# Publication 225

## Farmer's Tax Guide

For use in preparing **2023** 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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Publication 225 (Rev. 2023) Catalog Number 39248W
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**Reporting the exchange.** Report the exchange of like-kind property, even though no gain or loss is recognized, on Form 8824. The Instructions for Form 8824 explain how to report the details of the exchange.

If you have any recognized 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 recognized gain as ordinary income because of depreciation recapture on Form 4797. See chapter 9 for more information.

**Qualifying property.** In a like-kind exchange, both the real property you give up and the real property you receive must be held by you for investment or for productive use in your trade or business. The nonrecognition rules for like-kind exchanges apply only to exchanges of real property (as defined in Treasury Regulations section 1.1031(a)3). The following are examples of property that may qualify.

- Land and improvements to land.
- Unsevered natural products of land.
- Water and air space super adjacent to land.
- An intangible interest in real property including fee ownership; co-ownership; a leasehold; an option to acquire real property; an easement; and stock in a cooperative housing corporation.
- Real property that, on the date it is transferred in an exchange, is real property under the law of the state or local jurisdiction in which that property is located.

***Nonqualifying property.*** The rules for like-kind exchanges do not apply to exchanges of the following property.

- Real property used for personal purposes, such as your home.
- Real property held primarily for sale.

- Any personal or intangible property.

You may have a nontaxable exchange under other rules. See *Other Nontaxable Exchanges* in chapter 1 of Pub. 544.

***Special rule for stock in a mutual ditch, reservoir, or irrigation company.*** For purposes of real property, stock in a mutual ditch, reservoir, or irrigation company is treated as real property if both of the following conditions are met at the time of the trade.

1. The mutual ditch, reservoir, or irrigation company is an organization described in section 501(c)(12)(A) of the Internal Revenue Code (determined without regard to the percentage of its income that is collected from its members for the purpose of meeting losses and expenses).

2. The shares in the company have been recognized by the highest court of the state in which the company was organized or by applicable state statute as constituting or representing real property or an interest in real property.

**Like-kind property.** To qualify as a nontaxable exchange, the properties exchanged must be of like kind. Like-kind properties are properties of the same nature or character, even if they differ in grade or quality. Generally, real property exchanged for real property qualifies as an exchange of like-kind property. For example, an exchange of city property for farm property or improved property for unimproved property is a like-kind exchange.

***Note.*** Whether you engaged in a like-kind exchange depends on an analysis of each asset involved in the exchange.

**Partially nontaxable exchange.** If, in addition to like-kind property, you receive money or unlike property in an exchange on which you realize gain, you have a partially nontaxable exchange. You are taxed on the gain you realize, but only to the extent of the money and the FMV of the unlike property you receive. If you realize a loss on the exchange, no loss is deductible. However, see *Unlike property given up* below.

***Example 1.*** You trade farmland that cost $130,000 for $10,000 cash and other land to be used in farming with an FMV of $150,000. You have a realized gain of $30,000 ($150,000 FMV of new land + $10,000 cash − $130,000 basis of old farmland = $30,000 realized gain). However, only $10,000, the cash received, is recognized gain (included in income).

***Example 2.*** Assume the same facts as in *Example 1*, except that, instead of money, you received a tractor with an FMV 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 FMV of the land you received was only $115,000. You have a realized loss of $5,000 ($115,000 FMV + $10,000 cash – $130,000 basis of old farmland = $5,000 loss). However, your $5,000 loss is not recognized.

***Unlike property given up.*** If, in addition to like-kind property, you give up unlike property, you must recognize gain or loss on the unlike property you give up. The gain or loss is the difference between the FMV of the unlike property and the adjusted basis of the unlike property.

***Liabilities.*** If, in a like-kind exchange, you transfer property subject to debt, the debt transferred is considered the same as the receipt of unlike property. For purposes of figuring your realized gain, add any liabilities assumed by the other party to your amount realized. Subtract any liabilities of the other party that you assume from your amount realized. For more information, see *Partial Nontaxable Exchanges* in chapter 1 of Pub. 544.

**Like-kind exchanges between related persons.** Special rules apply to like-kind exchanges 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 the 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, related persons include, for example, you and a member of your family (spouse, sibling, parent, child, etc.), you and a corporation in which you have more than 50% ownership, you and 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 complete list of related persons, see *Related persons* in chapter 2 of Pub. 544.

