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Farmer's Tax Guide

For use in preparing
2004 Returns

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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 16 for information on ordering these publications.

The explanations and examples in this publication reflect the Internal Revenue Service's in-

terpretation 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.

The 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 suggestions. We welcome your comments about this publication and your suggestions for future editions.

You can write to us at the following address:

Internal Revenue Service
Business Forms and Publications Branch
SE:W:CAR:MP:T:B
1111 Constitution Ave. NW
Washington, DC 20224

We respond to many letters by telephone. Therefore, it would be helpful if you would include your daytime phone number, including the area code, in your correspondence.

You can email us at taxforms@irs.gov. Please put "Publications Comment" on the subject line. Although we cannot respond individually to each email, we do appreciate your feedback and will consider your comments as we revise our tax products.

Tax questions. If you have a tax question, visit www.irs.gov or call 1-800-829-1040. We cannot answer tax questions at either of the addresses listed above.

Ordering forms and publications. Visit www.irs.gov/formspubs to download forms and publications, call 1-800-829-3676, or write to one of the three addresses shown under *How To Get Tax Help* in the back of this publication.

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 of each agency and rate its responsiveness to small business. If you wish to comment on the enforcement actions of the IRS, you can:

- Call 1-888-734-3247,
- Fax your comments to 202-481-5719,
- Write to
Office of the National Ombudsman
U.S. Small Business Administration
409 3rd Street, S.W.
Washington, DC 20416
- Send an email to ombudsman@sba.gov, or
- Download the appraisal form at www.sba.gov/ombudsman.

Treasury Inspector General for Tax Administration. If you want to report, confidentially, 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.

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.

What's New for 2004

The following items highlight a number of administrative and tax law changes for 2004. They are discussed in more detail throughout the publication. More information on these and other changes can be found in Publication 553, *Highlights of 2004 Tax Changes*.

Addition to small watershed programs. The Forest Land Enhancement Program has been added to the list of small watershed programs. You may be able to exclude cost-share payments you receive from this program. See chapter 3.

Alternative Minimum Tax (AMT). When figuring AMT, income averaging is no longer used to compute your regular tax liability. See chapter 3.

Standard mileage rate. The standard mileage rate for the cost of operating your car, van, pickup, or panel truck in 2004 is 37.5 cents a mile for all business miles driven. See chapter 4.

Standard mileage method. Beginning in 2004, you can use the standard mileage rate to figure the deductible costs of operating up to four vehicles (at the same time) that you own or lease for business. In earlier years, you could not use the standard mileage rate if you used two or more vehicles at the same time. See chapter 4.

Reforestation costs. You can elect to deduct a limited amount of reforestation costs that are paid or incurred after October 22, 2004. The remaining costs can be amortized over an 84-month period. See chapter 4 and chapter 7. The reforestation credit is no longer available for costs paid or incurred after October 22, 2004.

Start-up costs. You can elect to deduct up to \$5,000 of business start-up costs paid or incurred after October 22, 2004. The remaining costs can be amortized over a 180-month period. See chapter 4 and chapter 7.

Increased section 179 deduction dollar limits. The maximum amount you can elect to deduct for most section 179 property you placed in service during 2004 is \$102,000. This limit is reduced by the amount by which the cost of the property placed in service during the tax year exceeds \$410,000. See chapter 7.

Making and revoking section 179 deduction elections on amended returns. You can make or revoke an election (or specifications made in an election) to deduct section 179 property by filing an amended return. This applies to elections made for section 179 property placed

in service after 2002. The amended return must be filed within the time prescribed for the applicable tax year. See chapter 7.

Depreciation limits for business cars. The total amount of depreciation (including the section 179 deduction and the special depreciation allowance) you can take for a passenger automobile (that is not an electric vehicle or a truck or van) you use in your business and first place in service in 2004 is generally \$10,610. Special rules apply to electric vehicles and trucks and vans. See chapter 7.

Depreciation deduction for MACRS property acquired in a nontaxable exchange. New guidance has been issued for depreciating MACRS property acquired after February 27, 2004, in a like-kind exchange or involuntary conversion. See chapter 7.

Section 179 deduction limit for sport utility vehicles. The maximum section 179 expense deduction for certain sport utility vehicles placed in service after October 22, 2004, is \$25,000. See chapter 7.

Bonus depreciation for aircraft. Certain non-commercial aircraft are eligible for the special depreciation allowances. See chapter 7.

Bond or other debt received as payment. For sales on or after October 22, 2004, any bond or other evidence of debt you receive from the buyer that has interest coupons attached or that can be readily traded on an established securities market is treated as a payment in the year you receive it. See chapter 10.

Postponing gain on weather-related sales of livestock. The following new rules apply to postponing gain on the sale or exchange of livestock (other than poultry) held for draft, breeding, or dairy purposes because of weather-related conditions. These rules are effective for tax years for which the return due date (excluding extensions) is after 2002.

1. If it is not practical for you to invest the sales proceeds in other livestock, other property (except real property) used for farming qualifies as replacement property.
2. The replacement period is at least 4 years if the weather-related conditions occur in an area eligible for federal assistance. See chapter 11.

If you don't replace the livestock, the due date for making the election to postpone reporting income from sales or exchanges because of weather-related conditions described in 2 above is also extended. See chapter 3.

Tax rates and maximum net earnings. The maximum net self-employment earnings subject to the social security part (12.4%) of the self-employment tax increased to \$87,900 for 2004. There is no maximum limit on earnings subject to the Medicare part (2.9%). See chapter 12.

What's New for 2005

Maximum net earnings. The maximum net self-employment earnings subject to the social

security part of the self-employment tax for 2005 will be published in Publications 533 and 553. There is no maximum limit on earnings subject to the Medicare part.

Increase to FUTA tax deposit threshold. The Treasury Department recently amended Regulations section 31.6302(c)-3 to increase the accumulated FUTA tax deposit threshold from \$100 to \$500. The \$500 threshold applies to FUTA tax deposits required for taxes reported on Forms 940, 940-EZ, and 940-PR, Employer's Annual Federal Unemployment (FUTA) Tax Return, for tax periods beginning after December 31, 2004.

Wage limit for social security tax. The limit on wages subject to the social security tax for 2005 will be published in Publication 51 (Circular A), Agricultural Employer's Tax Guide. There is no limit on wages subject to the Medicare tax.

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 because 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.

Additional special depreciation allowances. The additional special depreciation allowances will not apply to most property placed in service after December 31, 2004. For more information, see chapter 7.

Postponed tax deadlines in disaster areas. The IRS may postpone for up to 1 year certain tax deadlines of taxpayers who are affected by a Presidentially declared disaster.

Reportable transactions. You must file Form 8886, Reportable Transaction Disclosure Statement, to report certain transactions. You may have to pay a penalty if you are required to file Form 8886 but do not do so. Reportable transactions include (1) transactions the same as or substantially similar to tax avoidance transactions identified by the IRS, (2) transactions offered to you under conditions of confidentiality and for which you paid an advisor a minimum fee, (3) transactions for which you have or a related party has a right to a full or partial refund of fees if all or part of the intended tax consequences from the transaction are not sustained, (4) transactions that result in losses of at least \$2 million in any single year or \$4 million in any combination of years, (5) transactions resulting in book-tax differences of more than \$10 million, and (6) transactions with asset holding periods of 45 days in one year or less and that result in a tax credit of more than \$250,000. For more information, see the Instructions for Form 8886.

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.

Electronic deposits of taxes. You must use the Electronic Federal Tax Payment System (EFTPS) to make electronic deposits of all depository tax liabilities you incur in 2005 and thereafter if you deposited more than \$200,000 in federal depository taxes in 2003 or you had to use EFTPS in 2004. See chapter 13.

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 2005. You should make new Forms W-4 available to your employees and encourage them to check their income tax withholding for 2005. Those employees who owed a large amount of tax or received a large refund for 2004 may need to file a new Form W-4. See Publication 919, How Do I Adjust My Tax Withholding.

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 13.

Electronic Form 1099. Form 1099 can be issued electronically if the recipient consents to receive it that way.

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

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 13.

Social security tests for seasonal farm workers. If you pay seasonal farm workers 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 seasonal farm worker must meet certain tests. See chapter 13.

Dyed diesel fuel and dyed kerosene. Dyed diesel fuel and dyed kerosene used for a nontaxable use (such as use on a farm for farming purposes) are not taxed. However, the tax applies if these fuels are used for a taxable use (such as in operating a highway vehicle on the highway). In addition, a penalty is imposed on a person who uses dyed diesel fuel or dyed kerosene for a taxable use and knows or has reason to know the fuel was dyed. For more information, see chapter 14.

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 credit or refund of the excise tax on that fuel. Farmers cannot claim a credit or refund for the excise tax paid on that fuel. See chapter 14.

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.

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 2005.

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.

2005 Calendar Year

During January

Farm employers. Give your employees their copies of Form W-2 for 2004 by January 31, 2005.

January 18

Farmers. Pay your estimated tax for 2004 using Form 1040-ES. You have until April 15 to file your 2004 income tax return (Form 1040). If you do not pay your estimated tax by January 18, you must file your 2004 return and pay any tax due by March 1, 2005, to avoid an estimated tax penalty.

January 31

Farm employers. Give your employees their copies of Form W-2 for 2004. If an employee agreed to receive Form W-2 electronically, have it posted on a website and notify the employee of the posting.

Social security, Medicare, and withheld income tax. File Form 943 to report social security and Medicare taxes and withheld income tax for 2004. Deposit any undeposited tax. (If your tax liability is less than \$2,500, you can pay it in full with a timely filed 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. For more information, see chapter 13.

All farm businesses. Give annual information statements to recipients of certain pay-

ments you made during 2004. You can use the appropriate version of Form 1099 or other information return. Form 1099 can be issued electronically with the consent of the recipient. For more information, see the 2004 General Instructions for Forms 1099, 1098, 5498, and W-2G. (See Chapter 16 for information about getting forms, instructions, and publications.)

Federal unemployment (FUTA) tax. File Form 940 (or 940-EZ) for 2004. 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 13.

February 10

Social security, Medicare, and withheld income tax. File Form 943 to report social security, Medicare, and withheld income tax for 2004. 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 2004. 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 2004. 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 remains January 31.

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 2004.

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

For more information, see the 2004 Instructions for Forms W-2 and W-3.

March 1

Farmers. File your 2004 individual income tax return (Form 1040) and pay any tax due. However, you have until April 15 to file if you paid your 2004 estimated tax by January 18, 2005.

March 15

Corporations. File a 2004 calendar year corporate income tax return (Form 1120 or 1120-A) and pay any tax due by March 15. 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.

The due date for giving these forms to the recipient remains January 31.

For information about filing Forms 1099 electronically, see Publication 1220, Specifications for Filing Forms 1098, 1099, 5498, and W-2G Electronically or Magnetically. For information about filing Forms W-2 electronically with the SSA, call 1-800-772-6270 or visit www.ssa.gov/employer.

April 15

Farmers. File an individual income tax return (Form 1040) for 2004 and pay any tax due if you did not file by March 1.

Partnerships. File a 2004 calendar year return (Form 1065). For more information, see *Partnership Return (Form 1065)* in Publication 541, Partnerships.

May 2

Federal unemployment (FUTA) tax. If you are liable for FUTA tax, deposit the tax owed through March if more than \$500.

August 1

Federal unemployment (FUTA) tax. If you are liable for FUTA tax, deposit the tax owed through June if more than \$500.

October 31

Federal unemployment (FUTA) tax. If you are liable for FUTA tax, deposit the tax owed through September if more than \$500.

IRS e-file (Electronic Filing)



You can file your tax returns electronically using an IRS *e-file* option. The benefits of IRS *e-file* include faster refunds, increased accuracy, and acknowledgment of IRS receipt of your return. You can use one of the following IRS *e-file* options.

- Use an authorized IRS *e-file* provider.
- Use a personal computer.
- Use a telephone if you receive a Telefile Tax Package.
- Visit a VITA or TCE site.

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

1.

Importance of 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 the benefits of keeping 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.

The Farm Financial Standards Council has produced a publication that provides a detailed explanation of the recommendations of the Council for financial reporting and analysis. For information on recordkeeping, you may want to get a copy of *Financial Guidelines for Agricultural Producers*. You can order it from Country-side Marketing, Inc. in the following manner.

- Call 262-253-6902.
- Send a fax to 262-253-6903. Make sure the fax contains the address where you want the publication shipped.
- Write to:
Farm Financial Standards Council
N78 W14573 Appleton Ave #287
Menomonee Falls, WI 53051.

The document has 218 pages. If you order the document, you will be mailed an invoice for \$25.00 plus postage.

You can also download the publication at www.ffsc.org.

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 16 for information about getting publications.

Benefits of Recordkeeping

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

Monitor the progress of your farming business. You need 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. Records can increase the likelihood of business success.

Prepare your financial statements. You need 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 and help you to manage your farm business.

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 records to prepare your tax return. For example, your 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 specific kind of records. You can choose any recordkeeping system suited to your farming business that clearly shows, for example, 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 2. 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. For example, 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. Specific 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 14 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, 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 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.
- Bank statements.

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. These account statements must be highly legible. The following table lists acceptable account statements.

IF payment is by...	THEN the statement must show the...
Check	<ul style="list-style-type: none"> • Check number. • Amount. • Payee's name. • Date the check amount was posted to the account by the financial institution.
Electronic funds transfer	<ul style="list-style-type: none"> • Amount transferred. • Payee's name. • Date the transfer was posted to the account by the financial institution.
Credit card	<ul style="list-style-type: none"> • Amount charged. • Payee's name. • Transaction date.



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

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 following table contains the periods of limitations that apply to income tax returns. Unless otherwise stated, the years refer to the period after the return was filed. Returns filed before the due date are treated as filed on the due date.

Table 1. Period of Limitations

IF you...	THEN the period is...
1. Owe additional tax and situations (2), (3), and (4), below, do not apply to you	3 years
2. Do not report income that you should report and it is more than 25% of the gross income shown on your return	6 years
3. File a fraudulent return	Not limited
4. Do not file a return	Not limited
5. File a claim for credit or refund after you filed your return	Later of: 3 years or 2 years after tax was paid
6. File a claim for a (loss) from worthless securities or a bad debt deduction	7 years



Keep copies of your filed tax returns. They help in preparing future tax returns and making computations if you 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 received property in a non-taxable 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.

Accounting Periods and Methods

Introduction

You must figure your taxable income and file an income tax return for an annual accounting period called a tax year. You must consistently use an accounting method that clearly shows your income and expenses.

Topics

This chapter discusses:

- Calendar year
- Fiscal year
- Change in tax year
- Cash method
- Accrual method
- Farm inventory
- Special methods of accounting
- Change in accounting method

Useful Items

You may want to see:

Publication

- 538** Accounting Periods and Methods
- 535** Business Expenses

Form (and Instructions)

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

See chapter 16 for information about getting publications and forms.

Accounting Periods

You must figure taxable income on the basis of a tax year. A “tax year” is an annual accounting period for keeping records and reporting income and expenses. You can generally use one of the following tax years.

- A calendar year.
- A fiscal year.

However, special restrictions apply to partnerships, S corporations, and personal service corporations. If you operate as one of these entities, see Publication 538 for more information.

Calendar year. A calendar year is 12 consecutive months beginning January 1 and ending December 31.

You must adopt the calendar year if any of the following apply.

- You do not keep adequate records.
- You have no annual accounting period.
- Your present tax year does not qualify as a fiscal year.
- You are required to use the calendar year by a provision of the Internal Revenue Code or the Income Tax Regulations.

If you filed your first income tax return using the calendar year and you later begin business as a farmer, you must continue to use the calendar tax year unless you get IRS approval to change it. See *Change in tax year*, later.

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

Fiscal tax year. A fiscal year is 12 consecutive months ending on the last day of any month except December. A 52-53-week tax year is a fiscal year that varies from 52 to 53 weeks but may or may not end on the last day of a month.

If you adopt a fiscal year you must maintain your books and records and report your income and expenses using that same fiscal year.

For more information on a fiscal year, including a 52-53-week tax year, see Publication 538.

Change in Tax Year

Once you have chosen your tax year, you must, with certain exceptions, get IRS approval to change it. To get approval, file Form 1128. The Form 1128 instructions have details on the exceptions (circumstances in which Form 1128 may not be filed) as well as instructions for completing the form where it is required. If you are required to use the form to make a desired change in tax year, you should consult the references to new automatic approval procedures explained in detail in the Form 1128 instructions and Publication 538. If you qualify, you must use the automatic approval procedures. You will not have to pay a user fee. The Form 1128 instructions and Publication 538 also explain new procedures for taxpayers ineligible for automatic approval. These taxpayers must request a ruling and pay a user fee.

Accounting Methods

An accounting method is a set of rules used to determine when and how income and expenses are reported. Your accounting method includes not only your overall method of accounting, but also the accounting treatment you use for any material item.

You choose an accounting method for your farm business when you file your first income tax return that includes a Schedule F. However, you cannot use the crop method for any tax return, including your first tax return, unless you get IRS approval. The crop method of accounting is discussed later under *Special Methods of Accounting*. Getting IRS approval to change an

accounting method is discussed later under *Change in Accounting Method*.

Kinds of methods. Generally, you can use any of the following accounting methods.

- Cash method.
- Accrual method.
- Special methods of accounting for certain items of income and expenses.
- Combination (hybrid) method using elements of two or more of the above.

However, certain farm corporations and partnerships, and all tax shelters, must use an accrual method of accounting. See *Accrual method required*, later.

Business and personal items. You can account for business and personal items using different accounting methods. For example, you can figure your business income under an accrual method, even if you use the cash method to figure personal items.

Two or more businesses. If you operate two or more separate and distinct businesses, you can use a different accounting method for each. No business is separate and distinct, however, unless a complete and separate set of books and records is maintained for each business.

Accrual method required. The following businesses engaged in farming must use an accrual method of accounting.

1. A corporation (other than a family corporation) that had gross receipts of more than \$1,000,000 for any tax year beginning after 1975.
2. A family corporation that had gross receipts of more than \$25,000,000 for any tax year beginning after 1985.
3. A partnership with a corporation as a partner.
4. A tax shelter.

Note. Items (1), (2), and (3) do not apply to an S corporation or a business operating a nursery or sod farm, or the raising or harvesting of trees (other than fruit and nut trees).

Family corporation. A family corporation is generally a corporation that meets one of the following ownership requirements.

- 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.
- Members of two families have owned, directly or indirectly, since October 4, 1976, at least 65% of the total combined voting power of all classes of voting stock and at least 65% of the total shares of all other classes of the corporation's stock.
- Members of three families have owned, directly or indirectly, since October 4, 1976, at least 50% of the total combined voting power of all classes of voting stock and at least 50% of the total shares of all other classes of the corporation's stock.

For more information on family corporations, see section 447 of the Internal Revenue Code.

Tax shelter. A tax shelter is a partnership, noncorporate enterprise, or S corporation that meets either of the following tests.

1. Its principal purpose is the avoidance or evasion of federal income tax.
2. It is a farming syndicate. A farming syndicate is an entity that meets either of the following tests.
 - a. Interests in the activity have been offered for sale in an offering required to be registered with a federal or state agency with the authority to regulate the offering of securities for sale.
 - b. More than 35% of the losses during the tax year are allocable to limited partners or limited entrepreneurs.

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. A "limited entrepreneur" is one who has an interest in an enterprise other than as a limited partner and does not actively participate in the management of the enterprise.

Cash Method

Most farmers use the cash method because they find it easier to keep cash method records. However, certain farm corporations and partnerships and all tax shelters must use an accrual method of accounting. See *Accrual method required*, earlier.

Income

Under the cash method, include in your gross income all items of income you actually or constructively receive during the tax year. If you receive property or services, you must include their fair market value in income. See chapter 3 for information on how to report farm income on your income tax return.

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. If you authorize someone to be your agent and receive income for you, you are considered to have received it when your agent receives it. Income is not constructively received if your control of its receipt is subject to substantial restrictions or limitations.

Direct payments and counter-cyclical payments. If you received direct payments or counter-cyclical payments under Subtitle A or C of the Farm Security and Rural Investment Act of 2002 (Public Law 107-171), you will not be considered to constructively receive a payment merely because you had the option to receive it in the year before it is required to be paid.

Delaying receipt of income. You cannot hold checks or postpone taking possession of similar property from one tax year to another to avoid paying tax on the income. You must report

the income in the year the property is received or made available to you without restriction.

Example. Frances Jones, a farmer, was entitled to receive a \$10,000 payment on a grain contract in December 2004. She was told in December that her payment was available. At her request, she was not paid until January 2005. She must still include this payment in her 2004 income because it was made available to her in 2004.

Debts paid by another person or canceled. If your debts are paid by another person or are canceled by your creditors, you may have to report part or all of this debt relief as income. If you receive income in this way, you constructively receive the income when the debt is canceled or paid. See *Cancellation of Debt* in chapter 3.

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 tax year. You sell grain in December 2004 under a bona fide arm's-length contract that calls for payment in 2005. You include the sale proceeds in your 2005 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 2004 income, regardless of when you actually receive payment.

Repayment of income. If you include an amount in income and in a later year you have to repay all or part of it, you can usually deduct the repayment in the year in which you make it. If the amount you repay is over \$3,000, a special rule applies. For details about the special rule, see *Repayments* in chapter 13 of Publication 535, *Business Expenses*.

Expenses

Under the cash method, you generally deduct expenses in the tax year in which you actually pay them. This includes business expenses for which you contest liability. However, you may not be able to deduct an expense paid in advance or you may be required to capitalize certain costs, as explained under *Uniform Capitalization Rules* in chapter 6. See chapter 4 for information on how to deduct farm business expenses on your income tax return.

Prepayment. You cannot deduct expenses in advance, even if you pay them in advance. This rule applies to any expense paid far enough in advance to, in effect, create an asset with a useful life extending substantially beyond the end of the current tax year.

Example. In 2004, you signed a 3-year insurance contract. Even though you paid the premiums for 2004, 2005, and 2006 when you signed the contract, you can only deduct the premium for 2004 on your 2004 tax return. Deduct in 2005 and 2006 the premium allocable to those years.

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. The purpose of an accrual method of accounting is to correctly match income and expenses.

Income

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

If you use an accrual method of accounting, complete Part III of Schedule F (Form 1040).

Inventory. If you keep an inventory, you generally must use an accrual method of accounting to determine your gross income. See *Farm Inventory*, later, for more information.

Expenses

Under an accrual method of accounting, you generally deduct or capitalize a business expense when both of the following apply.

1. The all-events test has been met. This test is met when:
 - 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.

Economic performance. You generally cannot deduct or capitalize a business expense 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 as the property is used.

If your expense is for property or services you provide to others, economic performance occurs as you provide the property or services.

An exception to the economic performance rule allows certain recurring items to be treated as incurred during a tax year even though economic performance has not occurred. For more information on economic performance, see *Economic Performance* in Publication 538.

Example. Jane is a farmer who uses a calendar tax year and an accrual method of accounting. She enters into a contract with Waterworks in 2004. The contract states that Jane must pay Waterworks \$200,000 in December 2004 and they will install a complete irrigation system, including a new well, by the close of 2005. She pays Waterworks \$200,000 in December 2004, they start the installation in May 2005, and they complete the irrigation system in December 2005.

Economic performance for Jane's liability in the contract occurs as the property and services are provided. Jane incurs the \$200,000 cost in 2005.

Special rule for related persons. Business expenses and interest owed to a related person who uses the cash method of accounting are not deductible until you make the payment and the corresponding amount is includible in the related person's gross income. Determine the relationship for this rule as of the end of the tax year for which the expense or interest would otherwise be deductible. If a deduction is denied, the rule will continue to apply even if your relationship with the person ends before the expense or interest is includible in the gross income of that person.

Related persons include members of your immediate family, including brothers and sisters (either whole or half), your spouse, ancestors, and lineal descendants. For a list of other related persons, see *Related Persons* in Publication 538. For example, in the following examples, Corporation B is a legal person. A is related to Corporation B because of his majority stock ownership.

Example 1. As of December 31, 2004, A, a calendar year individual taxpayer, owns 60% of the stock in Corporation B, which is engaged in farming. A owes Corporation B \$1,000 interest due in December of 2004 but does not pay until January of 2005. Corporation B, also a calendar year taxpayer, uses cash basis accounting since its receipts are less than \$1,000,000. A may not deduct the \$1,000 payment when filing his or her 2004 tax year return in 2005 because the expense is not considered incurred until January of 2005.

Example 2. The facts are the same, but A sells all of his or her stock in the corporation in November of 2004. A still may not make the deduction in his or her 2004 tax year.

Contested liability. If you use an accrual method of accounting and contest an asserted liability for a farm business expense, you can deduct the liability either in the year you pay it (or transfer money or other property in satisfaction of it) or in the year you finally settle the contest. However, 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

If you keep an inventory, you generally must use an accrual method of accounting to determine your gross income. 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 applicable.

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

Accounting for inventory. Generally, if you produce, purchase, or sell merchandise in your business, you must keep an inventory and use the accrual method for purchases and sales of merchandise. However, if you are a qualifying taxpayer or a qualifying small business taxpayer that has an eligible business, you can use the

cash method of accounting, even if you produce, purchase, or sell merchandise. If you qualify, you also can choose not to keep an inventory, even if you do not change to the cash method.

A "qualifying taxpayer" is a taxpayer that for each prior tax year ending after December 16, 1998, has average annual gross receipts of \$1 million or less for the 3-tax-year period ending with that prior tax year. A tax shelter cannot be a qualifying taxpayer. See Publication 538 for more information.

A "qualifying small business taxpayer" is a taxpayer that (a) for each prior tax year ending after December 31, 2000, has average annual gross receipts of \$10 million or less for the 3-tax-year period ending with that prior tax year, and (b) whose principal business activity is not an ineligible activity. Certain other requirements must be met. See Publication 538 for more information.



The qualifying small business taxpayer exception does not apply to a farming business. However, if you are a qualifying small business taxpayer engaged in a farming business, this exception may apply to your nonfarming businesses, if any.

Hatchery business. If you are in the hatchery business, and use the accrual method of accounting, you must include in inventory 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 in inventory.

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

Livestock. Livestock held primarily for sale must be included in inventory. Livestock held for draft, breeding, or dairy purposes can either be depreciated or included in inventory. See also *Unit-livestock-price method*, later. If you are in the business of breeding and raising chinchillas, mink, foxes, or other fur-bearing animals, these animals are livestock for inventory purposes.

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. See *Uniform Capitalization Rules* in chapter 6.

Required to use accrual method. The following applies if you are required to use an accrual method of accounting.

- 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.
- The costs of animals are subject to the uniform capitalization rules.

Inventory valuation methods. The following methods, described below, are those generally available for valuing inventory.

- Cost.

- Lower of cost or market.
- Farm-price method.
- Unit-livestock-price method.

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



If you value your livestock inventory at cost or the lower of cost or market, you do not need IRS approval to change to the unit-livestock-price method.

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 broker's commissions, 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 under 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 must annually reevaluate your unit livestock prices and adjust the prices upward or downward to reflect increases or decreases in the costs of raising livestock. IRS approval is not required for these adjustments. Any other changes in unit prices or classifications do require IRS approval.

If you use this method, include all raised livestock in inventory, regardless of whether they are held for sale or for draft, breeding, sport, or dairy 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 those most recently acquired.

You must include in inventory all livestock purchased primarily for sale. You can choose either to include in inventory or depreciate livestock purchased for draft, breeding, sport or dairy purposes. However, you must be consistent from year to year, regardless of the practice you have chosen. You cannot change your practice without 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 6 months of the year. This no increase rule does

not apply to tax shelters which must make an adjustment for any animal purchased during the year. It also does not apply to taxpayers that must make an adjustment to reasonably reflect the particular period in the year in which animals are purchased, if necessary to avoid significant distortions in income.

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 tax year basis. You sell grain in December 2004, but you are not paid until January 2005. You must both include the sale proceeds and deduct the costs incurred in producing the grain on your 2004 tax return.

Example 2. Assume the same facts as in *Example 1* except that you use the cash method and there was no constructive receipt of the sale proceeds in 2004. Under this method, you include the sale proceeds in income for 2005 the year you receive payment. You deduct the costs of producing the grain in the year you pay for them.

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 that 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. Other special methods of accounting apply to the following items.

