends on how much income tax and SE tax you expect to owe for the year and how much tax will be withheld from your income.

You may have to pay a penalty if you do not pay enough estimated tax by its due date.

You must include the estimated SE tax in your estimated tax payments. However, if at least two-thirds of your gross income in 1998 or 1999 is from farming and you file your Form 1040 and pay all of the tax that is due by March 1, 2000, you do not have to pay any estimated tax. See chapter 2 for more information about estimated tax.

Self-employment tax deduction. You can deduct half of your SE tax in figuring your adjusted gross income. This adjustment only affects your income. It does not affect either your net earnings from self-employment or your SE tax.

To deduct the tax, enter on Form 1040, line 27, the amount shown on the "One-half of self-employment tax" line of Schedule SE.

Who Must Pay Self-Employment Tax

You must pay SE tax and file Schedule SE if you were self-employed and your net earnings from self-employment were \$400 or more.

Who is self-employed? You are self-employed if you carry on a trade or business (such as running a farm) as a sole proprietor, an independent contractor, a member of a partnership, or are otherwise in business for yourself. A trade or business is generally an activity carried on for a livelihood or in good faith to make a profit.



The SE tax rules apply even if you are fully insured under social security or have started receiving benefits.

Share farmers. You are a self-employed farmer under an income-sharing arrangement if both of the following apply.

- 1) You produce a crop or raise livestock on land belonging to another person.

- 2) Your share of the crop or livestock, or the proceeds from their sale, depends on the amount produced.

Your income from the income-sharing arrangement is your SE income.

If you produce a crop or livestock on land belonging to another person and are to receive a specified rate of pay, a fixed sum of money, or a fixed quantity of the crop or livestock, and not a share of the crop or livestock or their proceeds, you may be either self-employed or an employee of the landowner. This will depend on whether the landlord has the right to direct or control your performance of service.

Example. A share farmer produces a crop on land owned by another person, on a 60–40 crop-share basis. Under the terms of their agreement, the share farmer furnishes the labor and half the cost of seed and fertilizer. The landowner furnishes the machinery and equipment used to produce and harvest the crop, and half the cost of seed and fertilizer. The share farmer is provided a house in which to live. The landowner and the share farmer decide how much of the tract should be planted in cotton and how much in other crops. In addition, the landowner is in the hog business and the share farmer agrees to take care of the landowner's hogs in return for ten hogs. The landowner furnishes the feed and other necessities and supervises the care of the hogs.

The share farmer is a self-employed farmer for purposes of the agreement to produce the cotton and other crops, and the share farmer's part of the income from the crops is SE income. The share farmer is an employee for the services performed in caring for the landowner's hogs. The fair market value of the ten hogs received is not SE income but it is taxable for income tax purposes.

4-H Club or FFA project. If your child participates in a 4-H Club or FFA project, any net income the child receives from sales or prizes related to the project may be subject to income tax. Report the net income on line 21 of Form 1040. If necessary, attach a statement showing the gross income and expenses. The net income may not be subject to SE tax if the project is primarily for educational purposes and not for profit, and is completed by the child under the rules and economic restrictions of the sponsoring 4-H or FFA organization. Such a project is generally not considered a trade or business.

Husband and wife partners. You and your spouse may operate a farm as a partnership. (Partnerships are discussed in chapter 2.) If you and your spouse operate a farm as partners, report the farm income and expenses on Form 1065, *U.S. Partnership Return of Income*, and attach separate Schedules K–1 to show each partner's share of the net income. Each spouse must report his or her share of partnership income on Form 1040 and attach separate Schedules SE (Form 1040) showing each spouse's self-employment income.

However, if your spouse is your employee, not your partner, your spouse's wages are subject to social security and Medicare taxes. For more information on employment taxes, see chapter 16.

Self-Employment Income

This part of the chapter explains what is and what is not SE income and landlord participation in farming.

Types of SE income. The following items are included in SE income.

- 1) Taxable patronage dividends (distributions) from cooperatives.
- 2) Government agricultural program payments, including commodity program payments and conservation reserve program (CRP) payments. (If you do not materially participate in farming operations on the land, the CRP payment is not included in SE income.)
- 3) Taxable commodity credit loans.
- 4) Refunds and rebates, if they represent a reduction in a deductible expense item, including a fuel tax credit included in income.
- 5) Prizes or awards on farm produce or livestock.
- 6) Crop damage payments.
- 7) Value of merchandise received for farm products.
- 8) Sales of unharvested crops, if not sold with land that was held more than 1 year.
- 9) Rent you receive if you meet one of the four material participation tests explained later under *Landlord Participation in Farming*.
If you receive the rent as crop shares, you must meet the test at the time the crop shares are produced. However, the crop shares are included in SE income in the year they are converted to money or the equivalent of money.
- 10) Any amounts for depreciation, including any section 179 deduction, recaptured because the business use of the property was reduced to 50% or less (this does not include amounts recaptured on the disposition of property).
- 11) Lost income payments received from insurance or other sources for reducing or stopping farming activities. Even if you are not farming when you receive the payment, it is SE income if it relates to your farm business (even though it is temporarily inactive). A connection exists if it is clear that the payment would not have been made but for your conduct of your farm business.
- 12) Your distributive share of income or loss, including guaranteed payments, from your partnership or LLC's trade or business.

Income that is not SE income. Certain kinds of income are not SE income, even though they are included when figuring your income tax.

- 1) Rent from real estate and from personal property leased with real estate is not SE income. It does not matter if the rent

is received in crop shares, cash, or other property. This rule applies if the landlord does **not** materially participate in the production or management of production of farm products on the land. If the landlord materially participates, see *Landlord Participation in Farming*, later.

- 2) Interest is not SE income unless you receive it in your trade or business, such as interest on accounts receivable.
- 3) Dividends on securities you own are not SE income unless you are a dealer in securities who is not holding the securities for speculation or investment.
- 4) A gain or loss from the disposition of property that is neither stock in trade nor held primarily for sale to customers is not SE income. It does not matter whether the disposition is a sale, exchange, or an involuntary conversion. For example, gains or losses from the disposition of the following types of property are not SE income.
 - a) Investment property.
 - b) Depreciable property or other fixed assets used in your trade or business.
 - c) Livestock held for draft, dairy, breeding, or sporting purposes, and not held primarily for sale, regardless of how long the livestock was held, or whether it was raised or purchased.
 - d) Unharvested crops sold with land held more than one year.
 - e) Timber, coal, or iron ore held for more than one year, if an economic interest was retained, such as a right to receive coal royalties.
A gain or loss from the cutting of timber is not SE income if the cutting is treated as a sale or exchange.
- 5) Wages and salaries received for services performed as an employee and covered by social security or railroad retirement are not SE income.
- 6) Wages paid in kind to you for agricultural labor, such as commodity wages.
- 7) A limited partner's distributive share of partnership income (or loss) is not used to figure net SE income. However, guaranteed payments received for services performed by a limited partner are SE income.
- 8) Retirement income received by the partner from his or her partnership under a written plan is not SE income if all of the following apply.
 - a) The retired partner performs no services for the partnership during the year.
 - b) The retired partner is owed only the retirement payments.
 - c) The retired partner's share (if any) of the partnership capital was fully paid to the retired partner.
 - d) The payments to the retired partner are lifelong, periodic payments.

Landlord Participation in Farming

As a general rule, income and deductions from rentals and from personal property leased with real estate are not included in determining net self-employment income. However, income and deductions from farm rentals and from personal property leased with real estate, including government commodity program payments received by a landowner who rents land, are included if the rental arrangement provides that the landlord will, and he or she does, materially participate in the production or management of production of the farm products on the land.

Crop shares. Rent paid in the form of crop shares is included in self-employment income for the year you sell, exchange, give away, or use the crop shares if you meet one of the four material participation tests at the time the crop shares are produced. Feeding such crop shares to livestock is considered using them. Your gross income for figuring your net earnings from self-employment under the *Farm Optional Method* includes the fair market value of the crop shares when they are used as feed.

Material participation. You materially participate if you have an arrangement with your tenant for your participation and you meet one of the following four tests.

- 1) You do any three of the following.
 - a) Pay, using cash or credit, at least half the direct costs of producing the crop or livestock.
 - b) Furnish at least half the tools, equipment, and livestock used in the production activities.
 - c) Advise or consult with your tenant.
 - d) Inspect the production activities periodically.
- 2) You regularly and frequently make, or take an important part in making, management decisions substantially contributing to or affecting the success of the enterprise.
- 3) You work 100 hours or more spread over a period of 5 weeks or more in activities connected with agricultural production.
- 4) You do things which, considered in their totality, show that you are materially and significantly involved in the production of the farm commodities.

These tests may be used as general guides for determining whether you are materially participating.

Example. Drew Houston agrees to produce a crop on J. Clarke's cotton farm with each receiving half of the proceeds. Clarke furnishes all the necessary equipment and advises Houston when to plant the cotton and when it needs to be chopped, plowed, sprayed, and picked. During the growing season, Clarke inspects the crop every few days to determine whether Houston is properly taking care of the crop. Houston furnishes all labor needed to grow and harvest the crop.

The management decisions made by J. Clarke in connection with the planting, plowing, etc., of the cotton crop and his regular inspection of the crop, along with all the

necessary equipment he furnishes, establish that he participates to a material degree in the cotton production operations. The income Clarke receives from his cotton farm is included in computing his net earnings from self-employment.

Figuring Self-Employment Tax

There are three steps to figure the SE tax you owe.

- 1) Figure your net self-employment income.
- 2) Figure your net earnings from self-employment.
- 3) Multiply your net earnings by the tax rate.

Step 1—Figure Your Net Self-Employment Income

Net SE income usually includes all farm and nonfarm business income less all business deductions allowed for income tax purposes. You must claim all allowable deductions when figuring net SE income. Your net SE income is used to figure your net earnings from self-employment. (See *Step 2—Figure Your Net Earnings From Self-Employment*, later.) You must figure your net income from self-employment by using the same accounting method you use for income tax purposes.

Your net SE income is shown on the lines of the following schedules.

Schedule F (Form 1040)	Line 36
Schedule C (Form 1040)	Line 31
Schedule C-EZ (Form 1040)	Line 3
Schedule K-1 (Form 1065)	Line 15a
Schedule K-1 (Form 1065-B)	Box 9

More than one business. If you have more than one trade or business, you must combine the net profit (or loss) from each business to determine your net SE income. A loss from one business will reduce your profit from another business. File one Schedule SE showing the net SE income, but file a separate Schedule F or C for each business.

Deductions and exemptions. Do **not** reduce your SE income by any of the following.

- Deductions for personal exemptions for yourself, your spouse, or dependents.
- The standard deduction or itemized deductions.
- The net operating loss deduction.
- Nonbusiness deductions (including contributions on your behalf to a pension, profit-sharing plan, annuity plan, Keogh, SIMPLE, or SEP plan).
- The self-employed health insurance deduction.
- The deduction for one-half of your SE tax.

Step 2—Figure Your Net Earnings From Self-Employment

The net SE income subject to SE tax is called net earnings from self-employment.

Minimum earnings subject to SE tax. You must have \$400 or more of net earnings from self-employment to be subject to the tax. For this purpose, net earnings are figured on line 4 of Schedule SE, Section A, or line 4c of Schedule SE, Section B. If your net earnings are less than \$400, you do not have to file Schedule SE (Form 1040) or pay the tax, unless you performed services for a church as an employee and received income of \$108.28 or more.

How to figure net earnings. There are three ways to figure net earnings from self-employment.

- Regular method.
- Farm optional method.
- Nonfarm optional method.

You must use the regular method unless you are eligible to use one or both of the optional methods. See *Figure 15-1*.

Why use the optional methods? You may want to use the optional methods (discussed later) when you have a loss or a small amount of net income from self-employment and any one of the following applies.

- You want to receive credit for social security benefit coverage.
- You incurred child or dependent care expenses for which you could claim a credit. (This method will increase your earned income, which could increase your credit.)
- You are entitled to the earned income credit. (This method will increase your earned income, which could increase your credit.)

Regular Method

Multiply your net SE income by 92.35% (.9235) to get your net earnings under the regular method. See *Short Schedule SE*, line 4, or *Long Schedule SE*, line 4a.

You must use the regular method unless you are eligible to use one or both of the optional methods.

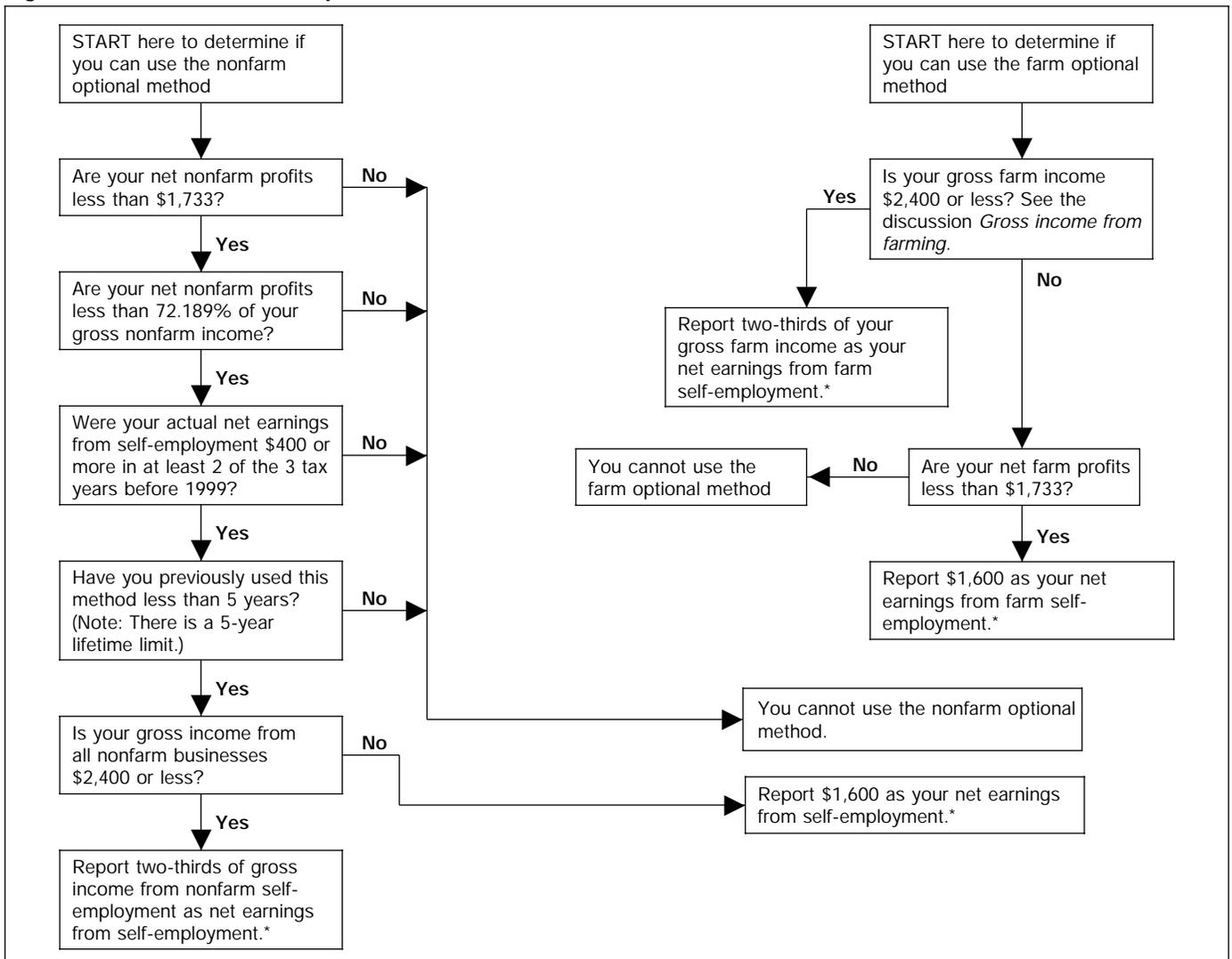
Farm Optional Method

As an individual farmer or as a partner in a farming business, you may be able to use the farm optional method to figure your net earnings from farm self-employment. This method allows you to continue paying SE tax for your social security coverage when your net profit for the year is small or you have a loss.

Optional earnings less than actual earnings. If your net earnings under the farm optional method are less than your actual net earnings, you can still use the farm optional method. For example, your actual net earnings from self-employment are \$425 and your net earnings figured under the farm optional method are \$390. You owe no SE tax if you use the optional method, because your net earnings under the farm optional method are below \$400.

Gross income of \$2,400 or less. If your gross income from farming is \$2,400 or less, you may report two-thirds of this gross income as your net earnings from farm self-employment.

Figure 15–1. Can I Use the Optional Methods?



*If you use both optional methods, see *Using Both Optional Methods* for limits on the amount to report.

Gross income of more than \$2,400. If your gross income from farming is more than \$2,400 and your net farm profit shown on line 36 of Schedule F (Form 1040) or line 15a of Schedule K-1 (Form 1065) is less than \$1,733, you may report \$1,600 as your net earnings from farm self-employment. But if your gross income from farming is more than \$2,400 and your net farm profit is \$1,733 or more, you cannot use the optional method.

Since two-thirds of \$2,400 is \$1,600, this counts for two credits (\$1,600 ÷ \$740) for social security coverage in 1999. You cannot use the full amount of your gross income to determine credits when you are figuring the SE tax on only two-thirds of that amount.

Gross income from farming. Farming income includes what you receive from cultivating the soil or raising or harvesting any agricultural commodities. It also includes income from the operation of a livestock, dairy, poultry, bee, fish, fruit, or truck farm, or plantation, ranch, nursery, orchard, or oyster bed. This includes income you receive in the form of crop shares if you materially participate in production or management of production of the crop.

Your gross income from farming does not include any item listed earlier under *Income*

that is not SE income. If you receive government commodity program payments on land you rent out, do not include these payments unless you meet one of the four material participation tests, explained earlier. Also, do not include any income from a nonfarm business.

Cash method of accounting. If you file your return using the cash method and are not a member of a farming partnership, your gross income from farming will ordinarily be the amount shown on line 11 of Schedule F.

Accrual method of accounting. If you file your return using an accrual method and you are not a member of a farming partnership, your gross income from farming will ordinarily be the amount shown on line 51 of Schedule F.

Gross income from a farm partnership. Your gross income under the farm optional method includes your distributive share of a partnership's gross income from farming.

To determine your distributive share of gross income from a farm partnership, the partnership does the following.

- 1) Figures the partnership's gross income from farming.

- 2) Subtracts any guaranteed payments to partners for services or the use of capital.
- 3) Determines your share of what is left. The gross income that remains after steps (1) and (2) is divided among the partners in the same way they share the ordinary income (or loss) of the partnership, unless the partnership agreement provides otherwise.

The result determined in (3) above is your distributive share of the partnership's gross income from farming. If you have no other gross income from farming, including guaranteed payments discussed next, use this distributive share of gross income to determine whether you can use the farm optional method to figure your net earnings from self-employment.

Guaranteed payments. Any guaranteed payments you receive from a farm partnership are gross income from your farming (not the partnership's). Use the total of these guaranteed payments, your distributive share of gross income from a farm partnership, and any other gross income you receive from farming to determine whether you can use the farm optional method to figure your net earnings from self-employment.

Example. Bill and John are partners and share in ordinary income or loss on a 50–50 basis, with no guaranteed payments. If the partnership has \$3,000 gross income from farming, each would have \$1,500 gross income for purposes of the optional method.

If Bill had been guaranteed \$1,000 without regard to partnership income, his gross income from farming would be \$2,000 (\$1,000 plus 50% of \$2,000). John's gross income would be \$1,000.

Two or more farms. If you run your own farm and are also a partner in a farm partnership, or in any way have gross farm income from more than one farm, you must add your farm income from all farming sources to get your total net earnings from farm self-employment. If you use the farm optional method, you must add all gross income from farming to make the \$2,400 test.

Example. Your gross income from your own farm is \$600 and your distributive share of the gross income from a farm partnership is \$900. Since your gross income from farming is less than \$2,400 (\$1,500), your net earnings from self-employment under the farm optional method are \$1,000 ($\frac{2}{3}$ of \$1,500).

Nonfarm Optional Method

This is an optional method available for determining net earnings from nonfarm self-employment much like the farm optional method.

If you are also engaged in a nonfarm business, you may be able to use this method to compute your net earnings from self-employment from your nonfarm business. You may use this method even if you do not use the farm optional method for determining your net earnings from your farm self-employment and even if you have a net loss from your nonfarm business. For more information about the nonfarm optional method, see Publication 533.

Using Both Optional Methods

You may not combine farming income with nonfarm income from self-employment to figure your net earnings under either of the optional methods. If you use both optional methods, you must add together the net earnings figured under each method to arrive at your total net earnings from self-employment. You may report less than your total actual net earnings from farm and nonfarm self-employment. If you use both optional methods, you may report no more than \$1,600 as your combined net earnings from self-employment.

Step 3—Multiply Your Net Earnings by the Tax Rate

Multiply the net earnings you figured in Step 2 by the tax rate to get your SE tax. The SE tax rate is 15.3% (12.4% social security tax plus 2.9% Medicare tax). It is the same for net earnings figured under each method.

Special rules (explained under *Maximum earnings subject to SE tax and Fiscal tax year*, next) apply to this computation if either of the following applies.

- Your combined wages, tips, and net earnings are more than \$72,600.
- You use a fiscal tax year.

Maximum earnings subject to SE tax. Only the first \$72,600 of your combined wages, tips, and net earnings in 1999 is subject to any combination of the 12.4% social security part of SE tax, social security tax, or railroad retirement (tier 1) tax.

All your combined wages, tips, and net earnings in 1999 are subject to any combination of the 2.9% Medicare part of SE tax, social security tax, or railroad retirement (tier 1) tax.

If your wages and tips are subject to either social security or railroad retirement (tier 1) tax, or both, and total at least \$72,600, you do not have to pay the 12.4% social security part of the SE tax on any of your net earnings. However, **you must pay the 2.9% Medicare part** of the SE tax on all your net earnings.

Fiscal tax year. If you use a tax year other than the calendar year, you must use the tax rate and maximum earnings limit in effect at the beginning of your tax year. Even if the tax rate or maximum earnings limit changes during your tax year, you should continue to use the same rate and limit throughout your tax year.

Regular Method

The following paragraphs explain how to figure the SE tax using net earnings under the regular method.

Net earnings and wages not more than \$72,600. If your net earnings from self-employment plus any wages and tips are not more than \$72,600 and you do not have to use *Long Schedule SE*, use *Short Schedule SE*. On line 5, multiply your net earnings by 15.3% (.153). The result is your SE tax.

Example 1. You have \$30,000 in net SE income and receive no wages subject to social security and Medicare taxes for the year. Multiply the \$30,000 by 0.9235 on *Short Schedule SE* to get your net earnings from self-employment of \$27,705. Your SE tax is 15.3% (.153) of \$27,705, or \$4,238.87.

Example 2. You have \$20,000 in net SE income and receive \$15,000 in wages subject to social security and Medicare taxes for the year. Multiply the \$20,000 by 0.9235 on *Short Schedule SE* to get your net earnings from self-employment of \$18,470. Your SE tax is 15.3% (.153) of \$18,470, or \$2,825.91.