CAUTION *If you transfer property using a qualified intermediary involving related persons, see Multiple-party transactions involving related persons in chapter 1 of Pub. 544.*

***Example.*** You own real property used in your business. Your sibling owns real property used in their business. In December 2022, you exchanged your property plus $15,000 for your sibling's property. At that time, the FMV of your real property was $200,000 and its adjusted basis was $65,000. The FMV of your sibling's real property was $215,000 and its adjusted basis was $70,000. You realized a gain of $135,000 (the $215,000 FMV of the real property received, minus the $15,000 you paid, minus your

$65,000 adjusted basis in the property). Your sibling realized a gain of $145,000 (the $200,000 FMV of your real property, plus the $15,000 you paid, minus their $70,000 adjusted basis in the property).

However, because this was a like-kind exchange and you received no cash or non-like-kind property in the exchange, you recognize no gain on the exchange. Your basis in the real property you received is $80,000 (the $65,000 adjusted basis of the real property given up plus the $15,000 you paid). Your sibling recognizes gain only to the extent of the money they received, $15,000. The basis in the real property received was $70,000 (the $70,000 adjusted basis of the real property exchanged minus the $15,000 received, plus the $15,000 gain recognized).

In 2023, you sold the real property you received to a third party for $220,000. Because you sold property you acquired from a related party (your sibling) within 2 years after the exchange with your sibling, that exchange is disqualified from nonrecognition treatment and the deferred gain must be recognized on your 2023 return. On your 2023 tax return, you must report your $135,000 gain on the 2022 exchange. You must also report the gain on the 2023 sale on your 2023 return. Additionally, for 2023, your sibling must report a gain of $130,000, which is the $145,000 gain on the 2022 exchange, minus the $15,000 recognized in 2022. Your sibling’s adjusted basis in the property is increased to $200,000 ($70,000 basis plus the $130,000 gain recognized).

***Exceptions to the rules for related persons.*** The following property dispositions are excluded from these rules.

- Dispositions due to the death of either related person.
- Involuntary conversions.
- Dispositions where 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.

**Multiple property exchanges.** 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 Pub. 544.

**Deferred exchange.** A deferred exchange for like-kind property may qualify for nonrecognition of gain or loss. A deferred exchange is an exchange in which you transfer property you use in business or hold for investment and later 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 of property for property rather than a transfer of property for money used to buy replacement property. In addition, the replacement property will not be treated as like-kind property unless certain identification and receipt requirements are met.

For more information, see *Deferred Exchange* in chapter 1 of Pub. 544.

## Transfer to Spouse

Generally, no gain or loss is recognized 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 in the following situations.

- Your spouse or former spouse is a nonresident alien (unless special elections have been made).
- Certain transfers in trust.
- Certain stock redemptions under a divorce or separation instrument or a valid written agreement.

For more information and special rules for transfers of property incident to divorce, see *Property Settlements* in Pub. 504, Divorced or Separated Individuals.

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 FMV 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.

## Ordinary or Capital Gain or Loss

Generally, you will have a capital gain or loss if you sell or exchange a capital asset (defined below). You may also have a capital gain if your section 1231 transactions result in a net gain.

See *Section 1231 Gains and Losses* in chapter 9.

To figure your net capital gain or loss, you must classify your gains and losses as either ordinary or capital, and your capital gains or losses as either short term or long term.

Your net capital gains may be taxed at a lower tax rate than ordinary income. See *Capital Gains Tax Rates*, later. Your deduction for a net capital loss may be limited. See *Treatment of Capital Losses*, later.

## Capital Assets

Almost everything you own and use for personal purposes, pleasure, or investment is a capital asset.

The following items are examples of capital assets.

- A home owned and occupied by you and your family.
- Household furnishings.
- 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.

- Stocks and bonds. However, there are special rules for gains on qualified small business stock. For more information on this subject, see *Gains on Qualified Small Business Stock* and *Losses on Section 1244 (Small Business) Stock* in chapter 4 of Pub. 550.

**Personal-use property.** Gain from a sale or exchange of personal-use property is a capital gain and is taxable. Loss from the sale or exchange of personal-use 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 on casualties and thefts, see chapter 11.

## 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 Form 8949, and/or Schedule D (Form 1040), as applicable. 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 Form 8949 and/or Schedule D, as applicable. See the Instructions for Form 8949 and the Instructions for Schedule D (Form 1040) for more information, including when Form 8949 is required. Also see chapter 4 of Pub. 544.

**Holding period.** To figure if you held property longer than 1 year, start counting on the day after the day you acquired the property. The day you disposed of the property is part of your holding period.

***Example.*** If you bought an asset on June 19, 2022, you should start counting on June 20, 2022. If you sold the asset on June 19, 2023, your holding period is not longer than 1 year, but if you sold it on June 20, 2023, your holding period is longer than 1 year.