- Amortization, see chapter 7.
- Casualties, see chapter 11.
- Condemnations, see chapter 11.
- Depletion, see chapter 7.
- Depreciation, see chapter 7.
- Farm business expenses, see chapter 4.
- Farm income, see chapter 3.
- Installment sales, see chapter 10.
- Soil and water conservation expenses, see chapter 5.
- Thefts, see chapter 11.

Combination Method

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

- If you use the cash method for figuring your income, you must use the cash method for reporting your expenses.
- If you use an accrual method for reporting your expenses, you must use an accrual method for figuring your income.

Change in Accounting Method

Once you have set up your accounting method, you must generally get IRS approval before you can change to another method. A change in your accounting method includes a change in:

- Your overall method, such as from cash to an accrual method, and
- 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).

To get approval, you must file Form 3115. You may have to pay a fee. For more information, see the Form 3115 instructions.

3.

Farm Income

What's New

Addition to small watershed programs. The Forest Land Enhancement Program has been added to the list of small watershed programs. You may be able to exclude cost-share payments you receive from this program. For more information, see *Cost-Sharing Exclusion (Improvements)*, later.

Sales of livestock because of weather-related conditions. The due date for making the election to postpone reporting income from certain involuntary conversions of livestock as a result of weather-related conditions has been extended. See *Sales Caused by Weather-Related Conditions*, later.

Alternative Minimum Tax (AMT). When figuring AMT, income averaging is no longer used to compute your regular tax liability. See *Alternative Minimum Tax (AMT)*, later.

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 (Form 1040). 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 2.

If you use an accrual method of accounting, different rules may apply to your situation. See *Accrual Method* in chapter 2.

Topics

This chapter discusses:

- Schedule F (Form 1040)
- Sales of farm products
- Rents (including crop shares)
- Agricultural program payments
- Income from cooperatives
- Cancellation of debt
- Income from other sources
- Income averaging for farmers

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)** Income Averaging for Farmers and Fishermen
- 982** Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)
- 1099-G** Certain Government Payments
- 1099-PATR** Taxable Distributions Received From Cooperatives
- 4797** Sales of Business Property
- 4835** Farm Rental Income and Expenses

See chapter 16 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 (Form 1040) 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 received from operating a nursery, which specializes in growing ornamental plants, is considered to be income from farming.

Income reported on Schedule F does not include gains or losses from sales or other dispositions of the following farm assets.

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

Gains and losses from most dispositions of farm assets are discussed in chapters 8 and 9. Gains and losses from casualties, thefts, and condemnations are discussed in chapter 11.

Sales of Farm Products

When you sell livestock, produce, grains, or other products you raised on your farm for sale or bought for resale, the entire amount you receive is reported on Schedule F. This includes money and the fair market value of any property or services you receive.

Where to report. Table 3-1 shows where to report the sale of farm products on your tax return.

Schedule F. When you sell farm products bought for resale, your profit or loss is the difference between your basis in the item (usually your cost) and any payment (money plus the fair market value of any property) you receive for it. See chapter 6 for information on the basis of assets. You generally report these amounts on Schedule F for the year you receive payment.

Example. In 2003, you bought 20 feeder calves for \$6,000 for resale. You sold them in 2004 for \$11,000. You report the \$11,000 sales

Table 3-1. Where To Report Sales of Farm Products

Item Sold	Schedule F	Form 4797
Farm products raised for sale	X	
Farm products bought for resale	X	
Farm products not held primarily for sale, such as livestock held for draft, breeding, sport, or dairy purposes (bought or raised)		X

price, subtract your \$6,000 basis, and report the resulting \$5,000 profit on your 2004 Schedule F, Part I.

Form 4797. Sales of livestock held for draft, breeding, sport, or dairy 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. See *Livestock* under *Ordinary or Capital Gain or Loss* in chapter 8. Animals you do not hold primarily for sale are considered business assets of your farm.

Sale by agent. If your agent sells your farm products, you must include the net proceeds from the sale in gross income for the year the agent receives payment. This applies even if your agent pays you in a later year. You have constructive receipt of the income when your agent receives payment. For a discussion on constructive receipt of income, see *Cash Method* under *Accounting Methods* in chapter 2.

Sales Caused by Weather-Related Conditions

If you sell or exchange 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 postpone reporting the gain from the additional animals until the next year. You must meet all the following conditions 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 or exchanged the additional animals this year except for the weather-related condition.
- The weather-related condition caused an area to be designated as eligible for assistance by the federal government.

Sales or exchanges made before an area became eligible for federal assistance qualify if the weather-related condition that caused the sale or exchange 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 departments or agencies.

TIP A weather-related sale or exchange of livestock (other than poultry) held for draft, breeding, or dairy purposes may be an involuntary conversion. See *Other Involuntary Conversions* in chapter 11.

Usual business practice. You must 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, but do not take into account your sales in any earlier year for which you postponed the gain. If you have not yet established a usual business practice, rely on the usual business practices of similarly situated farmers in your general region.

Connection with affected area. 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 a weather-related condition that affected the water, grazing, or other requirements of the livestock. This requirement generally will not be met if the costs of food, water, or other requirements of the livestock affected by the weather-related condition are not substantial in relation to the total costs of holding the livestock.

Classes of livestock. You must figure the amount to be postponed separately for each generic class of animals—for example, hogs, sheep, and cattle. Do not separate animals into classes based on 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. For this purpose, do not treat any postponed gain from the previous year as income received from the sale of livestock.
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 2004. You realized \$35,100 from the sale. On August 9, 2004, as a result of drought, the affected area was declared a disaster area eligible for federal assistance. The income you can postpone until 2005 is \$9,100 $[(\$35,100 \div 135) \times 35]$.

How to postpone gain. To postpone gain, 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 are postponing gain.

- A statement that you are postponing gain 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 in the absence of weather-related conditions.
- 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.

Generally, you must file the statement and the return by the due date of the return, including extensions. However, for sales or exchanges treated as an involuntary conversion from weather-related sales of livestock in an area eligible for federal assistance (discussed in chapter 11), you can file this statement at any time during the replacement period. For other sales or exchanges, if you timely filed your return for the year without postponing gain, you can still postpone gain by filing an amended return within 6 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 amended return. File the amended return at the same address you filed the original return. Once you have filed the statement, you can cancel your postponement of gain only with the approval of the IRS.

Rents (Including Crop Shares)

The rent you receive for the use of your farmland 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 12.

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 on Schedule E (Form 1040), Part I.

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 included in self-employment income. (See *Landlord Participation in Farming* in chapter 12.) 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 included in self-employment income.

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 cancel each other for figuring adjusted gross income on Form 1040, they may be necessary to figure your self-employment tax. See chapter 12.

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, direct payments, and counter-cyclical payments, whether you receive them in cash, materials, services, or commodity certificates. However, you can exclude from income 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 of Schedule F, Part I. 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 (CCC) 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 repayment or reduction.

Commodity Credit Corporation (CCC) Loans

Generally, you do not report loans you receive as income. However, if you pledge part or all of your production to secure a CCC loan, you can treat the loan as if it were a sale of the crop and report the loan proceeds as income in the year you receive them. You do not need approval from the IRS to adopt this method of reporting CCC loans.

Once you report a CCC loan as income for the year received, you generally must report all CCC loans in that year and later years in the same way. However, you can obtain automatic consent to change your method of accounting for loans received from the CCC, from including the loan amount in gross income for the taxable year in which the loan is received to treating the loan amount as a loan. For more information, see *Automatic Change Request Procedures under Change in Accounting Method* in Publication 538, Accounting Periods and Methods.



TIP You can request income tax withholding from CCC loan payments you receive. Use Form W-4V, Voluntary Withholding Request. See chapter 16 for information about ordering the form.

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

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 6 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 return. File the amended return at the same address you filed the original return.

When you make this choice, the amount you report as income becomes your basis in the commodity. See chapter 6 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 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.

Form 1099-A. If you forfeit pledged crops to the CCC in full payment of a loan, you may receive a Form 1099-A, Acquisition or Abandonment of Secured Property. "CCC" should be shown in box 6. The amount of any CCC loan outstanding when you forfeited your commodity should also be indicated on the form.

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 original loan amount is market gain. If you use cash to repay the loan, you will receive a Form CCC-1099-G showing the market gain you realized. If you repay the loan with CCC certificates, you will not be issued a Form CCC-1099-G. Whether or not you receive a Form CCC-1099-G, market gain should be reported as follows.

- If you chose to include the CCC loan in income in the year you received it, do not include the market gain in income. However, adjust the basis of the commodity for the amount of the market gain.
- If you did not include the CCC loan in income in the year received, include the market gain in your 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 his tax return on a calendar year basis. He has deducted all expenses incurred in producing the cotton and has a zero basis in the commodity. In 2003, Mike pledged 1,000 pounds of cotton as collateral for a CCC loan of \$500 (a loan rate of \$.50 per pound). In 2004, he repaid the loan and redeemed the cotton for \$420 when the world price was \$.42 per pound (lower than the loan amount). Later in 2004, he sold the cotton for \$600.

The market gain on the redemption was \$.08 (\$.50 - \$.42) per pound. Mike realized total 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 included CCC loans in income in 2003.

Included CCC loan. Mike reported the \$500 CCC loan as income for 2003, so he is treated as if 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 2004 as an Agricultural program payment on Schedule F, line 6a, but does not include it as a taxable amount on line 6b.

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 the \$180 gain as income for 2004 on Schedule F, line 4.

Excluded CCC loan. Mike has income of \$80 from market gain in 2004. He reports it on Schedule F, line 6a and line 6b. His basis in the cotton is zero, so his gain from its sale is \$600. He reports the \$600 gain as income for 2004 on Schedule F, line 4.

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 2004, 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 included CCC loans in income in 2003.

Included CCC loan. 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 2004 as an Agricultural program payment on Schedule F, line 6a, but does not include it as a taxable amount on line 6b.

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

Excluded CCC loan. As in Example 1, Mike has income of \$80 from market gain in 2004. He reports it on Schedule F, line 6a and line 6b. His basis in the cotton is zero, so his gain from its sale is \$420. He reports the \$420 gain as income for 2004 on Schedule F, line 4.

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 the annual rental payments and any one-time incentive payment you receive under the program on Schedule F, lines 6a and 6b. Cost-share payments you receive may qualify for the cost-sharing exclusion. (See *Cost-Sharing Exclusion*, later.) CRP payments are reported to you on Form CCC-1099-G.

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 16 for information about ordering the form.

Choice to postpone reporting until the following year. You can postpone reporting crop insurance proceeds as income until the year following the year the damage occurred if you meet all the following conditions.

- You use the cash method of accounting.

- You receive the crop insurance proceeds in the same tax year the crops are damaged.
- You can show that under your normal business practice you would have included income from the damaged crops in any tax year following the year the damage occurred.

To postpone reporting crop insurance proceeds received in 2004, report the amount you received on Schedule F, line 8a, but do not include it as a taxable amount 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 Regulations section 1.451-6.
- 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 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 unless the IRS approves your request to change it. To request IRS approval to change your choice, write to the IRS at the following address giving your name, address, identification number, the year you made the choice, and your reasons for wanting to change it.

Ogden Submission Processing Center
P. O. Box 9941
Ogden, UT 84409

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. Include in income:

- The market value of donated feed,
- The difference between the market value and the price you paid for feed you buy at below market prices, and
- Any cost reimbursement you receive.

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 on Schedule F, Part I, as agricultural program payments. 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. A 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.

1. 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 for a deductible expense in income, and you can take any offsetting deduction. (See chapter 5 for information on deducting soil and water conservation expenses.)
2. 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 the following amounts.
 - a. 10% of the average annual income derived from the affected property before receiving the improvement.
 - b. \$2.50 times the number of affected acres.
3. The Secretary of Agriculture certified that the payment was primarily made for conserving soil and water resources, protecting or restoring the environment, improving forests, or providing a habitat for wildlife.

Qualifying programs. If the three tests listed 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 later.
- Any program of a state, possession of the United States, a political subdivision of any of these, or of 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).

Small watershed programs. If the three tests listed earlier are met, you can exclude payments you receive under the following programs for improvements made in connection with a watershed.

- The Stewardship Incentive Program authorized by the Food, Agriculture, Conservation, and Trade Act of 1990.
- The programs under the Watershed Protection and Flood Prevention Act.
- The flood prevention projects under the Flood Control Act of 1944.
- The Emergency Watershed Protection Program under the Flood Control Act of 1950.
- Certain programs under the Colorado River Basin Salinity Control Act.
- The Wetlands Reserve Program authorized by the Food Security Act of 1985, the Federal Agriculture Improvement and Reform Act of 1996 and the Farm Security and Rural Investment Act of 2002.
- The Environmental Quality Incentives Program (EQIP) authorized by the Federal Agriculture Improvement and Reform Act of 1996.
- The Wildlife Habitat Incentives Program (WHIP) authorized by the Federal Agriculture Improvement and Reform Act of 1996.
- The Soil and Water Conservation Assistance Program authorized by the Agricultural Risk Protection Act of 2000.
- The Agricultural Management Assistance Program authorized by the Agricultural Risk Protection Act of 2000.

- The Conservation Reserve Program authorized by the Food Security Act of 1985 and the Federal Agriculture Improvement and Reform Act of 1996.
- The Forest Land Enhancement Program authorized under the Farm Security and Rural Investment Act of 2002.

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 (if any).

Value of the improvement. You determine the value of the improvement by multiplying its fair market value (defined in chapter 6) 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 items.

- Any government payments under a program not listed earlier.
- Any part of a government payment under a program listed earlier that the Secretary of Agriculture has not certified as primarily for conservation.
- 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 of the right to receive annual income 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 rural abandoned mine program 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 the annual income described in (1) above is \$1,380, and the present fair market value of the right to receive the annual income described in (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 1,550 11,550

Amount included in income **\$ 3,450**

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 information.

- 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 Schedule F, line 6a, and the taxable amount on line 6b.

Recapture. If you dispose of the property within 20 years after you received the excluded payments, 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 Gains* in chapter 9.

Choosing not to exclude payments. You can choose not to exclude all or part of any payments you receive under these programs. If you make this choice for all of these payments, none of the above restrictions and rules apply. 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 6 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.

Payments under the Farm Security and Rural Investment Act of 2002

The Farm Security and Rural Investment Act of 2002 created two new types of payments—direct and counter-cyclical payments. You must include these payments on Schedule F, lines 6a and 6b.

Peanut Quota Buyout Program Payments

The Farm Security and Rural Investment Act of 2002 repealed the marketing quota program for peanuts effective May 13, 2002. As a result, USDA will offer to enter into contracts with eligible peanut quota holders to provide compensation for the lost value of the quotas resulting from the repeal.

If you are an eligible peanut quota holder, your contract entitles you to receive one of the following payment options.

- Five equal annual payments of 11 cents per pound of peanut quota during the period 2002 through 2006.
- A single lump sum payment in any one of the five years.

Tax treatment. Your taxable gain or loss is the total amount received for your quota reduced by any amount treated as interest (discussed later), over your adjusted basis. The gain or loss is capital or ordinary depending on how you used the quota. See *Capital or ordinary gain or loss*, later.

Report the entire gain on your income tax return for the taxable year if you:

- Receive a lump sum payment or
- Choose not to use the installment method.

Adjusted basis. The adjusted basis of your quota is determined differently depending on how you obtained the quota.

- The basis of a quota derived from an original grant by the federal government of an acreage allotment is zero.
- The basis of a purchased quota is the purchase price.
- The basis of a quota derived from a purchased acreage allotment is the purchase price.
- The basis of an inherited quota is generally the fair market value of the quota at the time of the decedent's death.

If not previously allocated, the total basis of a quota (or acreage allotment) and land obtained at the same time must be properly allocated between the two assets.

Reduction of basis. You are required to reduce the basis of your peanut quota by the following amounts.

- Deductions you took for amortization, depletion, or depreciation.
- Amounts you previously deducted as a loss because of a reduction in the number of pounds of peanuts allowable under the quota.
- The entire cost of a purchased quota or acreage allotment you deducted in an earlier year (which reduces your basis to zero).

Amount treated as interest. You must reduce your peanut quota buyout program payment by the amount treated as interest, which is reportable as ordinary income. If payments total \$3,000 or less, your total quota buyout program payment does not include any amount treated as interest and you are not required to reduce the total payment you receive.

In all other cases, a portion of each payment may be treated as interest for federal tax purposes. You may be required to reduce your total quota buyout program payment before you calculate your gain or loss. For more information,

see Notice 2002-67 on page 715 of Internal Revenue Bulletin 2002-42. This bulletin is available at www.irs.gov/pub/irs-irbs/irb02-42.pdf.

Installment method. You may use the installment method to report a gain if you receive at least one payment after the close of your taxable year. Under the installment method, a portion of the gain is taken into account in each year in which a payment is received. See chapter 10 for more information.

Capital or ordinary gain or loss. Whether your gain or loss is ordinary or capital depends on how you used the quota.

Quota used in the trade or business of farming. If you used the quota in the trade or business of farming and you held it for more than one year, you report the transaction as a section 1231 transaction on Form 4797. See *Section 1231 transactions under Ordinary or Capital Gain or Loss* in chapter 8 for a definition of section 1231 transactions.

See the instructions for Form 4797 for detailed information on reporting section 1231 transactions.

Quota held for investment. If you held the quota for investment purposes, any gain or loss is capital gain or loss. The same result also applies if you held the quota for the production of income, though not connected with a trade or business.

Gain treated as ordinary income. If you previously deducted any of the following items, some or all of the capital gain must be recharacterized and reported as ordinary income. Any resulting capital gain is taxed as ordinary income up to the amount previously deducted.

- The cost of acquiring a quota.
- Amounts for amortization, depletion, or depreciation.
- Amounts to reflect a reduction in the quota pounds.

You should include the ordinary income on your return for the taxable year even if you use the installment method to report the remainder of the gain.

Self-employment income. The peanut quota buyout payments are not self-employment income.

Income averaging for farmers. The gain or loss resulting from the quota payments does not qualify for income averaging. A peanut quota is considered an interest in land. Income averaging is not available for gain or loss arising from the sale or other disposition of land.

Involuntary conversion. The buyout of the peanut quota is not an involuntary conversion.

Form 1099-S. A peanut quota is considered an interest in land, so the USDA will generally report the total amount you receive under a contract on Form 1099-S if the amount is \$600 or more. The USDA will generally report any portion of a payment treated as interest of \$600 or more to you on Form 1099-INT for the year in which the payment is made.

More information. For more information on the taxation of peanut quota buyout program payments, see Notice 2002-67.

Other Payments

You must include most other government program payments in income.

Fertilizer and Lime

Include in income the value of fertilizer or lime you receive under a government program. How to claim the offsetting deduction is explained under *Fertilizer and Lime* in chapter 4.

Improvements

If government payments are based on improvements, such as a pollution control facility, you must include them in income. You must also 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.

National Tobacco Growers' Settlement Trust Fund Payments

If you are a producer, landowner, or tobacco quota owner who receives money from the National Tobacco Growers' Settlement Trust Fund, you must report those payments as income. You should receive a Form 1099-MISC that shows the payment amount.

If you produce a tobacco crop, report the payments as income from farming on your Schedule F. If you are a landowner or tobacco quota owner who leases tobacco-related property but you do not produce the crop, report the payments as farm rental income on Form 4835.

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.

Report the total amount reported to you as the payee of record on Schedule F, line 6a or 8a. However, do not report as a taxable amount on line 6b or 8b any amount belonging to someone else.

See chapter 16 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 (refunds). If you sell your farm products through a cooperative, you may receive either 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 on Form 6251, Alternative Minimum Tax—Individuals, if you are required to file the form. For information on the alternative minimum tax, see the instructions for Form 6251.

Patronage Dividends

You generally report patronage dividends as income on Schedule F, lines 5a and 5b, 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.

Do **not** report as income on line 5b any patronage dividends from buying personal or family items, capital assets, or depreciable property. Personal items include fuel purchased for personal use, basic local telephone service, and personal long distance calls.

If you cannot determine what the dividend is for, report it as income on lines 5a and 5b.

Qualified written notice of allocation. If you receive a qualified written notice of allocation as part of a patronage dividend, you must generally include its stated dollar value in your income in the year you receive it. A written notice of allocation is qualified if at least 20% of the patronage dividend is paid in money or by qualified check and either of the following conditions is met.

1. The notice 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 same patronage dividend. You must cash the check

by the 90th day after the close of the payment period for the cooperative's tax year for which the patronage dividend was paid.

Qualified check. A qualified check is any instrument that is redeemable in money and meets both of the following requirements.

- It is part of a patronage dividend that also includes a qualified written notice of allocation for which you met condition (2)(c), above.
- It is imprinted with a statement that endorsing and cashing it constitutes the payee's consent to include in income the stated dollar value of any written notices of allocation paid as part of the same patronage dividend.

Loss on redemption. You can deduct on Schedule F, Part II, 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 notice of allocation. Do not include the stated dollar value of any nonqualified notice of allocation in income when you receive it. Your basis in the notice is zero. You must include in income for the tax year of disposition any amount you receive from its sale, redemption, or other disposition. Report that amount, up to the stated dollar value of the notice, on Schedule F, lines 5a and 5b. However, do not include that amount in your income if the notice resulted from buying or selling capital assets or depreciable property or from buying personal items, as explained in the following discussions.

If the amount you receive is more than the stated dollar value of the notice, report the excess as the type of income it represents. For example, if it represents interest income, report it on your return as interest.

Buying or selling capital assets or depreciable property. Do not include in income patronage dividends from buying capital assets or depreciable property used in your business. You must, however, reduce the basis of these assets by the dividends. This reduction is taken into account as of the first day of the tax year in which the dividends are received. If the dividends are more than your unrecovered basis, include the difference on Schedule F, line 5a, for the tax year you receive them. However, include only the taxable part on line 5b.

This rule and the exceptions explained later also apply to amounts you receive from the sale, redemption, or other disposition of a nonqualified notice of allocation that resulted from buying or selling capital assets or depreciable property.

Example. On July 1, 2003, 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 Appendix B of Publication 946). Mr. Brown files his return on a calendar year basis. For 2003, 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, 2004, the cooperative association paid Mr. Brown a \$300 cash patronage dividend for buying the machine. Mr. Brown adjusts the basis of the machine and figures his depreciation deduction for 2004 (and later years) as follows.

Cost of machine on July 1, 2003	\$2,900
Minus: 2003 depreciation	\$311
2004 cash dividend	<u>300</u>
	<u>611</u>

Adjusted basis for depreciation for 2004: \$2,289

Depreciation rate: $1 \div 6\frac{1}{2}$ (remaining recovery period as of 1/1/04) = $15.38\% \times 1.5 = 23.07\%$

Depreciation deduction for 2004 (\$2,289 × 23.07%) \$528

Exceptions. If the dividends are for buying or selling capital assets or depreciable property you did not own at any time during the year you received the dividends, you must include them on Schedule F, lines 5a and 5b, unless one of the following rules 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 the dividends are for selling capital assets or depreciable property during the year you received the dividends, treat them as an additional amount received on the sale.

Personal purchases. Omit from the taxable amount of patronage dividends on Schedule F, line 5b, 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 you receive 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 to include the stated dollar amount of these certificates in income in the year of receipt. The agreement may be made in writing or by getting or keeping membership in a cooperative whose bylaws or charter states that

membership constitutes agreement. If you receive qualified per-unit retain certificates, include the stated dollar amount of the certificates in income on Schedule F, Part I, for the tax year you receive them.

Nonqualified certificates. Do not include the stated dollar value of a nonqualified per-unit retain 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 from the disposition as ordinary income on Schedule F, Part I, for the tax year of disposition.

Cancellation of Debt

This section explains the general rule for including canceled debt in income and the exceptions to the general rule.

General Rule

Generally, if your debt 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. Report the canceled amount on Schedule F, line 10, if you incurred the debt in your farming business. If the debt is a nonbusiness debt, report the canceled amount on Form 1040, line 21.

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

Exceptions

The following discussion covers some exceptions to the general rule for canceled debt. These exceptions apply before the exclusions discussed below.

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

Deductible debt. You do not realize income from a canceled debt to the extent the payment of the debt would have been a deductible expense. This exception applies before the price reduction exception discussed above.

Example. You get accounting services for your farm on credit. Later, you have trouble paying your farm 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 canceled debt depends on your method of accounting.

- Cash method — You do not include the canceled debt in income because payment of the debt would have been deductible as a business expense.

- **Accrual method** — You include the canceled debt in income because the expense was deductible when you incurred the debt.

Exclusions

Do not include canceled debt in income in the following situations.

1. The cancellation takes place in a bankruptcy case under title 11 of the U.S. Code.
2. The cancellation takes place when you are insolvent.
3. The canceled debt is a qualified farm debt.
4. The canceled debt is a qualified real property business debt (in the case of a taxpayer other than a C corporation). See chapter 5 in Publication 334.

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

See *Form 982*, later, for information on how to claim an exclusion for a canceled debt.

Debt. For this discussion, debt includes any debt for which you are liable or that attaches to property you hold.

Bankruptcy and Insolvency

You can exclude a canceled 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 U.S. Code if you are under the jurisdiction of the court and the cancellation 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 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 this amount and the debt qualifies, you can apply the rules for qualified farm debt or qualified real property business debt to the difference. Otherwise, you include the difference 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 \$15,000 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 insol-

vent to the extent of \$5,000 (\$80,000 – \$75,000). You can exclude this amount from income. The remaining canceled debt (\$10,000) 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.

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 Regulations section 1.1017-1(b)(2). 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 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 choose 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 properties. 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 depreciable basis you choose to reduce first, use the difference to reduce the other tax benefits. In figuring the limit on the basis reduction in (5), *Basis*, use the remaining adjusted bases of your properties 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 9.

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 a canceled debt that is qualified farm debt owed to 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. This exclusion does not apply to a canceled debt excluded from income because it takes place in a bankruptcy case.

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.

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. The USDA is a qualified person. 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 can exclude from income is limited. It 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.

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 the insolvency 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). Reduce it 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 choosing 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 choosing 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 6 months of the due date of the return (excluding extensions). For more information, see *When to file* in the Form 982 instructions.

Income From Other Sources

This section discusses other types of income you may receive.

Barter income. If you are paid for your work 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 *Property for services* under *Labor Hired* in chapter 4.

Below-market loans. A below-market loan is a loan on which either 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 any 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 8 for information on gains and losses from commodity futures and options transactions.

Custom hire (machine work). Pay you receive for contract work or custom work that you or your hired help perform off your farm 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 Schedule F, Part I, line 9.

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 farmland, or both.

Example. You granted a right-of-way for a gas pipeline through your property for \$10,000. Only a specific part of your farmland 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 \$10,000.
2. If the payment is equal to or more than the basis of the affected part of your land, reduce the basis to zero and the rest, if any, 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 9.



Easement contracts usually describe the affected land using square feet. Your basis may be figured per acre. One acre equals 43,560 square feet.

If construction of the line damaged growing crops and you later receive a settlement of \$250 for this damage, the \$250 is income and is included on Schedule F, line 10. It does not affect the basis of your land.

Fuel tax credit and refund. Include any credit or refund of federal excise taxes on fuels in your gross income if you deducted the cost of the fuel as an expense that reduced your income tax. See chapter 14 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 you 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 Schedule F, line 10. 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.

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, Miscellaneous Income.

See chapter 12 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 8 through 11.

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 7 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 7) 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 Form 4797, Part IV, to figure how much to include in income.

Refund or reimbursement. You generally must 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 2003. He deducted \$1,000 on his 2003 Schedule F and the entire deduction reduced his tax. The landowner reimbursed him \$500 of the cost of the fertilizer in February 2004. The tenant farmer must include \$500 in income on his 2004 tax return because the entire deduction decreased his 2003 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 7.

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 7 for information on depletion and chapter 8 for the tax treatment of capital gains.

Timber sales. Timber sales, including sales of logs, firewood, and pulpwood, are discussed in chapter 8.

Income Averaging for Farmers

If you are engaged in a farming business, you may be able to average all or some of your farm income by allocating it to the 3 prior years (base years). This may give you a lower tax if your income from farming is high and your taxable income from one or more of the 3 prior years was low. The term "farming business" is defined in the instructions for Schedule J (Form 1040).

Who can use income averaging? You can use income averaging to figure your tax for any year in which you were engaged in a farming business as an individual, a partner in a partnership, or a shareholder in an S corporation. Services performed as an employee are disregarded in determining whether an individual is engaged in a farming business. However, a shareholder

of an S corporation engaged in a farming business may treat compensation received from the corporation that is attributable to the farming business as farm income. You do not need to have been engaged in a farming business in any base year.