Net earnings more than \$72,600 and no wages. If you had no wages, had net earnings from self-employment of more than \$72,600, and do not have to use *Long Schedule SE*, use *Short Schedule SE*. On line 5, multiply the line 4 net earnings by the 2.9% (.029) Medicare tax and add the result to \$9,002.40 (12.4% of \$72,600). The total is your SE tax.

Example. During 1999, you have \$80,000 in net SE income and receive no wages subject to social security and Medicare taxes. Multiply the \$80,000 by 0.9235 on *Short Schedule SE* to get your net earnings of \$73,880. Since only \$72,600 of your earnings are subject to the social security part of the SE tax, your tax for this part is \$9,002.40 (12.4% of \$72,600).

Since all your net earnings are subject to the Medicare part of the SE tax, multiply \$73,880 by 2.9% (.029) on *Short Schedule SE* for the Medicare part. The result is \$2,142.52. Add this to \$9,002.40 for a total SE tax of \$11,144.92.

Net earnings and wages more than \$72,600. If your net earnings from self-employment plus any wages and tips are more than \$72,600, you must use *Long Schedule SE*. Subtract your total wages and tips from \$72,600 to find the maximum earnings subject to the 12.4% social security part of the tax. If more than zero, multiply the amount by 12.4% (.124). The result is the social security tax amount. Then multiply your net earnings from self-employment by 2.9% (.029). The result is the Medicare tax amount. The total of the social security tax amount and the Medicare tax amount is your SE tax.

Example. During 1999, you have \$80,000 in net SE income and receive \$10,000 in wages subject to social security and Medicare taxes for the year. You figured your net earnings on *Long Schedule SE*, line 4a, to be \$73,880. Next, subtract your wages of \$10,000 from \$72,600, the maximum income subject to the social security part of the SE tax. The result is \$62,600. Since only \$62,600 of your earnings are subject to the social security part of the SE tax, your tax for this part is 12.4% (.124) \times \$62,600, or \$7,762.40.

Since all your net earnings are subject to the Medicare part of the SE tax, multiply all the net earnings from self-employment, \$73,880, by 2.9% (.029) on *Long Schedule SE* for the Medicare part. The result is \$2,142.52. Add this to the \$7,762.40 figured above for total SE tax of \$9,904.92.

Optional Methods

If your net earnings under the farm optional method or the nonfarm optional method are \$400 or more, use *Long Schedule SE* to figure your SE tax.

Effect on taxes. If you use either or both optional methods, you must figure and pay the SE tax due under these methods, even if you would have had a smaller tax or no tax using the regular method.

The optional methods may be used only to figure your SE tax. To figure your income tax, include your actual SE income in gross income, regardless of which method you use to figure SE tax.

Reporting Self-Employment Tax

Use Schedule SE (Form 1040) to report and figure SE tax. Then enter the tax on line 50 of Form 1040, and attach Schedule SE to Form 1040.

 **TIP** Even if you do not have to file Schedule SE, it may be to your benefit to file it and use either optional method in Part II of the Long Schedule SE.

 **CAUTION** If you have to pay SE tax, you must file Form 1040 (with Schedule SE attached) even if you do not otherwise have to file a federal income tax return.

Long Schedule SE. Most taxpayers can use *Short Schedule SE* (Section A) to figure their self-employment tax. However, the following taxpayers must use *Long Schedule SE* (Section B).

- Individuals whose total wages and tips subject to social security (or railroad retirement (tier 1)) tax plus net earnings from self-employment are more than \$72,600.
- Ministers, members of religious orders, and Christian Science practitioners not taxed on earnings from these sources (with IRS consent) who owe SE tax on other earnings.
- Employees who earned wages reported on Form W-2 of \$108.28 or more working for churches or church organizations that elected an exemption from social security and Medicare taxes.
- Individuals with tip income subject to social security and Medicare taxes that was not reported to their employers.
- Individuals who use one of the optional methods to figure SE tax.

Joint returns. If you file a joint return you cannot file a joint Schedule SE (Form 1040). This is true whether one spouse or both spouses have SE income. Your spouse is not considered self-employed just because you are. If both of you have SE income, each of you must complete a separate Schedule SE (Form 1040). Attach both schedules to the joint return. If you and your spouse operate a business as a partnership, see *Husband and wife partners*, earlier, under *Who Must Pay Self-Employment Tax*.

Community income. If any of the income from a farm or business other than a partnership is community income under state law, it is subject to SE tax as the income of the spouse carrying on the trade or business. The identity of the spouse carrying on the trade or business is determined by the facts in each case.

If you are a partner and your distributive share of any income or loss from a trade or business carried on by the partnership is community income, treat your share as your net self-employment income. Do not treat any of your share as net self-employment income of your spouse.

lished in Publication 51, *Circular A, Agricultural Employer's Tax Guide*. There is no wage base limit for wages subject to the Medicare tax.

Electronic deposits of taxes. The threshold that determines whether you must deposit taxes electronically has been increased to \$200,000. You must use the Electronic Federal Tax Payment System (EFTPS) to make electronic deposits of all depository tax liabilities that occur after 1999 if you deposited more than \$200,000 in federal depository taxes in 1998. If you do not meet the \$200,000 threshold, electronic deposits are voluntary, even if you were required to deposit electronically under a previous threshold.

The waiver of the penalty for failure to deposit taxes electronically that was scheduled to expire on July 1, 1999, has been extended to deposit obligations incurred before January 1, 2000, except for taxpayers who deposited more than \$200,000 in taxes in 1998.

See *Electronic deposit requirement* under *Social Security, Medicare, and Withheld Income Taxes*.

Introduction

You are generally required to withhold federal income tax from the wages of your employees. You may also be subject to social security and Medicare taxes under the Federal Insurance Contributions Act (FICA) and federal unemployment tax under the Federal Unemployment Tax Act (FUTA). This chapter includes information about these taxes.

Farmers must also pay self-employment tax on their earnings from farming. See chapter 15 for information on the self-employment tax.

Topics

This chapter discusses:

- Farm employment
- Social security and Medicare taxes
- Income tax withholding
- Federal unemployment tax (FUTA)
- Reporting and paying employment taxes
- Family employees
- Crew leaders
- Advance earned income credit (EIC) payment

Useful Items

You may want to see:

Publication

- 15** Circular E, Employer's Tax Guide
- 15-A** Supplemental Employer's Tax Guide
- 51** Circular A, Agricultural Employer's Tax Guide

Form (and Instructions)

- W-2** Wage and Tax Statement
- W-4** Employee's Withholding Allowance Certificate

- W-5** Earned Income Credit Advance Payment Certificate
- W-9** Request for Taxpayer Identification Number and Certification
- 940 (or 940-EZ)** Employer's Annual Federal Unemployment (FUTA) Tax Return
- 943** Employer's Annual Tax Return for Agricultural Employees
- 8109** Federal Tax Deposit Coupon

See chapter 21 for information about getting publications and forms.

Farm Employment

In general, your employees are farm workers if they do any of the following farm work.

- 1) Raise or harvest agricultural or horticultural products on a farm.
- 2) Care for your farm and equipment, when most of the care is done on a farm.
- 3) Handle, process, or package any agricultural or horticultural commodity if you produced more than half of the commodity.
- 4) Do work related to cotton ginning, turpentine, or gum resin products.
- 5) Do housework in your private home on a farm that is operated for profit.

Workers are your employees if they perform services subject to your control. You are not required to withhold or pay employment taxes for independent contractors who are not your employees. For more information, see Publication 15-A.

If you employ a family of workers, each worker subject to your control (not just the head of the family) is an employee.

Special rules apply to crew leaders. See *Crew Leaders*, later.

Employer identification number. If you have employees, you must have an employer identification number (EIN). You can apply for an EIN either by mail or by telephone. You can get an EIN immediately by calling the Tele-TIN number for the service center for your state. To receive your EIN by mail send a completed SS-4, *Application for Employer Identification Number*, directly to the service center. See the instructions for Form SS-4 for more information. Form SS-4 is available from IRS or Social Security Administration (SSA) offices.

Employee's social security number (SSN). An employee who does not have an SSN should submit Form SS-5, *Application for a Social Security Card*, to the nearest SSA office. Form SS-5 can be obtained from any SSA office or by calling **1-800-772-1213**.

The employee must furnish evidence of age, identity, and U.S. citizenship with the Form SS-5. An employee who is 18 or older must appear in person with this evidence at an SSA office.

INS Form I-9. You must verify that each new employee is legally eligible to work in the United States. This includes completing the Immigration and Naturalization Service (INS) Form I-9, *Employment Eligibility Verification*. You can get the form from INS offices by

16.

Employment Taxes

Important Changes for 2000

Wage limits for social security and Medicare taxes. The maximum wages subject to the social security tax for 2000 will be pub-

calling 1-800-870-3676. Contact the INS at 1-800-375-5283 for any other information.

Social Security and Medicare Taxes

All cash wages you pay to an employee during the year for farm work are subject to social security and Medicare taxes if you meet either of the following tests.

- 1) You pay the employee \$150 or more in **cash** wages during the year for farm work (the \$150 test).
- 2) You pay cash and noncash wages of \$2,500 or more during the year to all your employees for farm work (the \$2,500 test).

If the \$2,500 test for the group is not met, the \$150 test for an individual still applies.

Exceptions. The following wages are not subject to social security and Medicare taxes, even if you pay \$2,500 or more to all your farm workers. These wages, however, do count toward the \$2,500 test for determining social security and Medicare coverage of other farm workers.

- 1) Annual cash wages of less than \$150 paid to a seasonal farm worker. A seasonal farm worker is one who:
 - a) Works as a hand-harvest laborer,
 - b) Is paid piece rates in an operation usually paid on this basis in the region of employment,
 - c) Commutes daily from his or her permanent home to the farm, and
 - d) Worked in agriculture less than 13 weeks in the preceding calendar year.
- 2) Annual cash wages of less than \$1,100 paid to your household employee.

See Circular A for more information on these exceptions. See *Family Employees*, later, for special rules on social security and Medicare tax withholding that apply to your spouse and children.

Religious exemption. An exemption from social security and Medicare taxes is available to members of a recognized sect opposed to insurance. This exemption is available only if both the employee and the employer are members of such a sect.

For more information, see Publication 517, *Social Security and Other Information for Members of the Clergy and Religious Workers*.

Cash wages. Cash wages paid to farm workers are subject to social security tax, Medicare tax, and income tax withholding. Cash wages include checks, money orders, and any kind of money or cash.

Only cash wages subject to social security and Medicare taxes are credited to your employees for social security benefit purposes. Payments not subject to these taxes, such as commodity wages, do not contribute to your employees' social security coverage. For information about social security benefits, contact the Social Security Administration. Internet users can go to www.ssa.gov for more information.

Noncash wages. Noncash wages include food, lodging, clothing, transportation passes, and other goods. Noncash wages, including **commodity wages**, are not subject to social security and Medicare taxes and income tax withholding. However, they **are** subject to these taxes if the substance of the transaction is a cash payment.

The value of noncash wages is reported on Form W-2 in box 1, *Wages, tips, other compensation*, together with cash wages. Do not show noncash wages in box 3, *Social security wages*, or in box 5, *Medicare wages and tips*.

Tax rates and social security wage limit. For 2000, the employer and the employee will continue to pay:

- 1) 6.2% each for social security tax (old-age, survivors, and disability insurance), and
- 2) 1.45% each for Medicare tax (hospital insurance).

Wage limit. The maximum amount of 2000 wages subject to the social security tax will be published in Circular A. There is no limit on wages subject to the Medicare tax. All covered wages are subject to the tax.

Paying employee's share. If you would rather pay the employee's share of social security and Medicare taxes without deducting it from his or her wages, you may do so. If you do not deduct the taxes, you must still pay them. The employee's share of social security or Medicare tax that you pay is additional income to the employee. You must include it on the employee's Form W-2 in box 1, but do not count it as social security and Medicare wages (boxes 3 and 5 on Form W-2) or as wages for federal unemployment (FUTA) tax purposes.

Publication 51, Circular A. Circular A contains additional information about social security and Medicare taxes. See chapter 21 for information about getting forms and publications from the IRS.

Income Tax Withholding

If the cash wages you pay farm workers are subject to social security and Medicare taxes, they are also subject to income tax withholding. Withhold income tax on noncash payments only if you and the employee agree to do so. The amount to withhold is figured on gross wages without taking out social security and Medicare taxes, union dues, insurance, etc. You can use one of several methods to determine the amount to withhold. The methods are described in Circular A.

Generally, the amount of income tax you withhold is based on the employee's marital status and withholding allowances claimed on the employee's Form W-4. In general, an employee can claim withholding allowances on Form W-4 equal to the number of exemptions the employee will be entitled to claim on his or her tax return. An employee may also be able to claim a special withholding allowance and allowances for estimated deductions and credits.

Do not withhold income tax from the wages of an employee who, by filing Form

W-4, certifies that he or she had no income tax liability last year and anticipates no liability for the current year.

Circular A contains tables showing the correct amount of income tax you should withhold. It also contains additional information about income tax withholding. See chapter 21 for information about getting Circular A and Form W-4.

Form W-4 for 2000. Farmers who have employees should make the 2000 Form W-4 available to their employees and encourage them to check their income tax withholding for 2000. Those employees who owed a large amount of tax or received a large refund for 1999 may want to file a new Form W-4.

Nonemployee compensation. Generally, you are not required to withhold tax on payments for services to individuals who are not your employees. However, you may be required to report these payments on Form 1099-MISC, *Miscellaneous Income*, and to withhold under the backup withholding rules. See *Information Returns* in chapter 2 for information.

Federal Unemployment (FUTA) Tax

You must pay FUTA tax if you meet **either** of the following tests.

- 1) You paid cash wages of \$20,000 or more to farm workers in any calendar quarter during the current or preceding calendar year.
- 2) You employed 10 or more farm workers for some part of at least 1 day during any 20 or more different calendar weeks during the current or preceding calendar year.

These rules do not apply to your spouse, parents, or children under age 21. See *Family Employees*, later.

Alien farm workers. To determine whether you meet either test above, count wages you paid to aliens admitted on a temporary basis to the United States to perform farm work (also known as "H-2(A)" visa workers). However, wages paid to these workers are exempt from FUTA tax.

Commodity wages. Payments in kind for farm labor are not considered wages. Do not count them to figure whether you are subject to FUTA tax or to figure how much tax you owe.

Tax rate and credit. The gross FUTA tax is 6.2% of the first \$7,000 cash wages you pay each employee. However, you are given a credit of up to 5.4% for the state unemployment tax you pay. The net tax rate, therefore, can be as low as 0.8% (6.2% - 5.4%). If your state tax rate (experience rate) is less than 5.4%, you are still allowed the full 5.4% credit.

You cannot take the credit for any state tax you do not pay. If you are exempt from state unemployment tax for any reason, the

full 6.2% rate applies. See the instructions for Form 940 for additional information.

More information. For more information on FUTA tax, see Circular A. For information on depositing FUTA tax, see *FUTA Tax*, later.

Reporting and Paying Employment Taxes

There are special rules for reporting and paying employment taxes.

Penalties. If you pay your taxes late, you may have to pay a penalty as well as interest on any overdue amounts.

There are also civil and criminal penalties for intentionally not paying taxes, filing a false tax return, or filing no return at all.

Trust fund recovery penalty. If you are responsible for withholding, accounting for, depositing, or paying withholding taxes and **willfully** fail to do so, you can be held liable for a penalty equal to the tax not paid, plus interest. A responsible person can be an officer of a corporation, a partner, a sole proprietor, or an employee of any form of business. A trustee or agent with authority over the funds of the business can also be held responsible for the penalty.

"Willfully" in this case means voluntarily, consciously, and intentionally. Paying other expenses of the business instead of the taxes due is considered to be acting willfully.

Social Security, Medicare, and Withheld Income Taxes

You must withhold income, social security, and Medicare taxes required to be withheld from the salaries and wages of your employees. You are liable for the payment of these taxes to the federal government whether or not you collect them from your employees. If, for example, you withhold less than the correct tax from an employee's wages, you are still liable for the full amount. You must also pay your share of social security and Medicare taxes.

Form 943. Report withheld income tax and social security and Medicare taxes on Form 943. The 1999 form is due by January 31, 2000 (or February 10 if the tax was timely deposited in full).

Deposits. You will generally have to make tax deposits if you are liable for \$1,000 or more of social security and Medicare taxes and withheld income tax during the year. You must deposit both your part and your employees' part of social security and Medicare taxes and withheld income tax before you file Form 943.

Electronic deposit requirement. You may have to deposit all employment taxes using the Electronic Federal Tax Payment System (EFTPS). You can make deposits electronically with EFTPS using your telephone.

You must use EFTPS to make deposits of all depository tax liabilities (including social security, Medicare, withheld income, excise, and corporate income taxes) you incur after 1999 if you deposited more than \$200,000 in federal depository taxes in 1998. If you first meet the \$200,000 threshold in 1999 or a

later year, you must begin depositing using EFTPS in the second succeeding year. Once you must deposit electronically because you meet the \$200,000 threshold, you must continue to make deposits using EFTPS.

Electronic deposits are voluntary if you do not meet the \$200,000 threshold, even if you had to deposit electronically before 2000 because you met a previous threshold. To enroll in EFTPS, call 1-800-945-8400 or 1-800-555-4477. For general information about EFTPS, call 1-800-829-1040.

If you must use EFTPS but fail to do so, you may be subject to a 10% penalty. This penalty has been waived for deposit obligations incurred before January 1, 2000, except for taxpayers who deposited more than \$200,000 in 1998.

More information. For more information on deposit rules and penalties for late deposits, see Circular A.

Form W-2. By January 31, you must furnish each employee a Form W-2 showing total wages for the previous year and total income tax and social security and Medicare taxes withheld. However, if an employee stops working for you and requests the form earlier, you must give it to the employee within 30 days of the **later** of the following dates.

- 1) The date the employee requests the form.
- 2) The date you make your final payment of wages to the employee.

See *Form W-2* under *Other Forms* in chapter 2.

FUTA Tax

The federal unemployment (FUTA) tax is imposed on you as the employer. It must not be collected or deducted from the wages of your employees.

Form 940. FUTA tax is reported on Form 940, *Employer's Annual Federal Unemployment (FUTA) Tax Return*. This form covers one calendar year and is generally due January 31 after the year ends. However, you may have to make deposits of FUTA tax before filing the return. If you deposit the tax on time and in full, you have an extra 10 days to file — until February 10.

Form 940-EZ. You can use Form 940-EZ, a simplified version of Form 940, if you meet all the following tests.

- 1) You paid state unemployment tax (contributions) to only one state.
- 2) You paid the state tax by the due date of Form 940 or 940-EZ.
- 3) All wages taxable for FUTA tax were also taxable for state unemployment tax.

Deposits. If at the end of any calendar quarter you owe, but have not yet deposited, more than \$100 in FUTA tax for the year, you must make a deposit by the end of the next month. See *Social Security, Medicare, and Withheld Income Taxes*, earlier, for a discussion of the requirement for making deposits electronically.

If the undeposited tax is \$100 or less at the end of a quarter, you do not have to deposit it. You must add it to the tax for the next quarter. If the total undeposited tax is more than \$100 at the end of the next quarter, a

deposit will be required. If the total undeposited tax at the end of the 4th quarter is less than \$100, you can either make a deposit or pay it with your return by the January 31 due date.

See Circular A for more information on depositing FUTA tax.

Family Employees

Child employed by parent. Payments for the services of a child under age 18 who works for his or her parent in a trade or business (including a farm) are not subject to social security and Medicare taxes. However, see *Covered services of a child or spouse*, below. Payments for the services of a child under age 21 who works for his or her parent, whether or not in a trade or business, are not subject to federal unemployment (FUTA) tax. Although not subject to social security, Medicare, or FUTA tax, the child still may be subject to income tax withholding.

One spouse employed by another. The wages for the services of an individual who works for his or her spouse in a trade or business are subject to income tax withholding and social security and Medicare taxes, but not FUTA tax. However, the services of one spouse employed by another in other than a trade or business, such as domestic service in a private home, are not subject to social security and Medicare taxes or FUTA tax.

Covered services of child or spouse. The wages for the services of a child or spouse are subject to income tax withholding as well as social security, Medicare, and FUTA taxes if he or she works for:

- 1) A corporation, even if it is controlled by the child's parent or the individual's spouse.
- 2) A partnership, even if the child's parent is a partner, unless each partner is a parent of the child.
- 3) A partnership, even if the individual's spouse is a partner.
- 4) An estate, even if it is the estate of a deceased parent.

In these situations, the child or spouse is considered to work for the corporation, partnership, or estate, not the parent or other spouse.

Parent employed by child. The wages for the services of a parent employed by his or her child in a trade or business are subject to income tax withholding and social security and Medicare taxes. Social security and Medicare taxes do not apply to wages paid to a parent for services not in a trade or business, but they do apply to domestic services if:

- 1) The parent cares for a child who lives with a son or daughter and who is under age 18 or requires adult supervision for at least 4 continuous weeks in a calendar quarter due to a mental or physical condition, and
- 2) The son or daughter is a widow or widower, divorced, or married to a person who, because of a physical or men-

tal condition, cannot care for the child during such period.

Wages paid to a parent employed by his or her child are not subject to FUTA tax, regardless of the type of services provided.

Crew Leaders

Farmers can employ or use the services of crew leaders to provide them with farm labor.

Social security and Medicare taxes. For social security and Medicare tax purposes, the crew leader is considered the employer of the workers if the crew leader does all of the following.

- 1) Furnishes workers to do farm labor.
- 2) Pays (either on his or her own behalf or on behalf of the farmer) the workers for their farm labor.
- 3) Has not entered into a written agreement with the farmer under which the crew leader is designated as an employee of the farmer.

Federal income tax. If the crew leader is considered the employer for social security and Medicare tax purposes, the crew leader is considered the employer for federal income tax purposes.

Federal unemployment tax. For federal unemployment tax purposes, the crew leader is considered the employer of the workers if, in addition to the earlier requirements:

- 1) The crew leader is registered under the Migrant and Seasonal Agricultural Worker Protection Act, or
- 2) Substantially all crew members operate or maintain mechanized equipment provided by the crew leader as part of the service to the farmer.

The farmer is considered the employer of workers furnished by a crew leader in all other situations. In addition, the farmer is considered the employer of workers furnished by a registered crew leader if the workers are the employees of the farmer under the common-law test. For example, some farmers employ individuals to recruit farm workers exclusively for them. Although these individuals may be required to register under the Migrant and Seasonal Agricultural Worker Protection Act, the workers are employed directly by the farmer. The farmer is considered to be the employer in these cases. For information concerning who is a common-law employee, see section 1 of Publication 15-A.

Advance Earned Income Credit (EIC) Payment

An employee who is eligible for the earned income credit (EIC) and who has a qualifying child is entitled to receive EIC payments with his or her pay during the year. To get these payments, the employee must give you a properly completed **Form W-5, Earned Income Credit Advance Payment Certificate**. You are required to make advance EIC pay-

ments to employees who give you a properly completed Form W-5, except that you are not required to make these payments to farmworkers paid on a daily basis.

The payment is added to the employee's pay each payday. It is figured from tables in Circular A. You reduce your liability for income tax withholding, social security tax, and Medicare tax by the total advance EIC payments made. For more information, see Circular A.