***Livestock.*** See *Holding period* under *Livestock*, later.

***Inherited property.*** If you inherit property, you are considered to have held the property longer than 1 year, regardless of how long you actually held it. This rule does not apply to livestock used in a farm business. See *Holding period* under *Livestock*, later.

***Nonbusiness bad debt.*** A nonbusiness bad debt is a short-term capital loss, deductible in the year the debt becomes worthless. See chapter 4 of Pub. 550.

***Nontaxable exchange.*** If you acquire an asset in exchange for another asset and your basis for the new asset is figured, in whole or in part, by using 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 of your short-term capital gains. Then add all of your short-term capital losses. Subtract the lesser total from the greater. The difference 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, part of your gain (but not more than your net capital gain) may be taxed at a lower rate than the rate of tax on your ordinary income. See *Capital Gains 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. For taxpayers other than corporations, the yearly limit on 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 (discussed next).

**Capital loss carryover.** Generally, you have a capital loss carryover if either of the following situations applies to you.

- Your net loss on Schedule D (Form 1040) is more than the yearly limit.
- Your taxable income is less than zero.

If either of these situations applies to you for 2023, see *Capital Losses* under *Reporting Capital Gains and Losses* in chapter 4 of Pub. 550 to figure the amount you can carry over to 2024.

TIP *To figure your capital loss carryover from 2023 to 2024, you will need a copy of your 2023 Form 1040 or Form 1040-SR and Schedule D (Form 1040).*

## Capital Gains Tax Rates

The tax rates that apply to a net capital gain are generally lower than the tax rates that apply to other income. These lower rates are called the maximum capital gains rates.

The term “net capital gain” means the amount by which your net long-term capital gain for the year is more than your net short-term capital loss.

See Schedule D (Form 1040) and the Instructions for Schedule D (Form 1040). Also see Pub. 550.

## Noncapital Assets

Generally, 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 Instructions for Schedule D (Form 1040). Noncapital assets used in farming are discussed below.

**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 (Form 1040) (not on Schedule D (Form 1040) or Form 4797). The treatment of this property is discussed in chapter 3.

**Land and depreciable properties.** Land and depreciable property you use in farming are not capital assets. Noncapital assets also include livestock held for draft, breeding, dairy, or sport-

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 much different from a futures contract because its terms are not standardized and it 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 with exchange-traded commodity futures contracts that are not hedging transactions generally result in capital gain or loss and are subject to the mark-to-market rules discussed in Pub. 550. There is a limit on the amount of capital losses you can deduct each year. Hedging transactions are not subject to the mark-to-market rules and the deduction for hedging losses is not limited.

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 Schedule F, line 8.

Gains or losses from hedging transactions that hedge supplies of a type regularly used or consumed in the ordinary course of your trade or business may be ordinary gains or losses. Examples include fuel and feed.

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.

Retain the identification of each hedging transaction with your books and records. Also, identify the item(s) or aggregate risk that is being hedged in your records. Although the identification of the hedging transaction must be made before the end of the day it was entered into, you have 35 days after entering into the transaction to identify the hedged item(s) or risk.

For more information on the tax treatment of futures and options contracts, see *Commodity Futures* and *Section 1256 Contracts Marked to Market* in Pub. 550.

**Accounting methods for hedging transactions.** 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 limits on the method you can use for certain hedging transactions. See Regulations section 1.4464(e) for those requirements and limits.

Hedging transactions must be accounted for under the rules stated above unless the transaction is subject to mark-to-market accounting under section 475 or you use an accounting method other than the following methods.

1. Cash method.
2. Farm-price method.

3. Unit-livestock-price method.

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, you anticipate a yield of 50,000 bushels of corn this year. The December futures price is $5.75 a bushel, but there are indications that by harvest time the price will drop. To protect yourself against a drop in the price, 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 $5.75 a bushel.

The price did not drop as anticipated but rose to $6 a bushel. In November, you sell your crop at a local elevator for $6 a bushel. You also close out your futures position by buying 10 December contracts for $6 a bushel. You paid a broker's commission of $1,400 ($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 $6 a bushel. Your loss on the hedge is 25 cents a bushel. In effect, the net selling price of your corn is $5.75 a bushel.

Report the results of your futures transactions and your sale of corn separately on Schedule F. See the Instructions for Schedule F (Form 1040).