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

Elected Farm Income (EFI)

EFI is the amount of income from your farming business that you choose to have taxed at base year rates. You can designate as EFI any type of income attributable to your farming business. However, your EFI cannot be more than your taxable income, and any EFI from a net capital gain attributable to your farming business cannot be more than your total net capital gain.

Income from your farming business is the sum of any farm income or gain minus any farm expenses or losses allowed as deductions in figuring 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) used 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 1 year after stopping operations is a reasonable time. After that, what is a reasonable time depends on the facts and circumstances.

EFI and base year rates. If your EFI includes both ordinary income and capital gains, you must allocate an equal portion of each type of income to each base year to figure the tax on EFI. For example, you cannot allocate all of the capital gains to a single base year.

How To Figure the Tax

If you average your farm income, you will figure your tax on Schedule J (Form 1040).

Negative taxable income for base year. If your taxable income for any base year was zero because your deductions were more than your income, you may have negative taxable income for that year to combine with your EFI on Schedule J.

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

Effect on Other Tax Determinations

You subtract your EFI from your taxable income and add one-third of it to the taxable income of

each of the base years to determine the tax rate to use for income averaging. The allocation of your EFI to the base years does not affect other tax determinations. For example, you make the following determinations before subtracting your EFI (or adding it to income 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 \$1,600, part of that income may be taxed at your tax rate instead of your child's tax rate.

If you use income averaging, figure your child's tax on investment income using your rate after allocating 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 (AMT)

You can choose to use income averaging to compute your regular tax liability. However, income averaging is not used to determine your regular tax or tentative minimum tax when figuring your AMT. Using income averaging may reduce your total tax even if you owe AMT.

Credit for prior year minimum tax. You may be able to claim a tax credit if you owed AMT in a prior year. See the instructions for Form 8801.

Schedule J

You can use income averaging by filing Schedule J (Form 1040) with your timely filed (including extensions) return for the year. You can also use income averaging on a late return, or use, change, or cancel it on an amended return, if the time for filing a claim for refund has not expired for that election year. You generally must file the claim for refund within 3 years from the date you filed your original return or 2 years from the date you paid the tax, whichever is later.

4.

Farm Business Expenses

What's New

Standard mileage rate. The standard mileage rate for the cost of operating your car, van, pickup, or panel truck in 2004 is 37.5 cents a mile for all business miles driven. See *Truck and Car Expenses*, later.

Standard mileage method. Beginning in 2004, you can use the standard mileage rate to figure the deductible costs of operating up to four vehicles (at the same time) that you own or lease for business. In earlier years, you could not use the standard mileage rate if you used two or more vehicles at the same time. See *Truck and Car Expenses*, later.

Reforestation costs. You can elect to deduct a limited amount of the costs that are paid or incurred after October 22, 2004. See *Capital Expenses*, later.

Start-up costs. You can elect to deduct up to \$5,000 of business start-up costs paid or incurred after October 22, 2004. See *Capital Expenses*, later.

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 deduction 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
- Losses from operating a farm
- Not-for-profit farming

Useful Items

You may want to see:

Publication

- 463** Travel, Entertainment, Gift, and Car Expenses
- 535** Business Expenses
- 587** Business Use of Your Home
- 925** Passive Activity and At-Risk Rules
- 936** Home Mortgage Interest Deduction

Form (and Instructions)

- 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 16 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 an expense is reimbursed, either reduce the expense or report the reimbursement as income when received. See *Refund or reimbursement under Income From Other Sources* in chapter 3.

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.

You must allocate these mixed expenses between their business and personal parts. Generally, the personal part of these expenses is 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.

Prepaid Farm Supplies

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

- Feed, seed, fertilizer, and similar farm supplies not used or consumed during the year. However, do not include amounts paid for farm supplies that you would have consumed if not for a fire, storm, flood, other casualty, disease, or drought.
- Poultry (including egg-laying hens and baby chicks) bought for use (or for both use and resale) in your farm business. However, include only the amount that would be deductible in the following year if you had capitalized the cost and deducted

it ratably over the lesser of 12 months or the useful life of the poultry.

- Poultry bought for resale and not resold during the year.

Deduction limit. If you use the cash method of accounting to report your income and expenses, your deduction for prepaid farm supplies in the year you pay for them may be limited to 50% of your other deductible farm expenses for the year (all Schedule F deductions except prepaid farm supplies). This limit does not apply if you meet one of the exceptions described later.

If the limit applies, you can deduct the excess cost of farm supplies other than poultry in the year you use or consume the supplies. The excess cost of poultry bought for use (or for both use and resale) in your farm business is deductible in the year following the year you pay for it. The excess cost of poultry bought for resale is deductible in the year you sell or otherwise dispose of that poultry.

Example. During 2004, 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 2004 is \$5,500. Your other deductible farm expenses totaled \$10,000 for 2004. Therefore, your deduction for prepaid farm supplies cannot be more than \$5,000 (50% of \$10,000) for 2004. 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, and aunts and 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.

Prepaid Livestock Feed

If you report your income and expenses under the cash method of accounting, you cannot de-

duct in the year paid the cost of feed your livestock will consume in a later year unless you meet all the following tests.

1. The payment is for the purchase of feed rather than a deposit.
2. The prepayment has a business purpose and is not merely for tax avoidance.
3. Deducting the prepayment does not result in a material distortion of your income.

If you meet all three tests, you can deduct the prepaid feed, subject to the limit on prepaid farm supplies discussed earlier.

If you fail any of these tests, you can deduct the prepaid feed only in the year it is consumed.



This rule does not apply to the purchase of commodity futures contracts.

Payment for the purchase of feed. Whether a payment is for the purchase of feed or a deposit depends on the facts and circumstances in each case. It is for the purchase of feed 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, by contract or business custom, to a refund or repurchase.

The following are some factors that show a payment is a deposit rather than for the purchase of feed.

- The absence of specific quantity terms.
- The right to a refund of any unapplied payment credit at the end of the contract.
- The seller's treatment of the payment as a deposit.
- 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 your livestock's current diet requirements will not suggest a deposit. Further, a price adjustment to reflect market value at the date of delivery is not, by itself, proof of a deposit.

Business purpose. The prepayment has a business purpose only if you have a reasonable expectation of receiving some business benefit from prepaying the cost of livestock feed. The following are some examples of business benefits.

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

Other factors considered in determining the existence of a business purpose are whether the prepayment was a condition imposed by the seller and whether that condition was meaningful.

No material distortion of income. The following are some factors considered in determining whether deducting prepaid livestock feed materially distorts income.

- Your customary business practice in conducting your livestock operations.

- The expense in relation to past purchases.
- The time of year you made the purchase.
- The expense in relation to your income for the year.

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 can pay wages in cash or in noncash items such as inventory, 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 13 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.

Property for services. If you transfer property to an employee 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 wages deducted 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 8.

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 13.



A Form W-2 should be issued to the child employee.

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.



The amount of wages paid to the child could cause a loss of the dependency exemption depending on how the child uses the money.

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 13.

Nondeductible 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 13.

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 and renewal community 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.

Repairs and Maintenance

You can deduct most expenses for the repair and maintenance of your farm property. 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. However, repairs to, or overhauls of, depreciable property that substantially prolong the life of the property, increase its value, or adapt it to a different use are capital expenses. For example, if you repair the barn roof, the cost is deductible. But if you replace the roof, it is a capital expense. For more information, see *Capital Expenses*, later.

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 generally deduct interest paid during the tax 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 only in the tax year in which it is due.

Accrual method. If you use an accrual method of accounting, 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 includible in the gross income of that person. For more information, see *Accrual Method* in chapter 2.

Allocation of interest. If you use the proceeds of a loan for more than one purpose, you must allocate the interest on that loan to each use. Allocate the interest to the following categories.

- Trade or business interest.
- Passive activity interest.
- Investment interest.
- Portfolio interest.
- Personal interest.

You generally allocate interest on a loan the same way you allocate the loan proceeds. You allocate loan proceeds by tracing disbursements to specific uses.

TIP *The easiest way to trace disbursements to specific uses is to keep the proceeds of a particular loan separate from any other funds.*

Secured loan. The allocation of loan proceeds and the related interest is generally not 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.

TIP *If the property that secures the loan is your home, you generally do not allocate the loan proceeds or the related interest. The interest is usually deductible as qualified home mortgage interest, regardless of how the loan proceeds are used. However, you can choose to treat qualified home mortgage interest as a farm business expense. For information on how to make the choice to treat the loan as not secured by your home, see Publication 936.*

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 following dates.

- The date the loan is repaid.
- The date the loan is reallocated to another use.

More information. For more information on interest, see chapter 5 in Publication 535.

Breeding Fees

You can deduct breeding fees as a farm business expense. However, if you 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 required under Accounting Methods* in chapter 2.

Fertilizer and Lime

You can deduct in the year paid or incurred the cost of fertilizer, lime, and other materials applied to farmland to enrich, neutralize, or condition it if the benefits last a year or less. 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 one year, you generally must capitalize their cost and deduct a part each year the benefits last. However, you can choose to deduct these expenses in the year paid or incurred. If you make this choice, you will need IRS approval if you later decide to capitalize the cost of previously deducted items.

Farmland, for these purposes, 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* under *Agricultural Program Payments* in chapter 3.

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, farmland, and farm buildings. You also can 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 13.

Allocation of taxes. 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, allocate the taxes between the farm assets and nonbusiness assets. The allocation 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 and local general sales taxes. State and local general sales taxes on nondepreciable farm business expense items are deductible as part of the cost of those items. Include state and local general sales taxes imposed on the purchase of assets for use in your farm business

as part of the cost you depreciate. Also treat the taxes as part of your cost if they are imposed on the seller and passed on to you.

State and federal income taxes. Individuals cannot deduct state and federal income taxes as farm business expenses. Individuals can deduct state and local income taxes only as an itemized deduction on Schedule A (Form 1040). For 2004, you can choose to deduct state and local sales taxes instead of state and local income taxes as an itemized deduction. However, 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 truck 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 12.

Insurance

You generally can 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.

- Fire, storm, crop, theft, liability, and other insurance on farm business assets.
- Health and accident insurance on your farm employees.
- Workers' compensation insurance set by state law that covers any claims for job-related bodily injuries or diseases suffered by employees on your farm, regardless of fault.
- Business interruption insurance.
- State unemployment insurance on your farm employees (deductible as taxes if they are considered taxes under state law).

Insurance to secure a loan. If you take out a policy on your life or on the life of another person with a financial interest in your farm business to get or protect a business loan, you cannot deduct the premiums as a business expense. In the event of death, the proceeds of the policy are not taxed as income even if they are used to liquidate the debt.

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

Example. On June 28, 2004, 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, 2004. Only the cost for the 6 months in 2004 is deductible as an insurance expense on your 2004 calendar year 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 2005 and 2006, deduct \$1,000 ($\frac{12}{36}$ of \$3,000). Deduct the remaining \$500 in 2007. Had the policy been effective on January 1, 2004, the deductible expense would have

been \$1,000 for each of the years 2004, 2005, and 2006, based on one-third of the premium used each year.

Business interruption insurance. Use and occupancy and 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 in Part I of Schedule F.

Self-employed health insurance deduction. If you are self-employed, you can deduct 100% of your payments for medical, dental, and qualified long-term care insurance coverage for yourself, your spouse, and your dependents when figuring your adjusted gross income on your Form 1040. Generally, this deduction cannot be more than the net profit from the business under which the plan was established.

If you or your spouse is 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 (Form 1040) if you itemize your deductions.

For more information, see *Deductible Premiums* in chapter 7 of Publication 535.

Rent and Leasing

If you lease property for use in your farm business, you can generally deduct the rent you pay on Schedule F. 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, you must determine whether or not the agreement must be treated as a conditional sales contract rather than a lease. 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 agreement includes an option to purchase the equipment for a specified price. The lease payments and the specified option price equal the sales price of the equipment plus interest. Under the agreement, you are responsible for maintenance, repairs, and the risk of loss. For federal income tax purposes, the agreement is a conditional sales contract. You cannot deduct any of

the lease payments as rent. You can deduct interest, repairs, insurance, depreciation, and other expenses related to the equipment.

Conditional sales contract. Whether an agreement is a conditional sales contract depends on the **intent** of the parties. Determine intent based on the provisions of the agreement and the facts and circumstances that exist when you make the agreement. No single test, or special combination of tests, always applies. However, in general, an agreement may be considered a conditional sales contract rather than a lease if any of the following is true.

- The agreement applies part of each payment toward an equity interest you will receive.
- You get title to the property after you make a stated amount of required payments.
- The amount you must pay to use the property for a short time is a large part of the amount you would pay to get title to the property.
- You pay much more than the current fair rental value of the property.
- You have an option to buy the property at a nominal price compared to the value of the property when you may exercise the option. Determine this value when you make the agreement.
- You have an option to buy the property at a nominal price compared to the total amount you have to pay under the agreement.
- The agreement designates part of the payments as interest, or part of the payments can be easily recognized as interest.

Motor vehicle leases. Special rules apply to lease agreements that have a terminal rental adjustment clause. In general, this is a clause that provides for a rental price adjustment based on 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.

Leveraged leases. Special rules apply to leveraged leases of equipment (arrangements in which the equipment is financed by a nonrecourse loan from a third party). For more information, see chapter 4 of Publication 535 and the following revenue procedures.

- Revenue Procedure 2001-28 in Internal Revenue Bulletin 2001-19.
- Revenue Procedure 2001-29 in Internal Revenue Bulletin 2001-19.

You can find Revenue Procedure 2001-28 on page 1156 and Revenue Procedure 2001-29 on page 1160 of Internal Revenue Bulletin 2001-19 at www.irs.gov/pub/irs-irbs/irb01-19.pdf.

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 recover the cost over more than one year and deduct part of it each year on Schedule F as depreciation or amortization. However, you can choose to deduct part or all of the cost of certain qualifying property, up to a limit, as a section 179 deduction in the year you place it in service.

Depreciation, amortization, and the section 179 deduction are discussed in chapter 7.

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:

- As the principal place of business for any trade or business in which you engage,
- As a place to meet or deal with patients, clients, or customers in the normal course of your trade or business, or
- 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 both of the following requirements.

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

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 use of your home in your farming business 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 the following expenses.

- 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).
- Farm expenses other than expenses that relate to the use of your home. If you are self-employed, do not include your deduction for half of your self-employment tax.

Deductions over the current year's limit can be carried over to your next tax year. They are subject to the deduction limit for the next tax year.

More information. See Publication 587 for more information on deducting expenses for the business use of your home.

Telephone expense. You cannot deduct the cost of basic local telephone service (including any taxes) for the first telephone line you have in your home, even if you have an office in your home. However, charges for business long-distance phone calls on that line, as well as the cost of a second line into your home used exclusively for your farm business, are deductible business expenses.

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).

Standard mileage rate. Instead of using actual costs, under certain conditions you can use the standard mileage rate. For 2004, the rate is 37.5 cents a mile for all business miles driven. You can use the standard mileage rate for a car or a light truck, such as a van, pickup, or panel truck, you own or lease.

You cannot use the standard mileage rate if you operate five or more cars or light trucks at the same time. You are not using five or more vehicles at the same time if you alternate using the vehicles (you use them at different times) for business.

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

Business use percentage. You can claim 75% of the use of a car or light truck as business use without any records if you used the vehicle during most of the normal business day directly in connection with the business of farming. You choose this method of substantiating business use the first year the vehicle is placed in service. Once you make this choice, you may not change to another method later. The following are uses directly connected with the business of farming.

- Cultivating land.
- Raising or harvesting any agricultural or horticultural commodity.
- Raising, shearing, feeding, caring for, training, and managing animals.
- Driving to the feed or supply store.

If you keep records and they show that your business use was more than 75%, you may be able to claim more. See *Recordkeeping requirements* under *Travel Expenses*, later.

More information. For more information on deductible truck and car expenses, 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:

- Your duties require you to be absent from your farm substantially longer than an ordinary work day, and
- 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 travel expenses.

The following are some types of deductible travel expenses.

- Air, rail, bus, and car transportation.
- Meals and lodging.
- Dry cleaning and laundry.
- Telephone and fax.
- Transportation between your hotel and your temporary work or business meeting location.
- Tips for any of the above expenses.

Meals. You ordinarily can deduct only 50% of your business-related meals expenses. You can deduct the cost of your meals while traveling on business 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 50% of the actual cost or 50% of 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, such as receipts, that together support each element of an expense. Generally, it is best to record the expense and get documentation of it at the time you pay it.

If you choose to deduct a standard meal allowance rather than the actual expense, 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 generally can deduct reimbursements you pay to your employees for travel and transportation expenses they incur in the conduct of your business. Employees may be reimbursed under an accountable or nonaccountable plan. Under an accountable plan, the employee must provide evidence of expenses. Under a nonaccountable plan, no evidence of expenses is required. If you reimburse expenses under an accountable plan, deduct them as travel and transportation expenses. If you reimburse 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 13 of Publication 535.

Marketing Quota Penalties

You can deduct as *Other expenses* 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, utilities, 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 ordinarily deduct the cost of livestock and other items purchased for resale only in the year of sale. You deduct this cost, including freight charges for transporting the livestock to the farm, in Part I of Schedule F. However, see *Chickens, seeds, and young plants*, later.

Example. You use the cash method of accounting. In 2004, you buy 50 steers you will sell in 2005. You cannot deduct the cost of the steers on your 2004 tax return. You deduct their cost in Part I of your 2005 Schedule F.

Chickens, seeds, and young plants. If you are a cash method farmer, you can deduct the cost of hens and baby chicks bought for commercial egg production, or for raising and resale, as an expense in Part II of Schedule F in the year paid if you do it consistently and it does not distort income. You also can deduct the cost of seeds and young plants bought for further development and cultivation before sale as an expense in Part II of Schedule F 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 cost of chickens, seeds, and young plants as an expense, report their

entire selling price as income. You cannot also deduct the cost from the selling price.

You cannot deduct the cost 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 7.

The cost 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. These rules are discussed in chapter 6.

Example. You use the cash method of accounting. In 2004, you buy 500 baby chicks to raise for resale in 2005. You also buy 50 bushels of winter seed wheat in 2004 that you sow in the fall. Unless you previously adopted the method of deducting these costs in the year you sell the chickens or the harvested crops, you can deduct the cost of both the baby chicks and the seed wheat in 2004.

Election to use crop method. If you use the crop method, you can delay deducting the cost of seeds and young plants until you sell them. You must get IRS approval to use the crop method. If you follow this method, deduct the cost from the selling price to determine your profit in Part I of Schedule F. For more information, see *Crop method* under *Special Methods of Accounting* in chapter 2.

Choosing a method. You can adopt either the crop method or the cash method for deducting the cost in the first year you buy egg-laying hens, pullets, chicks, or seeds and young plants.

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 approval to change your method. For more information, see *Change in Accounting Method* in chapter 2.

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.

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.

Tax preparation fees. You can deduct as a farm business expense on Schedule F 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 also can deduct on Schedule F the amount you pay or incur in resolving tax issues relating to your farm business.

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 2 and 6.

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

- The cost of fertilizer, lime, etc. (See *Fertilizer and Lime* under *Deductible Expenses*, earlier.)
- Soil and water conservation expenses. (See chapter 5.)
- The cost of property that qualifies for a deduction under section 179. (See chapter 7.)
- The cost of qualifying clean-fuel vehicle property and clean-fuel vehicle refueling property. (See chapter 12 in Publication 535.)

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

1. Business start-up costs. (However, see *Business start-up costs*, later)
2. Land and buildings.
3. Additions, alterations, and improvements to buildings, etc.
4. Cars and trucks.
5. Equipment and machinery.

6. Fences.
7. Draft, breeding, sport, and dairy livestock.
8. Reforestation. (However, see *Reforestation costs*, later.)
9. Repairs to machinery, equipment, trucks, and cars 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 costs, 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,
 - h. Constructing earthen, masonry, or concrete tanks, reservoirs, or dams, and
 - i. Building roads.

Business start-up costs. You can elect to deduct up to \$5,000 of business start-up costs paid or incurred after October 22, 2004. The \$5,000 deduction amount is reduced by the amount your total start-up costs exceed \$50,000. The remaining costs can be amortized. See *Amortization*, in chapter 7.

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 6.

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. See *Depletion* in chapter 7.

Reforestation costs. You can elect to deduct up to \$10,000 (\$5,000 if married filing separately) of forestation and reforestation costs paid or incurred after October 22, 2004. The remaining costs can be amortized. See *Amortization* in chapter 7.



For more information about timber, see Agriculture Handbook Number 718, Forest Landowners' Guide to the Federal Income Tax. Copies are \$21 each and are available from the U.S. Government Printing Office. Place your order using Stock #001-000-04693-4. The address, telephone number, and website are:

Superintendent of Documents
P.O. Box 371954
Pittsburgh, PA 15250-7954
1-866-512-1800 (toll-free)
202-512-1800 (local)
www.gpoaccess.gov

You can view this publication on the web at www.fs.fed.us/publications.

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 7.

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.

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 11 for more information.

Repayment of loans. You cannot deduct the repayment of a loan. However, if you use the proceeds of a loan for farm business expenses, you can deduct the interest on the loan. See *Interest*, earlier.

Estate, inheritance, legacy, succession, and gift taxes. You cannot deduct 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 lineal 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 9.

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. The costs are not deductible in the year of the gift or any later year. For example, you cannot deduct the cost of raising cattle 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, golf and athletic clubs, hotel clubs, sporting clubs, airline clubs, and clubs operated to provide meals under circumstances generally considered to be conducive to business discussions.

Exception. The following organizations will not be treated as a club 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.

- Boards of trade.
- Business leagues.
- Chambers of commerce.
- Civic or public service organizations.
- Professional associations.
- Trade associations.
- Real estate boards.

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 the loss you can deduct when figuring your taxable income may be limited. To figure your deductible loss, you must apply the following limits.

- The at-risk limits.
- 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 Publication 536, Net Operating Losses (NOLs) for Individuals, Estates, and Trusts.



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 up to income from passive activities. Credits are similarly limited.

For more information, see Publication 925.

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 this limit. An investment activity intended only to produce tax losses for the investors also comes under this limit.

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:

- You operate your farm in a businesslike manner,
- The time and effort you spend on farming indicate you intend to make it profitable,
- You depend on income from farming for your livelihood,
- Your losses are due to circumstances beyond your control or are normal in the start-up phase of farming,
- You change your methods of operation in an attempt to improve profitability,
- You, or your advisors, have the knowledge needed to carry on the farming activity as a successful business,
- You were successful in making a profit in similar activities in the past,
- You make a profit from farming in some years and the amount of profit you make, and

- You can expect to make a future profit from the appreciation of the assets used in the farming activity.

Presumption of profit. Your farming or other activity is presumed 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 carried on for profit if they produced a profit in at least 2 of the last 7 tax years, including the current year. The activity must be substantially 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, presume it is 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 in every case, unless the IRS shows it is not valid.

If you fail the 3- (or 2-) years-of-profit test, you still may 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. You must file Form 5213 within 3 years after the due date of your return for the year in which you first carried on the activity, or, if earlier, within 60 days after receiving a written notice from the IRS proposing to disallow deductions attributable to the activity.

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-year (or 7-year) period with a loss.

Filing Form 5213 automatically extends the period of limitations on any year in the 5-year (or 7-year) period to 2 years after the due date of the return for the last year of the period. The period is extended only for deductions of the activity and any related deductions that might be affected.

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 11), belong in this category. For the limits that apply to mortgage interest, see Publication 936.

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) 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) 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, Miscellaneous Deductions, 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.

More information. For more information on not-for-profit activities, see *Not-for-Profit Activities* in chapter 1 of Publication 535.

5.

Soil and Water Conservation Expenses

Introduction

If you are in the business of farming, you can choose to deduct certain 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 6 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 *25% 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.

You must include in income most government payments for approved conservation practices. However, you can exclude some payments you receive under certain cost-sharing conservation programs. For more information, see *Agricultural Program Payments* in chapter 3.



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
- 25% Limit on deduction
- Choosing to deduct
- Sale of a farm

Business of Farming

For purposes of soil and water conservation expenses, 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 12.

If you get cash rental for a farm you own that is not used in farm production, you cannot deduct 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 soil and water conservation expenses 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. Keep a copy of the plan with your books and records to support your deductions.

Conservation plan. A conservation plan includes the farming conservation practices approved for the area where your farmland 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 farmland.
- NRCS county plans. These plans include a listing of farm conservation practices approved for the county where the farmland is located. You can deduct expenses for conservation practices not included on the NRCS county plans 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 the comparable state agencies.

Conservation Expenses

You can deduct conservation expenses only for land you or your tenant are using, or have used in the past, for farming. These expenses 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.

You cannot deduct expenses to drain or fill wetlands, or to prepare land for center pivot irrigation systems, as soil and water conservation expenses. These expenses are added to the basis of the land.



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 3 for information about excluding cost-sharing payments.

New farm or farmland. If you acquire a new farm or new farmland from someone who was using it in farming immediately before you acquired the land, soil and water conservation expenses you incur on it will be treated as made on land used in farming at the time the expenses were paid or incurred. 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, you can deduct your conservation expenses.

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 you can deduct 60% (120 ÷ 200) of the expenses. You can use another method to allocate these expenses if you can clearly show that your method is more reasonable.

Depreciable conservation assets. You generally cannot deduct your expenses for depreciable conservation assets. However, you can deduct certain amounts you pay or incur 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 expenses to buy, build, install, or improve depreciable structures or facilities. These expenses include those for materials, supplies, wages, fuel, hauling, and moving dirt when making structures such as tanks, reservoirs, pipes, culverts, canals, dams, wells, or pumps composed of masonry, concrete, tile, metal, or wood. You recover your capital investment through annual allowances for depreciation.

You can deduct soil and water conservation expenses for nondepreciable earthen items. Nondepreciable earthen items include certain dams, ponds, and terraces described in chapter 7.

Water well. You cannot deduct the cost of drilling a water well for irrigation and other agricultural purposes as a soil and water conservation expense. It is a capital expense. You recover your cost through depreciation. You also must 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 constitutes an abandonment.

Assessment by Conservation District

In some localities, a soil or water conservation or drainage district incurs expenses for soil or water conservation and levies an assessment against the farmers who benefit from the expenses. You can deduct as a conservation expense amounts you pay or incur for the part of an assessment that:

- Covers expenses you could deduct if you had paid them directly, or

- Covers expenses for depreciable property used in the district's business.

Assessment for Depreciable Property

You generally can deduct as a conservation expense amounts you pay or incur for the part of a conservation or drainage district assessment that covers expenses 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. However, the following limits apply to these assessments.

- The total assessment limit.
- The yearly assessment limit.

After you apply these limits, the amount you can deduct is added to your other conservation expenses for the year. The total for these expenses is then subject to the 25% of gross income from farming limit on the deduction, discussed later. See *Table 5-1* for a brief summary of these limits.

Total assessment limit. You cannot deduct more than 10% of the total amount assessed to all members of the conservation or drainage 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 amount assessed, 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 conservation expense and the capital expense.

Yearly assessment limit. The maximum amount you can deduct in any one year is the total of 10% of your deductible share of the cost as explained earlier, plus \$500. If the amount you pay or incur is equal to or less than the maximum amount, you can deduct it in the year it is paid or incurred. If the amount you pay or incur is more, you can deduct in that year only 10% of your deductible share of the cost. You can deduct the remainder in equal amounts over

Table 5-1. Limits on Deducting an Assessment by a Conservation District for Depreciable Property

Total Limit on Deduction for Assessment	Yearly Limit on Deduction for Assessment	Yearly Limit for All Conservation Expenses
10% of:	\$500 + 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.	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 paid in installments, each payment must be prorated between the conservation expense and the capital expense. 	<ul style="list-style-type: none"> • If the amount you pay or incur for any year is more than the limit, you can deduct for that year only 10% of your deductible share of the cost. • You can deduct the remainder 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.

the next 9 tax years. Your total conservation expense deduction for each year is also subject to the 25% of gross income from farming limit on the deduction, discussed later.