Notification. You must notify each employee who worked for you at any time during the year and from whom you did not withhold any income tax about the EIC. However, you do not have to notify employees who claim exemption from withholding on Form W-4.

You meet the notification requirement by giving each employee any one of the following.

- 1) Form W-2, which contains the notification on the back of Copy B.
- 2) A substitute Form W-2 with the exact EIC wording shown on the back of copy B of Form W-2.
- 3) Notice 797, *Possible Federal Tax Refund Due to the Earned Income Credit (EIC)*.
- 4) Your own written statement with the exact wording of Notice 797.

For more information about notification requirements and claiming the EIC, see Notice 1015, *Have You Told Your Employees About the Earned Income Credit (EIC)?*

17.

Retirement Plans

Important Reminder

Contributions to a SEP-IRA or a SIMPLE IRA. A SEP-IRA or a SIMPLE IRA *cannot* be designated as a Roth IRA. Contributions to a SEP-IRA or a SIMPLE IRA will not affect the amount that an individual can contribute to a Roth IRA. For information about Roth IRAs, see Publication 590.

Introduction

This chapter discusses retirement plans that you can set up and maintain for yourself and your employees. Retirement plans are savings plans that offer you tax advantages to set aside money for your own and your employees' retirement.

In general, a sole proprietor or a partner is treated as an employee for participating in a retirement plan.

SEP, SIMPLE, and qualified plans offer you and your employees a tax favored way to save for retirement. You can deduct contributions you make to the plan for your em-

ployees. If you are a sole proprietor, you can deduct contributions you make to the plan for yourself. You can also deduct trustees' fees if contributions to the plan do not cover them. Earnings on the contributions are generally tax free until you or your employees receive distributions from the plan in later years.

Under some plans, employees can have you contribute limited amounts of their before-tax pay to a plan. These amounts (and the earnings on them) are generally tax free until your employees receive distributions from the plan in later years.

In general, individuals who are employed can also set up and contribute to individual retirement arrangements (IRAs).

Topics

This chapter discusses:

- Simplified employee pensions (SEPs)
- SIMPLE retirement plans
- Qualified plans
- Individual retirement arrangements (IRAs)

Useful Items

You may want to see:

Publication

- 15** Circular E, Employer's Tax Guide
- 533** Self-Employment Tax
- 560** Retirement Plans for Small Business (SEP, SIMPLE, and Keogh Plans)
- 575** Pension and Annuity Income
- 590** Individual Retirement Arrangements (IRAs) (Including Roth IRAs and Education IRAs)

Form (and Instructions)

- W-2** Wage and Tax Statement
- 5305-SEP** Simplified Employee Pension-Individual Retirement Accounts Contribution Agreement
- 5305A-SEP** Salary Reduction and Other Elective Simplified Employee Pension-Individual Retirement Accounts Contribution Agreement
- 5304-SIMPLE** Savings Incentive Match Plan for Employees of Small Employers (SIMPLE) (Not subject to the Designated Financial Institution Rules)
- 5305-SIMPLE** Savings Incentive Match Plan for Employees of Small Employers (SIMPLE) (for Use With a Designated Financial Institution)
- 5500-EZ** Annual Return of One-Participant (Owners and Their Spouses) Retirement Plan

See chapter 21 for information about getting publications and forms.

Simplified Employee Pension (SEP)

A simplified employee pension (SEP) is a written plan that allows you to make deduct-

ible contributions toward your own and your employees' retirement without getting involved in more complex retirement plans. A corporation also can have a SEP and make deductible contributions toward its employees' retirement. But some advantages available to qualified plans, such as the special tax treatment that may apply to lump-sum distributions, do not apply to SEPs.

Under a SEP, you make the contributions to a traditional individual retirement arrangement (called a SEP-IRA).

SEP-IRAs are set up for, at a minimum, each *eligible employee*. A SEP-IRA may have to be set up for a *leased employee*, but need not be set up for an *excludable employee*. For more information, see Publication 560.

Form 5305-SEP. You may be able to use Form 5305-SEP in setting up your SEP.

Contribution Limits

Contributions you make for a year to a common-law employee's SEP-IRA are limited to the lesser of \$30,000 or 15% of the employee's compensation. Compensation generally does not include your contributions to the SEP, but does include certain elective deferrals unless you choose not to include them.

Annual compensation limit. You generally cannot consider the part of compensation of an employee that is over \$160,000 when you figure your contribution limit for that employee.

More than one plan. If you also contribute to a defined contribution retirement plan (defined later), annual additions to an account are limited to the lesser of \$30,000 or 25% of the participant's compensation. When you figure this limit, your contributions to all of the plans must be added. Because a SEP is considered a defined contribution plan for purposes of this limit, your contributions to a SEP must be added to your contributions to defined contribution plans.

Reporting on Form W-2. Do not include SEP contributions on Form W-2 unless there are contributions under a salary reduction arrangement.

Contributions for yourself. The annual limits on your contributions to a common-law employee's SEP-IRA also apply to contributions you make to your own SEP-IRA. However, special rules apply when you figure your maximum deductible contribution. See *Deferral of contributions for yourself*, later.

Deduction Limits

The most you can deduct for employer contributions for common-law employees is 15% of the compensation paid to them during the year from the business that has the plan.

Deduction of contributions for yourself. When figuring the deduction for employer contributions made to your own SEP-IRA, compensation is your net earnings from self-employment minus the following amounts.

- 1) The deduction for one-half of your self-employment tax.
- 2) The deduction for contributions to your own SEP-IRA.

The deduction for contributions to your own SEP-IRA and your net earnings depend

on each other. For this reason, you determine the deduction for contributions to your own SEP-IRA indirectly by reducing the contribution rate called for in your plan. Use the *Rate Worksheet for Self-Employed* shown under *Qualified Plan* to figure the rate.

SEP and profit-sharing plans. If you also contributed to a qualified profit-sharing plan, you must reduce the 15% deduction limit for that plan by the allowable deduction for contributions to the SEP-IRAs of those participating in both the SEP plan and the profit-sharing plan.

SEP and other qualified plans. If you also contributed to any other type of qualified plan, treat the SEP as a separate profit-sharing plan when applying the overall 25% deduction limit described in section 404(h)(3) of the Internal Revenue Code.

Employee contributions. Employees can also make contributions of up to \$2,000 to their SEP-IRAs independent of the employer's SEP contributions. However, the employee's deduction for IRA contributions may be reduced or eliminated because the employee is covered by an employer retirement plan (the SEP plan). See Publication 590 for details.

Salary Reduction Simplified Employee Pension (SARSEP)



An employer is no longer allowed to set up a SARSEP. However, participants in a SARSEP set up before 1997 (including employees hired after 1996) can continue to have their employer contribute part of their pay to the plan.

A SEP can include a salary reduction (elective deferral) arrangement. Under the arrangement, employees can choose to have you contribute part of their pay to their SEP-IRAs. The income tax on the contribution is deferred. This choice is called an elective deferral, which remains tax free until distributed (withdrawn).

This choice is available only if all the following requirements are met.

- At least 50% of your eligible employees choose the salary reduction arrangement.
- You had 25 or fewer eligible employees (or employees who would have been eligible if you had maintained a SEP) at any time during the preceding year.
- Each eligible **highly compensated employee's** deferral percentage each year is no more than 125% of the average deferral percentage (ADP) of all non-highly compensated employees eligible to participate (the **ADP test**). See Publication 560 for the definition of a highly compensated employee and information on how to figure the deferral percentage.

Limit on elective deferrals. In general, the total income an employee can defer under a salary reduction arrangement included in a SEP and certain other elective deferral arrangements for 1999 is limited to the lesser of \$10,000 or 15% of the participant's compensation (as defined in Publication 560). This limit applies only to amounts that reduce the employee's pay, not to any contributions from employer funds.

Employment taxes. Elective deferrals that meet the ADP test are not subject to income tax in the year of deferral, but they are included in wages for social security, Medicare, and unemployment (FUTA) tax purposes.

Reporting SEP Contributions on Form W-2

Your contributions to an employee's SEP-IRA are excluded from the employee's income. Unless there are contributions under a salary reduction arrangement, do not include these contributions in your employee's wages on Form W-2 for income, social security, or Medicare tax purposes. Your SEP contributions under a salary reduction arrangement are included in your employee's Form W-2 for social security and Medicare tax purposes only.

Example. Jim's salary reduction arrangement calls for a deferral contribution rate of 10% of his salary to be contributed by his employer as an elective deferral to Jim's SEP-IRA. Jim's salary for the year is \$30,000 (before reduction for the deferral). The employer did not choose to treat deferrals as compensation under the arrangement. To figure the deferral amount, the employer multiplies Jim's salary of \$30,000 by 9.0909%, the reduced rate equivalent of 10%, to get the deferral amount of \$2,727.27. (This method is the same one that you, as a self-employed person, use to figure the contributions you make on your own behalf.) See *Rate Worksheet for Self-Employed* under *Qualified Plan*.

On Jim's Form W-2, his employer shows total wages of \$27,272.73 (\$30,000 minus \$2,727.27), social security wages of \$30,000, and Medicare wages of \$30,000. Jim reports \$27,272.73 as wages on his individual income tax return.

If his employer chooses to treat deferrals as compensation under the salary reduction arrangement, Jim's deferral amount would be \$3,000 (\$30,000 x 10%). In this case, the employer uses the rate called for under the arrangement (not the reduced rate) to figure the deferral and the ADP test. On Jim's Form W-2, the employer shows total wages of \$27,000 (\$30,000 - \$3,000), social security wages of \$30,000, and Medicare wages of \$30,000. Jim reports \$27,000 as wages on his return.

In either case, the maximum deductible contribution would be \$3,913.05 (\$30,000 x 13.0435%).

For more information on employer withholding requirements, see Publication 15.

For more information on SEPs, see Publication 560.

SIMPLE Retirement Plan

A SIMPLE plan (Savings Incentive Match Plan for Employees) is a written salary reduction arrangement that allows a small business (an employer with 100 or fewer employees) to make elective contributions to a SIMPLE retirement account on behalf of each eligible employee. An eligible employer (defined later) is generally not allowed to maintain another retirement plan.

Setting Up a SIMPLE Plan

If an employer has 100 or fewer employees who were paid at least \$5,000 by the employer in the preceding year, the employer may be able to set up a SIMPLE retirement plan on behalf of eligible employees. The plan can be either of the following.

- A SIMPLE IRA for each eligible employee.
- Part of a qualified cash or deferred arrangement (a 401(k) plan).

The SIMPLE plan generally must be the only retirement plan of the employer to which contributions are made, or benefits are accrued, for service in any year beginning with the year the SIMPLE plan becomes effective.

Contributions to a SIMPLE plan are deductible by the employer and excluded from the gross income of the employee.

Definitions

SIMPLE retirement account. The SIMPLE retirement account of an *eligible employee* is an individual retirement plan that can be either an individual retirement account or an individual retirement annuity, as described in Publication 590. Employees' rights to the contributions cannot be forfeited.

A SIMPLE plan can also be set up as a 401(k) plan. See Publication 560 for information on how to adopt a SIMPLE plan as part of a 401(k) plan.

Qualified salary reduction arrangement. This is an arrangement that allows an eligible employee to choose, during the 60-day period before the beginning of any year, to have the employer make contributions (elective deferrals) to a SIMPLE retirement account on his or her behalf. An eligible employee may also stop making elective deferrals at any time during the year. The employer must match the employee's contributions or make nonelective contributions. No other types of contributions are allowed under a qualified salary reduction arrangement.

Eligible employer. Any employer who has 100 or fewer *eligible employees* in any year and does not maintain another employer-sponsored retirement plan can set up a SIMPLE plan.

Eligible employee. Any employee who receives at least \$5,000 in compensation during any 2 years preceding the plan year and is expected to earn at least \$5,000 during the calendar year can choose to have his or her employer make contributions to a SIMPLE retirement account under a qualified salary reduction arrangement.

Compensation. Compensation is the total wages required to be reported on Form W-2 plus elective deferrals. For a self-employed individual, compensation is net earnings from self-employment. It does not include any contribution made to the SIMPLE plan.

TIP Any SIMPLE elective deferrals made for an employee under a salary reduction arrangement are included in wages on the employee's Form W-2 for social security and Medicare tax purposes only.

Contribution Limits

Contributions include employee elective deferrals and employer contributions. The employer must satisfy one of two contribution formulas: the matching contribution formula or a 2% nonelective contribution. No other contributions can be made to the SIMPLE plan. These contributions, which are deductible by the employer, must be made timely.

Employee elective deferral limit. The amount that the employee chooses to have the employer contribute to a SIMPLE retirement account on his or her behalf (elective deferrals) must not exceed \$6,000 for any year and must be expressed as a percentage of the employee's compensation.

Dollar-for-dollar employer matching contributions. The employer must match all eligible employees' elective contributions on a dollar-for-dollar basis, up to 3% of the employee's compensation.

CAUTION If the employer chooses a matching contribution of less than 3%, the percentage cannot be less than 1%. The employer must notify the employee of the lower percentage within a reasonable time before the 60-day election period for the calendar year. A percentage of less than 3% cannot be chosen for more than 2 years during a 5-year period.

Nonelective contributions. In place of the dollar-for-dollar matching contributions, the employer can choose to make nonelective contributions of 2% of compensation on behalf of each eligible employee. Only \$160,000 of the employee's compensation can be taken into account when figuring the contribution limit.

CAUTION An employer who chooses the 2% contribution formula must timely notify the employee (within the 60-day election period described earlier).

Time limits for contributing funds. The employer must make the contribution to the SIMPLE account within 30 days after the end of the month for which the payments to the employee were deferred. The employer's matching contributions must be made by the due date of the tax return, including extensions, for the year.

Distributions (Withdrawals)

Distributions from a SIMPLE retirement account are subject to the IRA rules and are generally includible in income when withdrawn. Tax-free rollovers can be made from one SIMPLE account into another SIMPLE account or into an IRA. Early withdrawals generally are subject to a 10% (or 25%) additional tax.

Exceptions. A rollover to an IRA can be made tax free only after participating 2 years in the SIMPLE plan. A 25% additional tax for early withdrawal applies if funds are withdrawn within 2 years of beginning participation.

Employee notification. The employer must notify each eligible employee of his or her opportunity to make contributions under a SIMPLE plan. The employer must also notify all eligible employees of the contribution alternative that was chosen. This information

must be provided before the beginning of the employee's 60-day election period.

More information. This chapter does not cover all the rules and exceptions that apply to a SIMPLE IRA or a SIMPLE 401(k) plan. See Publication 560 for additional information on excludable employees, reporting and disclosure requirements, and other rules. Also, see Form 5304-SIMPLE or Form 5305-SIMPLE and their instructions.

See Publication 590 for information about IRA rules, including those on the tax treatment of distributions, rollovers, required distributions, and income tax withholding.

Qualified Plan

A qualified retirement plan is a written plan you can set up for the exclusive benefit of your employees and their beneficiaries. It is sometimes called a Keogh or HR-10 plan.

You, or you and your employees, can make contributions to the plan. If your plan meets the qualification requirements, you can generally deduct your contributions to the plan. For more information, see Publication 560.

Your employees generally are not taxed on your contributions or increases in the plan's assets until they are distributed to them. However, certain loans made from qualified employer plans are treated as taxable distributions. For more information, see Publication 575.

Qualification requirements. To be a qualified plan, the plan must meet many requirements. They include the following.

- Who must be covered by the plan.
- How contributions to the plan are to be invested.
- How contributions to the plan and benefits under the plan are to be determined.
- How much of an employee's interest in the plan must be guaranteed (vested).

For more information, see Publication 560.

More than one job. If you are self-employed and also work for someone else, you can participate in retirement plans for both jobs. Generally, your participation in a retirement plan for one job does not affect your participation in a plan for the other job. However, if you have an IRA, you may not be allowed to deduct some or all of your IRA contributions. See Publication 590.

Kinds of Qualified Plans

There are two basic kinds of qualified retirement plans: defined contribution and defined benefit.

Defined Contribution Plan

This plan provides for a separate account for each person covered by the plan. Benefits are based only on amounts contributed to or allocated to each account.

There are **three types** of defined contribution plans: profit-sharing, stock bonus, and money purchase pension.

Profit-sharing plan. This plan lets your employees or their beneficiaries share in the profits of your business. The plan must have

a definite formula for allocating the contributions made to the plan among the participating employees and for distributing the funds in the plan.

Stock bonus plan. This plan is similar to a profit-sharing plan, but it can only be set up by a corporation. Benefits are payable in stock of the employer.

Money purchase pension plan. Under this plan, your contributions are a stated amount or are based on a stated formula that is not subject to your discretion. For example, your formula could be 10% of each participating employee's compensation. Your contributions to the plan are not based on your profits.

Defined Benefit Plan

This is any plan that is not a defined contribution plan. In general, a qualified defined benefit plan must provide for set benefits and your contributions to the plan are based on actuarial assumptions. Generally, you will need continuing professional help to administer a defined benefit plan.

Plan Approval

You must adopt a written plan. The Internal Revenue Service (IRS) will issue a determination or opinion letter regarding the plan's qualification. The determination or opinion of the IRS will be based on how the plan is written, not on how it operates.

You are not required to request a determination or opinion letter to get all the tax benefits of a plan. But, if your plan does not have a determination letter, you may want to request one to ensure that your plan meets the requirements for tax benefits.

A request for a determination, opinion, or ruling letter can be complex. You may need professional help to complete the request. Also, the IRS charges a fee for issuing these letters. Attach **Form 8717, User Fee for Employee Plan Determination Letter Request**, to your application.

Master and prototype plans. It may be easier for you to adopt an IRS-approved existing master or prototype retirement plan than to set up your own original plan. Master and prototype plans can be provided by the following sponsoring organizations.

- Trade or professional organizations.
- Banks (including some savings and loan associations and federally insured credit unions).
- Insurance companies.
- Mutual funds.

Adoption of a master or prototype plan does not mean that your plan is automatically qualified. It must still meet all of the qualification requirements stated in the law.

Deduction Limit

The limit on your deduction for contributions to a qualified plan depends on the kind of plan you have.

 *In figuring the deduction for contributions to these plans, you cannot take into account any contributions or benefits that are more than the limits dis-*

ussed under Limits on Contributions and Benefits in Publication 560.

Defined contribution plans. The deduction limit for a defined contribution plan depends on whether it is a profit-sharing plan or a money purchase pension plan.

Profit-sharing plan. Your deduction for contributions to a profit-sharing plan cannot be more than **15%** of the compensation from the business paid (or accrued) during the year to the common-law employees participating in the plan. You must reduce this limit in figuring the deduction for contributions you make for your own account. See *Deduction of contributions for yourself*, later.

Money purchase pension plan. Your deduction for contributions to a money purchase pension plan is generally limited to **25%** of the compensation from the business paid during the year to a participating common-law employee. You must reduce this limit in figuring the deduction for contributions you make for yourself, as discussed later.

Defined benefit plans. An actuary must figure the deduction for contributions to a defined benefit plan since it is based on actuarial assumptions and computations.

Deduction of contributions for yourself. To take a deduction for contributions you make to a plan for yourself, you must have *net earnings* from the trade or business for which the plan was set up.

Limit on deduction. If the qualified plan is a profit-sharing plan, your deduction for yourself is limited to the lesser of \$30,000 or 13.0435% (15% reduced as discussed below) of your net earnings from the trade or business that has the plan. If the plan is a money purchase plan, the deduction is limited to the lesser of \$30,000 or 20% (25% reduced as discussed below) of your net earnings.

Net earnings. Your net earnings must be from self-employment in a trade or business in which your personal services are a material income-producing factor. If you are a partner who only contributed capital and did not perform personal services, you cannot participate in the partnership's plan. Your net earnings do not take into account tax-exempt income (or deductions related to that income), other than foreign earned income and foreign housing cost amounts.

Your net earnings are your business gross income minus the allowable deductions from that business. Allowable deductions include contributions to the plan for your common-law employees and your other business expenses.

If you are a partner other than a limited partner, your net earnings include your distributive share of the partnership income or loss (other than separately computed items such as capital gains and losses) and any guaranteed payments you receive from the partnership. If you are a limited partner, your net earnings include only guaranteed payments you receive for services rendered to or for the partnership. For more information, see *Partners* under *Who Must Pay Self-Employment Tax* in Publication 533.

Net earnings do not include income passed through to shareholders of S corporations.

Adjustments. You must reduce your net earnings by the deduction for one-half of your self-employment tax. Also, net earnings must

be reduced by the deduction for contributions you make for yourself. This reduction is made indirectly, as explained next.

Net earnings reduced by adjusting contribution rate. You must reduce net earnings by your deduction for contributions for yourself. The deduction and the net earnings depend on each other. You can make the adjustment to your net earnings indirectly by reducing the contribution rate called for in the plan and using the reduced rate to figure your maximum deduction for contributions for yourself.

Annual compensation limit. You generally cannot take into account more than \$160,000 of your compensation in figuring your contribution to a defined contribution plan.

Figuring Your Deduction

Use the following worksheet to find the reduced contribution rate for yourself. Make no reduction to the contribution rate for any common-law employees.

Rate Worksheet for Self-Employed

- 1) Plan contribution rate as a decimal (10½% = .105)
- 2) Rate in line 1 plus 1 (.105 + 1 = 1.105)
- 3) Self-employed rate as a decimal rounded to at least 3 decimal places (line 1 ÷ line 2)

Now that you have figured your self-employed rate, you can figure your maximum deduction for contributions for yourself by completing the following steps.

Deduction Worksheet for Self-Employed

- Step 1**
Enter the self-employed rate shown on line 3 above
- Step 2**
Enter your net earnings (net profit) from line 31, Schedule C (Form 1040); line 3, Schedule C-EZ (Form 1040); line 36, Schedule F (Form 1040); or line 15a, Schedule K-1 (Form 1065)
- Step 3**
Enter your deduction for self-employment tax from line 27, Form 1040
- Step 4**
Subtract step 3 from step 2 and enter the result
- Step 5**
Multiply step 4 by step 1 and enter the result
- Step 6**
Multiply \$160,000 by your plan contribution rate. Enter the result, but not more than \$30,000
- Step 7**
Enter the smaller of step 5 or step 6. This is your **maximum deductible contribution**. Enter your deduction on line 29, Form 1040

Example. You are a self-employed farmer and you have employees. The terms of your plan provide that you contribute 10½% (.105) of your compensation (defined earlier) and 10½% of your common-law employees' compensation. Your net earnings from line 36, Schedule F (Form 1040) are \$200,000. In figuring this amount, you deducted your common-law employees' pay of \$100,000 and contributions for them of \$10,500 (10½% x \$100,000). You figure your self-employed rate and maximum deduction for contributions on behalf of yourself as follows.