The loss on your futures transactions is $13,900, figured as follows.

| | |
|---|---|
| July 2—Sold December corn futures (50,000 bu. @ $5.75) | $287,500 |
| November 6—Bought December corn futures (50,000 bu. @ $6 plus $1,400 broker's commission) | 301,400 |
| **Futures loss** | **($13,900)** |

This loss is reported as a negative figure on Schedule F, Part I, line 8, as other income.

The proceeds from your corn sale at the local elevator are $300,000 (50,000 bu. × $6). Report it on Schedule F, Part I, line 2, as income from sales of products you raised.

Assume you were right and the price went down 25 cents a bushel. In effect, you would still net $5.75 a bushel, figured as follows.

| | |
|---|---|
| Sold cash corn, per bushel | $5.50 |
| Gain on hedge, per bushel | .25 |
| **Net price, per bushel** | **$5.75** |

The gain on your futures transactions would have been $11,100, figured as follows.

| | |
|---|---|
| July 2—Sold December corn futures (50,000 bu. @ $5.75) | $287,500 |
| November 6—Bought December corn futures (50,000 bu. @ $5.50 plus $1,400 broker's commission) | 276,400 |
| **Futures gain** | **$11,100** |

The $11,100 is reported on Schedule F, Part I, line 8, as other income.

The proceeds from the sale of your corn at the local elevator, $275,000 (50,000 bu. x $5.50), are reported on Schedule F, Part I, line 2, as income from sales of products you raised.

## 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 gain or loss. However, any part of the gain that is ordinary income from the recapture of depreciation is not included as section 1231 gain. See chapter 9 for more information on section 1231 gains and losses and the recapture of depreciation under section 1245.

CAUTION *The rules discussed here do not apply to the sale of livestock held primarily for sale to customers. The sale of this livestock is reported on Schedule F. See chapter 3 for more information.*

*Also, special rules apply to sales or exchanges caused by weather-related conditions. See* Sales Caused by Weather-Related Conditions *in chapter 3 for more information.*

**Holding period.** The sale or exchange of livestock used in your farm business (defined below) 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, furbearing animals, and other mammals. Also, for section 1231 transactions, 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 considered to be used in your farm business. The purpose for which an animal is held is ordinarily 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. However, a draft, breeding, dairy, or sporting purpose may be present if an animal is disposed of within a reasonable time after it is prevented from its intended use or made undesirable as a result of an accident, disease, drought, or unfitness of the animal.

***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 drought, these animals are treated as having been held for breeding or dairy purposes. See *Sales Caused by Weather-Related Conditions* in chapter 3.

***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. The business practice is 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, but rather you are holding them primarily for sale to customers. 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 breed, raise, and train horses for racing purposes. Every year, you cull horses from your racing stable. In 2023, you decided that to prevent your racing stable from getting too large to be effectively operated, you must cull six horses that had been raced at public tracks in 2022. 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. 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, if you are required to use the accrual accounting method, see *Uniform Capitalization Rules* in chapter 6.

***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 8, 2023, for $1,250. Expenses of the sale were $125. The cow was bought July 2, 2019, for $1,300. Depreciation (not less than the amount allowable) was $1,225.

| | | |
|---|---|---|
| Gross sales price | | $1,250 |
| Cost (basis) | $1,300 | |
| Minus: Depreciation deduction | 1,225 | |
| Unrecovered cost (adjusted basis) | $ 75 | |
| Expense of sale | 125 | 200 |
| **Gain realized** | | **$1,050** |

## 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 was 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.

A wetland (before conversion) is land that meets all the following conditions.

- 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.

- 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.
- 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 grazing animals. Generally, highly erodible cropland is land 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.

**Successor.** 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 Form 8949 and Schedule D (Form 1040), as applicable. If you held the timber primarily for sale to customers, it is not a capital asset. Gain or loss on its sale is ordinary business income or loss. It is reported on Schedule F, line 1 (if purchased timber) or line 2 (if raised timber).

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 if no allocation was made at the time of acquisition. Amounts realized from these sales, and the expenses incurred in cutting, hauling, etc., are ordinary farm income and expenses reported on Schedule F.

Different rules apply if you owned the timber longer than 1 year and elect to treat timber cutting as a sale or exchange or you enter into a cutting contract, discussed below.

**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.

**Election 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 can elect 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. See the example below.

To elect 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 in your trade or business.

***Making the election.*** You make the election 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 election in the first year you cut timber. You can make it in any year to which the election would apply. If the timber is partnership property, the election is made on the partnership return. This election cannot be made on an amended return.

Once you have made the election, it remains in effect for all later years unless you revoke it.