Example 1. This year, the soil conservation district levies and you pay an assessment of \$2,400 against your farm. Of the assessment, \$1,500 is for digging drainage ditches. You can deduct this part 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 deduct 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 you can deduct for the depreciable equipment this year, multiply your deductible share of the total assessment (\$700) by 10%. Add \$500 to the result for a total of \$570. Your deductible share, \$700, is greater than the maximum amount deductible in one year, so you can deduct only \$70 of the amount you paid or incurred for depreciable property this year (10% of \$700). You can deduct the balance 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 deduct \$1,570 of the \$2,400 assessment as a soil and water conservation expense this year, subject to the 25% of gross income from farming limit on the 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 amount assessed by the district against all its members for depreciable equipment is \$5,500. The total amount you can deduct for the depreciable equipment is limited to 10% of this amount, or \$550.

The maximum amount you can deduct this year for the depreciable equipment is \$555 (10% of your deductible share of the total assessment, \$55, plus \$500). Since your deductible share is less than the maximum amount deductible in one year, you can deduct the entire \$555 this year. You can deduct the entire assessment, \$2,400, as a soil and water conservation expense this year, subject to the 25% of gross income from farming limit on the deduction, discussed later.

Sale or other disposal of land during 9-year period. If you dispose of the land during the 9-year period for deducting conservation expenses subject to the yearly limit, any amounts you have not yet deducted because of this limit are added to the basis of the property.

Death of farmer during 9-year period. If a farmer dies during the 9-year period, any remaining amounts not yet deducted are deducted in the year of death.

25% 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 draft, breeding, or dairy livestock 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 2004, 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 excess (\$5,300 – \$4,000) is carried over to 2005 and added to deductible soil and water conservation expenses made in that year. The total of the 2004 carryover plus 2005 expenses is deductible in 2005, subject to the limit of 25% of your gross income from farming in 2005. Any expenses over the limit in that year are carried to 2006 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 choose to 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.



Send your request to the following address.

Cincinnati Submission Processing
Cincinnati, OH 45999

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 sale of farmland. If you held the land 5 years or less before you sold it, gain on the sale 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* under *Other Gains* in chapter 9.

6.

Basis of Assets

Introduction

Your basis is the amount of your investment in property for tax purposes. Use basis to figure the gain or loss on the sale, exchange, or other disposition of property. Also use basis to figure depreciation, amortization, depletion, and casualty losses. If you use property for both business or investment purposes and for personal purposes, you must allocate the basis based on the use. Only the basis allocated to the business or investment 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.



Keep accurate records of all items that affect your basis. For information on keeping records, see chapter 1.

Topics

This chapter discusses:

- Cost basis
- Adjusted basis
- Basis other than cost

Useful Items

You may want to see:

Publication

- 535 Business Expenses
- 544 Sales and Other Dispositions of Assets
- 551 Basis of Assets

Form (and Instructions)

- 706 United States Estate (and Generation-Skipping Transfer) Tax Return
- 706-A United States Additional Estate Tax Return

See chapter 16 for information about getting publications and forms.

Cost Basis

The basis of property you buy is usually its cost. Cost is the amount you pay in cash, debt obligations, other property, or services. Your cost includes amounts you pay for sales tax, freight, installation, and testing. The basis of real estate and business assets will include other items. Basis generally does not include interest payments. However, see *Carrying charges* in chapter 5 of Publication 535.

You also may 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 direct costs and certain indirect costs of producing property.

Loans with low or no interest. If you buy property on a 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, *Installment Sales*.

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.

Lump sum purchase. If you buy improvements, such as buildings, and the land on which they stand for a lump sum, allocate your cost basis between the land and improvements to figure the basis for depreciation of the improvements. Allocate the cost basis according to the respective fair market values (FMVs) of the land and improvements at the time of purchase. Figure the basis of each asset by multiplying the lump sum by a fraction. The numerator is the FMV of that asset and the denominator is the FMV of the whole property at the time of purchase.

Fair market value (FMV). FMV is the price at which property would change hands between a willing buyer and a willing 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.



If you are not certain of the FMV of the land and improvements, you can allocate the basis according to their assessed values for real estate tax purposes.

Real estate taxes. If you pay real estate taxes 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 an expense.

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 your property. If you did not reimburse the seller, you must reduce your basis by the amount of those taxes.

Settlement costs. Your basis includes the settlement fees and closing costs for buying the property. Do not include fees and costs for getting a loan on the property.

Also, do not include amounts placed in escrow for the future payment of items such as taxes and insurance. See Publication 551 for a list of settlement fees.

Points. If you pay points to get a loan (including a mortgage, second mortgage, or line-of-credit), do not add the points to the basis of the related property. Generally, you deduct the points over the term of the loan. For more information about deducting points, see *Points* in chapter 5 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. For information, see *Points* in Publication 936, *Home Mortgage Interest Deduction*.

Assumption of a mortgage. If you buy property and assume (or buy the property subject to) an existing mortgage, your basis includes the amount you pay for the property plus the amount you owe on the mortgage.

Example. If you buy a farm for \$100,000 cash and assume a mortgage of \$400,000, 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 costs.

- Land.
- Labor and materials.
- Architect's fees.
- Building permit charges.
- Payments to contractors.
- Payments for rental equipment.
- Inspection fees.

In addition, if you use your own employees, farm materials, and equipment to build an asset, do not deduct the following expenses. You must capitalize them (include them in the asset's basis).

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. Business supplies and materials used in the construction.



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.

Reduce the asset's basis by any of the following credits allowable on the wages you pay in (1).

- Empowerment zone and renewal community employment credit.
- Indian employment credit.
- Welfare-to-work credit.
- Work opportunity credit.

For information about these credits, see Publication 954, *Tax Incentives for Distressed Communities*.

Allocating the Basis

In some instances, the rules for determining basis apply to a group of assets acquired in the same transaction or to property that consists of separate items. To determine the basis of these assets or separate items, there must be an allocation of basis.

Group of assets acquired. If you buy multiple assets for a lump sum, allocate the amount you pay among the assets. Use this allocation to figure your basis for depreciation and gain or loss on a later disposition of any of these assets. You and the seller may agree in the sales contract to a specific allocation of the purchase price among the assets. If this allocation is based on the value of each asset and you and the seller have adverse tax interests, the allocation generally will be accepted.

Farming business acquired. If you buy a group of assets that constitutes a farming business, there are special rules you must use to allocate the purchase price among the assets. Generally, reduce the purchase price by any cash and general deposit accounts (including checking and savings accounts) received. Allocate the remaining purchase price to the other business assets received in proportion to (but not more than) their FMV and in a certain order. See *Trade or Business Acquired under Allocation the Basis* 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 without the implant. 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 based on its FMV and the FMV of the land or herd.

Uniform Capitalization Rules

Under the uniform capitalization rules, you must include certain direct and indirect costs in the basis of property you produce or in your inventory costs, rather than claim them as a current deduction. You recover these costs through depreciation, amortization, or cost of goods sold when you use, sell, or otherwise dispose of the property.

Generally, you are subject to the uniform capitalization rules if you do any of the following.

1. Produce real or tangible personal property.
2. Acquire property for resale. However, this rule does not apply to personal property if your average annual gross receipts for the 3-tax-year period ending with the year preceding the current tax year are \$10 million or less.

You produce property if you construct, build, install, manufacture, develop, improve, or create the property. In a farming business, you produce property if you raise or grow any agricultural or horticultural commodity, including plants and animals.



You are not subject to the uniform capitalization rules if the property is produced for personal use.

The direct and indirect costs of producing plants or animals include preparatory costs and preproductive period costs. Preparatory costs include the acquisition costs of the seed, seedling, plant, or animal. For plants, preproductive period costs include the costs of items such as irrigation, pruning, frost protection, spraying, and harvesting. For animals, preproductive period costs include the costs of items such as feed, maintaining pasture or pen areas, breeding, veterinary services, and bedding.

Table 6-1. Plants With a Preproductive Period of More Than 2 Years

Plants producing the following crops or yields have a nationwide weighted average preproductive period of more than 2 years.

- | | | | |
|----------------|--------------|------------------|------------------|
| • Almonds | • Currants | • Macadamia nuts | • Persimmons |
| • Apples | • Dates | • Mangoes | • Pistachio nuts |
| • Apricots | • Figs | • Nectarines | • Plums |
| • Avocados | • Grapefruit | • Olives | • Pomegranates |
| • Blackberries | • Grapes | • Oranges | • Prunes |
| • Blueberries | • Guavas | • Papayas | • Raspberries |
| • Cherries | • Kiwifruit | • Peaches | • Tangelos |
| • Chestnuts | • Kumquats | • Pears | • Tangerines |
| • Coffee beans | • Lemons | • Pecans | • Tangors |
| | • Limes | | • Walnuts |

Plants. A plant produced in a farming business includes the following items.

- A fruit, nut, or other crop-bearing tree.
- An ornamental tree.
- A vine.
- A bush.
- Sod.
- The crop or yield of a plant that will have more than one crop or yield.

Animals. An animal produced in a farming business includes any stock, poultry or other bird, and fish or other sea life.

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* under *Accounting Methods* in chapter 2.

In addition, you can elect not to use the uniform capitalization rules for plants with a preproductive period of more than 2 years. If you make this election, special rules apply. This election cannot be made by a corporation, partnership, or tax shelter required to use an accrual method of accounting. This election 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 the trees were planted.



If you elect not to use the uniform capitalization rules, you must use the alternative depreciation system for all property used in any of your farming businesses and placed in service in any tax year during which the election is in effect.

Example. You grow trees that have a preproductive period of more than 2 years. The trees produce an annual crop. You are an individual and the uniform capitalization rules apply to your farming business. You must capitalize the direct costs and an allocable part of indirect

costs incurred due to the production of the trees. You are not required to capitalize the costs of producing the annual crop because its preproductive period is 2 years or less.

Preproductive period of more than 2 years.

The preproductive period of plants grown in commercial quantities in the United States is based on their nationwide weighted average preproductive period. Plants producing the crops or yields shown in Table 6-1 have a nationwide weighted average preproductive period of more than 2 years. Other plants (not shown in Table 6-1) may also have a nationwide weighted average preproductive period of more than 2 years.

More information. For more information on the uniform capitalization rules, see the regulations under section 263A of the Internal Revenue Code. Section 1.263A-4 of the regulations applies to property produced in a farming business.

Adjusted Basis

Before figuring 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 (increases and decreases) to the basis of the property. The result of these adjustments is the adjusted basis of the property.

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.

The following costs 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 seeking a decrease in an assessment levied against property to pay for local improvements.

If you make additions or improvements to business property, keep separate accounts for them. Depreciate the basis of each addition or

improvement according to the depreciation rules that would apply to the original property if you had placed it in service at the same time you placed the addition or improvement in service. See chapter 7.

Assessments for local improvements. Increase the basis of property by assessments 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 amounts assessed for maintenance or repairs, or for meeting 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 are deductible as business expenses and are not added to basis. However, you can elect either to deduct or to capitalize certain other costs. See chapter 8 in Publication 535.

Decreases to Basis

The following items reduce the basis of property.

- Section 179 deduction.
- Deductions previously allowed or allowable for amortization, depreciation, and depletion.
- Special depreciation allowance on qualified property.
- Deduction for clean-fuel vehicles and clean-fuel vehicle refueling property.
- Investment credit (part or all) taken.
- Casualty and theft losses and insurance reimbursements.
- Payments you receive for granting an easement.
- Exclusion from income of subsidies for energy conservation measures.
- Credit for qualified electric vehicles.
- Certain canceled debt excluded from income.
- Rebates from a manufacturer or seller.
- Patronage dividends received from a cooperative association as a result of a purchase of property. See *Patronage Dividends* in chapter 3.
- Gas-guzzler tax.
- Credit for employer-provided childcare.

Some of these items are discussed next.

Depreciation and section 179 deduction. The adjustments you must make to the basis of property if you take the section 179 deduction or depreciate the property are explained below. For more information on these deductions, see chapter 7.

Section 179 deduction. If you take the section 179 expense deduction for all or part of the cost of qualifying business property, decrease the basis of the property by the deduction.

Depreciation. Decrease the basis of 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 or you did not take a depreciation deduction, reduce the basis by the full amount of depreciation you could have taken. If you deducted more depreciation than you should have, decrease your basis 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 7 for information on figuring the depreciation you should have claimed. See also *Changing Your Accounting Method* in chapter 7 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.

Special depreciation allowance. Decrease the basis of property by the special depreciation allowance for qualified property. Do not decrease the basis if you made the election not to claim any special allowance.

Deduction for clean-fuel vehicle and 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 deduction. For more information, see chapter 12 in Publication 535.

Casualty and theft losses. If you have a casualty or theft loss, decrease the basis of the property by any insurance or other reimbursement. Also, decrease it by any deductible loss not covered by insurance. See chapter 11 for information about figuring your casualty or theft loss.

You must increase your basis in the property by the amount you spend on repairs that substantially prolong the life of the property, increase its value, or adapt it to a different use. To make this determination, compare the repaired property to the property before the casualty.

Easements. The amount you receive for granting an easement is usually considered to be proceeds from the sale of an interest in the 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 3.

Exclusion from income of subsidies for energy conservation measures. You can exclude from gross income any subsidy you received from a public utility company for the purchase or installation of an energy conservation measure for a dwelling unit. Reduce the basis of the property by the excluded amount.

Credit for qualified electric vehicles. 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 infor-

mation on this credit, see chapter 12 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 any 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 any of the following.

1. Debt 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 canceled debt described in (1) or (2), you may have to reduce the basis of your depreciable and nondepreciable property. If you exclude canceled debt described in (3), you must only reduce the basis of your depreciable property by the excluded amount.

For more information about canceled debt in a bankruptcy case, see Publication 908, *Bankruptcy Tax Guide*. For more information about insolvency and canceled debt that is qualified farm debt, see chapter 3. For more information about qualified real property business debt, see chapter 5 in Publication 334, *Tax Guide for Small Business*.

Credit for employer-provided childcare. If you claim the credit for employer-provided childcare for amounts paid or incurred to acquire, construct, rehabilitate, or expand property used as part of your qualified childcare facility, you must reduce your basis in the property by the amount of the credit. For information on the credit, see Form 8882, *Credit for Employer-Provided Childcare Facilities and Services*.

Basis Other Than Cost

There are times when you cannot use cost as basis. In these situations, the fair market value or the adjusted basis of property may be used. Fair market value and adjusted basis were discussed earlier.

Property changed to business or rental use. When you hold property for personal use and then change it to business use or use it to produce rent, you must figure its basis for depreciation. An example of changing property from personal to rental use would be renting out your personal residence.

Basis for depreciation. The basis for depreciation is the lesser of the following 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.

Example. George Smith is an accountant and also operates a farming business. George agreed to do some accounting work for his neighbor in exchange for a dairy cow. The accounting work and the cow are each worth \$1,500. George must include \$1,500 in income for his accounting services. George's basis in the cow is \$1,500.

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. A taxable exchange occurs when you receive cash or get property that is not similar or related in use to the property exchanged. 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.

Example. You trade a tract of farmland 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.

Involuntary Conversions

If you receive property as a result of an involuntary conversion, such as a casualty, theft, or condemnation, figure the basis of the replacement property you receive using the basis of the converted property.

Similar or related property. If the replacement property is similar or related in service or use to the converted property, the replacement property's basis is the same as the old property's basis on the date of the conversion. However, make the following adjustments.

1. Decrease the basis by 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 the following amounts.
 - a. Any gain you recognize on the involuntary conversion.
 - b. Any cost of acquiring the replacement property.

Money or property not similar or related. If you receive money or property not similar or related in service or use to the converted property and you buy replacement property similar or related in service or use to the converted property, the basis of the replacement property is its cost decreased by the gain not recognized on the involuntary conversion.

Allocating the basis. If you buy more than one piece of replacement property, allocate your basis among the properties based on their respective costs.

Basis for depreciation. Special rules apply in determining and depreciating the basis of MACRS property acquired in an involuntary conversion. For information, see *What Is the Basis of Your Depreciable Property?* in chapter 7.

For more information about involuntary conversions, see chapter 11.

Nontaxable Exchanges

A nontaxable exchange is an exchange in which you are not taxed on any gain and you cannot deduct any loss. A nontaxable gain or loss also is known as an unrecognized gain or loss. If you receive property in a nontaxable exchange, its basis is usually the same as the basis of the property you transferred.

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 is \$14,000. Because this is a nontaxable exchange, you do not recognize any gain, and your basis in the new truck is \$10,000, the same as the adjusted basis of the 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 8.

The basis of the property you receive is the same as the adjusted basis of the property you gave up.

Example. You trade a machine (adjusted basis of \$8,000) for another like-kind machine (FMV of \$9,000). You use both machines in your farming business. The basis of the machine you receive 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, and deed preparation fees. Add them to the basis of the like-kind property you receive.

Property plus cash. If you trade property in a like-kind exchange and also pay money, the basis of the property you receive is the adjusted basis of the property you gave up plus the money you paid.

Example. You trade in a truck (adjusted basis of \$3,000) for another truck (FMV of \$7,500) and pay \$4,000. Your basis in the new truck is \$7,000 (the \$3,000 adjusted basis of the old truck plus the \$4,000 cash).

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 unless the loss is not deductible under the related party rules. 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 8.

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.

Basis for depreciation. Special rules apply in determining and depreciating the basis of MACRS property acquired in a like-kind transaction. For information, see *What Is the Basis of Your Depreciable Property?* in chapter 7.

Partially Nontaxable Exchanges

A partially nontaxable exchange is an exchange in which you receive unlike property or money in addition to like-kind property. The basis of the property you receive is the same as the adjusted basis of the property you gave up with the following adjustments.

1. Decrease the basis by the following amounts.
 - a. Any money you receive.
 - b. Any loss you recognize on the exchange.
2. Increase the basis by the following amounts.
 - a. Any additional costs you incur.
 - b. Any gain you recognize on the exchange.

If the other party to the exchange assumes your liabilities, treat the debt assumption as money you received in the exchange.

Example 1. You trade farmland (basis of \$10,000) for another tract of farmland (FMV of \$11,000) and \$3,000 cash. You realize 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 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 trade a truck (adjusted basis of \$22,750) for another truck (FMV of \$20,000) and \$10,000 cash. You realize 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. If you receive like-kind and unlike properties in the exchange, 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-kind property.

Example. You traded a tractor with an adjusted basis of \$15,000 for another tractor that had an FMV of \$12,500. You also received \$1,000 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 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). This is the truck's FMV. 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 want 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 depreciating the new tractor would then be \$13,500 (\$11,500 + \$2,000, the adjusted 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 – \$4,000). Your basis for depreciating the new tractor is \$13,500, the same as if you traded the old tractor.

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 2004, 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 \$39,000 (\$50,000 minus the \$11,000 annual exclusion). She paid a gift tax of \$9,000. Your basis, \$26,930, is figured as follows.

Fair market value	\$50,000
Minus: Adjusted basis	<u>-20,000</u>
Net increase in value	\$30,000
Gift tax paid	<u>\$9,000</u>
Multiplied by (\$30,000 ÷ \$39,000)	<u>× .77</u>
Gift tax due to net increase in value	\$6,930
Adjusted basis of property to your mother	<u>+20,000</u>
Your basis in the property	<u>\$26,930</u>

FMV less than donor's adjusted basis. If the FMV of the property at the time of the gift is 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 adjustments to basis while you held the property. Your basis for figuring loss is its FMV when you received the gift plus or minus any required adjustments 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 farmland 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.

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) as your basis to figure 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) as your basis 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, for property transferred in trust, adjust your basis for any gain recognized by your spouse or former spouse if 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 the records needed to determine the adjusted basis and holding period of the property as of the date of the transfer.

For more information, see *Property Settlements* in Publication 504, *Divorced or Separated Individuals*.

Inherited Property

Your basis in property you inherit from a decedent is generally one of the following.

- The FMV of the property at the date of the decedent's death.

- The FMV on the alternate valuation date, if the personal representative for the estate elects to use alternate valuation.
- 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.

For more information, see the instructions for Form 706.

Special-use valuation method. Under certain conditions, when a person dies, the executor or personal representative of that person's estate may elect to value qualified real property at other than its FMV. If so, the executor or personal representative values the qualified real property based on its use as a farm or other closely held business. If the executor or personal representative elects this method of valuation for estate tax purposes, this value is the basis of the property for the qualified 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 may be liable for an additional estate tax if, within 10 years after the death of the decedent, you transfer the property or the property stops being used as a farm. This tax does not apply if you dispose of the property in a like-kind exchange or in an involuntary conversion in which all of the proceeds are reinvested in qualified replacement property. The tax also does not apply if you transfer the property to a member of your family and certain requirements are met. See Form 706-A and its instructions for more information on this tax.

You can elect to increase your basis in special-use valuation property if it becomes subject to the additional estate tax. To increase your basis, you must make an irrevocable election and pay 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 resulted in the additional estate tax.

You make the election by filing, with Form 706-A, a statement that:

- Contains your (and the estate's) name, address, and taxpayer identification number;
- Identifies the election as an election under section 1016(c) of the Internal Revenue Code;

- Specifies the property for which you are making the election; and
- 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.

Example. You and your spouse owned community property that had a basis of \$80,000. When your spouse died, 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, Community Property.

Property Distributed From a Partnership or Corporation

The following rules apply to determine a partner's basis and a shareholder's basis in property distributed respectively from a partnership to the partner with respect to the partner's interest in the partnership and from a corporation to the shareholder with respect to the shareholder's ownership of stock in the corporation.

Partner's basis. Unless there is a complete liquidation of a partner's interest, the basis of property (other than money) distributed by a partnership to the partner is its adjusted basis to the partnership immediately before the distribution. However, the basis of the property to the partner cannot be more than the adjusted basis of his or her interest in the partnership reduced by any money received in the same transaction. For more information, see *Partner's Basis for Distributed Property* in Publication 541, Partnerships.

Shareholder's basis. The basis of property distributed by a corporation to a shareholder is its fair market value. For more information about corporate distributions, see *Distributions to Shareholders* in Publication 542, Corporations.

7.

Depreciation, Depletion, and Amortization

What's New

Increased section 179 deduction dollar limits. The maximum amount you can elect to deduct for most section 179 property you placed in service during 2004 is \$102,000. This limit is reduced by the amount by which the cost of the property placed in service during the tax year exceeds \$410,000. See *Dollar Limits under Section 179 Deduction*, later.

Making and revoking section 179 deduction elections on amended returns. You can make or revoke an election (or specifications made in an election) to deduct section 179 property by filing an amended return. This applies to elections made for section 179 property placed in service after 2002. The amended return must be filed within the time prescribed for the applicable tax year. See *How Do You Elect the Deduction*, later.

Depreciation limits for business cars. The total amount of depreciation (including the section 179 deduction and the special depreciation allowance) you can take for a passenger automobile (that is not an electric vehicle or a truck or van) you use in your business and first place in service in 2004 is generally \$10,610. Special rules apply to electric vehicles and trucks and vans. See *Do the Passenger Automobile Limits Apply under Additional Rules for Listed Property*, later.

Depreciation deduction for MACRS property acquired in a nontaxable exchange. New guidance has been issued for depreciating MACRS property acquired after February 27, 2004, in a like-kind exchange or involuntary conversion. See *Figuring the Deduction for Property Acquired in A Nontaxable Exchange under Figuring Depreciation Under MACRS*.

American Jobs Creation Act of 2004. The American Jobs Creation Act of 2004 made changes to the tax law for depreciation and amortization. Some of these changes are highlighted below.

Section 179 deduction limit for sport utility vehicles. The maximum section 179 expense deduction for certain sport utility vehicles placed in service after October 22, 2004, is \$25,000. For more information, see *Dollar Limits under Section 179 Deduction*, later.

Bonus depreciation for aircraft. Certain non-commercial aircraft are eligible for the special depreciation allowances. See *What Is Qualified Property under Claiming the Special Depreciation Allowance*, later.

Amortization of business start-up costs.

You can elect to deduct certain start-up costs. See chapter 4. The remaining costs can be amortized over a 180-month period. See *Amortization*, later.

Amortization of reforestation costs.

You can elect to deduct certain reforestation costs. See chapter 4. The remaining costs can be amortized over an 84-month period. See *Amortization*, later.

Reminder

Additional special depreciation allowances.

The additional special depreciation allowances will not apply to most property placed in service after December 31, 2004. For more information, see *Claiming the Special Depreciation Allowance*, later.

Introduction

If you buy farm property such as machinery, equipment, livestock, 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 the time you use the property and deduct part of it each year. For most types of property, this is called depreciation.

This chapter gives information on depreciation methods that generally apply to property placed in service after 1986. For information on depreciating pre-1987 property, see Publication 534, *Depreciating Property Placed in Service Before 1987*.



To help you understand depreciation and how to complete Form 4562, Depreciation and Amortization, see the filled-in Form 4562 and related discussion in chapter 15.

Topics

This chapter discusses:

- Overview of depreciation
- Section 179 deduction
- Special depreciation allowances
- Modified Accelerated Cost Recovery System (MACRS)
- Listed property rules
- Basic information on cost depletion (including timber depletion) and percentage depletion.
- Amortization of the costs of going into business, reforestation costs, the costs of pollution control facilities, and the costs of section 197 intangibles.

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 Schedule
- **1040X** Amended U.S. Individual Income Tax Return
- **3115** Application for Change in Accounting Method
- **4562** Depreciation and Amortization
- **4797** Sales of Business Property

See chapter 16 for information about getting publications and forms.

Overview of Depreciation

This overview discusses basic information on the following.

- What property can be depreciated.
- What property cannot be depreciated.
- When depreciation begins and ends.
- Whether MACRS can be used to figure depreciation.
- What the basis of your depreciable property is.
- How to treat improvements.
- When you must file Form 4562.
- How you can correct depreciation claimed incorrectly.

What Property Can Be Depreciated?

You can depreciate most types of tangible property (except land), such as buildings, machinery, equipment, vehicles, certain livestock, and furniture. You can also depreciate certain intangible property, such as copyrights, patents, and computer software. To be depreciable, the property must meet all the following requirements.

- It must be property you own.
- It must be used in your business or income-producing activity.
- It must have a determinable useful life.
- It must be expected to last more than one year.

Property You Own

To claim depreciation, you usually must be the owner of the property. You are considered as owning property even if it is subject to a debt.

Leased property. You can depreciate leased property only if you retain the incidents of ownership in the property (explained later). This means you bear the burden of exhaustion of the capital investment in the property. Therefore, if you lease property from someone to use in your trade or business or for the production of income, you generally cannot depreciate its cost. You can, however, depreciate any capital improvements you make to the leased property. See *Additions and Improvements* under *Which Recovery Period Applies* in chapter 4 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 of property include the following.

- The legal title to the property.
- The legal obligation to pay for the property.
- The responsibility to pay maintenance and operating expenses.
- The duty to pay any taxes on the property.
- The risk of loss if the property is destroyed, condemned, or diminished in value through obsolescence or exhaustion.

Life tenant. Generally, if you hold business or investment property as a life tenant, you can depreciate it as if you were the absolute owner of the property. However, see *Certain term interests in property* under *Excepted property*, later.

Property Used in Your Business or Income-Producing Activity

To claim depreciation on property, you must use it in your business or income-producing activity. If you use property to produce income (investment use), the income must be taxable. You cannot depreciate property that you use solely for personal activities.

Partial business or investment use. If you use property for business or investment purposes and for personal purposes, you can deduct depreciation based only on the percentage of business or investment use.

Example 1. If you use your car for farm business, you can deduct depreciation based on its percentage of use in farming. If you also use it for investment purposes, you can depreciate it based on its percentage of investment use.

Example 2. If you use part of your home for business, you may be able to deduct depreciation on that part based on its business use. For more information, see *Business Use of Your Home* in chapter 4.

Inventory. You can never depreciate inventory because it is not held for use in your busi-

ness. Inventory is any property you hold primarily for sale to customers in the ordinary course of your business.

Livestock. Livestock purchased for draft, breeding, or dairy purposes can be depreciated only if they are not kept in an inventory account.

Livestock you raise usually has no depreciable basis because the costs of raising them are deducted and not added to their basis. However, see *Immature livestock* under *When Does Depreciation Begin and End*, later.

Property Having a Determinable Useful Life

To be depreciable, your property must have a determinable useful life. This means it must be something that wears out, decays, gets used up, becomes obsolete, or loses its value from natural causes.

Irrigation systems and water wells. Irrigation systems and wells used in a trade or business can be depreciated if their useful life can be determined. 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 construct irrigation systems and water wells composed of these materials. However, land preparation costs for center pivot irrigation systems are not depreciable.