Rate Worksheet for Self-Employed

- 1) Plan contribution rate as a decimal
(10½% = .105) 0.105
- 2) Rate in line 1 plus 1
(.105 + 1 = 1.105) 1.105
- 3) Self-employed rate as a decimal
rounded to at least 3 decimal places
(line 1 ÷ line 2) 0.0950

Deduction Worksheet for Self-Employed

- Step 1**
Enter the self-employed rate shown on line 3 above 0.0950
- Step 2**
Enter your net earnings (net profit) from line 31, Schedule C (Form 1040); line 3, Schedule C–EZ (Form 1040); line 36, Schedule F (Form 1040); or line 15a, Schedule K–1 (Form 1065) \$200,000
- Step 3**
Enter your deduction for self-employment tax from line 27, Form 1040 7,180
- Step 4**
Subtract step 3 from step 2 and enter the result 192,820
- Step 5**
Multiply step 4 by step 1 and enter the result 18,318
- Step 6**
Multiply \$160,000 by your plan contribution rate. Enter the result but not more than \$30,000 16,800
- Step 7**
Enter the smaller of step 5 or step 6. This is your **maximum deductible contribution**. Enter your deduction on line 29, Form 1040 \$ 16,800

When to make contributions. To take a deduction for contributions for a particular year, you must make the contributions not later than the due date, plus extensions, of your tax return for that year.

More information. See Publication 560 for more information on retirement plans for small business owners, including the self-employed. Publication 560 also discusses the reporting forms that must be filed for these plans.

Individual Retirement Arrangements (IRAs)

An individual retirement arrangement (IRA) is a personal savings plan that allows you to set aside money for your retirement or for certain education expenses. You do not have to set up IRAs for your employees or make contributions for them. You may be able to deduct your contributions, depending on the type of IRA and your circumstances. Generally, amounts in an IRA, including earnings and gains, are not taxed until they are distributed. In some cases, your earnings and gains may not be taxed at all if they are distributed according to the rules. For more information on IRAs, see Publication 590.

18.

Excise Taxes

Important Reminders

Dyed diesel fuel and dyed kerosene. Dyed diesel fuel and dyed kerosene that are used for a nontaxable use (such as farm use) are not taxed. However, the excise tax and a penalty will be imposed on users of dyed diesel fuel or dyed kerosene who know or have reason to know that they used the fuel for a taxable purpose. You cannot use dyed diesel fuel or dyed kerosene in a registered highway vehicle. For information about registered highway vehicles, see *How To Buy Diesel Fuel and Kerosene Tax Free*, later.

Undyed diesel fuel and undyed kerosene. A registered ultimate vendor that sells undyed diesel fuel or undyed kerosene for use on a farm for farming purposes is allowed to claim a refund or credit of the excise tax on that fuel. Farmers *cannot* claim a refund or credit for the excise tax paid on that fuel. See *How To Buy Diesel Fuel and Kerosene Tax Free*, later.

Introduction

You may be eligible to claim a credit on your income tax return for federal excise tax on certain fuels. You may also be eligible to claim a quarterly refund of the fuel taxes during the year, instead of waiting to claim a credit on your income tax return.

Whether you can claim a credit or refund depends on the kind of fuel you purchased, whether it was taxed, and the purpose (nontaxable use) for which you used the fuel. The following are generally the nontaxable uses of fuel for which a farmer may claim a credit or refund.

- On a farm for farming purposes.
- Off-highway business use.
- Uses other than as a fuel in a propulsion engine, such as home use.

Table 18–1 presents an overview of credits and refunds for fuels used for the nontaxable uses listed above. See Publication 378 for information about credits and refunds for fuels used for nontaxable uses not discussed in this chapter.

Topics

This chapter discusses:

- Fuels used in farming
- How to buy diesel fuel and kerosene tax free
- Fuels used in off-highway business use
- Fuels used for household use
- How to claim a credit or refund
- Including the credit or refund in income

Useful Items

You may want to see:

Publication

- 378** Fuel Tax Credits and Refunds
- 510** Excise Taxes for 2000

Form (and Instructions)

- 4136** Credit for Federal Tax Paid on Fuels
- 8849** Claim for Refund of Excise Taxes

See chapter 21 for information about getting publications and forms.

Fuels Used in Farming

You may be eligible to claim a credit or refund of excise taxes on fuel used on a farm for farming purposes. This applies if you are the owner, tenant, or operator of a farm. You may claim only a credit for the tax on gasoline used on a farm for farming purposes. You may claim either a credit or refund for the tax on aviation fuel used on a farm for farming purposes. You **cannot** claim a credit or refund for the tax on undyed diesel fuel or undyed kerosene used on a farm for farming purposes or for any use of dyed diesel fuel or dyed kerosene.

Farm. A farm includes livestock, dairy, fish, poultry, fruit, fur-bearing animals, and truck farms, orchards, plantations, ranches, nurseries, ranges, and feed yards for fattening cattle. It also includes structures such as greenhouses used primarily for raising agricultural or horticultural commodities. A fish farm is an area where fish are grown or raised — not merely caught or harvested. You must operate the farm for profit. It must be located in any of the 50 states or the District of Columbia.

Farming purposes. You use fuel on a farm for farming purposes if you use it in any of the following ways.

- 1) To cultivate the soil or to raise or harvest any agricultural or horticultural commodity.
- 2) To raise, shear, feed, care for, train, or manage livestock, bees, poultry, fur-bearing animals, or wildlife.
- 3) To operate, manage, conserve, improve, or maintain your farm, tools, or equipment.
- 4) To handle, dry, pack, grade, or store any raw agricultural or horticultural commodity. For this use to qualify, you must have produced more than half the commodity that was so treated during the tax year. Commodity means a single raw product. For example, apples and peaches are two separate commodities. The more-than-one-half test applies separately to each commodity.
- 5) To plant, cultivate, care for, or cut trees or to prepare (other than sawing logs into lumber, chipping, or other milling) trees for market, but only if the planting, etc., is incidental to your farming operations. Your tree operations are incidental only

Table 18-1. **Fuel Tax Credits and Refunds at a Glance**

Use this table to see if you can take a credit or refund for a nontaxable use of the fuel listed.

Fuel Used	On a Farm for Farming Purposes	Off-Highway Business Use	Household Use ¹
Gasoline and gasohol	Credit only	Credit or refund	None
Aviation gasoline	Credit only	None	None
Undyed diesel fuel and kerosene	Credit or refund by registered ultimate vendor only ²	Credit or refund ³	Credit or refund ³
Dyed diesel fuel and kerosene	None	None	None
Aviation fuel	Credit or refund	None	None

¹ For a use other than as fuel in a propulsion engine.

² Fuel used for farming purposes cannot be considered as used for any other purpose.

³ Applies to kerosene not sold from a blocked pump.

if they are minor in nature when compared to the total farming operations.

If any other person, such as a neighbor or custom operator, performs a service for you on your farm for any of the purposes included in (1) or (2), you can still claim the credit or refund for the fuel so used (other than for diesel fuel or kerosene). However, see *Custom application of fertilizer and pesticide*, later. If the other person performs any other services for you on your farm for purposes not included in (1) or (2), no one can claim the credit or refund for fuel used on your farm for those other services.

Example. Farm owner Nancy Blue hired custom operator Harry Steele to prepare the soil on her farm for planting. Under the contract, she paid for 200 gallons of gasoline to be used by Harry in cultivating the soil on her farm. In addition, she hired Contractor Brown to pack and store her apple crop. Brown bought 25 gallons of gasoline to use in packing the apples and was not reimbursed by Nancy. She can claim the credit for the 200 gallons of gasoline used by Harry on her farm because it qualifies as fuel used on the farm for farming purposes. No one can claim a credit for the 25 gallons because they were not used for a farming purpose listed in (1) or (2) earlier.

Buyer of fuel (other than diesel fuel or kerosene). If doubt exists whether the owner, tenant, or operator of the farm bought the fuel, determine who actually bore the cost of the fuel. For example, if the owner of a farm and his tenant share the cost of gasoline used on the farm 50–50, each can claim a credit for the tax on half the fuel used.

Diesel fuel and kerosene. If undyed diesel fuel or undyed kerosene is used for any of the previously listed farming purposes, the fuel cannot be considered as being used for any other nontaxable use. The credit or refund is allowed only to the registered ultimate vendor. Farmers **cannot** claim a refund or credit for this fuel if it is used for farming purposes. See *How To Buy Diesel Fuel and Kerosene Tax Free*, later.

A **registered ultimate vendor** is the person who sells undyed diesel fuel or undyed kerosene to the user (ultimate purchaser) of the fuel for use on a farm for farming pur-

poses. The ultimate vendor must be registered with the Internal Revenue Service at the time the claim is made.

Custom application of fertilizer and pesticide. Fuel used on a farm for farming purposes includes fuel used in the aerial or other application of fertilizer, pesticides, or other substances. You as the owner, tenant, or operator may claim the credit or refund for the fuel (other than for diesel fuel or kerosene). You may waive your right to the claim and allow the applicator to make the claim. If you waive your right, the applicator is then treated as having used the fuel on a farm for farming purposes. See *How To Claim a Credit or Refund*, later.

Waiver. To waive your right to the credit or refund, you must take all the following actions.

- 1) Before the applicator files his or her claim, sign an irrevocable statement that you knowingly give up your right to the credit or refund. You may authorize an agent, such as a cooperative, to sign the waiver for you.
- 2) Identify clearly the period that the waiver covers. The effective period of your waiver cannot extend beyond the last day of your tax year.
- 3) The applicator must retain a copy of the waiver and give you a copy. Do **not** send a copy to the Internal Revenue Service unless requested to do so.

The waiver may be a separate document or it may appear on an invoice or another document from the applicator. If the waiver appears on an invoice or other document, it must be printed in a section clearly set off from all other material, and it must be printed in type large enough to put you on notice that you are waiving your right to the credit or refund. If the waiver appears as part of an invoice or other document, it must be signed separately from any other item that requires your signature.

Sign a separate waiver for each tax year or part of a tax year in which the fuel was used. When the period covered by the waiver extends beyond the applicator's tax year, the applicator must wait until the next tax year to claim the portion for that period.

Sample form of waiver. While no specific form is required, an acceptable statement waiving your right to claim a credit or refund is shown in *Table 18-2*.

Fuel not used for farming. You do not use fuel on a farm for farming purposes when you use it in any of the following ways.

- Off the farm, such as on the highway or in noncommercial aviation, even if the fuel is used in transporting livestock, feed, crops, or equipment.
- For personal use, such as mowing the lawn.
- In processing, packaging, freezing, or canning operations.
- In processing crude gum into gum spirits of turpentine or gum resin or in processing maple sap into maple syrup or maple sugar.

All-terrain vehicles (ATVs). Fuel used in ATVs on a farm for farming purposes, discussed earlier, is eligible for a credit or refund of excise taxes on the fuel. Fuel used in ATVs for nonfarming purposes is not eligible for a credit or refund of the taxes. If ATVs are used both for farming and nonfarming purposes, only that portion of the fuel used for farming purposes is eligible for the credit or refund.

How To Buy Diesel Fuel and Kerosene Tax Free

You buy **dyed** diesel fuel and **dyed** kerosene excise tax free. You must use them only for a nontaxable use, including use on a farm for farming purposes. If you use the dyed fuel for a taxable purpose, such as in a **registered highway vehicle**, you could be subject to the excise tax and a penalty. See *Registered highway vehicle*, later.

You may buy **undyed** diesel fuel and **undyed** kerosene tax free for use on a farm for farming purposes from a registered ultimate vendor. This applies to fuel bought by any of the following persons.

- The owner, tenant, or operator of a farm for use on a farm for any of the purposes listed earlier under *Farming purposes*.
- Any other person for use on a farm for any of the purposes in items (1) and (2) listed earlier under *Farming purposes*.

You must give the vendor a signed certificate, which should be substantially the same as the sample certificate shown in *Table 18-3*. (If kerosene is purchased, then kerosene, rather than diesel fuel, should be indicated on the certificate.) You may include the certificate as part of any business records you normally keep to document a sale and purchase.

You **cannot** claim a credit or refund for the excise tax on diesel fuel or kerosene used on a farm for farming purposes. The registered ultimate vendor who sells you the fuel at a tax-excluded price claims the credit or refund.

Registered highway vehicle. For determining whether a vehicle is considered to be a registered highway vehicle, the terms, "high-

Table 18–2. Sample Waiver

WAIVER OF RIGHT TO CREDIT OR REFUND	
I hereby waive my right as owner, tenant, or operator of a farm located at:	

<i>Address</i>	
to receive credit or refund for fuel used by:	

<i>Name of Applicator</i>	
on the farm in connection with cultivating the soil, or the raising or harvesting of any agricultural or horticultural commodity. This waiver applies to fuel used during the period:	

<i>Both Dates Inclusive</i>	
I understand that by signing this waiver, I give up my right to claim any credit or refund for fuel used by the aerial applicator or other applicator of fertilizer or other substances during the period indicated, and I acknowledge that I have not previously claimed any credit for that fuel.	

<i>Signature</i>	

<i>Date</i>	

Fuels Used In Off-Highway Business Use

You may be eligible to claim a credit or refund for fuels used in an off-highway business use.

Off-highway business use. Off-highway business use is any use of fuel in a trade or business or in any income-producing activity. The use must not be in a highway vehicle registered or required to be registered for use on public highways. Off-highway business use generally does not include any use in a motorboat.

Note. If undyed diesel fuel or undyed kerosene is used on a farm for farming purposes (discussed earlier), the fuel is not used in an off-highway business use. Farmers cannot claim a credit or refund for the tax on diesel fuel or kerosene used on a farm for farming purposes. See *How To Buy Diesel Fuel and Kerosene Tax Free*, earlier.

Examples. Off-highway business use includes fuels used in any of the following ways.

- In stationary machines such as generators, compressors, power saws, and similar equipment.
- For cleaning purposes.
- In forklift trucks and bulldozers.
- In vehicles operating off the highway in construction, mining, or timbering activities if the vehicles are neither registered nor required to be registered.

Generally, it does not include nonbusiness, off-highway use of fuel, such as use by minibikes, snowmobiles, power lawn mowers, chain saws, and other yard equipment.

For more information about the credit or refund for fuels used in an off-highway business use, see Publication 378.

Fuels Used For Household Use

You may be eligible to claim a credit or refund for the excise tax on undyed diesel fuel and undyed kerosene for home use. The home use of fuel applies to fuel you purchased and used in your home for heating, lighting, and cooking.

The home use of undyed diesel fuel and undyed kerosene is included as a use other than as a fuel in the propulsion engine of a train or diesel-powered highway vehicle. It is not considered to be an off-highway business use (discussed earlier).

How To Claim a Credit or Refund

You may be able to claim a credit or refund of the excise tax on fuels you use for nontaxable uses. You can claim only a credit for gasoline used for farming purposes. You can claim either a credit or a refund for aviation fuel used for farming purposes.

way vehicle" and "registered" have the meanings given in the following definitions.

Highway vehicle. A highway vehicle is any self-propelled vehicle designed to carry a load over public highways, whether or not it is also designed to perform other functions. Examples of vehicles designed to carry a load over public highways are passenger automobiles, motorcycles, buses, and highway-type trucks and truck tractors. A vehicle is a highway vehicle even though the vehicle's design allows it to perform a highway transportation function for only one of the following purposes.

- A particular type of load, such as passengers, furnishings, and personal effects (as in a house, office, or utility trailer).
- A special kind of cargo, goods, supplies, or materials.
- Some off-highway task unrelated to highway transportation, except as discussed next.

Vehicles not considered highway vehicles. Generally, the following kinds of vehicles are not considered highway vehicles.

- 1) Specially designed mobile machinery for nontransportation functions. A self-propelled vehicle is not a highway vehicle if all of the following conditions are met.
 - a) The chassis has permanently mounted to it machinery or equipment used to perform certain operations (construction, manufacturing, drilling, mining, timbering, processing, farming, or similar operations) if the operation of the machinery or equipment is unrelated to transportation on or off the public highways.
 - b) The chassis has been specially designed to serve only as a mobile

carriage and mount for the machinery or equipment, whether or not the machinery or equipment is in operation.

- c) The chassis could not, because of its special design and without substantial structural modification, be used as part of a vehicle designed to carry any other load.
- 2) Vehicles designed for off-highway transportation. A self-propelled vehicle is not a highway vehicle if it meets both of the following conditions.
 - a) The vehicle is designed primarily to carry a specific kind of load other than over the public highway for certain operations (construction, manufacturing, mining, processing, farming, drilling, timbering, or similar operations).
 - b) The vehicle's use in carrying this load over public highways is substantially limited or impaired because of its design. To determine if the use is substantially limited or impaired, you can take into account whether the vehicle may travel at regular highway speeds, requires a special permit for highway use, or is overweight, overheight, or overwidth for regular highway use.

Registered. A vehicle is considered registered if it is registered or required to be registered for highway use under the law of any state, the District of Columbia, or any foreign country in which it is operated or situated. Any highway vehicle operated under a dealer's tag, license, or permit is considered registered. A highway vehicle is not considered registered solely because a specific permit allows the vehicle to be operated at particular times and under specified conditions.

Table 18-3. Sample Exemption Certificate

EXEMPTION CERTIFICATE

(To support vendor's claim for credit or payment under section 6427 of the Internal Revenue Code)

Name, Address, and Employer Identification Number of Seller

The undersigned buyer ("Buyer") hereby certifies the following under penalties of perjury:

A. Buyer will use the diesel fuel to which this certificate relates either — (check one):

1. On a farm for farming purposes (as defined in §48.6420-4 of the Manufacturers and Retailers Excise Tax Regulations) and Buyer is the owner, tenant, or operator of the farm on which the fuel will be used; or
2. On a farm (as defined in §48.6420-4(c)) for any of the purposes described in ¶ (d) of that section (relating to cultivating, raising, or harvesting) (and Buyer is not the owner, tenant, or operator of the farm on which the fuel will be used).

B. This certificate applies to the following (complete as applicable):

1. If this is a single purchase certificate, check here and enter:
 - a. Invoice or delivery ticket number _____
 - b. Number of gallons _____
2. If this is a certificate covering all purchases under a specified account or order number, check here and enter:
 - a. Effective date _____
 - b. Expiration date _____
(period not to exceed 1 year after effective date)
 - c. Buyer account or order number _____

Buyer will provide a new certificate to the seller if any information in this certificate changes.

If Buyer uses the diesel fuel to which this certificate relates for a purpose other than stated in the certificate, Buyer will be liable for any tax.

Buyer understands that the fraudulent use of this certificate may subject Buyer and all parties making such fraudulent use of this certificate to a fine or imprisonment, or both, together with the costs of prosecution.

Signature and Date Signed

Printed or Typed Name and Title of Person Signing

Name, Address, and Employer Identification Number of Buyer

No credit or refund is allowed to anyone for any fuel, such as dyed diesel fuel or dyed kerosene, bought tax free.

Undyed diesel fuel and undyed kerosene.

You cannot claim a credit or refund for undyed diesel fuel or undyed kerosene used on a farm for farming purposes. Only the registered ultimate vendor that sells the fuel to you can make this claim. However, you can claim a credit or refund for undyed diesel fuel or undyed kerosene used for other nontaxable uses, such as off-highway business use. If undyed diesel fuel or undyed kerosene is used on a farm for farming purposes, you cannot consider it as being used for any other nontaxable use.

Taxpayer identification number. To file a claim for credit or refund, you MUST have a taxpayer identification number. See *Taxpayer Identification Number* in chapter 2.



Keep at your principal place of business all records needed to enable the IRS to verify the amount you claimed. You do not have to use any special form, but the records should establish all the following information.

- The total number of gallons bought and used during the period covered by your claim.
- The dates of the purchases.
- The names and addresses of suppliers and amounts bought from each during the period covered by your claim.
- The nontaxable use for which you used the fuel.
- The number of gallons used for each nontaxable use.

It is important that your records show separately the number of gallons used for each nontaxable use that qualifies as a claim. For more information about recordkeeping,

see Publication 583, *Starting a Business and Keeping Records*.

Credit or refund. A credit is an amount that reduces the tax on your income tax return when you file it at the end of the year. If you meet certain requirements, you can claim a refund during the year instead of waiting until you file your tax return.

Credit only. The following taxes can only be claimed as a credit.

- Tax on gasoline you used on a farm for farming purposes.
- Tax on fuels used for nontaxable uses if the total for the tax year is less than \$750.
- Tax on fuel that was not included in any claim for refund previously filed for the tax year.

The basic rules for claiming credits and refunds (discussed later) are listed in *Table 18-4*.

Claiming a Credit

You make a claim for a fuel tax credit on **Form 4136** and attach it to your income tax return. Do not claim a credit for any excise tax for which you have filed a refund claim.

How to claim a credit. How you claim a credit depends on whether you are an individual, partnership, corporation, S corporation, trust, or farmers' cooperative association.

Individuals. You claim the credit on line 63 of your 1999 Form 1040. Check box b. If you would not otherwise have to file an income tax return, you must do so to get a fuel tax credit. See the instructions for Form 1040.

Partnership. A partnership cannot claim the credit on Form 1065, *U.S. Partnership Return of Income*. The partnership must attach a statement to Form 1065 showing the number of gallons of each fuel allocated to each partner and the rate that applies. Each partner claims the credit on his or her income tax return for the partner's share of the fuel used by the partnership.

An electing large partnership can claim the credit on line 27 of Form 1065-B, *U.S. Return of Income for Electing Large Partnerships*.

Corporation. To claim the credit, a corporation uses either line 32g of Form 1120, *U.S. Corporation Income Tax Return*, or line 28g of Form 1120-A, *U.S. Corporation Short-Form Income Tax Return*.

S corporation. To claim the credit, an S corporation uses line 23c of Form 1120S, *U.S. Income Tax Return for an S Corporation*.

Farmers' cooperative association. If a cooperative must file Form 990-C, *Farmers' Cooperative Association Income Tax Return*, it uses line 32g to claim the credit.

Trust. A trust required to file Form 1041, *U.S. Income Tax Return for Estates and Trusts*, uses line 24g to claim the credit.

When to claim a credit. You can claim a fuel tax credit on your income tax return for the year you used the fuels or you may be able to amend your income tax return for that year. Generally, you must file an amended return by the later of 3 years after the date you filed your original return or within 2 years after you paid the tax. A return filed early is considered filed on the due date.

Table 18-4. **Claiming a Credit or Refund of Excise Taxes**

This tables gives the basic rules for claiming a credit or refund of excise taxes on fuels used for a nontaxable use.

	Credit	Refund
Which form to use	Form 4136, <i>Credit for Federal Tax Paid on Fuels</i>	Form 8849, <i>Claim for Refund of Excise Taxes</i>
Type of form	Annual	Quarterly
When to file	With your income tax return	By the last day of the quarter following the last quarter included in the claim
Amount of tax	Any amount	\$750 or more



Once you have filed a Form 4136, you cannot file an amended return to show an increase in the number of gallons reported on a line. See the following discussion for when you can file a claim on an amended return.

Fuel tax claim on amended return. You can file an amended return to claim a fuel tax credit only in the following situations.

- You did not claim any credit for fuel taxes on Form 4136 for the tax year.
- Your credit is for gasohol blending, discussed in Publication 378.
- Your credit is for a claim group, explained next, for which you did not previously file a claim on Form 4136 for the tax year.

Claims on Form 4136 (other than for gasohol blending, line 8) are separated into seven **claim groups** based on the type of fuel and the use of that fuel. Once you file Form 4136 with a claim for a group, you cannot file an amended return with another claim for that group. However, you can file an amended return with a claim for another group.

The following table shows which claims are in each group. The numbers in the second column refer to the line numbers on Form 4136. The numbers in the third column are from the *Type of Use Table* in the Form 4136 instructions.