***Election under section 631(a) may be revoked.*** If you previously elected for any tax year ending before October 23, 2004, to treat the cutting of timber as a sale or exchange under section 631(a), you may revoke this election without the consent of the IRS for any tax year ending after October 22, 2004. The prior election (and revocation) is disregarded for purposes of making a subsequent election. See Form T (Timber), Forest Activities Schedule, for more information.

***Gain or loss.*** Your gain or loss on the cutting of standing timber is the difference between its adjusted basis for depletion and its FMV on the first day of your tax year in which it is cut. 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.

Your adjusted basis for depletion of cut timber is based on the number of units (board feet, 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 and Regulations section 1.611-3.

Depletion of timber is discussed in chapter 7.

***Example.*** In April 2023, 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, 2023, the timber had an FMV of $350 per MBF. It was cut in April for sale. On your 2023 tax return, you elect 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, 2023 . . . . . . . | $1,400,000 |
| Minus: Adjusted basis for depletion . . . . | 160,000 |
| **Section 1231 gain**. . . . . . . . . . . . . . | **$1,240,000** |

**Outright sales of timber.** Outright sales of timber by landowners qualify for capital gains treatment using rules similar to the rules for certain disposal of timber under a contract with retained economic interest (defined later). However, for outright sales, the date of disposal is not deemed to be the date the timber is cut because the landowner can elect to treat the payment date as the date of disposal (see *Date of disposal*, later).

**Cutting contract.** You must treat the disposal of standing timber under a cutting contract as a section 1231 transaction if all 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.

You have kept an economic interest in standing timber if, under the cutting contract, the expected return on your investment is conditioned on the cutting of 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 or losses.

***Date of disposal.*** The date of disposal is the date the timber is cut. However, for outright sales by landowners or if you receive payment under the contract before the timber is cut, you can elect to treat the date of payment as the date of disposal.

This election applies 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 enter “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.

**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 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.

See Form T (Timber) and its separate instructions for more information about dispositions of timber.

## Sale of a Farm

The sale of your farm may 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 any gain from the sale includes a gain from the sale of your home, you may be allowed to exclude the gain on your home. For more information, see Pub. 523.

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. Your taxable gain or loss on the sale of property used in your farm business is taxed under the rules for section 1231 transactions. See chapter 9. Losses from personal-use property, other than casualty or theft losses, are not deductible. If you receive payments for your farm in installments, certain gains may be eligible to be taxed over the period of years the payments are received. See chapter 10 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 *Livestock*).
- Property (including real estate) used in your business and held longer than 1 year (including only 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. If the group of assets sold constitutes a trade or business, the residual method must be used. This method determines gain or loss from the transfer of each asset. It also determines the buyer's basis in the business assets. For more information, see *Sale of a Business* in chapter 2 of Pub. 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 9).

***Example.*** You sell your farm, including your main home, which you have owned since December 2006. You realize gain on the sale as follows.

| | Farm With Home | Home Only | Farm Without Home |
|---|---|---|---|
| Selling price . . . . | $382,000 | $158,000 | $224,000 |
| Cost (or other basis) . . . . . . . . | 240,000 | 110,000 | 130,000 |
| **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 if you meet the requirements explained later under *Sale of your 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. For a detailed discussion on installment sales, see Pub. 544.

***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. If your home is on the farm, you must properly adjust the basis to exclude those costs from your farm asset costs, as discussed later under *Sale of your home*.

***Example.*** You bought a 200 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 20 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 20 acres at the time of sale. Use this amount to determine your gain or loss on the sale of the 20 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 values 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 200 acres of land. The unadjusted basis of the 20 acres you sold would then be $52,500 ($^1/_{10}$ of $525,000).

**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 that are not used for business purposes.

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 chapter 6.

***More information.*** For more information on selling your home, see Pub. 523.

***Gain from condemnation.*** If you have a gain from a condemnation or sale of your home under threat of condemnation, you may use the preceding rules for excluding the gain, rather than the rules discussed under *Postponing Gain* in chapter 11. 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 11.

## Foreclosure or Repossession

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 FMV of the property.

**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.

You can use Worksheet 8-1 to figure your gain or loss from a foreclosure or repossession.