Dams, ponds, and terraces. In general, you cannot depreciate earthen dams, ponds, and terraces unless the structures have a determinable useful life.

Property Lasting More Than One Year

To be depreciable, property must have a useful life that extends substantially beyond the year you place it in service.

What Property Cannot Be Depreciated?

Certain property cannot be depreciated. This includes the following.

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. For information on land preparation costs you may be able to depreciate, see chapter 1 of Publication 946.

Excepted property. Even if the requirements explained in the preceding discussions are met, you cannot depreciate the following property.

- Property placed in service and disposed of in the same year. Determining when property is placed in service is explained later.
- Equipment used to build capital improvements. You must add otherwise allowable depreciation on the equipment during the period of construction to the basis of your improvements.
- Intangible property such as section 197 intangibles.

- Certain term interests.

Intangible property. This property does not have a determinable useful life and generally cannot be depreciated. Certain section 197 intangibles such as goodwill and a trademark or trade name can be amortized over a 15 year period. Special rules apply to computer software (discussed next). See *Amortization*, later, and chapter 9 of Publication 535 for more information.

Computer software. Computer software includes all programs designed 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. Computer software is a section 197 intangible only if you acquired it in connection with the acquisition of assets constituting a business or a substantial part of a business.

However, computer software is not a section 197 intangible even if acquired in connection with the acquisition of a business, if it meets all of the following tests.

- It is readily available for purchase by the general public.
- It is subject to a nonexclusive license.
- It has not been substantially modified.

If the software meets the tests above, it can be depreciated and may qualify for the section 179 deduction and the special depreciation allowance, discussed later.

Certain term interests in property. You cannot depreciate a term interest in property created or acquired after July 27, 1989, for any period during which the remainder interest is held, directly or indirectly, by a person related to you. This rule does not apply to the holder of a term interest in property acquired by gift, bequest, or inheritance. For more information, see chapter 1 of Publication 946.

When Does Depreciation Begin and End?

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

Property is placed in service when it is ready and available for a specific use, whether in a business activity, an income-producing activity, 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. You bought a planter for use in your farm business. The planter was delivered in December 2004 after harvest was over. You begin to depreciate the planter for 2004 because it was ready and available for its specific use in 2004, even though it will not be used until the spring of 2005.

If your planter comes unassembled in December 2004 and is put together in February 2005, it is not placed in service until 2005. You begin to depreciate it in 2005.

If your planter was delivered and assembled in February 2005 but not used until April 2005, it is placed in service in February 2005, because this is when the planter was ready for its specified use. You begin to depreciate it in 2005.

Fruit or nut trees and vines. If you acquire an orchard, grove, or vineyard before the trees or vines have reached the income-producing stage, and they have a preproductive period of more than 2 years, you must capitalize the preproductive-period costs under the uniform capitalization rules (unless you elect not to use these rules). See chapter 6 for information about the uniform capitalization rules. Your depreciation begins when the trees and vines reach the income-producing stage.

Immature livestock. Depreciation for livestock begins when the livestock reaches the age of maturity. If you acquire immature livestock for draft, dairy, or breeding purposes, your 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.

Idle Property

Continue to claim a deduction for depreciation on property used in your business or for the production of income even if it is temporarily idle. For example, if you stop using a machine because there is a temporary lack of a market for a product made with that machine, continue to deduct depreciation on the machine.

Cost or Other Basis Fully Recovered

You stop depreciating property when you have fully recovered your cost or other basis. This happens when your section 179 and allowed or allowable depreciation deductions equal your cost or investment in the property.

Retired From Service

You stop depreciating property when you retire it from service, even if you have not fully recovered its cost or other basis. You retire property from service when you permanently withdraw it from use in a trade or business or from use in the production of income because of any of the following events.

- You sell or exchange the property.
- You convert the property to personal use.
- You abandon the property.
- You transfer the property to a supplies or scrap account.
- The property is destroyed.

For information on abandonment of property, see chapter 8. For information on destroyed property, see chapter 11 and Publication 547, *Casualties, Disasters, and Thefts*.

Can You Use MACRS To Depreciate Your Property?

You must use the Modified Accelerated Cost Recovery System (MACRS) to depreciate most business and investment property placed in service after 1986. MACRS is explained later under *Figuring Depreciation Under MACRS*.

You cannot use MACRS to depreciate the following property.

- Property you placed in service before 1987.
- Certain property owned or used in 1986.
- Intangible property.
- Films, video tapes, and recordings.
- Certain corporate or partnership property acquired in a nontaxable transfer.
- Property you elected to exclude from MACRS.

For more information, see Chapter 1 of Publication 946.

Property You Placed in Service or Owned Before 1987

You cannot use MACRS for property you placed in service before 1987 (except property you placed in service after July 31, 1986, if MACRS was elected). Property placed in service before 1987 must be depreciated under the methods discussed in Publication 534, *Depreciating Property Placed in Service Before 1987*.

Use of real property changed. You generally must use MACRS to depreciate real property you acquired for personal use before 1987 and changed to business or income-producing use after 1986.

Property Owned or Used in 1986

Under special rules, you may not be able to use MACRS for property you acquired and placed in service after 1986. These rules apply to both personal and real property owned or used before 1987. If you cannot use MACRS, the property must be depreciated under the methods discussed in Publication 534. For specific information, see *Property Owned or Used in 1986* in chapter 1 of Publication 946.

Election To Exclude Property From MACRS

If you can 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 15 in Part II 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 6 months of the due date of the return (excluding extensions). Attach the elec-

tion 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.

Use of 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.

What Is the Basis of Your Depreciable Property?

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.

Cost as basis. The basis of property you buy is its cost plus amounts you paid for items such as sales tax, freight charges, and installation and testing fees. The cost includes the amount you pay in cash, debt obligations, other property, or services.

Other basis. Other basis refers to basis that is determined by the way you received the property. For example, your basis is other than cost if you acquired the property as a gift or as an inheritance. If you acquired property in this or some other way, see *Basis Other Than Cost* in chapter 6 to determine your basis.

Adjusted basis. To find your property's basis for depreciation, you may have to make certain adjustments (increases and decreases) to the basis of the property for events occurring between the time you acquired the property and the time you placed it in service. These events could include the following.

- Installing utility lines.
- Paying legal fees for perfecting the title.
- Settling zoning issues.
- Receiving rebates.
- Incurring a casualty or theft loss.

For a discussion of adjustments to the basis of your property, see *Adjusted Basis* in chapter 6.

Property changed from personal use. If you held property for personal use and later use it in your business or income-producing activity, your depreciable basis is the lesser of the following.

1. The fair market value (FMV) of the property on the date of the change in use.
2. Your original cost or other basis adjusted as follows.
 - a. Increased by the cost of any permanent improvements or additions and other costs that must be added to basis.
 - b. Decreased by any tax deductions you claimed for casualty and theft losses and other items that reduced your basis.

Property acquired in a nontaxable transaction. Generally, if you receive property in a

nontaxable exchange, the basis of the property you receive is the same as the adjusted basis of the property you gave up. Special rules apply in determining the basis and figuring the depreciation deduction for MACRS property acquired in a like-kind exchange or involuntary conversion. See *Like-kind exchanges and involuntary conversions* under *Claiming the Special Depreciation Allowance* and *Figuring the Deduction for Property Acquired In A Nontaxable Exchange* under *Figuring Depreciation Under MACRS*, later.

Basis adjustment for depreciation allowed or allowable. You must reduce the basis of property by the depreciation allowed or allowable, whichever is greater. Depreciation allowed is depreciation you actually deducted (from which you received a tax benefit). Depreciation allowable is depreciation you are entitled to deduct.

If you do not claim depreciation you are entitled to deduct, you must still reduce the basis of the property by the full amount of depreciation allowable.

If you deduct more depreciation than you should, you must reduce your basis by any amount deducted from which you received a tax benefit (the depreciation allowed).

How Do You Treat Improvements?

If you improve depreciable property, you must treat the improvement as separate depreciable property. For more information on improvements, see Publication 946.

Repairs. You generally deduct the cost of repairing business property in the same way as any other business expense. However, if a repair or replacement increases the value of your property, makes it more useful, or lengthens its life, you must treat it as an improvement and depreciate it.

Improvements to rented property. You can depreciate permanent improvements you make to business property you rent from someone else.

Do You Have To File Form 4562?

You must complete and attach Form 4562 to your tax return if you are claiming any of the following.

- A section 179 deduction for the current year or a section 179 carryover from a prior year. The section 179 deduction is discussed later.
- Depreciation for property placed in service during the current year.
- Depreciation on any vehicle or other listed property, regardless of when it was placed in service. Listed property is discussed later.
- Amortization of costs that began in the current year. Amortization is discussed later.

For more information on whether you must file 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 and listed property, see Publication 946.

How Do You Correct Depreciation Deductions?

If you deducted an incorrect amount of depreciation in any year, you may be able to make a correction by filing an amended return for that year. 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.

Filing an Amended Return

You can file an amended return to correct the amount of depreciation claimed for any property in any of the following situations.

- You claimed the incorrect amount because of a mathematical error made in any year.
- You claimed the incorrect amount because of a posting error made in any year (for example, omitting an asset from the depreciation schedule).
- You have not adopted a method of accounting for the property.

When to file. If an amended return is allowed, you must file it by the later of the following dates.

- 3 years from the date you filed your original return for the year in which you deducted the incorrect amount. (A return filed before an unextended due date is considered filed on the due date.)
- 2 years from the time you paid your tax for that year.

Changing Your Accounting Method

Generally, you must get IRS approval to change your method of accounting. File Form 3115, *Application for Change in Accounting Method*, to request a change in your method of accounting for depreciation.

The following are examples of a change in method of accounting for depreciation.

- A change in the treatment of an asset from nondepreciable to depreciable or vice versa.
- A change in the depreciation method, period of recovery, or convention of a depreciable asset.
- A change from not claiming to claiming the special depreciation allowance or vice versa.

- A change from claiming the 50% special depreciation allowance to claiming the 30% special depreciation allowance for qualified property (including property that is included in a class of property for which you elected the 30% special allowance instead of the 50% special allowance).

See section 1.446-1T(e)(2)(ii)(d)(2) of the regulations for additional examples.

Changes in depreciation that are not a change in method of accounting include the following.

- An adjustment in the useful life of a depreciable asset for which depreciation is determined under section 167.
- A change in use of an asset in the hands of the same taxpayer.
- Making a late depreciation election or revoking a timely valid depreciation election.
- Any change in the placed-in-service date of a depreciable asset.

See section 1.446-1T(e)(2)(ii)(d)(3) of the regulations for additional examples.

In some instances, you may be able to get an automatic approval from the IRS to change your method of accounting for depreciation. See the Instructions for Form 3115 for more information on getting approval, automatic approval procedures, and a list of exceptions to the automatic approval process. Revenue Procedure 2002-9, which is in *Internal Revenue Bulletin 2002-3*, and Revenue Procedure 2004-11, which is in *Internal Revenue Bulletin 2004-3*, provide additional guidance and special procedures for amending your return and filing Form 3115.

Changing your method of accounting for depreciation is discussed in more detail in chapter 1 of Publication 946.

Section 179 Deduction

Under section 179 of the Internal Revenue Code, you can elect to recover all or part of the cost of certain qualifying property, up to a limit, by deducting it in the year you place the property in service. You can recover through depreciation certain costs not recovered through the section 179 deduction.

This part of the chapter explains the rules for the section 179 deduction. It explains what property qualifies for the deduction, what property does not qualify for the deduction, the limits that may apply, and how to elect the deduction.

What Property Qualifies?

To qualify for the section 179 deduction, your property must meet all the following requirements.

- It must be eligible property.
- It must be acquired for business use.
- It must have been acquired by purchase.

Eligible Property

To qualify for the section 179 deduction, your property must be one of the following types of depreciable property.

1. Tangible personal property.
2. Other tangible property (except buildings and their structural components) used as:
 - 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 used in connection with any of the activities in (a) above, or
 - c. A facility used in connection with any of the activities in (a) for the bulk storage of fungible commodities.
3. Single purpose agricultural (livestock) or horticultural structures.
4. Storage facilities (except buildings and their structural components) used in connection with distributing petroleum or any primary product of petroleum.
5. Off-the-shelf computer software.

Tangible personal property. Tangible personal property is any tangible property that is not real property. It includes the following property.

- Machinery and equipment.
- Property contained in or attached to a building (other than structural components), such as milk tanks, automatic feeders, barn cleaners, and office equipment.
- Gasoline storage tanks and pumps at retail service stations.
- Livestock, including horses, cattle, hogs, sheep, goats, and mink and other fur-bearing animals.

Facility used for the bulk storage of fungible commodities. A facility used for the bulk storage of fungible commodities is qualifying property for purposes of the section 179 deduction if it is used in connection with any of the activities listed earlier in item (2)(a). Bulk storage means the storage of a commodity in a large mass before it is used.

Grain bins. A grain bin is an example of a storage facility that is qualifying section 179 property. It is a facility used in connection with the production of grain or livestock for the bulk storage of fungible commodities.

Single purpose agricultural or horticultural structures. A single purpose agricultural (livestock) or horticultural structure is qualifying property for purposes of the section 179 deduction.

Agricultural structure. A single purpose agricultural (livestock) structure is any building or enclosure specifically designed, constructed, and used for both the following reasons.

- To house, raise, and feed a particular type of livestock and its produce.

- To house the equipment, including any replacements, needed to house, raise, or feed the livestock.

For this purpose, livestock includes poultry.

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.

- A greenhouse specifically designed, constructed, and used for the commercial production of plants.
- 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 qualifying property if you use it to house poultry. Similarly, using part of your greenhouse to sell plants will make the greenhouse nonqualifying property.

If a structure includes work space, the work space can be used only for the following activities.

- Stocking, caring for, or collecting livestock or plants or their produce.
- Maintaining the enclosure or structure.
- Maintaining or replacing the equipment or stock enclosed or housed in the structure.

Off-the-shelf computer software. Off-the-shelf computer software placed in service after 2002 is qualifying property for purposes of the section 179 deduction. This is computer software that is readily available for purchase by the general public, is subject to a nonexclusive license, and has not been substantially modified. It includes any program designed to cause a computer to perform a desired function. However, a database or similar item is not considered computer software unless it is in the public domain and is incidental to the operation of otherwise qualifying software.

Property Acquired for Business Use

To qualify for the section 179 deduction, your property must have been acquired for use in your trade or business. Property you acquire only for the production of income, such as investment property, rental property (if renting property is not your trade or business), and property that produces royalties, does not qualify.

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 business in the year you place it in service. If you used the property more than 50% for business, multiply the cost of the property by the percentage of business use.

Use the resulting business cost to figure your section 179 deduction.

Property Acquired by Purchase

To qualify for the section 179 deduction, your property must have been acquired by purchase. For example, property acquired by gift or inheritance does not qualify.

Property is not considered acquired by purchase in the following situations.

1. It is acquired by one member of a controlled group from another member of the same group.
2. Its basis is determined either—
 - a. In whole or in part by its adjusted basis in the hands of the person from whom it was acquired, or
 - b. Under the stepped-up basis rules for property acquired from a decedent.
3. It 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 *Related persons* under *Property Acquired by Purchase* in chapter 2 of Publication 946.

What Property Does Not Qualify?

Land and improvements. Land and land improvements, such as buildings and other permanent structures and their components, are real property, not personal property and do not qualify as section 179 property. Land improvements include nonagricultural fences, swimming pools, paved parking areas, wharves, docks, bridges, and fences. However, agricultural fences do qualify as section 179 property. Similarly, field drainage tile also qualifies as section 179 property.

Excepted property. Even if the requirements explained in the preceding discussions are met, you cannot elect the section 179 deduction for the following property.

- Certain property you lease to others (if you are a noncorporate lessor).
- Certain property used predominantly to furnish lodging or in connection with the furnishing of lodging. (This exception does not apply to property used by a hotel or motel where the predominant portion of the accommodations is used by transients.)
- Air conditioning or heating units.
- Property used predominantly outside the United States (except property described in section 168(g)(4) of the Internal Revenue Code).
- Property used by certain tax-exempt organizations (except property used in connection with the production of income subject

to the tax on unrelated trade or business income).

- Property used by governmental units or foreign persons or entities (except property used under a lease with a term of less than 6 months).

How Much Can You Deduct?

Your section 179 deduction is generally the cost of the qualifying property. However, the total amount you can elect to deduct under section 179 is subject to a dollar limit and a business income limit. These limits apply to each taxpayer, not to each business. However, see *Married individuals* under *Dollar Limits*, later. See also the special rules for applying the limits for partnerships and S corporations, later, under *Partnerships and S Corporations*.

Use Part I of Form 4562 to figure your section 179 deduction.

Trade-in of other property. If you buy qualifying property with cash and a trade-in, its cost for purposes of the section 179 deduction includes only the cash you paid. 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 is the cash you paid. It does not include the adjusted basis of the old tractor you trade for the new tractor. For more information on figuring your adjusted basis, see *What is the Basis of Your Depreciable Property*, earlier.

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 allowance 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 allowance 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).

Depreciating any remaining cost. If you deduct only part of the cost of your qualifying property as a section 179 deduction, you can generally take the special depreciation allowance and MACRS depreciation on the cost you do not deduct. To figure your basis for depreciation used to determine the special depreciation allowance, you must subtract the amount of the section 179 deduction from the cost of the qualifying property. The result is then reduced by the amount of your allowance and the remaining cost is used to figure any MACRS depreciation deduction. For information on how to figure basis for depreciation, the special depreciation allowance, and MACRS depreciation, see *Claiming the Special Depreciation Allowance and Figuring Depreciation Under MACRS*, later.

Dollar Limits

The total amount you can elect to deduct under section 179 for most property in 2004 is

\$102,000. If you acquire and place in service more than one item of qualifying property during the year, you can allocate the section 179 deduction among the items in any way, as long as the total deduction is not more than \$102,000. You do not have to claim the full \$102,000. A separate limitation applies to certain sport utility vehicles. For more information, see *Sport utility vehicles*, below.

For 2005, the \$102,000 total amount you can elect to deduct under section 179 will be adjusted for inflation.

Example. This year, you bought and placed in service a tractor for \$98,000 and a mower for \$6,200 for use in your farming business. You elect to deduct the entire \$6,200 for the mower and \$95,800 for the tractor, a total of \$102,000. This is the most you can deduct. Your \$6,200 deduction for the mower completely recovered its cost. Your basis for depreciation is zero. The basis of your tractor for depreciation is \$2,200. You figure this by subtracting the amount of your section 179 deduction, \$95,800, from the cost of the tractor, \$98,000.

Sport utility vehicles. The total amount you can elect to deduct for certain sport utility vehicles placed in service after October 22, 2004, is \$25,000. For purposes of this limit, a sport utility vehicle is any 4-wheeled vehicle primarily made for use on public streets, roads, and highways, that meets all of the following.

- A vehicle that is not subject to the passenger automobile limits discussed under *Additional limit for passenger automobiles*, later.
- A vehicle with a gross vehicle weight of 14,000 pounds or less.

For more information, see chapter 2 of Publication 946.

Reduced dollar limit for cost exceeding \$410,000. If the cost of your qualifying section 179 property placed in service in 2004 is over \$410,000, you must reduce the dollar limit (but not below zero) by the amount of cost over \$410,000. If the cost of your section 179 property placed in service during 2004 is \$512,000 or more, you cannot take a section 179 deduction and you cannot carry over the cost that is more than \$512,000.

Example. This year, James Smith placed in service machinery costing \$482,000. Because this cost is \$72,000 more than \$410,000, he must reduce his dollar limit to \$30,000 (\$102,000 – \$72,000).

Additional limit for passenger automobiles. For a passenger automobile that is placed in service in 2004, the total section 179 and depreciation deductions (including any special depreciation allowance) is limited. See *Do the Passenger Automobile Limits Apply* under *Additional Rules for Listed Property*, later.

Married individuals. If you are married, how you figure your section 179 deduction depends on whether you file jointly or separately.

Joint return. If you file a joint return, you and your spouse are treated as one taxpayer in determining any reduction to the dollar limit,

regardless of which of you purchased the property or placed it in service.

Separate returns. If you and your spouse file separate returns, you are treated as one taxpayer for the dollar limit, including the reduction for costs over \$410,000. You must allocate the dollar limit (after any reduction) between you. You must allocate 50% to each, unless you both elect a different allocation. If the percentages elected by each of you do not total 100%, 50% will be allocated to each of you.

Joint return after separate returns. If you and your spouse elect to amend your separate returns by filing a joint return after the due date for filing your return, the dollar limit on the joint return is the lesser of the following amounts.

- The dollar limit (after reduction for any cost of section 179 property over \$410,000).
- The total cost of section 179 property you and your spouse elected to expense on your separate returns.

Business Income Limit

The total cost you can deduct each year after you apply the dollar limit 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.

Any cost not deductible in one year under section 179 because of this limit can be carried to the next year. See *Carryover of disallowed deduction*, later.

Taxable income. In general, figure taxable income for this purpose by totaling the net income and losses from all trades and businesses you actively conducted during the year. In addition to net income or loss from a sole proprietorship, partnership, or S corporation, net income or loss derived from a trade or business also includes the following items.

- Section 1231 gains (or losses) as discussed in chapter 9.
- Interest from working capital of your trade or business.
- Wages, salaries, tips, or other pay earned 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.
- Any unreimbursed employee business expenses.

Two different taxable income limits. In addition to the business income limit for your section 179 deduction, you may have a taxable income limit for some other deduction (for example, charitable contributions). You may have to figure the limit for this other deduction taking into account the section 179 deduction. If so, complete the following steps.

Step	Action
1	Figure taxable income without the section 179 deduction or the other deduction.
2	Figure a hypothetical section 179 deduction using the taxable income figured in Step 1.
3	Subtract the hypothetical section 179 deduction figured in Step 2 from the taxable income figured in Step 1.
4	Figure a hypothetical amount for the other deduction using the amount figured in Step 3 as taxable income.
5	Subtract the hypothetical other deduction figured in Step 4 from the taxable income figured in Step 1.
6	Figure your actual section 179 deduction using the taxable income figured in Step 5.
7	Subtract your actual section 179 deduction figured in Step 6 from the taxable income figured in Step 1.
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 \$102,000. It elects to expense the entire \$102,000 cost under section 179. The XYZ corporation also gave a charitable contribution of \$10,000 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 business 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 \$122,000. XYZ figures its section 179 deduction and its deduction for charitable contributions as follows.

Step 1. Taxable income figured without either deduction is \$122,000.

Step 2. Using \$122,000 as taxable income, XYZ's hypothetical section 179 deduction is \$102,000.

Step 3. \$20,000 (\$122,000 – \$102,000).

Step 4. Using \$20,000 (from Step 3) as taxable income, XYZ's hypothetical charitable contribution (limited to 10% of taxable income) is \$2,000.

Step 5. \$120,000 (\$122,000 – \$2,000).

Step 6. Using \$120,000 (from Step 5) as taxable income, XYZ figures the actual section 179 deduction. Because the taxable income is at least \$102,000, XYZ can take a \$102,000 section 179 deduction.

Step 7. \$20,000 (\$122,000 – \$102,000).

Step 8. Using \$20,000 (from Step 7) as taxable income, XYZ's actual charitable contribution (limited to 10% of taxable income) is \$2,000.

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 business 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. If you place more than one property in service in a year, you can select the properties for which all or a part of the cost will be carried forward. Your selections must be shown in your books and records.

Example. Last year, Joyce Jones placed in service a machine that cost \$8,000 and elected to deduct all \$8,000 under section 179. The taxable income from her business (determined without regard to both a section 179 deduction for the cost of the machine and the self-employment tax deduction) was \$6,000. Her section 179 deduction was limited to \$6,000. The \$2,000 cost that was not allowed as a section 179 deduction (because of the business 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 regard to both a section 179 deduction for the cost of the machine and 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 business 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 more information on figuring the carryover.

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 in a partnership or shareholder of an S corporation, you add the amount allocated from the partnership or S corporation to any section 179 costs not related to the partnership or S corporation and then apply the dollar limit to this total. To determine any reduction in the dollar limit for costs over \$410,000, 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 dollar limit, you apply the business income limit to any remaining section 179 costs. For more information, see chapter 2 of Publication 946.

Example. In 2004, Partnership P placed in service section 179 property with a total cost of \$490,000. P must reduce its dollar limit by \$80,000 (\$490,000 – \$410,000). Its maximum section 179 deduction is \$22,000 (\$102,000 – \$80,000), and it elects to expense that amount. Because P's taxable income from the active conduct of all its trades or businesses for the year was \$30,000, it can deduct the full \$22,000.

P allocates \$10,000 of its section 179 deduction and \$15,000 of its taxable income to John, one of its partners.

John also conducts a business as a sole proprietor and in 2004, placed in service in that business, section 179 property costing \$14,000. John's taxable income from that business was \$5,000. He elects to expense the \$10,000 allocated from P, plus the \$14,000 of his sole proprietorship's section 179 costs. However, John's deduction is limited to his business taxable income of \$20,000 (\$15,000 from P plus \$5,000 from his sole proprietorship). He carries over \$4,000 (\$24,000 – \$20,000) of the elected section 179 costs to 2005.

How Do You Elect the Deduction?

Making an election. You elect to take the section 179 deduction by completing Part I of Form 4562.



If you elect the deduction for listed property (described later), complete Part V of Form 4562 before completing Part I.

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).
- For tax years beginning after 2002, an amended return for the applicable tax year. An election made on an amended return must specify the item of section 179 property to which the election applies and the part of the cost of each such item to be taken into account. The amended return must be filed within the time prescribed by law for the applicable tax year. The amended return must also include any resulting adjustments to taxable income.

Revoking an election. An election (or any specification made in the election) to take a section 179 deduction for a tax year beginning after 2002 can be revoked by filing an amended return. The amended return must be filed within the time prescribed by law for the applicable tax year. The amended return must also include any resulting adjustments to taxable income. Once made, the revocation is irrevocable.

For more information on making or revoking a section 179 deduction, see chapter 2 of Publication 946.

When Must You 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. In the year the business use drops to 50% or less, you include the recapture amount as ordinary income. You also increase the basis of the property by the recapture amount. Recovery periods for property are discussed later.



If you sell, exchange, or otherwise dispose of the property, do not figure the recapture amount under the rules explained in this discussion. Instead, use the rules for recapturing depreciation explained in chapter 9 under Section 1245 Property.



If the property is listed property (described later), do not figure the recapture amount under the rules explained in this discussion when the percentage of business use drops to 50% or less. Instead, use the rules for recapturing depreciation explained in chapter 5 of Publication 946 under Recapture of Excess Depreciation.

Figuring the recapture amount. To figure the amount to recapture, take the following steps.

1. Figure the depreciation that would have been allowable on the section 179 deduction you claimed. Begin with the year you placed the property in service and include the year of recapture.
2. Subtract the depreciation figured in (1) from the section 179 deduction you claimed. The result is the amount you must recapture.

Example. In January 2002, Paul Lamb, a calendar year taxpayer, bought and placed in service section 179 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 2002 and 2003. During 2004, he used the property 40% for business and 60% for personal use. He figures his recapture amount as follows.

Section 179 deduction claimed (2002)	\$5,000
Minus: Allowable depreciation (instead of section 179 deduction):	
2002	\$1,250
2003	1,875
2004 (\$1,250 × 40%)	
(business))	<u>500</u>
2004 — Recapture amount	<u>\$1,375</u>

Paul must include \$1,375 in income for 2004.

Where to report recapture. Report any recapture of the section 179 deduction as ordinary income in Part IV of Form 4797 and include it in income on Schedule F (Form 1040).

Claiming the Special Depreciation Allowance

You can take a special depreciation allowance to recover part of the cost of qualified property (defined below) placed in service during the tax year. The allowance applies for the first year you place the property in service. For qualified property placed in service in 2004, you can take an additional 50% (or 30%, if applicable) special depreciation allowance. The allowance is an additional deduction you can take after any section

179 deduction and before you figure regular depreciation under MACRS. This part of the chapter explains what is qualified property, how to figure the allowance, and how to elect not to claim it.

What Is Qualified Property?

Your property is qualified property if it is new property of one of the following types.