Group	Line No.	Type of Use
I	1b, 1d-f, 2b	1
II	1a, 1d-f, 2a	2
III	1c-f	5, 7
IV	1c-f, 2b	3, 4, 9
V	3c, 7	5, 7
VI	3a-b, 4, 5, 6	See line instructions
VII	2b	10

For each tax year, you can make only one claim for each group.

Example. You file your income tax return and claim a fuel tax credit. Your Form 4136 shows an amount on line 1b for use of gasoline on a farm for farming purposes. This is a Group I claim. You cannot amend your return to claim a credit for an amount on line 2b for use of aviation gasoline on a farm for farming purposes (Type of Use 1), since that is also a Group I claim. However, if you used aviation fuel on a farm for farming purposes, you can amend your return to claim the credit for that fuel tax because that would be a Group VI claim reported on line 4b (Type of Use 1).

Claiming a Refund

You make a claim for refund on **Form 8849**. Do not claim a credit against your income tax for any excise tax for which you filed a timely claim for refund.

You can file a claim for refund for any quarter of your tax year for which you can claim \$750 or more. This amount is the excise tax paid on all fuels used for any nontaxable use during that quarter or any prior quarter (for which no other claim has been filed) during the tax year.



You cannot claim a refund for excise tax on gasoline used on a farm for farming purposes. You must claim a credit on your income tax return for the excise tax on gasoline used on a farm for farming purposes.

If you cannot claim at least \$750 at the end of a quarter, you carry the amount over to the next quarter of your tax year to determine if you can claim at least \$750 for that quarter. If you cannot claim at least \$750 at the end of the fourth quarter of your tax year, you must claim a credit on your income tax return.

How to file a quarterly claim. File the claim by filling out Schedule 1 (Form 8849) and attaching it to Form 8849. Send it to the address shown in the instructions. If you file Form 720, you can use the Schedule C portion of Form 720 for your refund claims. (See the Form 720 instructions.)

When to file a quarterly claim. You must file a quarterly claim by the last day of the first quarter following the last quarter included in the claim. If you do not file a timely refund claim for the fourth quarter of your tax year, you will have to claim a credit for that amount on your income tax return, as discussed earlier.

Including the Credit or Refund in Income

Include any credit or refund of excise taxes on fuels in your gross income if you included the cost of the fuel as an expense deduction that reduced your income tax liability.

Which year you include a credit or refund in gross income depends on whether you use the cash or an accrual method of accounting.

Cash method. If you use the cash method and file a claim for refund, include the refund in gross income for the tax year in which you receive the refund. If you claim a credit on your income tax return, include the credit in gross income for the tax year in which you file Form 4136. If you file an amended return and claim a credit, include the credit in gross income for the tax year in which you receive it.

Example. Ed Brown, a cash basis farmer, filed his 1999 Form 1040 on March 1, 2000. On his Schedule F, he deducted the total cost of gasoline (including \$110 of excise taxes) used on the farm for farming purposes. Then, on Form 4136, he claimed the \$110 as a credit. Ed reports the \$110 as other income on line 10 of his 2000 Schedule F.

Accrual method. If you use an accrual method, include the entire claim in gross income for the tax year in which you used the fuels. It does not matter if an accrual basis taxpayer filed for a quarterly refund or claimed the entire amount as a credit.

Example. Todd Green, an accrual basis farmer, files his 1999 Form 1040 on April 17, 2000. On Schedule F, he deducts the total cost of gasoline (including \$155 of excise taxes) that he used on the farm during 1999. On Form 4136, Todd claims the \$155 as a credit. He reports the \$155 as other income on line 10 of his 1999 Schedule F.

19.

Your Rights as a Taxpayer

The first part of this chapter explains some of your most important rights as a taxpayer. The second part explains the examination, appeal, collection, and refund processes.

Declaration of Taxpayer Rights

Protection of your rights. IRS employees will explain and protect your rights as a taxpayer throughout your contact with us.

Privacy and confidentiality. The IRS will not disclose to anyone the information you give us, except as authorized by law. You have the right to know why we are asking you for information, how we will use it, and what happens if you do not provide requested information.

Professional and courteous service. If you believe that an IRS employee has not treated you in a professional, fair, and courteous manner, you should tell that employee's supervisor. If the supervisor's response is not satisfactory, you should write to your IRS District Director or Service Center Director.

Representation. You may either represent yourself or, with proper written authorization, have someone else represent you in your

place. Your representative must be a person allowed to practice before the IRS, such as an attorney, certified public accountant, or enrolled agent. If you are in an interview and ask to consult such a person, then we must stop and reschedule the interview in most cases.

You can have someone accompany you at an interview. You may make sound recordings of any meetings with our examination, appeal, or collection personnel, provided you tell us in writing 10 days before the meeting.

Payment of only the correct amount of tax.

You are responsible for paying only the correct amount of tax due under the law—no more, no less. If you cannot pay all of your tax when it is due, you may be able to make monthly installment payments.

Help with unresolved tax problems. The National Taxpayer Advocate's Problem Resolution Program can help you if you have tried unsuccessfully to resolve a problem with the IRS. Your local Taxpayer Advocate can offer you special help if you have a significant hardship as a result of a tax problem. For more information, call toll free 1-877-777-4778 (1-800-829-4059 for TTY/TDD users) or write to the Taxpayer Advocate at the IRS office that last contacted you.

Appeals and judicial review. If you disagree with us about the amount of your tax liability or certain collection actions, you have the right to ask the Appeals Office to review your case. You may also ask a court to review your case.

Relief from certain penalties and interest. The IRS will waive penalties when allowed by law if you can show you acted reasonably and in good faith or relied on the incorrect advice of an IRS employee. We will waive interest that is the result of certain errors or delays caused by an IRS employee.

Examinations, Appeals, Collections, and Refunds

Examinations (audits). We accept most taxpayers' returns as filed. If we inquire about your return or select it for examination, it does not suggest that you are dishonest. The inquiry or examination may or may not result in more tax. We may close your case without change; or, you may receive a refund.

The process of selecting a return for examination usually begins in one of two ways. First, we use computer programs to identify returns that may have incorrect amounts. These programs may be based on information returns, such as Forms 1099 and W-2, on studies of past examinations, or on certain issues identified by compliance projects. Second, we use information from outside sources that indicates that a return may have incorrect amounts. These sources may include newspapers, public records, and individuals. If we determine that the information is accurate and reliable, we may use it to select a return for examination.

Publication 556, *Examination of Returns, Appeal Rights, and Claims for Refund*, explains the rules and procedures that we follow

in examinations. The following sections give an overview of how we conduct examinations.

By mail. We handle many examinations and inquiries by mail. We will send you a letter with either a request for more information or a reason why we believe a change to your return may be needed. You can respond by mail or you can request a personal interview with an examiner. If you mail us the requested information or provide an explanation, we may or may not agree with you, and we will explain the reasons for any changes. Please do not hesitate to write to us about anything you do not understand.

By interview. If we notify you that we will conduct your examination through a personal interview, or you request such an interview, you have the right to ask that the examination take place at a reasonable time and place that is convenient for both you and the IRS. If our examiner proposes any changes to your return, he or she will explain the reasons for the changes. If you do not agree with these changes, you can meet with the examiner's supervisor.

Repeat examinations. If we examined your return for the same items in either of the 2 previous years and proposed no change to your tax liability, please contact us as soon as possible so we can see if we should discontinue the examination.

Appeals. If you do not agree with the examiner's proposed changes, you can appeal them to the Appeals Office of the IRS. Most differences can be settled without expensive and time-consuming court trials. Your appeal rights are explained in detail in both Publication 5, *Your Appeal Rights and How To Prepare a Protest If You Don't Agree*, and Publication 556, *Examination of Returns, Appeal Rights, and Claims for Refund*.

If you do not wish to use the Appeals Office or disagree with its findings, you may be able to take your case to the U.S. Tax Court, U.S. Court of Federal Claims, or the U.S. District Court where you live. If you take your case to court, the IRS will have the burden of proving certain facts if you kept adequate records to show your tax liability, cooperated with the IRS, and meet certain other conditions. If the court agrees with you on most issues in your case, and finds that our position was largely unjustified, you may be able to recover some of your administrative and litigation costs. You will not be eligible to recover these costs unless you tried to resolve your case administratively, including going through the appeals system, and you gave us the information necessary to resolve the case.

Collections. Publication 594, *The IRS Collection Process*, explains your rights and responsibilities regarding payment of federal taxes. It describes:

- What to do when you owe taxes. It describes what to do if you get a tax bill and what to do if you think your bill is wrong. It also covers making installment payments, delaying collection action, and submitting an offer in compromise.
- IRS collection actions. It covers liens, releasing a lien, levies, releasing a levy, seizures and sales, and release of property.

Publication 1660, *Collection Appeal Rights*, explains your collection appeal rights

for liens, levies, seizures, and installment agreement terminations.

Innocent spouse relief. Generally, both you and your spouse are responsible, jointly and individually, for paying the full amount of any tax, interest, or penalties due on your joint return. However, you may not have to pay the tax, interest, and penalties related to your spouse (or former spouse).

New tax law changes make it easier to qualify for innocent spouse relief and add two other ways for you to get relief. For more information, see Publication 971, *Innocent Spouse Relief*, and Form 8857, *Request for Innocent Spouse Relief (And Separation of Liability and Equitable Relief)*.

Refunds. You may file a claim for refund if you think you paid too much tax. You must generally file the claim within 3 years from the date you filed your original return or 2 years from the date you paid the tax, whichever is later. The law generally provides for interest on your refund if it is not paid within 45 days of the date you filed your return or claim for refund. Publication 556, *Examination of Returns, Appeal Rights, and Claims for Refund*, has more information on refunds.

20.

Sample Return

This sample return uses actual forms to show you how to prepare your income tax return. However, the information shown on the filled-in forms is not from any actual farming operation.

Walter Brown is a dairy farmer and his wife, Jane, is a substitute teacher for the county school system. They have three children. Their return has been prepared using the cash method of accounting. See chapter 3 for an explanation of the cash method and other methods of accounting.

Rounding off cents. You may round off cents to the nearest whole dollar on your return and schedules. This will make it easier to complete your return. To do so, drop amounts under 50 cents and increase amounts from 50 to 99 cents to the next dollar. For example, \$129.49 becomes \$129 and \$235.50 becomes \$236.

If you do round off, do so for all amounts. However, if you have to add two or more amounts to figure the total to enter on a line, include cents when adding the amounts and round off only the total.

Losses from operating a farm. The sample return shows a gain from the operation of the farm. However, if your deductible farm expenses are more than your farm income for the year, you have a loss from the operation of your farm. If your loss is more than your other income for the year, you may have a net operating loss (NOL). You may also have an NOL if you had a casualty or theft loss that was more than your income.

If you have an NOL this year, you may be able to reduce your income (and tax) in other years by carrying the NOL to those years and deducting it from income.

To determine if you have an NOL, complete your tax return for the year. You may have an NOL if a negative figure appears on line 37 of Form 1040. If this is the case, see *Losses From Operating a Farm* in chapter 5.

Preparing the Return

Schedule F (Form 1040)

The first step in preparing Mr. Brown's income tax return is to determine his net farm profit or loss on Schedule F. The income and expenses shown on this Schedule F are taken from his farm receipt and expense records. Data for the depreciation and section 179 deductions are taken from Form 4562 and the illustrated *Depreciation Worksheet* that follows Form 4562. (Farm income is discussed in chapter 4 and farm expenses are discussed in chapter 5.) Mr. Brown has filed all required Form 1099 information returns.

On line B he writes the number "112120" from the list of *Principal Agricultural Activity Codes* on page 2 of Schedule F (not shown). This indicates that his principal source of farm income is from dairy farming.

Schedule F—Part I (Income)

Mr. Brown keeps records of the various types of farm income he receives during the year. He uses this information to complete Part I of Schedule F.

Line items. He then fills in all applicable items of farm income.

Line 1. In 1999, he sold steers he had bought for resale. He enters sales of \$26,584.

Line 2. He enters the cost of the steers, \$6,523. He has kept a record of the cost of the livestock he bought and is careful to deduct the cost of an animal in the year of its sale.

Line 3. He subtracts his cost on line 2 from the sales on line 1 and reports the difference, \$20,061, as his profit on line 3. Had he sold any other items he bought for resale, he would combine the sales and costs of these items with the sales and costs of the steers and report only the totals on lines 1, 2, and 3. He does not report here sales of animals held for draft, dairy, breeding, or sport. He reports those sales on Form 4797.

Line 4. He enters the income he received during 1999 from sales of items he raised or produced on his farm. His principal source of farm income is dairy farming. The amount reported on this line, \$163,018, includes sales of all of the following.

Milk	\$133,874
Raised steers and calves	2,914
Vegetables he grew	1,457
Corn (\$7,286), hay (\$8,944), and wheat (\$8,543) he raised	24,773
Total reported on line 4	\$163,018

Lines 5a and 5b. He reports the \$33 of patronage dividends received from cooperatives on line 5a. Since it was a qualified written notice of allocation, he enters \$33 as the taxable amount on line 5b.

Lines 6a and 6b. He received Farm Service Agency (FSA) cost sharing of \$438 on a soil conservation project (diversion channels) completed in 1999. He received the income as materials and services paid for by the government and reports it on both line 6a

and line 6b. The Department of Agriculture (USDA) reports this amount to the Internal Revenue Service (IRS), generally on Form 1099-G. The entire \$438 has been included on line 14 of Schedule F as a conservation expense. He did not receive any cost-sharing payments this year that he could exclude from his farm income.

Line 7a. He reports the \$665 loan he received from the Commodity Credit Corporation (CCC) because he elected in a previous year to treat these loans as income in the year received. (If he had elected not to report his CCC loan as income in the year received and forfeited the loan in a later year, he would report the loan as income in the year of forfeiture.)

Line 9. He reports his \$1,258 of income from custom harvesting.

Line 10. On his 1998 income tax return, he claimed a credit of \$142 for excise taxes on gasoline used on his farm. He includes the entire \$142 in his 1999 income on line 10 because he deducted the total cost of gasoline (including the \$142 of excise taxes) as a farm business expense in 1998. He also includes \$250 he received as a director of the local milk marketing cooperative and \$175 received for firewood that he cut and sold in 1999.

Schedule F—Part II (Expenses)

Mr. Brown records his farm expenses during the year for tax purposes and summarizes these expenses at the end of the year. This gives him his deductible expenses, which he enters in Part II of Schedule F.

Line items. He then fills in all applicable items of farm expense deductions.

Line 12. He uses his trucks 100% for his farming business and the actual cost (not including depreciation) of operating the trucks in 1999 was \$2,659. He uses his family car 60% for business. It cost \$2,307 to operate the car in 1999. He can deduct \$1,384 for the car ($\$2,307 \times .60$). He enters a total of \$4,043 on line 12. (Depreciation is reported on line 16.)

Line 13. The \$2,701 on this line is the amount he paid for pesticides and herbicides purchased during the year.

Line 14. He deducts the \$1,040 spent on diversion channels in 1999. The amount listed here includes the full cost of the government cost-sharing project, which has been reported as income on line 6. He continues the policy elected in previous years of deducting annual soil and water conservation expenses. The expenses are consistent with a plan approved by the Natural Resources Conservation Service of the USDA. Because the amount was not more than 25% of Mr. Brown's gross income from farming, the entire amount is deductible. See chapter 6 for more information on soil and water conservation expenses.

Line 15. The \$1,575 on this line is the amount he paid a company for spraying his crops. He made the payment to a corporation, so he does not file a Form 1099-MISC to report the payment.

Line 16. He enters the \$37,978 depreciation from Form 4562, discussed later.

Line 18. He enters the \$18,019 cost of feed bought for livestock. He did not include the cost of feed bought for livestock he and his family intend to consume. He also did not include the value of feed grown on his farm.

Line 19. He enters \$6,544. This is the amount paid for fertilizer and lime.

Line 20. He deducts the \$5,105 he paid for trucking and milk marketing expenses. He chose to itemize the \$807 government milk assessment and lists it separately on line 34a.

Line 21. He deducts the \$3,521 cost of gasoline, fuel, and oil bought for farm use, other than amounts he included on line 12 for car and truck expenses. He did not deduct the cost of fuel used for heating, lighting, or cooking in his home.

Line 22. He deducts the \$1,070 cost of insurance on his farm buildings (but not his home), equipment, livestock, and crops. He did not deduct the entire premiums on 3-year and 5-year insurance policies in the year of payment, but deducts each year only the part that applies to that year. For more information, see *Insurance* in chapter 5.

Lines 23a and 23b. He deducts on line 23a the \$3,175 interest paid on the farm mortgage for the land and buildings used in farming. He deducts on line 23b the \$1,043 interest paid on obligations incurred to buy livestock and other personal property used in farming or held for sale. Interest on his home is deducted on Schedule A (Form 1040), which is not shown.

Line 24. He enters the \$16,416 in wages he paid during the year for labor hired to operate his farm, including wages paid to his wife and children. He did not include amounts paid to himself. He has no employment credits. Not all the wages paid were subject to social security and Medicare taxes, but for those that were, he included the full amount of the wages before reduction for the employee's share of those taxes, or other amounts withheld. His share of the social security and Medicare taxes is included in the total taxes deducted on line 31. See chapter 16 for information on employment taxes.

Line 26b. He enters only cash rent paid, \$2,400, for the use of land he rented from a neighbor, Mr. Green. He did not deduct rent paid in crop shares. He completed a Form 1099-MISC for the rent paid to Mr. Green and sent Copy A to the IRS with Form 1096. He gave Mr. Green Copy B of the Form 1099-MISC.

Line 27. The \$5,424 he enters includes \$4,902 for repairs to farm machinery and \$522 for repairs to farm buildings. He did not include the value of his own labor. He prepared Form 1099-MISC for the farm machinery repairs because the repair shop is not incorporated. He sent Copy A to the IRS with Form 1096 and gave Copy B to the owner of the repair shop.

Line 28. He enters the \$2,132 cost of seeds and plants used in farming. He deducts these costs from year to year. He did not include the cost of plants and seeds purchased for the family garden.

Line 30. He enters the \$2,807 paid for livestock supplies and other supplies, including bedding.

Line 31. He enters \$3,201 for taxes paid during 1999, including state and local taxes on the real estate and personal property used in farming. He did not include the sales tax paid on farm supplies, or 60% of the gasoline tax for gasoline used in the family car for farm business, because these taxes were included in the costs for supplies and gasoline that he deducted on lines 30 and 21, respectively. He included his share of social security and Medicare taxes paid for agricultural employees. He filed Form 943 (not shown) in Janu-

ary 2000, reporting these taxes for calendar year 1999.

He does not deduct, on Schedule F, his state income tax or the taxes on his home and his land not used for farming. He deducts these taxes on Schedule A (Form 1040), which is not shown. He does not deduct any federal income tax paid during the year.

Line 32. He enters \$3,997 for the cost of water, electricity, gas, and telephone service used only in farming. He cannot deduct the cost of basic local telephone service (including any taxes) for the first telephone line to his home.

Line 33. He enters \$3,217, the total paid during 1999 for veterinary fees (\$1,821), livestock medicines (\$650), and breeding fees (\$746). He does not prepare Form 1099-MISC for the veterinarian and the supplier of breeding services because both are incorporated.

Line 34. He enters other farm business expenses. These include: an \$807 government milk assessment; \$347 for commissions, dues, and fees; \$287 for financial records and office supplies; and \$534 for farm business travel and meals. Farm business travel includes expenses for the State Forage Tour and for attending the farm management conference at State University. He included only 50% of the cost of meals in the deduction.

Line 36—Net farm profit. To arrive at his net farm profit, he subtracts the amount on line 35 (\$127,383) from the amount on line 11 (\$186,040). His net farm profit, entered on line 36, is \$58,657. He also enters that amount on line 18 of Form 1040, and on line 1 of Section A, Schedule SE (Form 1040). Because he shows a net profit on line 36, he skips line 37.

Form 4562 — Depreciation and Amortization

Mr. Brown follows the instructions and lists the information called for in Parts I through IV. He also completes Part V on page 2 to provide information on listed property used in his farming business. The three vehicles used in his business are listed property. The truck, sold in July and shown on Form 4797, was placed in service in 1990 and fully depreciated in 1995. No depreciation is allowed for 1999.

Depreciation record. He records information on his depreciable property in a book that he can use to figure his depreciation allowance for several years. He uses the *Depreciation Worksheet* from the Form 4562 instructions to figure his 1999 deduction.

Basis for depreciation. He bought his farm on January 8, 1978. Timber on the farm was immature and had no fair market value (FMV). He immediately divided the total purchase price of the farm among the land, house, barn, and fences (no other capital improvements were included in the price of the farm). He made the division on the purchase date in proportion to (but not in excess of) the FMVs of the assets and in the required order. See *Trade or Business Acquired* in Publication 551 for more information.

He entered in his depreciation record the part of the purchase price for the depreciable barn and fences, giving him the basis for figuring his depreciation allowance. The fences

were fully depreciated in 1987. Because he cannot depreciate the house and land, he keeps a separate record showing their bases.

Methods of depreciation. He depreciates all his property placed in service before 1981 using the straight-line method. He chose the alternate ACRS method for his machine shed placed in service in 1986. Using the Modified Accelerated Cost Recovery System (MACRS) and the half-year convention, he chose the following systems for all of his assets placed in service in the year indicated.

- 1995—straight line ADS.
- 1996—150% declining balance Alternative Depreciation System (ADS).
- 1997 & 1999—150% declining balance General Depreciation System (GDS).

Depreciable property. One of his purchased dairy cows was killed by lightning in July 1999. Two other purchased cows (#52 and #60) were sold in 1999. The cows were depreciated under MACRS (ADS), using a half-year convention. Therefore, he can claim a half-year's depreciation for each cow in 1999.

He has other breeding and dairy cows that he raised. He did not claim depreciation on them because his basis in the cows is zero for income tax purposes.

During 1999 the Browns owned two family cars. One of them was not used for farm business. Mr. Brown cannot deduct depreciation on it. He determined that his other car was used 60% for his farm business and 40% for personal driving.

The *Depreciation Worksheet* contains an itemized list of Mr. Brown's assets for which he is deducting depreciation in 1999. He must list each item separately to keep track of its basis. The pickup truck and car purchased in 1996 are listed property in the 5-year property class.

New assets. Mr. Brown added three assets to his farming business in 1999.

- 1) In January, he completed and placed in service a dairy facility. Since the new structure is designed specifically for the production of milk and to house, feed, and care for dairy cattle, it is a single purpose livestock structure. The building is depreciated separately from the milking equipment it houses. The cost of the building is \$56,500 and it is 10-year property under MACRS. The cost of the equipment is \$72,000 and it is 7-year property under MACRS.
- 2) In February, he made improvements to his machine shed for a total cost of \$1,300. The improvements are depreciated as if they were a separate building with a 20-year recovery period.
- 3) In March, he acquired tractor #5 by trading tractor #2 and paying \$23,729 cash. The adjusted basis of tractor #2 was \$1,378 when it was traded (Mr. Brown claimed half a year of depreciation). The new tractor has a basis of \$25,107 (\$23,729 + \$1,378). He completed Form 8824, *Like-Kind Exchanges*, (not shown) to report the trade and will include this form when he files his return. He elected to expense part of the cost of the tractor in 1999 and depreciate the rest of the basis (cost + basis of trade-in).