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## Worksheet 8-1. **Worksheet for Foreclosures and Repossessions**

*Keep for Your Records*

| | |
|---|---|
| **Part 1.** Use Part 1 to figure your ordinary income from the cancellation of debt upon foreclosure or repossession. Complete this part only if you were personally liable for the debt. Otherwise, go to Part 2. | |
| **1.** Enter the amount of outstanding debt immediately before the transfer of property reduced by any amount for which you remain personally liable after the transfer of property . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | ______ |
| **2.** Enter the fair market value of the transferred property . . . . . . . . . . . . . . . . . . | ______ |
| **3. Ordinary income from cancellation of debt upon foreclosure or repossession.*** Subtract line 2 from line 1. If zero or less, enter -0- . . . . . . . . . . | ______ |
| **Part 2.** Figure your gain or loss from foreclosure or repossession. | |
| **4.** If you completed Part 1, enter the **smaller** of line 1 or line 2. If you did not complete Part 1, enter the outstanding debt immediately before the transfer of property . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | ______ |
| **5.** Enter any proceeds you received from the foreclosure sale . . . . . . . . . . . . . . | ______ |
| **6.** Add lines 4 and 5 . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | ______ |
| **7.** Enter the adjusted basis of the transferred property . . . . . . . . . . . . . . . . . . . . | ______ |
| **8. Gain or loss from foreclosure or repossession.** Subtract line 7 from line 6 . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | ______ |

* The income may not be taxable. See *Cancellation of debt*, later.

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***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 canceled debt is included in the amount realized even if the FMV of the property is less than the canceled debt.

***Example 1.*** You paid $200,000 for land used in your farming business. You paid $15,000 down and borrowed the remaining $185,000 from a bank. You are not personally liable for the loan (nonrecourse debt), but pledge the land as security. The bank foreclosed on the loan 2 years after you stopped making payments. When the bank foreclosed, the balance due on the loan was $180,000 and the FMV of the land was $170,000. The amount you realized on the foreclosure was $180,000, the debt canceled by the foreclosure. You figure your gain or loss on Form 4797, Part I, by comparing the amount realized ($180,000) with your adjusted basis ($200,000). You have a $20,000 deductible loss.

***Example 2.*** Assume the same facts as in *Example 1*, except the FMV of the land was $210,000. The result is the same. The amount you realized on the foreclosure is $180,000, the debt canceled by the foreclosure. Because your adjusted basis is $200,000, you have a deductible loss of $20,000, which you report on Form 4797, Part I.

***Amount realized on a recourse debt.*** If you are personally liable for the debt (recourse debt), the amount realized on the foreclosure or repossession includes the lesser of:

- The outstanding debt immediately before the transfer reduced by any amount for which you remain personally liable immediately after the transfer, or

- The FMV of the transferred property.

You are treated as receiving ordinary income from the canceled debt for the part of the debt that is more than the FMV. The amount realized does not include the canceled debt that is your income from cancellation of debt. See *Cancellation of debt*, later.

***Example 3.*** Assume the same facts as in *Example 1* earlier, except you are personally liable for the loan (recourse debt). In this case, the amount you realize is $170,000. This is the canceled debt ($180,000) up to the FMV of the land ($170,000). You figure your gain or loss on the foreclosure by comparing the amount realized ($170,000) with your adjusted basis ($200,000). You have a $30,000 deductible loss, which you figure on Form 4797, Part I. You are 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. You report this as other income on Schedule F, line 8.

**Seller's (lender's) gain or loss on repossession.** If you finance a buyer's purchase of your property in an installment sale 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 Pub. 537, Installment Sales.

**Cancellation of debt.** If property that is repossessed or foreclosed upon secures a debt for which you are personally liable (recourse debt), you must generally report as ordinary income the amount by which the canceled debt is more than the FMV 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 8. Report the income from cancellation of a nonbusiness debt as miscellaneous income on Form 1040 or Form 1040-SR.

TIP *You can use Worksheet 8-1 to figure your income from cancellation of debt.*

However, income from cancellation of debt is not taxed in certain situations. See *Cancellation of Debt* in chapter 3.

## Abandonment

The abandonment of property is a disposition of property. You abandon property when you voluntarily and permanently give up possession and use 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 a loss. Loss from abandonment of business or investment property that is not treated as a sale or exchange is generally an ordinary loss. If your adjusted basis is more than the amount you realize (if any), then you have a loss. If the amount you realize (if any) is more than your adjusted basis, then you have a gain. This rule also applies to leasehold improvements the lessor made for the lessee. However, if the property is foreclosed on or repossessed in lieu of abandonment, gain or loss is figured as discussed earlier under *Foreclo- sure or Repossession*.

If the abandoned property is secured by debt, special rules apply. The tax consequences of abandonment of property that secures a debt depend on whether you are personally liable for the debt (recourse debt) or were not personally liable for the debt (nonrecourse debt). For more information, see chapter 3 of Pub. 4681, Canceled Debts, Foreclosures, Repossessions, and Abandonments.

The abandonment loss is deducted in the tax year in which the loss is sustained. Report the loss on Form 4797, Part II, line 10.