- Tangible property depreciated under the modified accelerated cost recovery system (MACRS) with a recovery period of 20 years or less. See *Can You Use MACRS To Depreciate Your Property*, earlier, and *Which Recovery Period Applies*, later.
- Water utility property. See *25-year property* under *Which Property Class Applies Under GDS?* in chapter 4 of Publication 946.
- Computer software that is not a section 197 intangible as described in *Computer software* under *What Property Cannot Be Depreciated*, earlier. (The cost of some computer software is treated as part of the cost of hardware and is depreciated under MACRS.)
- Qualified leasehold improvement property (defined next).
- Certain non-commercial aircraft (discussed below).

Qualified leasehold improvement property.

Generally, this is any improvement to an interior part of a building that is nonresidential real property, provided all of the following requirements are met.

- The improvement is made under or according to a lease by the lessee (or any sublessee) or the lessor of that part of the building.
- That part of the building is to be occupied exclusively by the lessee (or any sublessee) of that part.
- The improvement is placed in service more than 3 years after the date the building was first placed in service.

However, a qualified leasehold improvement does not include any improvement for which the expenditure is for any of the following.

- The enlargement of the building.
- Any elevator or escalator.
- Any structural component benefiting a common area.
- The internal structural framework of the building.

Generally, a binding commitment to enter into a lease is treated as a lease and the parties to the commitment are treated as the lessor and lessee. However, a lease between related persons is not treated as a lease.

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.

Certain non-commercial aircraft. Certain aircraft placed in service before January 1, 2006 are eligible for the special depreciation allowance. In addition, the aircraft has to meet the following requirements to qualify.

- The aircraft must not be tangible personal property used in the trade or business of transporting persons or property (except for agricultural or firefighting purposes).
- The aircraft must be purchased by a purchaser who at the time of the contract for purchase, makes a nonrefundable deposit of the lesser of 10% of the cost or \$100,000.
- The aircraft must have an estimated production period exceeding four months and a cost exceeding \$200,000.
- The aircraft must meet all of the tests discussed under *Other Tests To Be Met*, below.

Other Tests To Be Met

Qualified property must also meet the following requirements.

Acquisition test. To qualify for the 50% special allowance, you must have acquired the property after May 5, 2003. If a binding contract to acquire the property existed before May 6, 2003, the property does not qualify.

The 30% special allowance applies to qualified property for which the 50% special allowance does not apply. To qualify for the 30% special allowance, you must have acquired the property after September 10, 2001. If a binding contract to acquire the property existed before September 11, 2001, the property does not qualify.



You can elect to claim the 30% special allowance instead of the 50% allowance for property that qualifies for the 50% allowance. This election applies to all property in the same property class placed in service during the tax year. See How Can You Elect Not To Claim the Allowance, later.

Placed in service test. Generally, qualified property must be placed in service before January 1, 2005. Property you manufacture, construct, or produce for your own use is qualified property if you began the manufacture, construction, or production of the property after May 5, 2003 (after September 10, 2001, if applicable) and before January 1, 2005. Property that is manufactured, constructed, or produced for your own use by another person under a written binding contract is considered to be manufactured, constructed, or produced by you. This property must be placed in service before January 1, 2006.

For special rules regarding when property involved in certain transactions is treated as placed in service, see chapter 3 of Publication 946 and section 1.168(k)-1T(b)(5) of the regulations.

Original use test. The original use of the property must have begun with you after May 5, 2003 (after September 10, 2001, if applicable). Original use means the first use to which the property is put, whether or not by you. Therefore, property used by any person before May 6,

2003 (before September 11, 2001, if applicable) does not meet the original use test.

For special rules regarding the original use of qualified property, see chapter 3 of Publication 946 and section 1.168(k)-1T(b)(3) of the regulations.

Change in use. If you acquire new property for personal use and then use the property in your trade or business or for the production of income, you are considered to be the original user. Property acquired for personal use after September 10, 2001 and placed in service in your trade or business or for the production of income before January 1, 2005 is qualified property. For more information, see chapter 3 of Publication 946.

What Property Is Not Qualified Property?

Qualified property does not include any of the following.

- Property placed in service and disposed of in the same tax year.
- Property converted from business use to personal use in the same tax year it is acquired. (Property converted from personal use to business use in the same or later tax year may be qualified property. See *Change in use*, above.)
- Property required to be depreciated using ADS. This includes property used predominantly in a farming business and placed in service in any tax year during which an election not to apply the uniform capitalization rules to certain farming costs is in effect and listed property used 50% or less in a qualified business use.
- Qualified New York Liberty Zone leasehold improvement property (defined in chapter 3 of Publication 946).
- Property for which you elected not to claim a special depreciation allowance (discussed later).

How Much Can You Deduct?

The special depreciation allowance for qualified property is an additional deduction of 50% of the property's depreciable basis if the 50% special depreciation allowance applies. It is an additional deduction of 30% of the property's depreciable basis if the 30% special depreciation allowance applies.

Depreciable basis. This is the property's cost or other basis multiplied by the percentage of business/investment use and then reduced by the following items allocable to the property.

- Any section 179 deduction.
- Any deduction for removal of barriers to the disabled and the elderly.
- Any disabled access credit, enhanced oil recovery credit, and credit for employer-provided childcare facilities and services.
- Basis adjustment to investment credit property under section 50(c) of the Internal Revenue Code.

For information about how to determine the cost or other basis of property, see *What Is the Basis of Your Depreciable Property*, earlier. For a discussion of business/investment use, see *Property Used in Your Business or Income-Producing Activity*, earlier.

Depreciating the remaining cost. After you figure the special depreciation allowance for your qualified property, you can use the remaining cost to figure your regular MACRS depreciation deduction (discussed later). In the year you claim the special allowance (the year you place the property in service), you must reduce the depreciable basis of the property by the allowance before figuring your regular MACRS depreciation deduction.

Example. On November 1, 2004, Tom Brown bought and placed in service in his business qualified property costing \$202,000. He elects to deduct \$102,000 of the property's cost as a section 179 deduction. He uses the remaining \$100,000 of cost to figure his special depreciation allowance of \$50,000 ($\$100,000 \times 50\%$). He uses the remaining \$50,000 ($\$100,000 - \$50,000$) of cost to figure his regular MACRS depreciation deduction for 2004 and later years.

Like-kind exchanges and involuntary conversions. If you acquire qualified MACRS property or qualified computer software in a like-kind exchange or involuntary conversion before January 1, 2005 (before January 1, 2006 for property with a long production period), the remaining carried-over basis of the acquired property is eligible for a special depreciation allowance. The remaining excess basis, if any, (the part of the acquired property's basis that exceeds its carried-over basis) is also eligible for a special depreciation allowance.

You must reduce the remaining carried-over basis of the property by the special depreciation allowance before figuring your regular MACRS depreciation deduction. See *Figuring the Deduction for Property Acquired in A Nontaxable Exchange* under *Figuring Depreciation Under MACRS*, later.

How Can You Elect Not To Claim the Allowance?

For qualified property acquired after May 5, 2003, you can elect, for any class of property, either:

- To deduct the 30% special allowance, instead of the 50%, for all property in such class placed in service during the tax year, or
- Not to deduct any special allowances for all property in such class placed in service during the tax year.

To make either election, attach a statement to your return indicating what election you are making and the class of property for which you are making the election.

When to make election. Generally, you must make the election on a timely filed tax return (including extensions) for the year in which you place the property in service.

However, if you timely filed your return for the year without making the election, you still can

make the election by filing an amended return within 6 months of the due date of the original return (not including extensions). Attach the election statement to the amended return. On the amended return, write "Filed pursuant to section 301.9100-2."

Once made, the election may not be revoked without IRS consent.

Figuring Depreciation Under MACRS

The Modified Accelerated Cost Recovery System (MACRS) is used to recover the basis of most business and investment property placed in service after 1986. MACRS consists of two depreciation systems, the General Depreciation System (GDS) and the Alternative Depreciation System (ADS). Generally, these systems provide different methods and recovery periods to use in figuring depreciation deductions.



To be sure you can use MACRS to figure depreciation for your property, see Can You Use MACRS To Depreciate Your Property, earlier.

This part explains how to determine which MACRS depreciation system applies to your property. It also discusses the following information that you need to know before you can figure depreciation under MACRS.

- Property's recovery class.
- Placed-in-service date.
- Basis for depreciation.
- Recovery period.
- Convention.
- Depreciation method.

Finally, this part explains how to use this information to figure your depreciation deduction.

Which Depreciation System (GDS or ADS) Applies?

Your use of either the General Depreciation System (GDS) or the Alternative Depreciation System (ADS) to depreciate property under MACRS determines what depreciation method and recovery period you use. You should use GDS unless you are specifically required by law to use ADS or you elect to use ADS.

Required use of ADS. You must use ADS for the following property.

- All property used predominantly in a farming business and placed in service in any tax year during which an election not to apply the uniform capitalization rules to certain farming costs is in effect.
- Listed property used 50% or less in a qualified business use. For information on listed property, see *Additional Rules for Listed Property*, later.
- Any tax-exempt use property.
- Any tax-exempt bond-financed property.
- Any property imported from a foreign country for which an Executive Order is in

effect because the country maintains trade restrictions or engages in other discriminatory acts.

- Any tangible property used predominantly outside the United States during the year.



If you are required to use ADS to depreciate your property, you cannot claim the special depreciation allowance (discussed earlier).

Electing ADS. Although your property may qualify for GDS, you can elect to use ADS. The election generally must cover all property in the same property class you placed in service during the year. However, the election for residential rental property and nonresidential real property can be made on a property-by-property basis. Once you make this election, you can never revoke it.

You make the election by completing line 20 in Part III of Form 4562.

Which Property Class Applies Under GDS?

The following is a list of the nine property classes under GDS.

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. 25-year property.
8. Residential rental property.
9. Nonresidential real property.

See *Which Property Class Applies Under GDS* in chapter 4 of Publication 946 for examples of the types of property included in each class.

What Is the Placed-in-Service Date?

You begin to claim depreciation when your property is placed in service for use either in a trade or business or for the production of income. The placed-in-service date for your property is the date the property is ready and available for a specific use. It is therefore not necessarily the date it is first used. If you converted property held for personal use to use in a trade or business or for the production of income, treat the property as being placed in service on the conversion date. See *Placed in Service* under *When Does Depreciation Begin and End*, earlier, for examples illustrating when property is placed in service.

What Is the Basis for Depreciation?

The basis for depreciation of MACRS property is the property's cost or other basis multiplied by the percentage of business/investment use. Reduce that amount by the following items.

- Any deduction for section 179 property.

- Any deduction for removal of barriers to the disabled and the elderly.
- Any disabled access credit, enhanced oil recovery credit, and credit for employer-provided childcare facilities and services.
- Any special depreciation allowance.
- Basis adjustment for investment credit property under section 50(c) of the Internal Revenue Code.

For information about how to determine the cost or other basis of property, see *What Is the Basis of Your Depreciable Property*, earlier.

Which Recovery Period Applies?

The recovery period of property is the number of years over which you recover its cost or other basis. It is determined based on the depreciation system (GDS or ADS) used.

Recovery periods. See *Table 7-1* for recovery periods under both GDS and ADS for some commonly used assets. For a complete list of

recovery periods, see the *Table of Class Lives and Recovery Periods* in Appendix B of Publication 946.

House trailers for farm laborers. To depreciate a house trailer you supply as housing for those who work on your farm, use one of the following recovery periods if the house trailer is mobile (it has wheels and a history of movement).

- A 7-year recovery period under GDS.
- A 10-year recovery period under ADS.

However, if the house trailer is not mobile (its wheels have been removed and permanent utilities and pipes attached to it), use one of the following recovery periods.

- A 20-year recovery period under GDS.
- A 25-year recovery period under ADS.

Water wells. Water wells used to provide water for raising poultry and livestock are land improvements. If they are depreciable, use one of the following recovery periods.

- A 15-year recovery period under GDS.

- A 20-year recovery period under ADS.

The types of water wells that can be depreciated were discussed earlier in *Irrigation systems and water wells under Property Having a Determinable Useful Life*.

Which Convention Applies?

Under MACRS, averaging conventions establish when the recovery period begins and ends. The convention you use determines the number of months for which you can claim depreciation in the year you place property in service and in the year you dispose of the property. Use one of the following conventions.

- The half-year convention.
- The mid-month convention.
- The mid-quarter convention.

The mid-month convention. Use this convention for all nonresidential real property and 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 a one-half month of depreciation is allowed for the month the property is placed in service or disposed of.

The mid-quarter convention. Use this convention if the mid-month convention does not apply and the total depreciable bases of MACRS property you placed in service during the last 3 months of the tax year (excluding nonresidential real property, residential rental property, and property placed in service and disposed of in the same year) are more than 40% of the total depreciable bases of all MACRS property you placed in service during the year.

Under this convention, you treat all property placed in service or disposed of during any quarter of the tax year as placed in service or disposed of at the midpoint of that quarter. This means that 1½ months of depreciation is allowed for the quarter the property is placed in service or disposed of.



For purposes of determining whether the mid-quarter convention applies, the depreciable basis of property you placed in service during the tax year does not reflect any reduction in basis for the special depreciation allowance.

The half-year convention. Use this convention if neither the mid-quarter convention nor the mid-month convention applies.

Under this convention, you treat all property placed in service or disposed of during a tax year as placed in service or disposed of at the midpoint of the year. This means that a one-half year of depreciation is allowed for the year the property is placed in service or disposed of.

Which Depreciation Method Applies?

MACRS provides three depreciation methods under GDS and one depreciation method under ADS.

- The 200% declining balance method over a GDS recovery period.

Table 7-1. 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
Computer 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 (actual weight less than 13,000 lbs)	5	5
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.

- The 150% declining balance method over a GDS recovery period.
- The straight line method over a GDS recovery period.
- The straight line method over an ADS recovery period.

Property used in farming business. 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 have elected to use the 150% declining balance method using the ADS recovery periods for certain property classes. If you made this election, continue to use the same method and recovery period for that property.

Real property. You can depreciate real property using the straight line method under either GDS or ADS.

Depreciation Table. The following table lists the types of property you can depreciate under each method. The declining balance method is abbreviated as DB and the straight line method is abbreviated as SL.

Depreciation Table

System/Method	Type of Property
GDS using 150% DB	<ul style="list-style-type: none"> • All property used in a farming business (except real property) • All 15- and 20-year property • Nonfarm 3-, 5-, 7-, and 10-year property¹
GDS using SL	<ul style="list-style-type: none"> • Nonresidential real property • Residential rental property • Trees or vines bearing fruit or nuts • All 3-, 5-, 7-, 10-, 15-, and 20-year property¹
ADS using SL	<ul style="list-style-type: none"> • Property used predominantly outside the U.S. • Farm property used when an election not to apply the uniform capitalization rules is in effect • Tax-exempt property • Tax-exempt bond-financed property • Imported property² • Any property for which you elect to use this method¹
GDS using 200% DB	<ul style="list-style-type: none"> • Nonfarm 3-, 5-, 7-, and 10-year property

¹Elective method

²See section 168(g)(6) of the Internal Revenue Code

Switching to straight line. If you use a declining balance method, you switch to the straight line method in the year it provides an equal or greater deduction. If you use the MACRS percentage tables, discussed later under *How Is the Depreciation Deduction Figured*, 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 shown in *Table 6-1* of chapter 6 and 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 6 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 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 activities. 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 are 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 apples. You also process the apples you have harvested in order to produce applesauce and apple cider. 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 apples, you are not in the farming business with respect to the processing of the apples to produce the food products.

Electing a different method. As shown in the *Depreciation Table*, you can elect a different method for depreciation for certain types of property. You must make the election by the due date of the return (including extensions) for the year you placed 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 6 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. Once you make the election, you cannot change it.



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.

Straight line election. Instead of using the declining balance method, you can elect to use the straight line method over the GDS recovery period. Make the election by entering "S/L" under column (f) in Part III of Form 4562.

ADS election. As explained earlier under *Which Depreciation System (GDS or ADS) Applies*, you can elect to use ADS even though your property may come under GDS. ADS uses the straight line method of depreciation over the ADS recovery periods, which are generally longer than the GDS recovery periods. The ADS recovery periods for many assets used in the business of farming are listed in *Table 7-1*. 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 20 in Part III of Form 4562.

How Is the Depreciation Deduction Figured?

To figure your depreciation deduction under MACRS, you first determine the depreciation system, property class, placed-in-service date, basis amount, recovery period, convention, and depreciation method that applies to your property. Then you are ready to figure your depreciation deduction. You can figure it in one of two ways.

- You can use the percentage tables provided by the IRS.
- You can figure your own deduction without using the tables.



Figuring your own MACRS deduction will generally result in a slightly different amount than using the tables.

Using the MACRS Percentage Tables

To help you figure your deduction under MACRS, the IRS has established percentage tables that incorporate the applicable conven-

tion and depreciation method. These percentage tables are in Appendix A of Publication 946.

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 4 of Publication 946 for information on how to figure the deduction for a short tax year.
3. You generally must continue to use them for the entire recovery period of the property.
4. You must stop using the tables if you adjust the basis of the property for any reason other than—
 - a. Depreciation allowed or allowable, or
 - b. An addition or improvement to the property. (An addition or improvement is depreciated as a separate property.)

Basis adjustment due to casualty loss. If you reduce the basis of your property because of a casualty, you cannot continue to use the percentage tables. For the year of the adjustment and the remaining recovery period, you must figure the depreciation yourself using the property's adjusted basis at the end of the year. See *Figuring the Deduction Without Using the Tables* in chapter 4 of Publication 946.

Figuring the unadjusted basis of your property. You must apply the table rates to your property's unadjusted basis each year of the recovery period. Unadjusted basis is the same basis amount you would use to figure gain on a sale but figured without reducing your original basis by any MACRS depreciation taken in earlier years. However, you do reduce your original basis by the following amounts.

- Any amortization taken on the property.
- Any section 179 deduction claimed on the property.
- Any special depreciation allowance.
- Any deduction claimed for a clean-fuel vehicle or clean-fuel vehicle refueling property.
- Any electric vehicle credit.

The clean-fuel vehicle and clean-fuel vehicle refueling property deductions and the credit for electric vehicles are discussed in chapter 12 of Publication 535.

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.

Figuring depreciation using the 150% DB method and half-year convention. Table 7-2 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.

The following examples show how to figure depreciation under MACRS using the percentages in Table 7-2.

Example 1. During the year, you bought an item of 7-year property for \$10,000 and placed it in service. You do not elect a section 179 deduction for this property and elect not to claim the special depreciation allowance. The unadjusted basis of the property is \$10,000. You use the percentages in Table 7-2 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, your depreciation will be \$1,913 (\$10,000 × 19.13%).

Example 2. You had a barn constructed on your farm at a cost of \$20,000. You placed the barn in service this year. You elect not to claim the special depreciation allowance. 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 \$1,443.80 (\$20,000 × 7.219%).

Figuring depreciation using the straight line method and 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.

Straight Line Percentages

Year	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

The following example shows how to figure depreciation under MACRS using the straight line percentages in the table.

Example. If in Example 2, earlier, you had elected the straight line method, you figure this year's depreciation by multiplying \$20,000 (unadjusted basis) by 2.5% to get \$500. For next year, your depreciation will be \$1,000 (\$20,000 × 5%).

Figuring Depreciation Without the Tables

If you are required to or would prefer to figure your own depreciation without using the tables, see *Figuring the Deduction Without Using the Tables* in chapter 4 of Publication 946.

Figuring the Deduction for Property Acquired in A Nontaxable Exchange

If your property has a carryover basis because you acquired it in an exchange or involuntary conversion of other property or in a nontaxable transfer, you generally figure depreciation for the property as if the exchange, conversion, or transfer had not occurred. However, see *Like-kind exchanges and involuntary conversions*, earlier, under *Claiming the Special Depreciation Allowance*.

Property acquired in a like-kind exchange or involuntary conversion. You generally must depreciate the carryover basis of MACRS property acquired in a like-kind exchange or involuntary conversion over the remaining recovery period of the property exchanged or involuntarily converted. You also generally continue to use the same depreciation method and convention used for the exchanged or involuntarily converted property. The excess basis, if any, of the acquired MACRS property is treated as newly placed in service MACRS property. This applies only to acquired property with the same or a shorter recovery period or the same or more accelerated depreciation method than the property exchanged or converted.

For transactions after February 27, 2004, you can elect not to use the above rules. The election, if made, applies to both the acquired property and the exchanged or involuntarily converted property. If you make the election, figure depreciation by treating the carryover basis and excess basis, if any, for the acquired property as if placed in service on the date you acquired it. For depreciation purposes the adjusted basis of the exchanged property is treated as if it was disposed of at the time of the exchange or conversion.

Table 7-2. 150% Declining Balance Method (Half-year Convention)

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

When to make the election. You must make the election on a timely filed return (including extensions) for the year of replacement. Once made, the election may not be revoked without IRS consent.

For more information and special rules, see chapter 4 of Publication 946 and the Instructions for Form 4562.

Property acquired in a nontaxable transfer. You must depreciate MACRS property acquired by a corporation or partnership in certain nontaxable transfers over the property's remaining recovery period in the transferor's hands, as if the transfer had not occurred. You must continue to use the same depreciation method and convention as the transferor. You can depreciate the part of the property's basis in excess of its carried-over basis (the transferor's adjusted basis in the property) as newly purchased MACRS property. For information on the kinds of nontaxable transfers covered by this rule, see chapter 4 of Publication 946.

How Do You Use General Asset Accounts?

To make it easier to figure MACRS depreciation, you can group separate properties into one or more general asset accounts (GAAs). You can then depreciate all the properties in each account as a single item of property. Each account can include only property with the same asset class (if any), recovery period, depreciation method, and convention. You cannot include property if you use it in both a personal activity and a trade or business (or for the production of income) in the year in which you first place it in service.

After you have set up a GAA, you generally figure the depreciation for it by using the applicable depreciation method, recovery period, and convention for the property in the GAA. For each GAA, record the depreciation allowance in a separate depreciation reserve account.

There are additional rules for grouping property in a GAA, figuring depreciation for a GAA, disposing of GAA property, and terminating GAA treatment. Special rules apply in determining the basis and figuring the depreciation deduction for MACRS property in a GAA acquired in a like-kind exchange or involuntary conversion. See chapter 4 in Publication 946.

When Do You Recapture MACRS Depreciation?

When you dispose of property you depreciated using MACRS, any gain on the disposition is generally recaptured (included in income) as ordinary income up to the amount of the depreciation previously allowed or allowable for the property. Depreciation, for this purpose, includes any section 179 deduction claimed on the property, any special depreciation allowance available for the property (unless you elected not to claim it), and any deduction claimed for clean-fuel vehicles and clean-fuel vehicle refueling property. There is no recapture for residential rental and nonresidential real property, unless that property is qualified property for which you claimed a special depreciation allowance (discussed earlier). For more information on depreciation recapture, see chapter 9.

Additional Rules for Listed Property

This part discusses the depreciation deduction limits and other special rules that apply to certain listed property. It also discusses the recordkeeping rules for listed property. Listed property includes cars and other property used for transportation, property used for entertainment, and certain computers and cellular phones.

Deductions for listed property (other than certain leased property) are subject to the following special rules and limits (discussed later).

- Deduction for employees.
- Business-use requirement.
- Passenger automobile limits and rules.

What Is Listed Property?

Listed property is any of the following.

- Passenger automobiles weighing 6,000 pounds or less.
- Any other property used for transportation, unless it is an excepted vehicle.
- Property generally used for entertainment, recreation, or amusement.
- Computers and related peripheral equipment unless used only at a regular business establishment and owned or leased by the person operating the establishment.
- Cellular telephones (or similar telecommunication equipment).

Passenger automobiles. A passenger automobile is any 4-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. Electric passenger automobiles are vehicles produced by an original equipment manufacturer and designed to run primarily on electricity. Passenger automobiles also include trucks and vans (such as minivans and sport utility vehicles that are built on a truck chassis) placed in service after 2002 that are not qualified nonpersonal use vehicles.



A truck or van that is a qualified nonpersonal use vehicle placed in service after July 6, 2003, is not considered a passenger automobile. See Qualified nonpersonal use vehicles under Passenger Automobiles in chapter 5 of Publication 946 for the definition of qualified nonpersonal use vehicles.

Other property used for transportation. This includes trucks, buses, boats, airplanes, motorcycles, and other vehicles used for transporting persons or goods.

Excepted vehicles. Other property used for transportation does not include the following vehicles.

- Tractors and other special purpose farm vehicles.
- Bucket trucks (cherry pickers), dump trucks, flatbed trucks, and refrigerated trucks.
- Combines, cranes and derricks, and forklifts.
- Buses with a capacity of at least 20 passengers that are used as passenger buses.

Can Employees Claim a Deduction?

If you are an employee, you can claim a depreciation deduction for the use of your listed property (whether owned or rented) in performing services as an employee only if your use is a business use. The use of your property in performing services as an employee is a business use only if both the following requirements are met.

- The use is for your employer's convenience.
- The use is required as a condition of your employment.

If these requirements are not met, you cannot deduct depreciation (including the section 179 deduction) or rent expenses for your use of the property as an employee.

Employer's convenience. Whether the use of listed property is for your employer's convenience must be determined from all the facts. The use is for your employer's convenience if it is for a substantial business reason of the employer. The use of listed property during your regular working hours to carry on your employer's business is generally for the employer's convenience.

Condition of employment. Whether the use of listed property is a condition of your employment depends on all the facts and circumstances. The use of property must be required for you to perform your duties properly.

What Is the Business-Use Requirement?

You can claim the section 179 deduction and a special depreciation allowance for listed property and depreciate listed property using GDS and a declining balance method, if the property meets the business-use requirement. To meet this requirement, listed property must be used predominantly (more than 50% of its total use) for qualified business use. If this requirement is not met, the following rules apply.

- Property not used predominantly for qualified business use during the year it is placed in service does not qualify for the section 179 deduction.
- Property not used predominantly for qualified business use during the year it is placed in service does not qualify for a special depreciation allowance.

- Any depreciation deduction under MACRS for property not used predominantly for qualified business use during any year must be figured using the straight line method over the ADS recovery period. This rule applies each year of the recovery period.
- Excess depreciation on property previously used predominantly for qualified business use must be recaptured (included in income) in the first year in which it is no longer used predominantly for qualified business use.
- A lessee must include an amount in income if the leased property is not used predominantly for qualified business use.

Investment use. The use of property to produce income in a nonbusiness activity (investment use) is not a qualified business use. However, you can treat the investment use as business use to figure the depreciable basis of the property.

Allocating use. To determine whether the business-use requirement is met, you must allocate the use of any item of listed property used for more than one purpose during the year among its various uses.

Do the Passenger Automobile Limits Apply?

The depreciation deduction (including the section 179 deduction and the special depreciation allowance) you can claim for a passenger automobile each year is limited. (For the definition of a passenger automobile, see *Passenger automobiles* under *What Is Listed Property*, earlier.)

Exception for clean fuel modifications. The passenger automobile limits do not apply to any costs you pay to retrofit parts and components to modify an automobile to permit it to run on a clean-burning fuel. The limits apply only to the cost of the automobile without the modification.

Exception for leased cars. The passenger automobile limits generally do not apply to passenger automobiles leased or held for leasing by anyone regularly engaged in the business of leasing passenger automobiles.

Maximum Depreciation Deduction

The passenger automobile limits are the maximum depreciation amounts you can deduct for a passenger automobile. They are based on the date you placed the automobile in service. The maximum deductions (in dollar amounts) for most passenger automobiles are shown in the following table.

Maximum Depreciation Deduction for Passenger Automobiles

Date Placed In Service	1st Year	2nd Year	3rd Year	4th & Later Years
2004	\$10,610 ¹	\$4,800	\$2,850	\$1,675
5/06/2003–12/31/2003	10,710 ²	4,900	2,950	1,775
1/01/2003–5/05/2003	7,660 ²	4,900	2,950	1,775
2002	7,660 ²	4,900	2,950	1,775
9/11/2001–12/31/2001	7,660 ³	4,900	2,950	1,775
1/01/2001–9/10/2001	3,060	4,900	2,950	1,775
2000	3,060	4,900	2,950	1,775
1999	3,060	5,000	2,950	1,775
1998	3,160	5,000	2,950	1,775
1997	3,160	5,000	3,050	1,775
1995–1996	3,060	4,900	2,950	1,775

¹If you elected **not** to claim any special depreciation allowance for the vehicle or the vehicle is not qualified property, the maximum depreciation is \$2,960.

²If you acquired the vehicle before 5/06/03, the maximum deduction is \$7,660. If you elect **not** to claim any special depreciation allowance for the vehicle or the vehicle is not qualified property, the maximum deduction is \$3,060.