Line items. Form 4562 is completed by referring to the *Depreciation Worksheet*.

Line 2. Mr. Brown enters \$152,229 on line 2. This is the total cost of all section 179 property placed in service in 1999. In figuring his cost, he does not include the basis of the traded tractor (\$1,378). The dairy facility and equipment qualify as section 179 property. However, the machine shed improvement does not qualify. It is not a single purpose agricultural (livestock) structure.

Line 6. He enters the description of the property (tractor) he is electing to expense under section 179. His cost basis for the section 179 deduction is limited to the cash he paid for the tractor. He enters his cost basis of \$23,729 in column (b). He then enters the tentative deduction, \$19,000, in column (c). However, this amount is subject to the business income limit on line 11. (The total cost of his section 179 property did not exceed the investment limit, \$200,000, and he is therefore subject to the maximum dollar limit, \$19,000.)

Lines 11 and 12. His taxable income from his farming business (without including the section 179 deduction and the self-employment tax deduction) exceeds the maximum dollar limit on line 5. He enters \$19,000 on lines 11 and 12. See chapter 8 for information on the section 179 deduction.

Line 15. All property placed in service in 1999 in each class is combined and entered in Part II, line 15. The abbreviation HY used in column (e) stands for the half-year convention. The 150 DB in column (f) stands for the 150% declining balance method under MACRS.

Line 17. He enters \$2,708, his MACRS depreciation deduction for assets placed in service from 1995 through 1997, on line 17 of Part III. None of the assets included are listed property. Listed property is entered in Part V as explained later under *Line 20*.

Line 19. On line 19, he enters \$1,374 for assets placed in service before 1981 and those depreciated under ACRS that are not listed property.

Line 20. He enters his depreciation deduction for listed property, \$2,244, on line 20. This is the total shown on line 26, Part V, page 2 of the form. He has two depreciable assets that are listed property—the car used 60% for business and the pickup truck purchased in 1996. His deduction for the car cannot be more than 60% of the limit for passenger automobiles for the year he placed the car in service. The other truck, which he sold this year, was fully depreciated.

Line 21. He enters the total depreciation on line 21 and carries the total, \$37,978, to line 16 of Schedule F.

Other items. He completes Sections A and B of Part V to provide the information required for listed property. He does not complete Section C because he does not provide vehicles for his employees' use.

He follows the practice of writing down the odometer readings on his vehicles at the end of each year and when he places the vehicles in service and disposes of them. In addition, because he uses his car only partly for business, he writes down the number of business miles it is driven any day that it is used for business. He uses these records to answer the questions on lines 23a and 23b of Section A and lines 28 through 34 of Section B.

He has no amortization, so he does not use Part VI of Form 4562.

Schedule SE (Form 1040) Self-Employment Tax

After figuring his net farm profit on page 1 of Schedule F, Mr. Brown figures his self-employment tax. To do this, he figures his net earnings from farm self-employment on Short Schedule SE (Section A). He is not required to use Long Schedule SE (Section B). First he prints his name (as shown on his Form 1040) and his social security number at the top of Schedule SE. Only his name and social security number go on Schedule SE. His wife does not have self-employment income. If she had self-employment income, she would file her own Schedule SE.

Line items. He figures his self-employment tax on the following lines.

Line 1. He enters his net farm profit, \$58,657. All of the income, losses, and deductions that he listed on Schedule F are included in determining net earnings from farm self-employment (see the types of self-employment income listed in chapter 15). Consequently, he did not have to adjust his net profit to determine his self-employment net earnings from farming.

Line 3. If he were engaged in any other business in addition to farming, he would combine his net profits from all his trades or businesses on line 3 of this schedule. However, because farming was his only business, he enters his net profit from farming (the amount shown on line 1).

Line 4. He multiplies line 3 by .9235 to get his net earnings from self-employment and enters \$54,170 on line 4.

Lines 5 and 6. He multiplies line 4 by 15.3% and enters \$8,288 on line 5. This is his self-employment tax for 1999. He also enters \$8,288 on line 50 of Form 1040. He enters \$4,144 on line 6 and also on line 27 of Form 1040 (deduction for one-half of his self-employment tax).

Form 4684—Casualties and Thefts

Mr. Brown's only business casualty occurred when a purchased dairy cow was killed by lightning on July 7. He shows the loss from the casualty on page 2 of Form 4684. Only page 2 is shown, since page 1 is for non-business casualties.

He prints his name, his wife's name, and his identifying number at the top of page 2.

Part I. He shows the kind of property, "Dairy cow #42," its location, and the date acquired on line 19. He enters his adjusted basis in the cow, \$257, on line 20 and the \$109 insurance payment he received for the cow on line 21. Since line 20 is more than line 21, he skips line 22. On lines 23 and 24, he enters the FMV before, \$500, and after, \$-0-, the casualty, and he shows the difference, \$500, on line 25. He enters the amount from line 20 on line 26, subtracts line 21 from line 26, and enters \$148 on lines 27 and 28.

Part II. On line 34, he identifies the casualty and enters \$148 on lines 34(b)(i), 35(b)(i), 37, and 38a, and on Form 4797, Part II, line 14.

Form 4797—Sales of Business Property

After completing Schedule F and Section B of Form 4684, Mr. Brown fills in Form 4797 to report the sales of business property. See *Table 11-1* in chapter 11 for examples of items reported on Form 4797.

He prints his name, his wife's name, and his identifying number at the top of Form 4797.

Before he can complete Parts I and II, he must complete Part III to report the sale of certain depreciable property.

Part III. Mr. Brown sold three depreciable assets in 1999 at a gain. He has information about their cost and depreciation in his records. Only dairy cow #60 appears on the *Depreciation Worksheet*. The truck and mower are fully depreciated.

He sold a truck on July 9 and a mower on August 12. He also sold one purchased dairy cow, #60, on October 28. Since the gains on these items were gains from dispositions of depreciable personal property, as explained in chapter 11, he must determine the part of each gain that was ordinary income.

He enters the description of each item on lines 19A through 19C and relates the corresponding property columns to the properties on those lines. He completes lines 20 through 25(b) for each disposition of property.

Gain from dispositions. The gain on each item is shown on line 24. His gain on the sale of the truck is \$700 (Property A). His gain on the sale of the mower is \$70 (Property B). His gain on the sale of cow #60 is \$82 (Property C). The gain on each item is entered in the appropriate property column on line 25(b).

Summary of Part III gains. On line 30, he enters \$852, the total of property columns A through C, line 24. On line 31, he enters \$852, the total of property columns A through C, line 25(b). This amount is the gain that is ordinary income. He also enters this amount on line 13, Part II.

He subtracts line 31 from line 30 and enters -0- on line 32. He has no long-term capital gain on the dispositions. All of his gain is ordinary income.

Part I. All of the animals in Part I met the required holding period.

Mr. Brown sold at a gain several cows he had raised and used for dairy purposes. His selling expense was \$325 for these cows, which he shows on line 2(f). He enters the gain from the sale on line 2(g). He also enters on line 2(g) the gain from the sale of a raised dairy heifer and the loss from the sale of purchased dairy cow #52. Because he sold purchased dairy cow #52 at a loss, he entered it in Part I instead of Part III. See *Table 11-1* in chapter 11 for where to report items on Form 4797.

He combines the gains and loss on line 2(g) and enters \$14,770 on line 7(g). Since he has no nonrecaptured net section 1231 losses from prior years, he does not fill in lines 8, 9, and 12. If he had nonrecaptured section 1231 losses, part or all of the gain on line 7 would be ordinary income and entered on line 12. Following the instructions for line 7, he enters \$14,770 as a long-term capital gain on line 11(f) of Schedule D.

Part II. Mr. Brown enters on line 10 the \$250 gain from the sale of a 23-month old raised dairy heifer held for breeding purposes. He

had previously entered the \$852 gain from line 31, Part III, on line 13 and the \$148 loss from Form 4684 on line 14. He totals lines 10 through 17 and enters \$954 on line 18. He carries the gain from line 18 to line 18b(2) and shows it as ordinary income on line 14 of Form 1040.

Schedule D (Form 1040) Capital Gains and Losses

After completing Form 4797, Mr. Brown fills in Schedule D to report gains and losses on capital assets. He prints his name, his wife's name, and his social security number at the top of Schedule D.

Entries. He enters the required information in the appropriate columns.

Lines 1 and 3. He reports as a short-term loss on line 1 his \$50 loss on the 1999 sale of H. T. Corporation stock held one year or less. He includes the gross sales price of the stock in column (d) on lines 1 and 3.

Line 7. He completes Part I of Schedule D by entering on line 7 the loss in column 1(f).

Lines 8 and 10. He enters on line 8 his \$745 long-term gain on the sale of Circle Corporation stock held more than one year and also enters the gross sales price on line 10.

Line 11. Mr. Brown had previously entered on line 11 the gain from line 7 of Form 4797.

Line 16. He combines the column (f) amounts on lines 8 and 11 and enters the result on line 16.

Line 17. In Part III, he combines lines 7 and 16 and enters his total capital gain on line 17. He also enters this amount on Form 1040, line 13.

After he completes his Form 1040 through line 39, he will use Part IV to figure his tax without regard to farm income averaging. See *Schedule J (Form 1040) Farm Income Averaging*, later.

He does not have a capital loss carryover this year, so he does not complete the *Capital Loss Carryover Worksheet* in the instructions.

TIP Although Mr. Brown is required to complete Schedule D (Form 1040) and attach it to his return, certain other taxpayers may be able to complete the Capital Gain Tax Worksheet in the Form 1040 instructions instead. See the instructions for line 13 of the 1999 Form 1040.

Form 1040, Page 1

Mr. Brown is filing a joint return with his wife. He uses the form he received from the IRS.

Line items. He fills in all applicable items on page 1 of Form 1040.

Line 6c. He prints the name and social security number of each dependent child he claims.

Line 7. Mrs. Brown worked part time as a substitute teacher for the county school system during 1999. She also worked for Mr. Brown on the farm during 1999. He enters on line 7 her total wages, \$8,950 (\$7,750 from the school system and \$1,200 from the farm), as shown on the Forms W-2 that he and the school system gave her.

Lines 8a and 9. He did not actually receive cash payment for the interest he listed on line 8a (\$375). It was credited to his account so that he could have withdrawn it in 1999. Therefore, he constructively received it

and correctly included it in his income for 1999. He enters the \$220 in dividends he received from the Circle Corporation on line 9.

He received patronage dividends from farmers' cooperatives based on business done with these cooperatives. He does not list these dividends here, but properly included them on lines 5a and 5b, Part I of Schedule F.

Since he did not receive more than \$400 in interest or \$400 in dividends and none of the other conditions listed at the beginning of the Schedule B instructions applied, he is not required to complete Schedule B.

Lines 13, 14, and 18. He previously entered the following items.

- His capital gain on line 13 from Schedule D, line 17.
- His other gain on line 14 from Form 4797, line 18b(2).
- His net farm profit on line 18 from Schedule F, line 36.

Line 22. He adds the amounts on lines 7 through 21 and enters the total, \$84,621.

Line 27. He has already entered one-half of his self-employment tax, \$4,144, which he figured on Schedule SE.

Line 28. He paid premiums of \$8,400 during 1999 for health insurance coverage for himself and his family and qualifies for the self-employed health insurance deduction. He figures the part of his insurance payment that he can deduct by completing the *Self-Employed Health Insurance Deduction Worksheet* (not shown) in the instructions for Form 1040. He enters the result, \$5,040, on line 28 and includes the remaining part of his insurance payment in figuring his medical expense deduction on Schedule A (Form 1040), which is not shown.

Line 32. He adds the amounts on lines 23 through 31a and enters the total, \$9,184, on line 32.

Lines 33 and 34. He subtracts line 32 from line 22 to get his "adjusted gross income" and enters the result, \$75,437, on line 33 and also on line 34 of page 2.

Form 1040, Page 2

Mr. Brown fills in the following lines on page 2 of Form 1040.

Line 36. He enters \$7,500 from his Schedule A (Form 1040), which is not shown, because the total of his itemized deductions is larger than the \$7,200 standard deduction for his filing status (married filing joint return).

Lines 37, 38, and 39. He subtracts the \$7,500 on line 36 from the \$75,437 on line 34 and enters the result, \$67,937 on line 37. He enters \$13,750 ($5 \times \$2,750$) on line 38 and subtracts this amount from the amount on line 37 to get taxable income on line 39.

Line 40. He enters \$7,348 from Schedule J, line 22. For information on how he figured his tax using farm income averaging, see *Schedule J (Form 1040)*, later.

Line 43. The Browns qualify for the child tax credit. He figures his credit by completing the *Child Tax Credit Worksheet* (not shown) in the instructions for Form 1040. He enters his credit, \$1,500, on line 43.

Lines 48 and 49. He enters on line 48 the amount of the child tax credit from line 43 since it is the only amount he entered on lines 41 through 47. He subtracts that amount from the tax on line 40 and enters \$5,848 on line 49.

Line 50. He has already entered the \$8,288 self-employment tax he figured on Schedule SE.

Line 56. He adds the amounts on lines 49 through 55 and enters \$14,136, which is the total tax for 1999.

Line 57. He enters the income tax withheld from Mrs. Brown's wages, \$435, as shown on the Forms W-2 she received. He attaches Copy B of her Forms W-2 to the front of Form 1040.

Line 58. He did not make 1999 estimated tax payments since two-thirds of his gross income for 1998 was from farming. He was sure that at least two-thirds of his gross income for 1999 would again be from farming. Farmers who meet either of these conditions do not have to make 1999 estimated tax payments. If he files his Form 1040 and pays the tax due no later than March 1, 2000, he will not be penalized for failure to pay estimated taxes. He makes no entry on line 58.

Line 59a. The Browns are not entitled to claim the earned income credit on line 59a, because their modified adjusted gross income is more than \$30,580.

Line 63. Mr. Brown enters his credit for \$350 of federal excise tax on gasoline used in 1999. He checks box "b" and attaches Form 4136 (not shown) to his return, showing how he figured the credit. The credit must be reported as other income on Schedule F on his 2000 return.

Lines 64 and 68. He adds the amounts on lines 57 through 63 and enters the total, \$785, on line 64. He subtracts that figure from the amount on line 56. The balance, \$13,351, is entered on line 68.

Schedule J (Form 1040) Farm Income Averaging

In 1999, Mr. Brown's taxable income, \$54,187, is substantially higher than in each of the 3 previous years. His taxable income amounts were only \$2,500, \$1,050, and \$700 for 1998, 1997, and 1996, respectively, and he had no gains or losses from farming. He elects to use farm income averaging by completing Schedule J to figure his tax.

First, he uses Part IV of Schedule D to figure his tax without regard to farm income averaging. Next, he uses Schedule J to figure his tax using farm income averaging.

Line items. He fills in the lines on Schedule J.

Line 1. He enters \$54,187, his taxable income from line 39 of Form 1040.

Line 2. He enters the part of his farm income he is electing to average, \$35,187. This amount of farm income allows him to take advantage of the lowest tax brackets for this year and the 3 previous years.

Line 3. He subtracts the amount on line 2 from the amount on line 1 and enters \$19,000 on line 3.

Line 4. Because he has capital gains and losses this year, he computes the tax on \$19,000 using Part IV of Schedule D (not shown) and enters the result, \$2,076, on line 4.

Lines 5, 9, and 13. He enters his taxable income from 1996, 1997, and 1998 on lines 5, 9, and 13, respectively.

Lines 6, 10, and 14. He divides the amount on line 2 by 3.0 and enters the result, \$11,729, on lines 6, 10, and 14.

Lines 7, 11, and 15. He figures his adjusted taxable income for the 3 previous years by adding the amounts on lines 6, 10, and 14 to the amounts on lines 5, 9, and 13, respectively.

Lines 8, 12, and 16. He figures the tax on the amounts on lines 7, 11, and 15 using the appropriate Tax Rate Schedules and enters the results on lines 8, 12, and 16, respectively. His income is taxed at the 15% rate for each year.

Line 17. He adds the amounts on lines 4, 8, 12, and 16 and enters the total, \$7,991, on line 17.

Lines 18, 19, and 20. He enters his tax from his 1996, 1997, and 1998 returns on lines 18, 19, and 20, respectively.

Line 21. He adds the amounts on lines 18, 19, and 20 and enters the total, \$643, on line 21.

Line 22. He subtracts the amount on line 21 from the amount on line 17 and enters \$7,348 on line 22. The tax on this line is less than the \$8,469 of tax he figured using Schedule D. Therefore, he enters on line 40 of his Form 1040 the amount from this line.

Completing the Return

The Browns sign their names and enter the date signed, their occupations, and their telephone number on the bottom of page 2 of Form 1040. (If they had not prepared their own tax return, the preparer would also sign the return and provide the information requested at the bottom of the page.) Mr. Brown attaches to the return the address label in the instructions after verifying the accuracy of the label. He writes his and his wife's social security numbers in the boxes next to the address label.

He writes a check payable to the U.S. Treasury for the full amount on line 68 of Form 1040. On the check, he writes his social security number, their telephone number, and "1999 Form 1040." His name and address are printed on the check. Mr. Brown could instead have chosen to pay part or all of his taxes by credit card (MasterCard, American Express, or Discover). This is a new method of payment that is optional.

After making a copy of their complete return for his records, he assembles the various forms and schedules in the following order (see "Attachment Sequence Number" in the upper right corner of each schedule or form).

- 1) Their original Form 1040.
- 2) Schedule A.
- 3) Schedule D.
- 4) Schedule F.
- 5) Schedule SE.
- 6) Schedule J.
- 7) Form 4136.
- 8) Form 4684.
- 9) Form 4797.
- 10) Form 4562.
- 11) Form 8824.

He completes Form 1040-V, *Payment Voucher*, which was included in his tax package. He carefully follows the instructions for mailing his return and paying the tax.

For the year Jan. 1–Dec. 31, 1999, or other tax year beginning _____, 1999, ending _____

Label
(See instructions on page 18.)
Use the IRS label. Otherwise, please print or type.
Presidential Election Campaign (See page 18.)

L A B E L H E R E	Your first name and initial Walter A.	Last name Brown
	If a joint return, spouse's first name and initial Jane W.	Last name Brown
	Home address (number and street). If you have a P.O. box, see page 18. RR 1 Box 25	
	City, town or post office, state, and ZIP code. If you have a foreign address, see page 18. Hometown, VA 22870	
	Apt. no.	

Your social security number
543 : 00 : 2111

Spouse's social security number
543 : 00 : 1222

IMPORTANT!
You must enter your SSN(s) above.

Yes	No	Note. Checking "Yes" will not change your tax or reduce your refund.
X		
X		

Filing Status

1 Single

2 Married filing joint return (even if only one had income)

3 Married filing separate return. Enter spouse's social security no. above and full name here. ▶ _____

4 Head of household (with qualifying person). (See page 18.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶ _____

5 Qualifying widow(er) with dependent child (year spouse died ▶ 19 ____). (See page 18.)

Exemptions

6a Yourself. If your parent (or someone else) can claim you as a dependent on his or her tax return, do not check box 6a.

6b Spouse

6c **Dependents:**

(1) First name	Last name	(2) Dependent's social security number	(3) Dependent's relationship to you	(4) <input checked="" type="checkbox"/> if qualifying child for child tax credit (see page 19)
MICHAEL	BROWN	579 : 00 : 9999	Son	<input checked="" type="checkbox"/>
MATTHEW	BROWN	579 : 00 : 9998	Son	<input checked="" type="checkbox"/>
SARAH	BROWN	579 : 00 : 9997	Daughter	<input checked="" type="checkbox"/>
				<input type="checkbox"/>
				<input type="checkbox"/>
				<input type="checkbox"/>

6d Total number of exemptions claimed **5**

Income

7 Wages, salaries, tips, etc. Attach Form(s) W-2. 7 8,950 -

8a Taxable interest. Attach Schedule B if required. 8a 375 -

9 Ordinary dividends. Attach Schedule B if required. 9 220 -

10 Taxable refunds, credits, or offsets of state and local income taxes (see page 21). 10 -

11 Alimony received. 11 -

12 Business income or (loss). Attach Schedule C or C-EZ. 12 -

13 Capital gain or (loss). Attach Schedule D if required. If not required, check here 13 15,465 -

14 Other gains or (losses). Attach Form 4797. 14 954 -

15a Total IRA distributions. 15a Taxable amount (see page 22) 15b -

16a Total pensions and annuities. 16a Taxable amount (see page 22) 16b -

17 Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E. 17 -

18 Farm income or (loss). Attach Schedule F. 18 58,657 -

19 Unemployment compensation. 19 -

20a Social security benefits. 20a Taxable amount (see page 24) 20b -

21 Other income. List type and amount (see page 24) 21 -

22 Add the amounts in the far right column for lines 7 through 21. This is your total income ▶ 22 84,621 -

Adjusted Gross Income

23 IRA deduction (see page 26). 23 -

24 Student loan interest deduction (see page 26). 24 -

25 Medical savings account deduction. Attach Form 8853. 25 -

26 Moving expenses. Attach Form 3903. 26 -

27 One-half of self-employment tax. Attach Schedule SE. 27 4,144 -

28 Self-employed health insurance deduction (see page 28). 28 5,040 -

29 Keogh and self-employed SEP and SIMPLE plans. 29 -

30 Penalty on early withdrawal of savings. 30 -

31a Alimony paid b Recipient's SSN ▶ 31a -

32 Add lines 23 through 31a. 32 9,184 -

33 Subtract line 32 from line 22. This is your adjusted gross income ▶ 33 75,437 -

Tax and Credits

Standard Deduction for Most People
 Single: \$4,300
 Head of household: \$6,350
 Married filing jointly or Qualifying widow(er): \$7,200
 Married filing separately: \$3,600

34	Amount from line 33 (adjusted gross income)	34	75,437	-
35a	Check if: <input type="checkbox"/> You were 65 or older, <input type="checkbox"/> Blind; <input type="checkbox"/> Spouse was 65 or older, <input type="checkbox"/> Blind. Add the number of boxes checked above and enter the total here	35a		
b	If you are married filing separately and your spouse itemizes deductions or you were a dual-status alien, see page 30 and check here	35b		
36	Enter your itemized deductions from Schedule A, line 28, OR standard deduction shown on the left. But see page 30 to find your standard deduction if you checked any box on line 35a or 35b or if someone can claim you as a dependent	36	7,500	-
37	Subtract line 36 from line 34	37	67,937	-
38	If line 34 is \$94,975 or less, multiply \$2,750 by the total number of exemptions claimed on line 6d. If line 34 is over \$94,975, see the worksheet on page 31 for the amount to enter	38	13,750	-
39	Taxable income. Subtract line 38 from line 37. If line 38 is more than line 37, enter -0-	39	54,187	-
40	Tax (see page 31). Check if any tax is from a <input type="checkbox"/> Form(s) 8814 b <input type="checkbox"/> Form 4972	40	7,348	-
41	Credit for child and dependent care expenses. Attach Form 2441	41		
42	Credit for the elderly or the disabled. Attach Schedule R	42		
43	Child tax credit (see page 33)	43	1,500	-
44	Education credits. Attach Form 8863	44		
45	Adoption credit. Attach Form 8839	45		
46	Foreign tax credit. Attach Form 1116 if required	46		
47	Other. Check if from a <input type="checkbox"/> Form 3800 b <input type="checkbox"/> Form 8396 c <input type="checkbox"/> Form 8801 d <input type="checkbox"/> Form (specify)	47		
48	Add lines 41 through 47. These are your total credits	48	1,500	-
49	Subtract line 48 from line 40. If line 48 is more than line 40, enter -0-	49	5,848	-

Other Taxes

50	Self-employment tax. Attach Schedule SE	50	8,288	-
51	Alternative minimum tax. Attach Form 6251	51		
52	Social security and Medicare tax on tip income not reported to employer. Attach Form 4137	52		
53	Tax on IRAs, other retirement plans, and MSAs. Attach Form 5329 if required	53		
54	Advance earned income credit payments from Form(s) W-2	54		
55	Household employment taxes. Attach Schedule H	55		
56	Add lines 49 through 55. This is your total tax	56	14,136	-

Payments

57	Federal income tax withheld from Forms W-2 and 1099	57	435	-
58	1999 estimated tax payments and amount applied from 1998 return	58		
59a	Earned income credit. Attach Sch. EIC if you have a qualifying child	59a		
b	Nontaxable earned income: amount and type			
60	Additional child tax credit. Attach Form 8812	60		
61	Amount paid with request for extension to file (see page 48)	61		
62	Excess social security and RRTA tax withheld (see page 48)	62		
63	Other payments. Check if from a <input type="checkbox"/> Form 2439 b <input checked="" type="checkbox"/> Form 4136	63	350	-
64	Add lines 57, 58, 59a, and 60 through 63. These are your total payments	64	785	-

Refund

Have it directly deposited! See page 48 and fill in 66b, 66c, and 66d.