**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 may realize ordinary income equal to the 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 on Form 1040 or Form 1040-SR.

However, income from cancellation of debt is not taxed in certain circumstances. See *Cancellation of debt*, earlier, under *Foreclosure or Repossession*.

**Forms 1099-A and 1099-C.** A lender who acquires an interest in your property in a foreclosure, repossession, or abandonment should send you Form 1099-A showing the information you need to figure your loss from the foreclosure, repossession, or abandonment. However, if the lender cancels part of your debt and the lender must file Form 1099-C, the lender may include the information about the foreclosure, repossession, or 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, or any organization that has a significant trade or business of lending money. For foreclosures, repossessions, abandonments of property, and debt cancellations occurring in 2023, these forms should be sent to you by January 31, 2024.

# 9.

# Dispositions of Property Used in Farming

## Introduction

When you dispose of property used in your farm business, your taxable gain or loss is usually treated as ordinary income or capital gain (under the rules for section 1231 transactions). Ordinary income is taxed at the same rate as wages and interest. Capital gain is generally taxed at lower rates.

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 gain remaining after applying the depreciation recapture rules is a section 1231 gain, which may be taxed as a capital gain. Similar rules apply to the sale of property on which soil and water conservation expenses have been deducted or government cost-sharing payments have been received.

Gains and losses from property used in farming are reported on Form 4797, Sales of Business Property. Table 9-1 contains examples of items reported on Form 4797 and refers to the part of that form on which they should first be reported.

## Topics

This chapter discusses:

- Section 1231 gains and losses
- Depreciation recapture
- Other gains

## 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 16 for information about getting publications and forms.

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## Table 9-1. **Where To First Report Certain Items on Form 4797**

| | Type of property | Held 1 year or less | Held more than 1 year |
|---|---|---|---|
| **1** | Depreciable trade or business property: | | |
| | **a** Sold or exchanged at a gain . . . . . . . . . . . . . . . . . . . . | Part II | Part III (1245, 1250) |
| | **b** Sold or exchanged at a loss . . . . . . . . . . . . . . . . . . . . | Part II | Part I |
| **2** | Farmland held less than 10 years for which soil or water expenses were deducted: | | |
| | **a** Sold at a gain . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | Part II | Part III (1252) |
| | **b** Sold at a loss . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | Part II | Part I |
| **3** | All other farmland used in a trade or business | Part II | 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: | **Held less than 24 mos.** | **Held 24 mos. or more** |
| | **a** Sold at a gain . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | Part II | Part III (1245) |
| | **b** Sold at a loss . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | Part II | Part I |
| | **c** Raised cattle and horses sold at a gain . . . . . . . . . . . . | Part II | Part I |
| **6** | Livestock other than cattle and horses used in a trade or business for draft, breeding, dairy, or sporting purposes: | **Held less than 12 mos.** | **Held 12 mos. or more** |
| | **a** Sold at a gain . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | Part II | Part III (1245) |
| | **b** Sold at a loss . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | Part II | Part I |
| | **c** Raised livestock sold at a gain . . . . . . . . . . . . . . . . . . | Part II | Part I |
| | | **Held 1 year or less** | **Held more than 1 year** |
| **7** | Real or tangible trade or business property which was deducted under the de minimis safe harbor . . . . . . . . . . . . . | Part II | Part II |

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## Section 1231 Gains and Losses

Section 1231 gains and losses are the taxable gains and losses from section 1231 transactions (explained below). Their treatment as ordinary income or loss or capital gains depends on whether you have a net gain or a net loss from all of your section 1231 transactions in the tax year.

If you have a gain from a section 1231 transaction, first determine whether any of the gain is ordinary income under the depreciation (or other) recapture rules explained later. Do not take that gain into account as section 1231 gain. Only gain in excess of the recapture amount is considered section 1231 gain. See *Treatment as ordinary or capital*, later.

**Section 1231 transactions.** Section 1231 transactions are sales and exchanges of real or depreciable property used in trade or business and held the required holding period (based on type of asset, as discussed below). Gain or loss on the following transactions is 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 purposes and held for 24 months or longer.
- ***Sale or exchange of other livestock.*** This livestock must be held for draft, breeding, dairy, or sporting purposes and held for 12 months or longer. Other livestock includes hogs, mules, sheep, goats, donkeys, and other furbearing animals. Other livestock does not include poultry.
- ***Sale or exchange of depreciable real property or 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. This property must also be either real property or is of a kind that is subject to depreciation under section 167 of the Internal Revenue Code. Examples of depreciable personal property include 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 and held longer than 1 year. Examples include 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. You 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 leasehold on the land, even if sold to the same person in a single transaction, is not considered a section 1231 transaction.