³If you acquired the vehicle before 9/11/01, you elected **not** to claim any special depreciation allowance for the vehicle or the vehicle is not qualified property, the maximum deduction is \$3,060.



If your business/investment use of the automobile is less than 100%, you must reduce the maximum deduction amount by multiplying the maximum amount by the percentage of business/investment use determined on an annual basis during the tax year.

Electric vehicles. The maximum depreciation deductions for passenger automobiles that are produced to run primarily on electricity are higher than those for other automobiles. The maximum deductions (in dollar amounts) for electric vehicles are shown in the following table.

Maximum Depreciation Deduction For Electric Vehicles

Date Placed In Service	1st Year	2nd Year	3rd Year	4th & Later Years
2004	\$31,830 ¹	\$14,300	\$8,550	\$5,125
5/06/2003–12/31/2003	32,030 ²	14,600	8,750	5,225
1/01/2003–5/05/2003	22,880 ³	14,600	8,750	5,225
2002	22,980 ⁴	14,700	8,750	5,325
9/11/2001–12/31/2001	23,080 ⁵	14,800	8,850	5,325
1/01/2001–9/10/2001	9,280	14,800	8,850	5,325
2000	9,280	14,800	8,850	5,325
1999	9,280	14,900	8,950	5,325
1998	9,380	15,000	8,950	5,425
1997	9,480	15,100	9,050	5,425

¹If you elected **not** to claim any special depreciation allowance for the vehicle or the vehicle is not qualified property, the maximum deduction is \$8,880.

²If you acquired the vehicle before 5/06/03, the maximum deduction is \$22,880. If you elected **not** to claim any special depreciation allowance for the vehicle or the vehicle is not qualified property, the maximum deduction is \$9,080.

³If you elected **not** to claim any special depreciation allowance for the vehicle or the vehicle is not qualified property, the maximum deduction is \$9,080.

⁴If you elected **not** to claim any special depreciation allowance for the vehicle or the vehicle is not qualified property, the maximum deduction is \$9,180.

⁵If you acquired the vehicle before 9/11/01, you elected **not** to claim any special depreciation allowance for the vehicle or the vehicle is not qualified property, the maximum deduction is \$9,280.

For more information on electric vehicles, see chapter 12 of Publication 535.

Trucks and vans. The maximum depreciation deductions for passenger automobiles such as minivans and sport utility vehicles that are built on a truck chassis, are generally higher than those for other automobiles. The maximum deductions (in dollar amounts) for these trucks and vans for 2004 are shown in the following table.

Maximum Depreciation Deduction for Trucks and Vans

Date Placed In Service	1st Year	2nd Year	3rd Year	4th & Later Years
2004	\$10,910 ¹	\$5,300	\$3,150	\$1,875
5/06/2003–12/31/2003	11,010 ²	5,400	3,250	1,975
1/01/2003–5/05/2003	7,960 ³	5,400	3,250	1,975

¹If you elected **not** to claim any special depreciation allowance for the vehicle or the vehicle is not qualified property, the maximum deduction is \$3,260.

²If you acquired the vehicle before 5/06/03, the maximum deduction is \$7,960. If you elected **not** to claim any special depreciation allowance for the vehicle or the vehicle is not qualified property, the maximum deduction is \$3,360.

³If you elected **not** to claim any special depreciation allowance for the vehicle or the vehicle is not qualified property, the maximum deduction is \$3,360.

Car expenses. For information about deducting expenses for the business use of your passenger automobile, see chapter 4 in Publication 463.

Deductions for passenger automobiles acquired in a trade-in. Special rules apply in figuring the depreciation for a passenger automobile received in a like-kind exchange or involuntary conversion. See chapter 5 of Publication 946 and section 1.168(i)-6T(d)(3) of the regulations.

What Records Must Be Kept?



You cannot take any depreciation or section 179 deduction for the use of listed property 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 ac-

count 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 recovery period.

For more information on records, see chapter 5 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 operator 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 (defined below), 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 the following apply.

- You have acquired by investment any interest in mineral deposits or standing timber.
- You have a legal 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 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.

Mineral property is each separate interest you own in each mineral deposit in each separate tract or parcel of land. You can treat two or more separate interests as one property or as separate properties. See section 614 of the Internal Revenue Code and the related regulations for rules on how to treat separate mineral interests.

Timber property is 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 of mineral in the property's natural deposit.
- The number of units of mineral 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 10 of Publication 535.

Number of units sold. You determine the number of units sold during the tax year based on your method of accounting. Use the following table to make this determination.

IF you use ...	THEN the units sold during the year are ...
The cash method of accounting	Units sold for which you receive payment during the tax year (regardless of year of sale).
An accrual method of accounting	Units sold based on your inventories.

The number of units sold during the tax year does not include any units for 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 for ground water in 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 the Ogallala Formation in areas outside the Southern High Plains were not

required to reduce their basis in ground water by any allowable cost depletion not claimed.

Timber Depletion

Depletion takes place when you cut standing timber (including Christmas trees). You can figure your depletion deduction when the quantity of cut timber is first accurately measured in the process of exploitation.

To figure your cost depletion allowance, 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 timber units acquired during the year and any additions to capital.
3. Figure the number of timber units to take into account by adding the number of timber units acquired during the year to the number of timber units on hand in the account at the beginning of the year and then adding (or subtracting) any correction to the estimate of the number of timber 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 8. 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 you sell the timber products.

Form T. Complete and 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 ($20,000 \times \$.08$) for this year and he

would have included the balance of \$560 (7,000 × \$.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.

To figure percentage depletion, you multiply a certain percentage, specified for each mineral, by your gross income from the property during the year. See *Mines and other natural deposits* in chapter 10 of Publication 535 for a list of the percentages. You can find a complete list in section 613(b) of the Internal Revenue Code.

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.



The 100 percent taxable income limit does 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 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 mineral property. See section 1.613-5(b)(1) of the regulations for information on how to figure the ordinary gain allocable to the property.

For more information on depletion, see chapter 10 in Publication 535.

Amortization

Amortization is a method of recovering (deducting) certain capital costs over a fixed period of time. It is similar to the straight line method of depreciation. The amortizable costs discussed in this section include costs of going into business, reforestation costs, pollution control facilities, and section 197 intangibles. See chapter 9 in Publication 535 for more information on these topics.

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.

You can elect to amortize certain costs for setting up your business, such as business start-up costs.

Business start-up costs. Start-up costs are costs for creating an active trade or business or investigating the creation or acquisition of 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.



You can elect to deduct certain business start-up costs paid or incurred after October 22, 2004. See Capital Expenses in chapter 4.

If you elect to amortize your start-up costs, complete Part VI of Form 4562 and attach a statement that contains the following information.

- A description of the business to which the start-up costs relate.
- A description of each start-up cost incurred.
- The month your active business began (or was acquired).
- The number of months in your amortization period.

Amortization period. The amortization period for business start-up costs paid or incurred before October 23, 2004, cannot be less than 60 months. For start-up costs paid or incurred after October 22, 2004, the amortization period is 180 months. The period starts with the month your active trade or business begins.

Note. Once you elect an amortization period, you cannot change it.

For more information, see *Going Into Business* in chapter 9 of Publication 535.

Reforestation Costs

Generally, you can elect to amortize over an 84-month period up to \$10,000 (\$5,000 if married filing separately) of qualifying reforestation costs for qualified timber property paid or incurred before October 23, 2004. However, for reforestation costs paid or incurred after October 22, 2004, there is no annual limit on the amount you can elect to amortize. Reforestation costs are the direct costs of planting or seeding for forestation or reforestation.



You can elect to deduct certain reforestation costs paid or incurred after October 22, 2004. See Capital Expenses in chapter 4.

Qualifying costs. Qualifying costs include only those costs you must otherwise capitalize and include in the adjusted basis of the property. They 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 for reforestation costs 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 is property that contains trees in significant commercial quantities. It can be a woodlot or other site that you own or lease. The property qualifies only if it meets all the following requirements.

- It is located in the United States.
- 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.
- 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 or ornamental trees, such as Christmas trees.

Amortization period. The amortization period for reforestation costs is 84 months. The 84-month amortization period starts on the first day of the first month of the second half of the tax year you incur the costs (July 1 for a calendar year taxpayer), regardless of the month you actually incur the costs. You can claim amortization deductions for no more than 6 months of the first and last (eighth) tax years of the period.

How to make the election. To elect to amortize qualifying 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.

Generally, you must make the election 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 6 months of the due date of your return (excluding extensions). Attach Form 4562 and the statement to the amended return and write "Filed pursuant to section 301.9100-2" on Form 4562. File the amended return at the same address you filed the original return.

For additional information on reforestation costs, see chapter 9 of Publication 535.

Pollution Control Facilities

You can elect to amortize the cost of a certified pollution control facility over a 60-month period, beginning either the month following the month the facility is completed or acquired or with the

tax year following the year the facility was completed or acquired.



You can claim a special depreciation allowance on a certified pollution control facility that is qualified property even if you elect to amortize its cost rather than capitalizing the costs and depreciating the facility. You must reduce its cost (amortizable basis) by the amount of any special allowance you claim. For a definition of qualified property, see What Is Qualified Property, earlier, under Claiming the Special Depreciation Allowance.

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.

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). The federal certifying authority will describe the nature of the potential cost recovery. You must then reduce the amortizable basis of the facility by this potential recovery.

Example. This year, you purchase a new \$75,000 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. You can also take a special depreciation allowance on the facility. Otherwise, you can capitalize the cost and depreciate the facility.

In addition, to amortize its cost over 60 months, the facility must not significantly increase the output or capacity, extend the useful life, or reduce the total operating costs of the plant or other property. Also, it must not significantly change the nature of the manufacturing or production process or facility.

Example. This year, you converted your 100-sow farrow-to-finish swine operation, which has existed on your farm since 1975, to a 5,000-head finishing swine operation. Even though you are in a similar business after the conversion, you cannot amortize the cost of a manure control facility used in connection with your swine operation because you have significantly increased its output or capacity.

More information. For more information on the amortization of pollution control facilities, see chapter 9 of Publication 946 and section 169 of the Internal Revenue Code and the related regulations.

Section 197 Intangibles

You must generally amortize over 15 years the capitalized costs of section 197 intangibles you acquired after August 10, 1993. You must amortize these costs if you hold the section 197 intangible in connection with your farming business or in an activity engaged in for the production of income. Your amortization deduction each year is the applicable part of the intangible's adjusted basis (for purposes of determining gain), figured by amortizing it ratably over 15 years. The 15-year period begins with the later of:

- The month the intangible is acquired, or
- The month the farming business or activity engaged in for the production of income begins.

You cannot deduct amortization for the month you dispose of the intangible.

If you pay or incur an amount that increases the basis of a section 197 intangible after the 15-year period begins, amortize it over the remainder of the 15-year period beginning with the month the basis increase occurs.

You are not allowed any other depreciation or amortization deduction for an amortizable section 197 intangible.

Cost attributable to other property. The rules for section 197 intangibles do not apply to any amount included in determining the cost of property that is not a section 197 intangible. For example, if the cost of computer software is not separately stated from the cost of the hardware or other tangible property and you consistently treat it as part of the cost of the hardware or other tangible property, these rules do not apply. Similarly, none of the cost of acquiring real property held for the production of rental income is considered the cost of goodwill, going concern value, or any other section 197 intangible.

Assets that are not section 197 intangibles. Intangible property not amortizable under the rules for section 197 intangibles can be depreciated if it meets certain requirements. You generally must use the straight line method over its useful life. For certain intangibles, the depreciation period is specified in the law and regulations. For example, the depreciation period for computer software that is not a section 197 intangible is 36 months.

Interest in land. Section 197 intangibles do not include any interest in land. An interest in land includes a fee interest, life estate, remainder, easement, mineral right, timber right, grazing right, riparian right, air right, zoning variance, and any other similar right, such as a farm allotment, quota for farm commodities, or crop acreage base.

See chapter 9 in Publication 535 for more information, including a list of assets that are section 197 intangibles.

Dispositions. A section 197 intangible is treated as depreciable property used in your trade or business. If you held the intangible for more than one year, any gain on its 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 intangible one year or less, any gain or loss on its disposition is an ordinary gain or loss. For

more information on dispositions of intangible property, see chapter 2 in Publication 544.

8.

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

- 334** Tax Guide for Small Business
- 523** Selling Your Home
- 544** Sales and Other Dispositions of Assets
- 550** Investment Income and Expenses
- 908** Bankruptcy Tax Guide

Form (and Instructions)

- Sch D (Form 1040)** Capital Gains and Losses
- Sch F (Form 1040)** Profit or Loss From Farming
- 1099-A** Acquisition or Abandonment of Secured Property
- 1099-C** Cancellation of Debt
- 4797** Sales of Business Property

See chapter 16 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 certain 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 6 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 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 you must include in gross income and report on your income tax return. A recognized loss is a loss 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 the exchange of property may not be 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 any gain from the exchange is not recognized, 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 rules for like-kind property exchanges must be followed carefully to ensure the validity of these exchanges.

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-kind 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 exchange*, 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 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 can still treat this transaction as a like-kind exchange if it meets all the requirements.

Basis of property received. If you receive property in a like-kind exchange, the basis of the property will be the same as the basis of the property you gave up. See chapter 6 for more information about basis.

Money paid. If, in addition to giving up like-kind 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 with an adjusted basis of \$1,500 for a new one. The new tractor costs \$30,000. He is allowed \$8,000 for the old tractor and pays \$22,000 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 \$8,000 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, even though no gain or loss is recognized, on Form 8824, *Like-Kind Exchanges*. The instructions for the form 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 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, breeding livestock, 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 may have a nontaxable exchange under other rules. See *Other Nontaxable Exchanges* in chapter 1 of Publication 544.

Like-kind 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.

Personal property. Depreciable tangible personal property can be either like kind or like class to qualify for nontaxable exchange treatment. Like-class properties are depreciable tangible personal properties within the same General Asset Class or Product Class. Property classified in any General Asset Class may not be classified within a 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 6-digit product class (except any ending in 9) in sectors 31 through 33 of the North American Industry Classification System (NAICS) of the Executive Office of the President, Office of Management and Budget, United States, 2002 (NAICS Manual). It can be accessed at <http://www.census.gov/naics>. Copies of the manual may be obtained from the National Technical Information Service by calling 1-800-553-NTIS (1-800-553-6847). The cost of the manual is \$49 (plus shipping and handling) and the order number is PB2002101430.

Examples. An exchange of a tractor for a new 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 prop-

erty. 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, 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 fair market value of the unlike property you receive. A loss is not deductible.

Example 1. You trade farmland that cost \$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 realized gain of \$30,000, but only \$10,000, the cash received, is recognized (included in income).

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 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 fair market value of the unlike property and the adjusted basis of the unlike property.

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, brother, sister, 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 *Nondeductible Loss under Sales and Exchanges Between Related Persons* in chapter 2 of Publication 544.

Example. You used a 1999 pickup truck in your farming business. Your sister used a 2000 pickup truck in her landscaping business. In December 2003, you exchanged your 1999

pickup truck, plus \$200, for your sister's 2000 pickup truck. At that time, the fair market value (FMV) of your 1999 pickup truck was \$7,000 and its adjusted basis was \$6,000. The FMV of your sister's 2000 pickup truck was \$7,200 and its adjusted basis was \$1,000. You realized a gain of \$1,000 (the \$7,200 FMV of the 1999 pickup truck minus the \$200 you paid, minus the \$6,000 adjusted basis of the 1999 pickup truck). Your sister realized a gain of \$6,200 (the \$7,000 FMV of your 1999 pickup truck plus the \$200 you paid, minus the \$1,000 adjusted basis of the 2000 pickup truck).

However, because this was a like-kind exchange, you recognized no gain. Your basis in the 2000 pickup truck was \$6,200 (the \$6,000 adjusted basis of the 1999 pickup truck plus the \$200 you paid). Your sister recognized gain only to the extent of the money she received, \$200. Her basis in the 1999 pickup truck was \$1,000 (the \$1,000 adjusted basis of the 2000 pickup truck minus the \$200 received, plus the \$200 gain recognized).

In 2004, you sold the 2000 pickup truck 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 2004, you must report your \$1,000 gain on the exchange in 2003. You also report a loss on the sale of \$200 (the adjusted basis of the 2000 pickup truck, \$7,200 (its \$6,200 basis plus the \$1,000 gain recognized), minus the \$7,000 realized from the sale).

In addition, your sister must report on her tax return for 2004 the \$6,000 balance of her gain on the 2003 exchange. Her adjusted basis in the 1999 pickup 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 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 Publication 544.

Deferred exchange. A deferred exchange is one 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 (that is, property for property) rather than a transfer of property for money used to buy replacement property unless the money is held by a qualified intermediary (defined later).

A deferred exchange for like-kind property may qualify for nonrecognition of gain or loss if the like-kind property is identified in writing 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.
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.



To comply with the 45-day written notice requirement to identify property to be received, you must designate and clearly describe the replacement property in a written document signed by you. For more information, see Identifying replacement property in chapter 1 of Publication 544.

A qualified intermediary is a person who enters into a written exchange agreement with you to acquire and transfer the property you give up and to acquire the replacement property and transfer it to you. This agreement must expressly limit your rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by the qualified intermediary. A qualified intermediary cannot be your agent at the time of the transaction or certain persons related to you or your agent.



A taxpayer who transfers property given up to a qualified intermediary in exchange for replacement property formerly owned by a related person is not entitled to nonrecognition treatment if the related person receives cash or unlike property for the replacement property.

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

Transfer to Spouse

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 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.

ent. 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, *Divorced or Separated Individuals*.

Ordinary or 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). 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 Gains 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 9 for more information.

Capital Assets

Almost everything you own and use for personal purposes 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 non-capital asset, defined later.
- 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 Section 1244 (Small Business) 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 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, 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, 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. The day you disposed of the property is part of your holding period.

Example. If you bought an asset on June 19, 2003, you should start counting on June 20, 2003. If you sold the asset on June 19, 2004, your holding period is not longer than 1 year, but if you sold it on June 20, 2004 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, 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. 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 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 your short-term capital gains. Then add 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, 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. 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.

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, line 16, is more than the yearly limit (line 21).
- The amount shown on Form 1040, line 40, (your taxable income without your deduction for exemptions), is less than zero.

If either of these situations applies to you for 2004, see *Capital Losses under Reporting Capital Gains and Losses* in chapter 4 of Publication 550 to figure the amount you can carry over to 2005.

TIP To figure your capital loss carryover from 2004 to 2005, you will need a copy of your 2004 Form 1040 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 its instructions.

Unrecaptured section 1250 gain. This is the part of any long-term capital gain on section 1250 property (real property) due to straight-line depreciation. 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.

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 non-capital 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 3.

Land and depreciable properties. Land and depreciable property you use in farming are not capital assets. They also include livestock held for draft, breeding, dairy, or sporting purposes. However, your gains and losses from sales and exchanges of your farmland 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 9 for more information.

Hedging (Commodity Futures)

Hedging transactions are transactions that you enter into in the normal course of business primarily to manage 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 with exchange-traded commodity futures contracts that are not hedging

transactions, generally, result in capital gain or loss and are, generally, subject to the mark-to-market rules discussed in Publication 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.

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 10.

Gain or loss on transactions that hedge supplies of a type regularly used or consumed in the ordinary course of its trade or business may be ordinary.



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, you have 35 days after entering into the transaction to identify the hedged item, items, 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 Publication 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 section 1.446-4(e) of the regulations 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 of the Internal Revenue Code 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, 2004, 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 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, 2004-Sold Dec. corn futures (50,000 bu. @ \$2.75)	\$137,500
Nov. 6, 2004-Bought Dec. corn futures (50,000 bu. @ \$3 plus broker's commission)	150,700
Futures loss	<u>(\$13,200)</u>

This loss is reported as a negative figure on Schedule F, Part I, line 10.

The proceeds from your corn sale at the local elevator are \$150,000 (50,000 bu. × \$3). Report it on Schedule F, Part I, line 4.

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 bushel	.25
	<u>\$2.75</u>

The gain on your futures transactions would have been \$11,800, figured as follows.

July 2, 2004—Sold Dec. corn futures (50,000 bu. @ \$2.75)	\$137,500
Nov. 6, 2004—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 Schedule F, Part I, line 10.

The proceeds from the sale of your corn at the local elevator, \$125,000, are reported on Schedule F, Part I, line 4.

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.



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.

Holding period. The sale or exchange of livestock used in your farm business (defined later) 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. However, a draft, breeding, 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.

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. 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 horses from your racing stable. In 2004, 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 2003. 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, 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, 2004, for \$1,250. Expenses of the sale were \$125. The cow was bought July 2, 2001, for \$1,300. Depreciation (not less than the amount allowable) was \$759.

Gross sales price	\$1,250
Cost (basis)	\$1,300
Minus: Depreciation deduction	759
Unrecovered cost (adjusted basis)	\$ 541
Expense of sale	125
Gain realized	\$ 584

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 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 ordinary business income or loss. It is reported on Schedule F, line 1 (purchased timber) or line 4 (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. These sales

constitute a very minor part of their farm businesses. Amounts realized from these minor 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 of timber is discussed in chapter 7.

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.

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 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 the 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 cancel it.

Canceling a post-1986 election. You can cancel an election you made for a tax year beginning after 1986 only if you can show undue hardship and you get the approval of the IRS. Thereafter, you cannot make a new election unless you have the approval of the IRS.

Canceling a pre-1987 election. You can cancel an election you made for a tax year beginning before 1987 without the approval of the IRS. You can cancel the election by attaching a statement to your tax return for the year the cancellation is to be effective. If you make this cancellation, which can be made only once, you can make a new election without the approval of the IRS. Any further cancellation will require the approval of the IRS.

The statement must include all 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 election 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 temporary regulations section 301.9100-7T.

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 (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 of the Internal Revenue Code and section 1.611-3 of the regulations.

Example. In April 2004, 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, 2004, the timber had a fair market value (FMV) of \$350 per MBF. It was cut in April for sale. On your 2004 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, 2004 . . .	\$1,400,000
Minus: Adjusted basis for depletion . . .	160,000
Section 1231 gain	<u>\$1,240,000</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 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 can choose to treat the date of payment as the date of disposal.

This choice 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 choice, 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 choice and the contract under which they were made.

If you timely filed your return for the year you received payment without making the choice, you can still make the choice 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 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 non-business 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 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. The residual method is required only if the group of assets sold constitutes a trade or business. This method determines gain or loss from the transfer of each asset. It also determines the buyer's basis in the business assets.

Consideration. The buyer's consideration is the cost of the assets acquired. The seller's consideration is the amount realized (money plus the fair market value of property received) from the sale of assets.

Residual method. The residual method must be used for any transfer of a group of assets that constitutes a trade or business and for which the buyer's basis is determined only by the amount paid for the assets. This applies to both direct and indirect transfers, such as the sale of a business or the sale of a partnership interest in which the basis of the buyer's share of the partnership assets is adjusted for the amount paid under section 743(b) of the Internal Revenue Code. Section 743(b) of the Internal Revenue Code applies if a partnership has an election in effect under section 754 of the Internal Revenue Code.

A group of assets constitutes a trade or business if either of the following applies.

- Goodwill or going concern value could, under any circumstances, attach to them.
- The use of the assets would constitute an active trade or business under section 355 of the Internal Revenue Code.

The residual method provides for the consideration to be reduced first by the cash, and general deposit accounts (including checking and savings accounts but excluding certificates of deposit). The consideration remaining after this reduction must be allocated among the various business assets in a certain order.

For asset acquisitions occurring after March 15, 2001, make the allocation among the following assets in proportion to (but not more than) their fair market value on the purchase date in the following order.

1. Certificates of deposit, U.S. Government securities, foreign currency, and actively

traded personal property, including stock and securities.

2. Accounts receivable, other debt instruments, and assets that you mark to market at least annually for federal income tax purposes. However, see section 1.338-6(b)(2)(iii) of the regulations for exceptions that apply to debt instruments issued by persons related to a target corporation, contingent debt instruments, and debt instruments convertible into stock or other property.
3. Property of a kind that would properly be included in inventory if on hand at the end of the tax year or property held by the taxpayer primarily for sale to customers in the ordinary course of business.
4. All other assets except section 197 intangibles.
5. Section 197 intangibles (other than goodwill and going concern value).
6. Goodwill and going concern value (whether or not the goodwill or going concern value qualifies as a section 197 intangible).

If an asset described in (1) through (6) is includible in more than one category, include it in the lower number category. For example, if an asset is described in both (4) and (6), include it in (4).

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 1998. 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. 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 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 ($\frac{1}{10}$ 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 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 $\frac{3}{4}$ (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 ($\frac{1}{10}$ 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.

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 the following are true.

Table 8-1. Worksheet for Foreclosures and Repossessions

(Keep for your records)

Part 1. Figure your income from cancellation of debt. (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.)	
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 cancelled 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*.

- You are married and file a joint return for the year.
- Either you or your spouse meets the ownership test.
- Both you and your spouse meet the use test.
- During the 2-year period ending on the date of sale, neither you nor your spouse excluded gain from the sale of another home.

In some circumstances, you may be able to claim a reduced exclusion even if you do not meet the above requirements. 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 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.

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.

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 fair market value 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 Table 8-1 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 total canceled debt is included in the amount realized even if the fair market value of the property is less than the canceled debt.

Example 1. Ann paid \$200,000 for land used in her farming business. 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 2 years after Ann stopped making payments. When the bank foreclosed, 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 on Form 4797, Part I, 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, which she reports on Form 4797, Part I.

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 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 Ann is personally liable for the loan (recourse debt). In this case, the amount she realizes is \$170,000. This is the canceled debt (\$180,000) up to the fair market value of the land (\$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, which she figures on Form 4797, Part I. 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. She reports this income on Schedule F, line 10.

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, *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 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 Form 1040, line 21.



You can use Table 8-1 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 3).
- The debt is qualified real property business debt (see chapter 5 of Publication 334).
- You are insolvent or bankrupt (see 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 an ordinary loss, even if the property is a capital asset. The loss is 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 *Foreclosure or Repossession*.

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.

Example. Abena 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 *Foreclosure or Repossession*.

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 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 Form 1040, line 21.

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 your debt is canceled 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, federal government agency, or any organization that has a significant trade or business of lending money. For foreclosures, repossessions, or abandonments of property and debt cancellations occurring in 2004, these forms should be sent to you by January 31, 2005.

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 gain remaining after applying the depreciation recapture rules 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 9-1* contains examples of items reported on Form 4797 and refers to the part of that form on which they first should be reported. Chapter 15, Sample Return, contains a sample filled-in Form 4797.

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.

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 a

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 b Sold or exchanged at a loss	Part II Part II	Part III (1245, 1250) Part I
2 Farmland held less than 10 years for 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
3 All other farmland	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: a Sold at a gain b Sold at a loss c Raised cattle and horses 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

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 business. Their treatment as ordinary or capital, generally, depends on whether you have a net gain or a net loss from all 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 recapture rules (explained later). Do not take that gain into account as section 1231 gain.

Section 1231 transactions. 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 2 years or longer.
- **Sale or exchange of other livestock.** This livestock must be held for draft,

breeding, dairy, or sporting purposes 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 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 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. 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 lease on the land, even if 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 and held longer than 1 year (or for the required period for certain livestock).
- **Cutting or disposal of timber.** You must treat the cutting or disposal of timber as a sale, 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 1 year. However, if your casualty or theft losses are more than your casualty or theft gains, neither the gains nor the losses are taken into account 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.

Property 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 busi-

ness, 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 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 2004, Ben has a \$2,000 net section 1231 gain. To figure how much he has to report as ordinary income and long-term capital gain, he must first determine his section 1231 gains and losses from the previous 5-year period. From 1999 through 2003 he had the following section 1231 gains and losses.

Year	Amount
1999	-0-
2000	-0-
2001	(\$2,500)
2002	-0-
2003	\$1,800

Using this information, Ben figures how to report his net section 1231 gain for 2004 as shown below.

1) Net section 1231 gain (2004)	\$2,000
2) Net section 1231 loss (2001)	(\$2,500)
3) Net section 1231 gain (2003)	1,800
4) Remaining net section 1231 loss	(\$700)
5) Gain treated as ordinary income	\$700
6) Gain treated as long-term capital gain	\$1,300

His remaining net section 1231 loss from 2001 is completely recaptured in 2004.

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 recognized gain 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 reduced by certain amortization deductions (including those for certified pollution control facilities, childcare 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.