65	If line 64 is more than line 56, subtract line 56 from line 64. This is the amount you OVERPAID	65		
66a	Amount of line 65 you want REFUNDED TO YOU	66a		
b	Routing number			
c	Type: <input type="checkbox"/> Checking <input type="checkbox"/> Savings			
d	Account number			
67	Amount of line 65 you want APPLIED TO YOUR 2000 ESTIMATED TAX	67		

Amount You Owe

68	If line 56 is more than line 64, subtract line 64 from line 56. This is the AMOUNT YOU OWE . For details on how to pay, see page 49	68	13,351	-
69	Estimated tax penalty. Also include on line 68	69		

Sign Here

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Joint return? See page 18. Keep a copy for your records.

Your signature	Date	Your occupation	Daytime telephone number (optional)
WALTER A. BROWN	2-23-00	FARMER	(555) 735-0001
Spouse's signature. If a joint return, BOTH must sign.	Date	Spouse's occupation	
JANE W. BROWN	2-23-00	TEACHER	

Paid Preparer's Use Only

Preparer's signature	Date	Check if self-employed <input type="checkbox"/>	Preparer's SSN or PTIN
Firm's name (or yours if self-employed) and address			EIN
			ZIP code

**SCHEDULE D
(Form 1040)**

Department of the Treasury
Internal Revenue Service

Capital Gains and Losses

▶ Attach to Form 1040. ▶ See Instructions for Schedule D (Form 1040).
▶ Use Schedule D-1 for more space to list transactions for lines 1 and 8.

OMB No. 1545-0074

1999

Attachment
Sequence No. **12**

Name(s) shown on Form 1040

WALTER A. & JANE W. BROWN

Your social security number

543 : 00 : 2111

Part I Short-Term Capital Gains and Losses—Assets Held One Year or Less

(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see page D-5)	(e) Cost or other basis (see page D-5)	(f) GAIN or (LOSS) Subtract (e) from (d)
1 25 shares HT Corp	12-3-98	3-6-99	400 -	450 -	(50 -)
2 Enter your short-term totals, if any, from Schedule D-1, line 2	2				
3 Total short-term sales price amounts. Add column (d) of lines 1 and 2	3		400 -		
4 Short-term gain from Form 6252 and short-term gain or (loss) from Forms 4684, 6781, and 8824	4				
5 Net short-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1	5				
6 Short-term capital loss carryover. Enter the amount, if any, from line 8 of your 1998 Capital Loss Carryover Worksheet	6				()
7 Net short-term capital gain or (loss). Combine lines 1 through 6 in column (f) ▶	7				(50 -)

Part II Long-Term Capital Gains and Losses—Assets Held More Than One Year

(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see page D-5)	(e) Cost or other basis (see page D-5)	(f) GAIN or (LOSS) Subtract (e) from (d)	(g) 28% RATE GAIN or (LOSS) * (see instr. below)
8 40 shares Circle Corp	10-16-79	6-5-99	1,000 -	255 -	745 -	
9 Enter your long-term totals, if any, from Schedule D-1, line 9	9					
10 Total long-term sales price amounts. Add column (d) of lines 8 and 9	10		1,000 -			
11 Gain from Form 4797, Part I; long-term gain from Forms 2439 and 6252; and long-term gain or (loss) from Forms 4684, 6781, and 8824	11				14,770 -	
12 Net long-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1	12					
13 Capital gain distributions. See page D-1	13					
14 Long-term capital loss carryover. Enter in both columns (f) and (g) the amount, if any, from line 13 of your 1998 Capital Loss Carryover Worksheet	14				()	()
15 Combine lines 8 through 14 in column (g)	15					
16 Net long-term capital gain or (loss). Combine lines 8 through 14 in column (f) ▶ Next: Go to Part III on the back.	16				15,515 -	

* 28% Rate Gain or Loss includes all "collectibles gains and losses" (as defined on page D-5) and up to 50% of the eligible gain on qualified small business stock (see page D-4).

Part III Summary of Parts I and II

17	Combine lines 7 and 16. If a loss, go to line 18. If a gain, enter the gain on Form 1040, line 13 Next: Complete Form 1040 through line 39. Then, go to Part IV to figure your tax if: <ul style="list-style-type: none"> • Both lines 16 and 17 are gains, and • Form 1040, line 39, is more than zero. 	17	15,465	-
18	If line 17 is a loss, enter here and as a (loss) on Form 1040, line 13, the smaller of these losses: <ul style="list-style-type: none"> • The loss on line 17, or • (\$3,000) or, if married filing separately, (\$1,500) Next: Skip Part IV below. Instead, complete Form 1040 through line 37. Then, complete the Capital Loss Carryover Worksheet on page D-6 if: <ul style="list-style-type: none"> • The loss on line 17 exceeds the loss on line 18, or • Form 1040, line 37, is a loss. 	18	()

Part IV Tax Computation Using Maximum Capital Gains Rates

19	Enter your taxable income from Form 1040, line 39	19	54,187	-
20	Enter the smaller of line 16 or line 17 of Schedule D	20	15,465	-
21	If you are filing Form 4952, enter the amount from Form 4952, line 4e	21	- 0 -	
22	Subtract line 21 from line 20. If zero or less, enter -0-	22	15,465	-
23	Combine lines 7 and 15. If zero or less, enter -0-	23	- 0 -	
24	Enter the smaller of line 15 or line 23, but not less than zero	24	- 0 -	
25	Enter your unrecaptured section 1250 gain, if any, from line 16 of the worksheet on page D-7	25	- 0 -	
26	Add lines 24 and 25	26	- 0 -	
27	Subtract line 26 from line 22. If zero or less, enter -0-	27	15,465	-
28	Subtract line 27 from line 19. If zero or less, enter -0-	28	38,722	-
29	Enter the smaller of: <ul style="list-style-type: none"> • The amount on line 19, or • \$25,750 if single; \$43,050 if married filing jointly or qualifying widow(er); \$21,525 if married filing separately; or \$34,550 if head of household 	29	43,050	-
30	Enter the smaller of line 28 or line 29	30	38,722	-
31	Subtract line 22 from line 19. If zero or less, enter -0-	31	38,722	-
32	Enter the larger of line 30 or line 31	32	38,722	-
33	Figure the tax on the amount on line 32. Use the Tax Table or Tax Rate Schedules, whichever applies Note. If line 29 is less than line 28, go to line 38.	33	5,809	-
34	Enter the amount from line 29	34	43,050	-
35	Enter the amount from line 28	35	38,722	-
36	Subtract line 35 from line 34. If zero or less, enter -0-	36	4,328	-
37	Multiply line 36 by 10% (.10) Note. If line 27 is more than zero and equal to line 36, go to line 52.	37	433	-
38	Enter the smaller of line 19 or line 27	38	15,465	-
39	Enter the amount from line 36	39	4,328	-
40	Subtract line 39 from line 38	40	11,137	-
41	Multiply line 40 by 20% (.20) Note. If line 25 is zero or blank, skip lines 42 through 47 and read the note above line 48.	41	2,227	-
42	Enter the smaller of line 22 or line 25	42		
43	Add lines 22 and 32	43		
44	Enter the amount from line 19	44		
45	Subtract line 44 from line 43. If zero or less, enter -0-	45		
46	Subtract line 45 from line 42. If zero or less, enter -0-	46		
47	Multiply line 46 by 25% (.25) Note. If line 24 is zero or blank, go to line 52.	47		
48	Enter the amount from line 19	48		
49	Add lines 32, 36, 40, and 46	49		
50	Subtract line 49 from line 48	50		
51	Multiply line 50 by 28% (.28)	51		
52	Add lines 33, 37, 41, 47, and 51	52	8,469	-
53	Figure the tax on the amount on line 19. Use the Tax Table or Tax Rate Schedules, whichever applies	53	9,573	-
54	Tax on all taxable income (including capital gains). Enter the smaller of line 52 or line 53 here and on Form 1040, line 40.	54	8,469	-

**SCHEDULE F
(Form 1040)**

Department of the Treasury
Internal Revenue Service

Profit or Loss From Farming

▶ Attach to Form 1040, Form 1041, Form 1065, or Form 1065-B.

▶ See Instructions for Schedule F (Form 1040).

OMB No. 1545-0074

1999

Attachment
Sequence No. **14**

Name of proprietor
WALTER A. BROWN

Social security number (SSN)
543 : 00 : 2111

A Principal product. Describe in one or two words your principal crop or activity for the current tax year.
MILK

B Enter code from Part IV
▶ | 1 | 1 | 2 | 1 | 2 | 0

C Accounting method: (1) Cash (2) Accrual

D Employer ID number (EIN), if any
1 | 0 | 9 | 8 | 7 | 6 | 5 | 4 | 3

E Did you "materially participate" in the operation of this business during 1999? If "No," see page F-2 for limit on passive losses. Yes No

**Part I Farm Income—Cash Method. Complete Parts I and II (Accrual method taxpayers complete Parts II and III, and line 11 of Part I.)
Do not include sales of livestock held for draft, breeding, sport, or dairy purposes; report these sales on Form 4797.**

1	Sales of livestock and other items you bought for resale	1	26,584	-			
2	Cost or other basis of livestock and other items reported on line 1	2	6,523	-			
3	Subtract line 2 from line 1	3			20,061	-	
4	Sales of livestock, produce, grains, and other products you raised	4			163,018	-	
5a	Total cooperative distributions (Form(s) 1099-PATR)	5a	33	-	5b Taxable amount	33	-
6a	Agricultural program payments (see page F-2)	6a	438	-	6b Taxable amount	438	-
7	Commodity Credit Corporation (CCC) loans (see page F-3):						
a	CCC loans reported under election	7a			665	-	
b	CCC loans forfeited	7b			7c Taxable amount		
8	Crop insurance proceeds and certain disaster payments (see page F-3):						
a	Amount received in 1999	8a			8b Taxable amount		
c	If election to defer to 2000 is attached, check here ▶ <input type="checkbox"/>	8d			8d		
	8d Amount deferred from 1998						
9	Custom hire (machine work) income	9			1,258	-	
10	Other income, including Federal and state gasoline or fuel tax credit or refund (see page F-3)	10			567	-	
11	Gross income. Add amounts in the right column for lines 3 through 10. If accrual method taxpayer, enter the amount from page 2, line 51 ▶	11			186,040	-	

Part II Farm Expenses—Cash and Accrual Method. Do not include personal or living expenses such as taxes, insurance, repairs, etc., on your home.

12	Car and truck expenses (see page F-4—also attach Form 4562)	12	4,043	-	25	Pension and profit-sharing plans	25		
13	Chemicals	13	2,701	-	26	Rent or lease (see page F-5):			
14	Conservation expenses (see page F-4)	14	1,040	-	a	Vehicles, machinery, and equipment	26a		
15	Custom hire (machine work)	15	1,575	-	b	Other (land, animals, etc.)	26b	2,400	-
16	Depreciation and section 179 expense deduction not claimed elsewhere (see page F-4)	16	37,978	-	27	Repairs and maintenance	27	5,424	-
17	Employee benefit programs other than on line 25	17			28	Seeds and plants purchased	28	2,132	-
18	Feed purchased	18	18,019	-	29	Storage and warehousing	29		
19	Fertilizers and lime	19	6,544	-	30	Supplies purchased	30	2,807	-
20	Freight and trucking	20	5,105	-	31	Taxes	31	3,201	-
21	Gasoline, fuel, and oil	21	3,521	-	32	Utilities	32	3,997	-
22	Insurance (other than health)	22	1,070	-	33	Veterinary, breeding, and medicine	33	3,217	-
23	Interest:				34	Other expenses (specify):			
a	Mortgage (paid to banks, etc.)	23a	3,175	-	a	Milk assessment	34a	807	-
b	Other	23b	1,043	-	b	Commissions, dues & fees	34b	347	-
24	Labor hired (less employment credits)	24	16,416	-	c	Records/Office supplies	34c	287	-
					d	Travel & meals	34d	534	-
					e	34e		
					f	34f		
35	Total expenses. Add lines 12 through 34f ▶	35						127,383	-
36	Net farm profit or (loss). Subtract line 35 from line 11. If a profit, enter on Form 1040, line 18, and ALSO on Schedule SE, line 1. If a loss, you MUST go on to line 37 (estates, trusts, and partnerships, see page F-6)	36						58,657	-
37	If you have a loss, you MUST check the box that describes your investment in this activity (see page F-6). • If you checked 37a, enter the loss on Form 1040, line 18, and ALSO on Schedule SE, line 1. • If you checked 37b, you MUST attach Form 6198.				37a	<input type="checkbox"/> All investment is at risk.			
					37b	<input type="checkbox"/> Some investment is not at risk.			

**SCHEDULE SE
(Form 1040)**

Department of the Treasury
Internal Revenue Service

Self-Employment Tax

▶ See Instructions for Schedule SE (Form 1040).

▶ Attach to Form 1040.

OMB No. 1545-0074

1999

Attachment
Sequence No. **17**

Name of person with self-employment income (as shown on Form 1040)
WALTER A. BROWN

Social security number of person
with self-employment income ▶

543 : 00 : 211

Who Must File Schedule SE

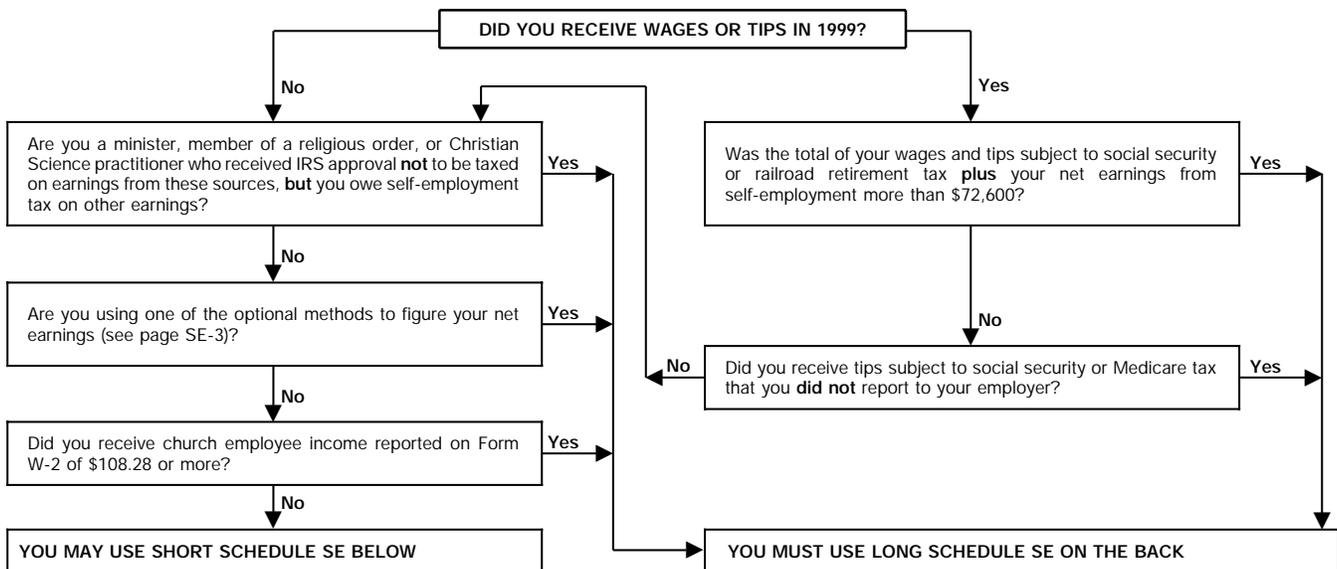
You must file Schedule SE if:

- You had net earnings from self-employment from **other than** church employee income (line 4 of Short Schedule SE or line 4c of Long Schedule SE) of \$400 or more, **OR**
- You had church employee income of \$108.28 or more. Income from services you performed as a minister or a member of a religious order **is not** church employee income. See page SE-1.

Note: Even if you had a loss or a small amount of income from self-employment, it may be to your benefit to file Schedule SE and use either "optional method" in Part II of Long Schedule SE. See page SE-3.

Exception. If your only self-employment income was from earnings as a minister, member of a religious order, or Christian Science practitioner **and** you filed Form 4361 and received IRS approval not to be taxed on those earnings, **do not** file Schedule SE. Instead, write "Exempt-Form 4361" on Form 1040, line 50.

May I Use Short Schedule SE or MUST I Use Long Schedule SE?



Section A—Short Schedule SE. Caution: Read above to see if you can use Short Schedule SE.

1	Net farm profit or (loss) from Schedule F, line 36, and farm partnerships, Schedule K-1 (Form 1065), line 15a	1	58,657	–
2	Net profit or (loss) from Schedule C, line 31; Schedule C-EZ, line 3; Schedule K-1 (Form 1065), line 15a (other than farming); and Schedule K-1 (Form 1065-B), box 9. Ministers and members of religious orders, see page SE-1 for amounts to report on this line. See page SE-2 for other income to report	2		
3	Combine lines 1 and 2	3	58,657	–
4	Net earnings from self-employment. Multiply line 3 by 92.35% (.9235). If less than \$400, do not file this schedule; you do not owe self-employment tax ▶	4	54,170	–
5	Self-employment tax. If the amount on line 4 is: <ul style="list-style-type: none"> • \$72,600 or less, multiply line 4 by 15.3% (.153). Enter the result here and on Form 1040, line 50. • More than \$72,600, multiply line 4 by 2.9% (.029). Then, add \$9,002.40 to the result. Enter the total here and on Form 1040, line 50. 	5	8,288	–
6	Deduction for one-half of self-employment tax. Multiply line 5 by 50% (.5). Enter the result here and on Form 1040, line 27	6	4,144	–

**SCHEDULE J
(Form 1040)**

Farm Income Averaging

OMB No. 1545-0074

1999

Attachment
Sequence No. **20**

Department of the Treasury
Internal Revenue Service

▶ Attach to Form 1040.

▶ See Instructions for Schedule J (Form 1040).

Name(s) shown on Form 1040

WALTER A. & JANE W. BROWN

Social security number (SSN)

543 : 00 : 2111

1	Enter your taxable income from Form 1040, line 39				1	54,187	-
2	Enter your elected farm income (see page J-1).				2	35,187	-
3	Subtract line 2 from line 1. If zero or less, enter -0-				3	19,000	-
4	Figure the tax on the amount on line 3. Use the 1999 Tax Table, Tax Rate Schedules, Capital Gain Tax Worksheet, or Schedule D, whichever applies				4	2,076	-
5	If you used Schedule J to figure your tax for 1998, enter the amount from line 11 of that Schedule J. Otherwise, enter the taxable income (but not less than zero) from your 1996 Form 1040, line 37; Form 1040A, line 22; or Form 1040EZ, line 6	5	700	-			
6	Divide the amount on line 2 by 3.0	6	11,729	-			
7	Add lines 5 and 6	7	12,429	-			
8	Figure the tax on the amount on line 7. Use the 1996 Tax Rate Schedules or Capital Gain Tax Worksheet, whichever applies (see page J-2)				8	1,864	-
9	If you used Schedule J to figure your tax for 1998, enter the amount from line 15 of that Schedule J. Otherwise, enter the taxable income (but not less than zero) from your 1997 Form 1040, line 38; Form 1040A, line 22; or Form 1040EZ, line 6	9	1,050	-			
10	Enter the amount from line 6	10	11,729	-			
11	Add lines 9 and 10	11	12,779	-			
12	Figure the tax on the amount on line 11. Use the 1997 Tax Rate Schedules or Schedule D, whichever applies (see page J-3)				12	1,917	-
13	If you used Schedule J to figure your tax for 1998, enter the amount from line 3 of that Schedule J. Otherwise, enter the taxable income (but not less than zero) from your 1998 Form 1040, line 39; Form 1040A, line 24; or Form 1040EZ, line 6	13	2,500	-			
14	Enter the amount from line 6	14	11,729	-			
15	Add lines 13 and 14	15	14,229	-			
16	Figure the tax on the amount on line 15. Use the 1998 Tax Rate Schedules or Schedule D, whichever applies (see page J-4)				16	2,134	-
17	Add lines 4, 8, 12, and 16				17	7,991	-
18	If you used Schedule J to figure your tax for 1998, enter the amount from line 12 of that Schedule J. Otherwise, enter the tax from your 1996 Form 1040, line 38*; Form 1040A, line 23; or Form 1040EZ, line 10	18	107	-			
19	If you used Schedule J to figure your tax for 1998, enter the amount from line 16 of that Schedule J. Otherwise, enter the tax from your 1997 Form 1040, line 39*; Form 1040A, line 23; or Form 1040EZ, line 10	19	159	-			
20	If you used Schedule J to figure your tax for 1998, enter the amount from line 4 of that Schedule J. Otherwise, enter the tax from your 1998 Form 1040, line 40*; Form 1040A, line 25; or Form 1040EZ, line 10	20	377	-			
* Caution. Do not include any amount from Form 4972 or 8814.							
21	Add lines 18 through 20				21	643	-
22	Subtract line 21 from line 17. Also include this amount on Form 1040, line 40 Caution. Your tax may be less if you figure it using the 1999 Tax Table, Tax Rate Schedules, Capital Gain Tax Worksheet, or Schedule D. Attach Schedule J only if you are using it to figure your tax.				22	7,348	-

Name(s) shown on tax return. Do not enter name and identifying number if shown on other side.

Identifying number

WALTER A. & JANE W. BROWN

543-00-2111

SECTION B—Business and Income-Producing Property

Part I Casualty or Theft Gain or Loss (Use a separate Part I for each casualty or theft.)