- ***Distributive share of partnership gains and losses.*** Your distributive share must be from the sale or exchange of property listed above and held by the partnership for longer than 1 year (or for the required period for certain livestock). You will receive Schedule K1 (Form 1065) showing the appropriate classification of any gains or losses distributed to you.
- ***Cutting or disposal of timber.*** Special rules apply if you owned the timber longer than 1 year and elect to treat timber cutting as a sale or exchange, or you enter into a cutting contract, as described in chapter 8 under *Timber*.
- ***Condemnation.*** The condemned property (defined in chapter 11) 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.*** The casualty or theft must have affected business property, property held for the production of rents or royalties, or investment property (such as notes and bonds). You must have held the property longer than the required holding period. However, if your casualty or theft losses are more than your casualty or theft gains, the net casualty or theft loss is fully deductible and is not combined with other section 1231 transactions in the section 1231 computation. Section 1231 does not apply to personal casualty gains and losses. See chapter 11 for information on how to treat those gains and losses.

*If the property is not held for the required holding period, the transaction is not subject to section 1231 treatment, and any gain or loss is ordinary income reported in Part II of Form 4797. See Table 9-1.*

**Treatment as ordinary or capital.** To determine the treatment of section 1231 gains and losses, combine all of 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 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. Therefore, if in any of your 5 preceding tax years you had section 1231 losses, a net gain for the current year from the sale of section 1231 assets is ordinary gain to the extent of your prior losses. These losses are applied against your net section 1231 gain beginning with the earliest loss in the 5year period.

***Example.*** In 2023, you have a $20,000 net section 1231 gain. To figure how much you have to report as ordinary income and long-term capital gain, you must first determine your section 1231 gains and losses from the previous 5year period. From 2018 through 2022, you had the following section 1231 gains and losses.

| Year | Amount |
|---|---|
| 2018 | -0- |
| 2019 | -0- |

| | |
|---|---|
| 2020 | ($25,000) |
| 2021 | -0- |
| 2022 | $18,000 |

You used this information to figure how to report your net section 1231 gain for 2023 as shown below.

| | | | |
|---|---|---|---|
| 1. | Net section 1231 gain (2023) | | $20,000 |
| 2. | Net section 1231 loss (2020) | ($25,000) | |
| 3. | Net section 1231 gain (2022) | $18,000 | |
| 4. | Remaining net section 1231 loss from prior 5 years | ($7,000) | |
| 5. | Gain treated as ordinary income | | $7,000 |
| **6.** | **Gain treated as long-term capital gain** | | **$13,000** |

Your remaining net section 1231 loss from 2020 is completely recaptured in 2023.

**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.

**Property deducted under the de minimis safe harbor for tangible property.** If you deducted the cost of a property under the de minimis safe harbor for tangible property (currently $2,500 or less), then upon its sale or disposition, this property is not treated as a capital asset or as property used in the trade or business under section 1231. Generally, any gain on the disposition of this property is treated as ordinary income reported on Part II of Form 4797.

## Depreciation Recapture

If you dispose of depreciable property (section 1245 or section 1250 property) 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. Any remaining gain is section 1231 gain (discussed earlier).

*To figure any gain that must be reported as ordinary income, you must keep permanent records of the facts necessary to figure the depreciation or amortization allowed or allowable on your property. For more information on depreciation recapture, see chapter 3 of Pub. 544. Also see Pub. 946.*

### 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. Any recognized gain that is more than the part that is ordinary income is a section 1231 gain.

Section 1245 property includes any property that is or has been subject to an allowance for depreciation or amortization and that 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. See *Buildings and structural components*, later.
    a. An integral part of manufacturing, production, or extraction, or of furnishing certain services.
    b. A research facility in any of the activities in (a).

c. A facility in any of the activities in (a) above, for the bulk storage of fungible commodities (discussed later).

3. Where applicable, that part of real property (not included in (2)) with an adjusted basis reduced by (but not limited to) the following.

   a. Amortization of certified pollution control facilities.

   b. The section 179 expense deduction.

   c. Deduction for clean-fuel vehicles and certain refueling property.

   d. Expenditures to remove architectural and transportation barriers to the handicapped and elderly.

e. Certain reforestation expenditures (as described under *Reforestation Costs* in chapter 7).

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.

Do not treat a structure that is essentially machinery or equipment as a building or structural component. Also, do not treat a structure that houses property used as an integral part of an activity as 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 cannot be used economically for other purposes indicates 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.