- 19 Description of properties (show type, location, and date acquired for each):
 Property A DAIRY COW #42 HOMETOWN, VA 6-22-95
 Property B
 Property C
 Property D

	Properties (Use a separate column for each property lost or damaged from one casualty or theft.)			
	A	B	C	D
20 Cost or adjusted basis of each property	20 257	-		
21 Insurance or other reimbursement (whether or not you filed a claim). See the instructions for line 3 Note: If line 20 is more than line 21, skip line 22.	21 109	-		
22 Gain from casualty or theft. If line 21 is more than line 20, enter the difference here and on line 29 or line 34, column (c), except as provided in the instructions for line 33. Also, skip lines 23 through 27 for that column. See the instructions for line 4 if line 21 includes insurance or other reimbursement you did not claim, or you received payment for your loss in a later tax year.	22			
23 Fair market value before casualty or theft	23 500	-		
24 Fair market value after casualty or theft	24 - 0	-		
25 Subtract line 24 from line 23	25 500	-		
26 Enter the smaller of line 20 or line 25 Note: If the property was totally destroyed by casualty or lost from theft, enter on line 26 the amount from line 20.	26 257	-		
27 Subtract line 21 from line 26. If zero or less, enter -0-	27 148	-		
28 Casualty or theft loss. Add the amounts on line 27. Enter the total here and on line 29 or line 34 (see instructions).	28	148	-	

Part II Summary of Gains and Losses (from separate Parts I)

(a) Identify casualty or theft	(b) Losses from casualties or thefts		(c) Gains from casualties or thefts includible in income
	(i) Trade, business, rental or royalty property	(ii) Income-producing and employee property	

Casualty or Theft of Property Held One Year or Less

29	()	()	
30 Totals. Add the amounts on line 29	30 ()	()	
31 Combine line 30, columns (b)(i) and (c). Enter the net gain or (loss) here and on Form 4797, line 14. If Form 4797 is not otherwise required, see instructions	31		
32 Enter the amount from line 30, column (b)(ii) here. Individuals, enter the amount from income-producing property on Schedule A (Form 1040), line 27, and enter the amount from property used as an employee on Schedule A (Form 1040), line 22. Estates and trusts, partnerships, and S corporations, see instructions	32		

Casualty or Theft of Property Held More Than One Year

33 Casualty or theft gains from Form 4797, line 32	33		
34 Cow killed by lightning	(148)	()	
35 Total losses. Add amounts on line 34, columns (b)(i) and (b)(ii)	35 (148)	()	
36 Total gains. Add lines 33 and 34, column (c)	36	- 0	-
37 Add amounts on line 35, columns (b)(i) and (b)(ii)	37	(148)	-
38 If the loss on line 37 is more than the gain on line 36: a Combine line 35, column (b)(i) and line 36, and enter the net gain or (loss) here. Partnerships (except electing large partnerships) and S corporations, see the note below. All others, enter this amount on Form 4797, line 14. If Form 4797 is not otherwise required, see instructions	38a	(148)	-
b Enter the amount from line 35, column (b)(ii) here. Individuals, enter the amount from income-producing property on Schedule A (Form 1040), line 27, and enter the amount from property used as an employee on Schedule A (Form 1040), line 22. Estates and trusts, enter on the "Other deductions" line of your tax return. Partnerships (except electing large partnerships) and S corporations, see the note below. Electing large partnerships, enter on Form 1065-B, Part II, line 11	38b		
39 If the loss on line 37 is less than or equal to the gain on line 36, combine lines 36 and 37 and enter here. Partnerships (except electing large partnerships), see the note below. All others, enter this amount on Form 4797, line 3, column (g)	39		

Note: Partnerships, enter the amount from line 38a, 38b, or line 39 on Form 1065, Schedule K, line 7. S corporations, enter the amount from line 38a or 38b on Form 1120S, Schedule K, line 6.

Sales of Business Property
(Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2))

Department of the Treasury
Internal Revenue Service

▶ **Attach to your tax return.** ▶ **See separate instructions.**

Name(s) shown on return WALTER A. & JANE W. BROWN	Identifying number 543-00-2111
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1 Enter here the gross proceeds from the sale or exchange of real estate reported to you for 1999 on Form(s) 1099-S (or a substitute statement) that you will be including on line 2, 10, or 20 **1**

Part I Sales or Exchanges of Property Used in a Trade or Business and Involuntary Conversions From Other Than Casualty or Theft—Property Held More Than 1 Year

(a) Description of property	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Gross sales price	(e) Depreciation allowed or allowable since acquisition	(f) Cost or other basis, plus improvements and expense of sale	(g) GAIN or (LOSS) Subtract (f) from the sum of (d) and (e)
2						
Raised cows	before 1991	1999	14,110. –	– 0 –	325. –	13,785. –
Dairy cow #52	7-15-95	2-3-99	303. –	514. –	912. –	(95. –)
Raised heifer	6-2-97	8-3-99	1,100	– 0 –	20. –	1,080. –
3 Gain, if any, from Form 4684, line 39						3
4 Section 1231 gain from installment sales from Form 6252, line 26 or 37						4
5 Section 1231 gain or (loss) from like-kind exchanges from Form 8824						5
6 Gain, if any, from line 32, from other than casualty or theft						6
7 Combine lines 2 through 6. Enter the gain or (loss) here and on the appropriate line as follows: Partnerships (except electing large partnerships). Report the gain or (loss) following the instructions for Form 1065, Schedule K, line 6. Skip lines 8, 9, 11, and 12 below. S corporations. Report the gain or (loss) following the instructions for Form 1120S, Schedule K, lines 5 and 6. Skip lines 8, 9, 11, and 12 below, unless line 7 is a gain and the S corporation is subject to the capital gains tax. All others. If line 7 is zero or a loss, enter the amount from line 7 on line 11 below and skip lines 8 and 9. If line 7 is a gain and you did not have any prior year section 1231 losses, or they were recaptured in an earlier year, enter the gain from line 7 as a long-term capital gain on Schedule D and skip lines 8, 9, and 12 below.						7 14,770. –
8 Nonrecaptured net section 1231 losses from prior years (see instructions)						8
9 Subtract line 8 from line 7. If zero or less, enter -0-. Also enter on the appropriate line as follows (see instructions): S corporations. Enter any gain from line 9 on Schedule D (Form 1120S), line 14, and skip lines 11 and 12 below. All others. If line 9 is zero, enter the gain from line 7 on line 12 below. If line 9 is more than zero, enter the amount from line 8 on line 12 below, and enter the gain from line 9 as a long-term capital gain on Schedule D.						9

Part II Ordinary Gains and Losses

10 Ordinary gains and losses not included on lines 11 through 17 (include property held 1 year or less):						
Raised dairy heifer	10-2-98	3-3-99	255. –	– 0 –	5. –	250. –
11 Loss, if any, from line 7						11 ()
12 Gain, if any, from line 7 or amount from line 8, if applicable						12
13 Gain, if any, from line 31						13 852. –
14 Net gain or (loss) from Form 4684, lines 31 and 38a						14 (148. –)
15 Ordinary gain from installment sales from Form 6252, line 25 or 36						15
16 Ordinary gain or (loss) from like-kind exchanges from Form 8824						16
17 Recapture of section 179 expense deduction for partners and S corporation shareholders from property dispositions by partnerships and S corporations (see instructions)						17
18 Combine lines 10 through 17. Enter the gain or (loss) here, and on the appropriate line as follows:						18 954. –
a For all except individual returns: Enter the gain or (loss) from line 18 on the return being filed.						
b For individual returns:						
(1) If the loss on line 11 includes a loss from Form 4684, line 35, column (b)(ii), enter that part of the loss here. Enter the part of the loss from income-producing property on Schedule A (Form 1040), line 27, and the part of the loss from property used as an employee on Schedule A (Form 1040), line 22. Identify as from "Form 4797, line 18b(1)." See instructions						18b(1)
(2) Redetermine the gain or (loss) on line 18, excluding the loss, if any, on line 18b(1). Enter here and on Form 1040, line 14						18b(2) 954. –

Part III Gain From Disposition of Property Under Sections 1245, 1250, 1252, 1254, and 1255

19 (a) Description of section 1245, 1250, 1252, 1254, or 1255 property:		(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)		
A	TRUCK	6-22-90	7-9-99		
B	MOWER	4-21-89	8-12-99		
C	PURCHASED DAIRY COW #60	2-21-96	10-28-99		
D					
These columns relate to the properties on lines 19A through 19D. ▶		Property A	Property B	Property C	Property D
20	Gross sales price (Note: See line 1 before completing)	700. –	70. –	670. –	
21	Cost or other basis plus expense of sale	4,390. –	1,200. –	1,200. –	
22	Depreciation (or depletion) allowed or allowable	4,390. –	1,200. –	612. –	
23	Adjusted basis. Subtract line 22 from line 21	– 0 –	– 0 –	588. –	
24	Total gain. Subtract line 23 from line 20	700. –	70. –	82. –	
25 If section 1245 property:					
a	Depreciation allowed or allowable from line 22	4,390. –	1,200. –	612. –	
b	Enter the smaller of line 24 or 25a	700. –	70. –	82. –	
26 If section 1250 property: If straight line depreciation was used, enter -0- on line 26g, except for a corporation subject to section 291.					
a	Additional depreciation after 1975 (see instructions)				
b	Applicable percentage multiplied by the smaller of line 24 or line 26a (see instructions)				
c	Subtract line 26a from line 24. If residential rental property or line 24 is not more than line 26a, skip lines 26d and 26e				
d	Additional depreciation after 1969 and before 1976				
e	Enter the smaller of line 26c or 26d				
f	Section 291 amount (corporations only)				
g	Add lines 26b, 26e, and 26f				
27 If section 1252 property: Skip this section if you did not dispose of farmland or if this form is being completed for a partnership (other than an electing large partnership).					
a	Soil, water, and land clearing expenses				
b	Line 27a multiplied by applicable percentage (see instructions)				
c	Enter the smaller of line 24 or 27b				
28 If section 1254 property:					
a	Intangible drilling and development costs, expenditures for development of mines and other natural deposits, and mining exploration costs (see instructions)				
b	Enter the smaller of line 24 or 28a				
29 If section 1255 property:					
a	Applicable percentage of payments excluded from income under section 126 (see instructions)				
b	Enter the smaller of line 24 or 29a (see instructions)				

Summary of Part III Gains. Complete property columns A through D through line 29b before going to line 30.

30	Total gains for all properties. Add property columns A through D, line 24	30	852. –
31	Add property columns A through D, lines 25b, 26g, 27c, 28b, and 29b. Enter here and on line 13	31	852. –
32	Subtract line 31 from line 30. Enter the portion from casualty or theft on Form 4684, line 33. Enter the portion from other than casualty or theft on Form 4797, line 6	32	– 0 –

Part IV Recapture Amounts Under Sections 179 and 280F(b)(2) When Business Use Drops to 50% or Less (See instructions.)

		(a) Section 179	(b) Section 280F(b)(2)
33	Section 179 expense deduction or depreciation allowable in prior years	33	
34	Recomputed depreciation. See instructions	34	
35	Recapture amount. Subtract line 34 from line 33. See the instructions for where to report	35	

Part V Listed Property—Automobiles, Certain Other Vehicles, Cellular Telephones, Certain Computers, and Property Used for Entertainment, Recreation, or Amusement

Note: For any vehicle for which you are using the standard mileage rate or deducting lease expense, complete **only** 23a, 23b, columns (a) through (c) of Section A, all of Section B, and Section C if applicable.

Section A—Depreciation and Other Information (Caution: See page 7 of the instructions for limits for passenger automobiles.)

23a Do you have evidence to support the business/investment use claimed? **Yes** **No** **23b** If "Yes," is the evidence written? **Yes** **No**

(a) Type of property (list vehicles first)	(b) Date placed in service	(c) Business/investment use percentage	(d) Cost or other basis	(e) Basis for depreciation (business/investment use only)	(f) Recovery period	(g) Method/Convention	(h) Depreciation deduction	(i) Elected section 179 cost	
24 Property used more than 50% in a qualified business use (See page 6 of the instructions.):									
CAR	1-6-96	60 %	12,350. -	7,410. -	5	150DB/HY	1,065. - *	- 0 -	
PICKUP TRUCK	5-18-96	100 %	7,076. -	7,076. -	5	150DB/HY	1,179. -	- 0 -	
PICKUP TRUCK	6-22-90	100 %							
25 Property used 50% or less in a qualified business use (See page 6 of the instructions.):									
		%				S/L -			
		%				S/L -			
		%				S/L -			
26 Add amounts in column (h). Enter the total here and on line 20, page 1							26	2,244. -	
27 Add amounts in column (i). Enter the total here and on line 7, page 1								27	- 0 -

Section B—Information on Use of Vehicles

Complete this section for vehicles used by a sole proprietor, partner, or other "more than 5% owner," or related person. If you provided vehicles to your employees, first answer the questions in Section C to see if you meet an exception to completing this section for those vehicles.

	(a) Vehicle 1		(b) Vehicle 2		(c) Vehicle 3		(d) Vehicle 4		(e) Vehicle 5		(f) Vehicle 6	
	Yes	No										
28 Total business/investment miles driven during the year (DO NOT include commuting miles—see page 1 of the instructions)	6,270		11,350		2,350							
29 Total commuting miles driven during the year	- 0 -		- 0 -		- 0 -							
30 Total other personal (noncommuting) miles driven	4,180		- 0 -		- 0 -							
31 Total miles driven during the year. Add lines 28 through 30.	10,450		11,350		2,350							
32 Was the vehicle available for personal use during off-duty hours?	✓		✓		✓							
33 Was the vehicle used primarily by a more than 5% owner or related person?	✓		✓		✓							
34 Is another vehicle available for personal use?	✓		✓		✓							

Section C—Questions for Employers Who Provide Vehicles for Use by Their Employees

Answer these questions to determine if you meet an exception to completing Section B for vehicles used by employees who are not more than 5% owners or related persons.

	Yes	No
35 Do you maintain a written policy statement that prohibits all personal use of vehicles, including commuting, by your employees?		
36 Do you maintain a written policy statement that prohibits personal use of vehicles, except commuting, by your employees? See page 8 of the instructions for vehicles used by corporate officers, directors, or 1% or more owners		
37 Do you treat all use of vehicles by employees as personal use?		
38 Do you provide more than five vehicles to your employees, obtain information from your employees about the use of the vehicles, and retain the information received?		
39 Do you meet the requirements concerning qualified automobile demonstration use? See page 8 of the instructions		

Note: If your answer to 35, 36, 37, 38, or 39 is "Yes," you need not complete Section B for the covered vehicles.

Part VI Amortization

(a) Description of costs	(b) Date amortization begins	(c) Amortizable amount	(d) Code section	(e) Amortization period or percentage	(f) Amortization for this year
40 Amortization of costs that begins during your 1999 tax year:					
41 Amortization of costs that began before 1999				41	
42 Total. Enter here and on "Other Deductions" or "Other Expenses" line of your return				42	

* Limited deduction for passenger automobile

How To Get More Information

You can order free publications and forms, ask tax questions, and get more information from the IRS in several ways. By selecting the method that is best for you, you will have quick and easy access to tax help.

Free tax services. To find out what services are available, get Publication 910, *Guide to Free Tax Services*. It contains a list of free tax publications and an index of tax topics. It also describes other free tax information services, including tax education and assistance programs and a list of TeleTax topics.



Personal computer. With your personal computer and modem, you can access the IRS on the Internet at www.irs.gov. While visiting our web site, you can select:

- *Frequently Asked Tax Questions* (located under *Taxpayer Help & Ed*) to find answers to questions you may have.
- *Forms & Pubs* to download forms and publications or search for forms and publications by topic or keyword.
- *Fill-in Forms* (located under *Forms & Pubs*) to enter information while the form is displayed and then print the completed form.
- *Tax Info For You* to view Internal Revenue Bulletins published in the last few years.
- *Tax Regs in English* to search regulations and the Internal Revenue Code (under *United States Code (USC)*).
- *Digital Dispatch* and *IRS Local News Net* (both located under *Tax Info For Business*) to receive our electronic newsletters on hot tax issues and news.
- *Small Business Corner* (located under *Tax Info For Business*) to get information on starting and operating a small business.

You can also reach us with your computer using File Transfer Protocol at ftp.irs.gov.



TaxFax Service. Using the phone attached to your fax machine, you can receive forms and instructions by calling **703-368-9694**. Follow the directions from the prompts. When you order forms, enter the catalog number for the form you need. The items you request will be faxed to you.



Phone. Many services are available by phone.

- *Ordering forms, instructions, and publications.* Call **1-800-829-3676** to order current and prior year forms, instructions, and publications.
- *Asking tax questions.* Call the IRS with your tax questions at **1-800-829-1040**.
- *TTY/TDD equipment.* If you have access to TTY/TDD equipment, call **1-800-829-4059** to ask tax questions or to order forms and publications.
- *TeleTax topics.* Call **1-800-829-4477** to listen to pre-recorded messages covering various tax topics.

Evaluating the quality of our telephone services. To ensure that IRS representatives give accurate, courteous, and professional answers, we evaluate the quality of our telephone services in several ways.

- A second IRS representative sometimes monitors live telephone calls. That person only evaluates the IRS assistor and does not keep a record of any taxpayer's name or tax identification number.
- We sometimes record telephone calls to evaluate IRS assistors objectively. We hold these recordings no longer than one week and use them only to measure the quality of assistance.
- We value our customers' opinions. Throughout this year, we will be surveying our customers for their opinions on our service.



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The CD-ROM can be purchased from National Technical Information Service (NTIS) by calling **1-877-233-6767** or on the Internet at www.irs.gov/cdorders. The first release is available in mid-December and the final release is available in late January.

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Tax Publications for Business Taxpayers

See *How To Get More Information* for a variety of ways to get publications, including by computer, phone, and mail.

General Guides

- 1 Your Rights as a Taxpayer
- 17 Your Federal Income Tax (For Individuals)
- 225 Farmer's Tax Guide
- 334 Tax Guide for Small Business
- 509 Tax Calendars for 2000
- 553 Highlights of 1999 Tax Changes
- 595 Tax Highlights for Commercial Fishermen
- 910 Guide to Free Tax Services

Employer's Guides

- 15 Circular E, Employer's Tax Guide
- 15-A Employer's Supplemental Tax Guide
- 51 Circular A, Agricultural Employer's Tax Guide
- 80 Federal Tax Guide For Employers in the U.S. Virgin Islands, Guam, American Samoa, and the Commonwealth of the Northern Mariana Islands (Circular SS)
- 179 Circular PR Guía Contributiva Federal Para Patronos Puertorriqueños
- 926 Household Employer's Tax Guide

Specialized Publications

- 378 Fuel Tax Credits and Refunds

- 463 Travel, Entertainment, Gift, and Car Expenses
- 505 Tax Withholding and Estimated Tax
- 510 Excise Taxes for 2000
- 515 Withholding of Tax on Nonresident Aliens and Foreign Corporations
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- 551 Basis of Assets
- 556 Examination of Returns, Appeal Rights, and Claims for Refund
- 560 Retirement Plans for Small Business (SEP, SIMPLE, and Keogh Plans)
- 561 Determining the Value of Donated Property
- 583 Starting a Business and Keeping Records
- 587 Business Use of Your Home (Including Use by Day-Care Providers)
- 594 Understanding the Collection Process

- 597 Information on the United States-Canada Income Tax Treaty
- 598 Tax on Unrelated Business Income of Exempt Organizations
- 686 Certification for Reduced Tax Rates in Tax Treaty Countries
- 901 U.S. Tax Treaties
- 908 Bankruptcy Tax Guide
- 911 Direct Sellers
- 925 Passive Activity and At-Risk Rules
- 946 How To Depreciate Property
- 947 Practice Before the IRS and Power of Attorney
- 954 Tax Incentives for Empowerment Zones and Other Distressed Communities
- 1544 Reporting Cash Payments of Over \$10,000
- 1546 The Taxpayer Advocate Service of the IRS

Spanish Language Publications

- 1SP Derechos del Contribuyente
- 579SP Cómo Preparar la Declaración de Impuesto Federal
- 594SP Comprendiendo el Proceso de Cobro
- 850 English-Spanish Glossary of Words and Phrases Used in Publications Issued by the Internal Revenue Service
- 1544SP Informe de Pagos en Efectivo en Exceso de \$10,000 (Recibidos en una Ocupación o Negocio)

Commonly Used Tax Forms

See *How To Get More Information* for a variety of ways to get forms, including by computer, fax, phone, and mail. Items with an asterisk are available by fax. For these orders only, use the catalog numbers when ordering.

Form Number and Title	Catalog Number	Form Number and Title	Catalog Number
W-2 Wage and Tax Statement	10134	1120S U.S. Income Tax Return for an S Corporation	11510
W-4 Employee's Withholding Allowance Certificate*	10220	Sch D Capital Gains and Losses and Built-In Gains	11516
940 Employer's Annual Federal Unemployment (FUTA) Tax Return*	11234	Sch K-1 Shareholder's Share of Income, Credits, Deductions, etc.	11520
940EZ Employer's Annual Federal Unemployment (FUTA) Tax Return*	10983	2106 Employee Business Expenses*	11700
941 Employer's Quarterly Federal Tax Return	17001	2106-EZ Unreimbursed Employee Business Expenses*	20604
1040 U.S. Individual Income Tax Return*	11320	2210 Underpayment of Estimated Tax by Individuals, Estates, and Trusts*	11744
Sch A & B Itemized Deductions & Interest and Ordinary Dividends*	11330	2441 Child and Dependent Care Expenses*	11862
Sch C Profit or Loss From Business*	11334	2848 Power of Attorney and Declaration of Representative*	11980
Sch C-EZ Net Profit From Business*	14374	3800 General Business Credit	12392
Sch D Capital Gains and Losses*	11338	3903 Moving Expenses*	12490
Sch D-1 Continuation Sheet for Schedule D	10424	4562 Depreciation and Amortization*	12906
Sch E Supplemental Income and Loss*	11344	4797 Sales of Business Property*	13086
Sch F Profit or Loss From Farming*	11346	4868 Application for Automatic Extension of Time To File U.S. Individual Income Tax Return*	13141
Sch H Household Employment Taxes*	12187	5329 Additional Taxes Attributable to IRAs, Other Qualified Retirement Plans, Annuities, Modified Endowment Contracts, and MSAs*	13329
Sch J Farm Income Averaging*	25513	6252 Installment Sale Income*	13601
Sch R Credit for the Elderly or the Disabled*	11359	8283 Noncash Charitable Contributions*	62299
Sch SE Self-Employment Tax*	11358	8300 Report of Cash Payments Over \$10,000 Received in a Trade or Business*	62133
1040-ES Estimated Tax for Individuals*	11340	8582 Passive Activity Loss Limitations*	63704
1040X Amended U.S. Individual Income Tax Return*	11360	8606 Nondeductible IRAs*	63966
1065 U.S. Partnership Return of Income	11390	8822 Change of Address*	12081
Sch D Capital Gains and Losses	11393	8829 Expenses for Business Use of Your Home*	13232
Sch K-1 Partner's Share of Income, Credits, Deductions, etc.	11394		
1120 U.S. Corporation Income Tax Return	11450		
1120-A U.S. Corporation Short-Form Income Tax Return	11456		