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.

Facility for bulk storage of fungible commodities. 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 sorted and boxed oranges, 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. For details, see chapter 3 of Publication 544.

Use Part III of Form 4797 to figure the ordinary income part of the gain.

Depreciation claimed on other property or claimed by other taxpayers. Depreciation and amortization include the amounts you claimed on the section 1245 property as well as 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. For details on exchanges of property that are not taxable, see *Like-Kind Exchanges* in chapter 8.
- 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).

Example. Jeff Free paid \$120,000 for a tractor in 2002. He depreciated it using the 150% declining balance method. The tractor is 7-year property. On February 23, 2004 he traded it for a chopper and paid an additional \$30,000. To figure his depreciation deduction for the current year, Jeff continues to use the basis of the tractor as he would have before the trade to depreciate the chopper. Because this is the third year of depreciation, he takes a deduction of \$18,036 ($\$120,000 \times .1503$).

Jeff can also depreciate the additional \$30,000 basis on the chopper. Because this is the first year of depreciation on the \$30,000, he takes a depreciation deduction of \$3,213 ($\$30,000 \times .1071$). The total depreciation he can deduct for 2004 is \$21,249 ($\$18,036 + \$3,213$).



Temporary regulations were issued to provide more flexibility for computing depreciation deductions when property is acquired in a like-kind exchange. For details, see chapter 7 and the instructions for Form 4562.

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. Section 179 deduction (see chapter 7).
3. Any special depreciation allowance.
4. Amortization deductions for all the following costs.
 - a. Acquiring a lease.
 - b. Lessee improvements.
 - c. Pollution control facilities.
 - d. Reforestation expenses.
 - e. Section 197 intangibles.
 - f. Childcare facility expenses incurred before 1982.
 - g. Franchises, trademarks, and trade names acquired before August 11, 1993.
5. Deductions for all the following costs.
 - a. Removing barriers to the disabled and the elderly.
 - b. Tertiary injectant expenses.
 - c. Depreciable clean-fuel vehicles and refueling property (minus any recaptured deduction).
6. Any basis reduction for the investment credit (minus any basis increase for a credit recapture).
7. 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 2002, 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 2002 and \$2,550 in 2003. You did not claim the section 179 expense deduction for the truck. You sold it in May 2004 for \$7,000. The MACRS deduction in 2004, 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 (February 2002)	\$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)	\$1,943

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 al-

lowed 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 the 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 (see chapter 6), you must treat any plant you produce as section 1245 property. If you have a gain on the property's disposition, you must recapture the preproductive expenses you would have capitalized if you had not made the choice by treating the gain, up to the amount of these expenses, as ordinary income. For section 1231 transactions, show these expenses as depreciation on Form 4797, Part III, line 22. For plant sales that are reported on Schedule F, 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 2 to figure these expenses.

Example. Janet Maple sold her apple orchard in 2004 for \$80,000. Her adjusted basis at the time of sale was \$60,000. She bought the orchard in 1997, but the trees did not produce a crop until 2000. Her preproductive expenses were \$6,000. She chose not to apply the uniform capitalization rules. Janet must treat \$6,000 of the gain as ordinary income.

Section 1250 Property

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 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 to the property disposed of.

- 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 1 year.
- You chose the alternate ACRS (straight line) method for the property, which was a type of 15-, 18-, or 19-year real property covered by the section 1250 rules.
- The property was nonresidential real property placed in service after 1986 (or after July 31, 1986, if the choice to use MACRS was made) and you held it longer than 1 year. These properties are depreciated using the straight line method.

Additional Depreciation

If you hold section 1250 property longer than 1 year, the additional depreciation is the actual depreciation adjustments that are 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 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.

Depreciation claimed by other taxpayers or claimed 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 carryover 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 percentage for nonresidential real property is explained next. The applicable percentages for residential rental property and low-income housing are 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 from its disposition because of additional depreciation before 1970.

More information. For more information about depreciation recapture on section 1250 property, see chapter 3 of Publication 544.

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 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 earlier. Stop here if (2) is equal to or more than (1). This is the gain treated as ordinary income because of additional depreciation for the periods after 1975.
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 total gain treated as ordinary income because of additional depreciation.

Use Part III, Form 4797, to figure the ordinary income part of the gain.

Installment Sale

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, include the recapture income in your installment sale basis to determine your gross profit on the installment sale.

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 10.

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 Gains

This section discusses gain on the disposition of farmland 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 farmland you held more than 1 year and less

than 10 years at a gain and you were allowed deductions for soil and water conservation expenses for the land, as discussed in chapter 5, you must treat part of the gain as ordinary income and treat the balance as section 1231 gain.

Exceptions. Do not treat gain on the following transactions as gain on section 1252 property.

- Disposition of farmland by gift.
- Transfer of farm property at death (except for income in respect of a decedent).

For more information, see section 1.1252-2 of the regulations.

Amount to report as ordinary income.

You report as ordinary income the lesser of the following amounts.

- 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).
- The total deductions allowed for soil and water conservation expenses multiplied by the applicable percentage, discussed next.

Applicable percentage. The applicable percentage is based on the length of time you held the land. If you dispose of your farmland 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 or part of a 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 0%, and the entire gain is a section 1231 gain.

Example. You acquired farmland on January 19, 1997. On October 3, 2004, you sold the land at a \$30,000 gain. Between January 1 and October 3, 2004, you make soil and water conservation expenditures of \$15,000 for the land that are fully deductible in 2004. 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 (as discussed in chapter 3), you may have to treat part of 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

come 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 after you receive the payments, the percentage 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 part of a gain from the sale, exchange, or involuntary conversion of section 1252 property and section 1255 property.

10.

Installment Sales

What's New

Bond or other debt received as payment. For sales on or after October 22, 2004, any bond or other evidence of debt you receive from the buyer that has interest coupons attached or that can be readily traded on an established securities market is treated as a payment in the year you receive it. For more information, see *Bond* under *Property used as a payment*, later.

Introduction

An installment sale is a sale of property where you receive at least one payment after the tax year of the sale. If you realize a gain on an installment sale you may be able to report part of your gain when you receive each payment. This method of reporting gain is called the installment method. You cannot use the installment method to report a loss. You can choose to report all of your gain in the year of sale.

Installment obligation. The buyer's 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.

Topics

This chapter discusses:

- The installment method
- Figuring installment sale income
- Payments received or considered received
- Installment sale of a farm

Useful Items

You may want to see:

Publication

- **523** Selling Your Home
- **535** Business Expenses
- **537** Installment Sales
- **538** Accounting Periods and Methods

Form (and Instructions)

- **4797** Sales of Business Property
- **6252** Installment Sale Income

See chapter 16 for information about getting publications and forms.

Installment Method

An installment sale is a sale of property where you receive at least one payment after the tax year of the sale. A 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.

TIP *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.*

If a sale qualifies as an installment sale, the gain must be reported under the installment method unless you elect out of using the installment method. See *Electing out of the installment method*, later, for information on recognizing the entire gain in the year of sale.

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.

Form 6252. Use Form 6252 to report an installment sale in the year it takes place and to report payments received in later years. Attach it to your tax return for each year.

Disposition of installment obligation. If you are using the installment method and you dispose of the installment obligation, generally you will 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 the original installment sale produced ordinary income, the disposition of the obligation will result in ordinary income or loss. If the original sale resulted in a capital gain, the disposition of the obligation will result in a capital gain or loss.

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 (FMV) at the time you cancel it. If the parties are related, the FMV of the obligation is considered to be no less than its full face value.

Transfer due to death. The transfer of an installment obligation (other than to a buyer) as a result of the death of the seller 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. Whoever receives the installment obligation as a result of the seller's death is taxed on the installment payments the same as the seller would have been had the seller 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. If the holder and buyer were related, the FMV of the installment obligation is considered to be no less than its full face value.

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 receive payment in later years.

However, if you 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 examples of farm inventory, see *Farm Inventory* in chapter 2.

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 of the installment method. If you elect not to use the installment method, you generally report the entire gain in the year of sale, even though you do not receive all the sale proceeds in that year.

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. Once made, the election can be revoked only with IRS approval. However, if you timely file your tax return for the year the sale takes place you can still make the election by filing an amended return within 6 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 where the original return was filed.

More information. See *Electing Out of the Installment Method* in Publication 537 for more information.



You must continue to report the interest income on payments you receive in subsequent years.

Figuring Installment Sale Income

Each payment on an installment sale usually consists of the following three parts.

- Interest income.
- Return of your adjusted basis in the property.
- Gain on the sale.

In each year you receive a payment, you must 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 basis in the property. Basis is the amount of your investment in the property for tax purposes.

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. Interest provided in the agreement is called stated interest. If the agreement does not provide for enough stated interest, there may be unstated interest or original issue discount. See *Unstated interest*, later.

Adjusted basis and installment sale income (Gain on sale). After you have determined how much of each payment to treat as interest, you treat the rest of each payment as if it were made up of two parts.

- A tax-free return of your adjusted basis in the property, and
- Your gain (referred to as “installment sale income” on Form 6252).

Figuring adjusted basis for installment sale purposes. You can use Worksheet A to figure your adjusted basis in the property for installment sale purposes. When you have completed the worksheet, you will also have determined the gross profit percentage necessary to figure your installment sale income (gain) for this year.

Worksheet A. **Figuring Adjusted Basis and Gross Profit Percentage**



1. Enter the selling price for the property	1. ___
2. Enter your adjusted basis for the property	2. ___
3. Enter your selling expenses	3. ___
4. Enter any depreciation recapture	4. ___
5. Add lines 2, 3, and 4. This is your adjusted basis for installment sale purposes	5. ___
6. Subtract line 5 from line 1. If zero or less, enter -0-. This is your gross profit	6. ___
If the amount entered on line 6 is zero, Stop here. You cannot use the installment method.	
7. Enter the contract price for the property	7. ___
8. Divide line 6 by line 7. This is your gross profit percentage	8. ___

Selling price. The selling price is the total cost of the property to the buyer. It includes:

- Any money you are to receive,
- The fair market value (FMV) of any property you are to receive (FMV is discussed later under *Property used as a payment*),
- Any existing mortgage or other debt the buyer pays, assumes, or takes (a note, mortgage, or any other liability, such as a lien, accrued interest, or taxes you owe on the property), and
- Any of your selling expenses the buyer pays.

The selling price does not include interest, whether stated or unstated.

Adjusted basis for installment sale purposes. Your adjusted basis is the total of the following three items.

- Adjusted basis.
- Selling expenses.
- Depreciation recapture.

Adjusted basis. Basis is the amount of your investment in the property for tax purposes. The way you figure basis depends on how you acquire the property. The basis of property you buy is generally its cost. The basis of property you inherit, receive as a gift, build yourself, or receive in a tax-free exchange is figured differently.

While you own property, various events may change your original basis. 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 the property you sold was depreciable property, you may need to recapture part of the gain on the sale as ordinary income. See *Depreciation Recapture Income*, in Publication 537.

Gross profit. Gross profit is the total gain you report on the installment method.

To figure your gross profit, subtract your adjusted basis for installment sale purposes from the selling price. If the property you sold was your home, subtract from the gross profit any gain you can exclude.

Contract price. Contract price equals the selling price plus mortgages, debts, and other liabilities assumed or taken by the buyer that are in excess of your adjusted basis for installment sale purposes.

Gross profit percentage. A certain percentage of each payment (after subtracting interest) is reported as installment sale income.

This percentage 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 the example under *Selling price reduced*, later, for a situation where the gross profit percentage changes.

Example. You sell property at a contract price of \$2,000 and your gross profit is \$500. Your gross profit percentage is 25% (\$500 ÷ \$2,000). After subtracting interest, you report 25% of each payment, including the down payment, as installment sale income from the sale for the tax year you receive the payment. The remainder (balance) of each payment is the tax-free return of your adjusted basis.

Amount to report as installment sale income. Multiply the payments you receive each year (less interest) by the gross profit percentage. The result is your installment sales income for the tax year. In certain circumstances, you may be treated as having received a payment, even though you received nothing directly. A receipt of property or the assumption of a mortgage on the property sold may be treated as a payment. For a detailed discussion, see *Payments Received or Considered Received*, later.

Sale of depreciable property. You cannot use the installment method to report any depreciation recapture income up to the gain on the sale. However, report any gain greater than the recapture income on the installment method.

The recapture income reported in the year of sale is included in your installment sale basis to determine your gross profit on the installment sale.

You generally cannot report gain from the sale of depreciable property to a related person on the installment method. See *Sale to a 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. See the Form 6252 instructions for details.

For more information on the section 179 deduction, see *Section 179 Deduction* in chapter 7. For more information on the section 179A deductions, see chapter 12 in Publication 535. For more information on depreciation recapture, see *Depreciation Recapture* in chapter 9.

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 the gross profit percentage for the remaining payments. Refigure your gross profit using Worksheet B, *New Gross Profit Percentage — Selling Price Reduced*. You will spread any remaining gain over future installments.



1. Enter the reduced selling price for the property	1. _____
2. Enter your adjusted basis for the property	2. _____
3. Enter your selling expenses	3. _____
4. Enter any depreciation recapture	4. _____
5. Add lines 2, 3, and 4.	5. _____
6. Subtract line 5 from line 1. This is your adjusted gross profit	6. _____
7. Enter any installment sale income reported in prior year(s)	7. _____
8. Subtract line 7 from line 6.	8. _____
9. Divide line 8 by line 6. This is your new gross profit percentage *.	9. _____

* Apply this percentage to all future payments to determine how much of each of those payments is installment sale income.

Example. In 2002, 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 2003. Your gross profit percentage is 60%. You reported a gain of \$12,000 on each payment received in 2002 and 2003.

In 2004, you and the buyer agreed to reduce the purchase price to \$85,000 and payments during 2004, 2005, and 2006 are reduced to \$15,000 for each year.

The new gross profit percentage, 46.67%, is figured in Worksheet B.

You will report a gain of \$7,000 (46.67% of \$15,000) on each of the \$15,000 installments due in 2004, 2005, and 2006.



1. Enter the reduced selling price for the property	1. <u>185,000</u>
2. Enter your adjusted basis for the property	2. <u>40,000</u>
3. Enter your selling expenses	3. <u>-0-</u>
4. Enter any depreciation recapture	4. <u>-0-</u>
5. Add lines 2, 3, and 4.	5. <u>40,000</u>
6. Subtract line 5 from line 1. This is your adjusted gross profit	6. <u>645,000</u>
7. Enter any installment sale income reported in prior year(s)	7. <u>24,000</u>
8. Subtract line 7 from line 6.	8. <u>21,000</u>
9. Divide line 8 by line 6. This is your new gross profit percentage *.	9. <u>46.67%</u>

* Apply this percentage to all future payments to determine how much of each of those payments is installment sale income.

Sale to a related person. If you sell property to a related person and the sale is an installment sale, you may not be able to report the sale using the installment method. If you sell property to a related person and the related person disposes of the property before you receive all payments with respect to the sale, you may have to treat the amount realized by the related person as received by you when the related person disposes of the property. The definition of related persons depends on whether you sold depreciable property or the related person disposed of the property.

For information on these rules, see the instructions for Form 6252 and *Sale to a Related Person* in Publication 537.

Trading property for like-kind property. If you trade business or investment property solely for the same kind of property to be held as business or investment property, you can postpone reporting the gain. See *Like-Kind Exchanges* in chapter 8 for a discussion of like-kind property.

If, in addition to like-kind property, you receive an installment obligation in the exchange, the following rules apply.

- The contract price is reduced by the FMV of the like-kind property received in the trade.
- The gross profit is reduced by any gain on the trade that can be postponed.
- Like-kind property received in the trade is not considered payment on the installment obligation.

Payments Received or Considered Received

You must figure your gain each year on the payments you receive, or are treated as receiving, from an installment sale.

In certain situations, you are considered to have received a payment, even though the buyer does not pay you directly. These situations occur when the buyer assumes or pays any of your debts, such as a loan, or pays any of your expenses, such as a sales commission. See *Mortgage less than basis*, later for an exception to this rule.

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 not more than your installment sale basis in the property, it is not considered a payment to you. It is actually a

recovery of your basis. The selling price minus the mortgage equals the contract price.

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.

To figure the contract price, subtract the mortgage from the selling price. This is the total amount you will receive directly from the buyer. Add to this amount the payment you are considered to have received (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 assume an existing mortgage of \$6,000. Your adjusted 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	<u>\$3,000</u>
Add difference:	
Mortgage	\$6,000
Minus: Installment sale basis	5,000
<u>1,000</u>	
Contract price	<u>\$4,000</u>

Your gross profit on the sale is also \$4,000:

Selling price	\$9,000
Minus: Installment sale basis	(5,000)
Gross profit	<u>\$4,000</u>

Your gross profit percentage is 100%. Report 100% of each payment as gain from the sale. 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 any 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 only to the following types of debt the buyer assumes.

- Those acquired from ownership of the property you are selling, such as a mortgage, lien, overdue interest, or back taxes.
- 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 then considered a payment to you in the year of sale.

Property used as a payment. If you receive property rather than money from the buyer, it is still considered a payment in the year received. However, see *Trading property for like-kind property*, earlier. Generally, the amount of the payment is the property's FMV on the date you receive it.

Exception. If the property the buyer gives you is payable on demand or readily tradable, the amount you should consider as payment in the year received is:

- The FMV of the property on the date you receive it if you use the cash receipts and disbursements method of accounting,
- The face amount of the obligation on the date you receive it if you use the accrual method of accounting, or
- The stated redemption price at maturity less any original issue discount (OID) or, if there is no OID, the stated redemption price at maturity appropriately discounted to reflect total unstated interest. See *Unstated interest*, later.

Fair market value (FMV). This is the price at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and who both have a reasonable knowledge of all the necessary facts.

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 the sale. However, see *Exception under Property used as a payment*, earlier.

Example. You sold real estate in an installment sale. As part of the down payment, the buyer assigned to you a \$50,000, 8% third-party

note. The FMV of the third-party note at the time of the sale was \$30,000. This amount, not \$50,000, is a payment to you in the year of sale. The third-party note had an FMV equal to 60% of its face value (\$30,000 ÷ \$50,000), so 60% of each principal payment you receive on this note is a nontaxable return of capital. The remaining 40% is 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. However, see *Exception under Property used as a payment*, earlier.



For sales on or after October 22, 2004, any bond or other evidence of debt you receive from the buyer that has interest coupons attached or that can be readily traded on an established securities market is treated as a payment in the year you receive it. For information on the amount you should treat as a payment, see Exception under Property used as a payment, earlier.

Buyer's note. The buyer's note (unless payable on demand) is not considered payment on the sale. However, 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 received.

Guarantee. Any evidence of debt you receive from the buyer that is not payable on demand is not considered a payment, even if it is guaranteed by a third party, including a government agency.

Unstated interest. An installment sale contract may provide 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 does not provide for adequate stated interest, part of the stated principal amount of the contract may be recharacterized as interest. If section 483 applies to the contract, this interest is called 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 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 and Original Issue Discount (OID)* 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 property and personal property reportable 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 a capital asset or as property used in the business, and by the length of time held. (See chapter 8 for a discussion of capital assets.) Separate computations must be made to figure the gain or loss for each class of asset sold. See *Sale of a Farm* in chapter 8.

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 generally taxable as ordinary income in the year of sale. See *Depreciation recapture*, later. This applies even if no payments are received in that year.

Example

On January 3, 2004, 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 2004. 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 2003 in anticipation of selling the farm. The section 179 deduction was not 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
	<u>\$300,000</u>	<u>\$15,000</u>	<u>\$142,483</u>	<u>\$142,517</u>

* 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 9 for more information on depreciation recapture.

Special rules may apply when you sell section 1250 assets depreciated under the straight line method. See the *Unrecaptured Section 1250 Gain Worksheet* in the instructions for Schedule D (Form 1040).

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 entire depreciation of \$1,977 is recapture income because it is less than the gain. The remaining gain of \$750 is reported on the installment method.

The cattle used for breeding and held for 2 years or more are also section 1245 property. Since the gain 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 gain reported as depreciation recapture income on the truck and the cattle held less than 2 years (\$3,001 and \$1,977) is added to the adjusted basis of each property when making the installment sale computations.

Assets not reported on the 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 8. 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
	<u>\$190,000</u>	<u>\$107,750</u>	<u>\$82,250</u>

* Held less than 2 years

Section 1231 gains. The ordinary income part of the gain on the truck is reported in the year of sale, so 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 9.

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	<u>58.75</u>

* 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 2004 is \$75,000 (\$50,000 down payment + \$25,000 payment on July 1). The installment sale part of the total payments received in 2004 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 2004	<u>\$24,675</u>

* 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.



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.

Section 1231 gains. The gains on the land, buildings, and truck are section 1231 gain. They may be reported as either capital or ordinary gain depending on the net balance when combined with other section 1231 losses. A net 1231 gain is capital gain and a net 1231 loss is an ordinary loss.

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 9–1* in chapter 9.

Installment income for years after 2004.

You figure installment income for the years after 2004 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:

	Income
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

In this example, no gain is ever recognized from the sale of your home. 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 section 1231 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	(107,750)
Gross profit	<u>\$82,250</u>
Gain reported in 2004 (year of sale)	\$24,675
Gain reported in 2005:	
\$28,000 × 58.75%	16,450
Gain reported in 2006:	
\$28,000 × 58.75%	16,450
Gain reported in 2007:	
\$28,000 × 58.75%	16,450
Gain reported in 2008:	
\$14,000 × 58.75%	8,225
Total gain reported	<u>\$82,250</u>

11.

Casualties, Thefts, and Condemnations

What's New

Postponing gain on weather-related sales of livestock. The following new rules apply to postponing gain on the sale or exchange of livestock (other than poultry) held for draft, breeding, or dairy purposes because of weather-related conditions. These rules are effective for tax years for which the return due date (excluding extensions) is after 2002.

- If it is not practical for you to invest the sales proceeds in other livestock, other property (except real property) used for farming qualifies as replacement property. See *Weather-related sales of livestock under Replacement Property*.
- The replacement period is at least 4 years if the weather-related conditions occur in an area eligible for federal assistance. See *Weather-related sales of livestock in an area eligible for federal assistance under Replacement Period*.

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 and you buy qualified replacement property within the specified replacement period, you can postpone reporting the gain on your income tax return. For more information, see *Postponing Gain*, later.

Topics

This chapter discusses:

- Casualties and thefts
- How to figure a loss or gain

- Other involuntary conversions
- Postponing gain
- Disaster area losses
- Reporting gains and losses

Useful Items

You may want to see:

Publication

- 523** Selling Your Home
- 525** Taxable and Nontaxable Income
- 536** Net Operating Losses (NOLs) for Individuals, Estates, and Trusts
- 544** Sales and Other Dispositions of Assets
- 547** Casualties, Disasters, and Thefts
- 584** Casualty, Disaster, and Theft Loss Workbook (Personal-Use Property)
- 584-B** Business Casualty, Disaster, and Theft Loss Workbook

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 16 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 (but see *Nondeductible losses*, next, for exceptions).
- Floods.
- Freezing.
- Government-ordered demolition or relocation of a home that is unsafe to use because of a disaster as discussed under *Disaster Area Losses*, in Publication 547.

- Lightning.
- Storms, including hurricanes and tornadoes.

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, truck, or farm equipment 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 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.

Decline in market value of stock. You cannot deduct as a theft loss the decline in market value of stock acquired on the open market for investment if the decline is caused by disclosure of accounting fraud or other illegal misconduct by the officers or directors of the corporation that issued the stock. However, you can deduct as a capital loss the loss you sustain when you sell or exchange the stock or the stock becomes completely worthless. You report a capital loss on Schedule D (Form 1040). For more information about stock sales, worthless stock, and capital losses, see chapter 4 of Publication 550.

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

You can deduct certain casualty or theft losses that occur in the business of farming. 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 6.

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. A severe flood destroyed your crops. Because you are a cash method taxpayer and already deducted the cost of raising the crops as farm expenses, this loss is not deductible, as explained earlier under *Livestock, plants, produce, and crops raised for sale*. You estimate that the crop loss will reduce your farm income by \$25,000. This loss of future income is also not deductible.

Loss of timber. If you sell timber downed as a result of 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 your 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*, 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.

- You use inventories to determine your income and you included the animals in your inventory.
- You capitalized the expenses associated with the animals under the uniform capitalization rules and therefore have a tax basis in the animals subject to a casualty or theft.

When you include livestock in inventory, its last inventory value is its basis. When you lose an inventoried animal held for draft, breeding, dairy, or sport by casualty or theft during the year, decrease ending inventory by the amount you included in inventory for the animal. 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

TIP You can use the schedules in Publication 584-B to list your stolen, damaged, or destroyed business property and to figure your loss.

If your farm property was partially damaged, use the steps shown under *Personal-use property*, next, to figure your casualty loss. However, the deduction limits, discussed later, do not apply.

Personal-use property. Personal-use property is property used by you or your family members for personal use. You figure the casualty or theft loss on this property by taking 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.



You can use Publication 584 to list your stolen or damaged personal-use property and figure your loss. It includes schedules to help you figure the loss on your home, its contents, and 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 6.

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 afterward. FMV is defined in chapter 10 under *Payments Received or Considered Received*.

Appraisal. To figure the decrease in FMV because of a casualty or theft, you generally need a competent appraisal. But other measures, such as the cost of cleaning up or making repairs (discussed next) can be used to establish decreases in FMV.

An appraisal to determine the difference between the FMV of the property immediately before a casualty or theft and immediately afterward should be made by a competent appraiser. The appraiser must recognize the effects of any general market decline that may occur along with the casualty. This information is needed to limit any deduction to the actual loss resulting from damage to the property.

Cost of cleaning up or making repairs. The cost of cleaning up after a casualty is not part of a casualty loss. Neither is the cost of repairing damaged property after a casualty. But you can use the cost of cleaning up or making repairs after a casualty as a measure of the decrease in FMV if you meet all the following conditions.

- The repairs are actually made.
- 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 the damage only.
- 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, temporary housing, or 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.



There is an exception to this rule 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 \$28,000 just before the fire and \$10,000 immediately afterward. The barn had an adjusted basis of \$28,000. Its FMV was \$55,000 just before the fire and \$25,000 immediately afterward. You received insurance reimbursements of \$2,100 on the tractor and \$26,000 on the barn. Figure your deductible casualty loss separately for the two items of property.

	<u>Tractor</u>	<u>Barn</u>
1) Adjusted basis	\$3,300	\$28,000
2) FMV before fire	\$28,000	\$55,000
3) FMV after fire	10,000	25,000
4) Decrease in FMV (line 2 – line 3)	\$18,000	\$30,000
5) Loss (lesser of line 1 or line 4)	\$3,300	\$28,000
6) Minus: Insurance	2,100	26,000
7) Deductible casualty loss	<u>\$1,200</u>	<u>\$2,000</u>
8) Total deductible casualty loss	<u>\$3,200</u>	<u>\$2,000</u>

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 now \$16,000. In 2004, 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 \$130,000, and \$126,000 immediately after the storm. The trees were not covered by insurance.

1) Adjusted basis	<u>\$16,000</u>
2) FMV before the storm	\$130,000
3) FMV after the storm	126,000
4) Decrease in FMV (line 2 – line 3)	<u>\$4,000</u>
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.

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.

 Do not subtract from your loss any insurance payments you receive for living expenses if you lose the use of your main home or are denied access to it because of a casualty. You may have to include a portion of these payments in your income. See Publication 547 for details.

Disaster relief. Food, medical supplies, and other forms of assistance you receive do not reduce your casualty loss, unless they are replacements for lost or destroyed property. Excludable cash gifts you receive also do not reduce your casualty loss if there are no limits on how you can use the money.


Generally, disaster relief grants received under the Disaster Relief and Emergency Assistance Act are not included in your income. See *Disaster relief grants*, later, under *Disaster Area Losses*.

Qualified disaster relief payments for expenses you incurred as a result of a Presidentially declared disaster are not taxable income to you. See *Qualified disaster relief payments*, later, under *Disaster Area Losses*.

Reimbursement received after deducting loss. If you figure your casualty or theft loss using your expected reimbursement, you may have to adjust your 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. 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. See Publication 547 for information on how to treat a gain from the reimbursement you receive because of a casualty or theft.

Actual reimbursement same as expected. If you receive exactly the reimbursement you expected to receive, you do not have to include any amount in your income or deduct any loss.

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 6 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 deduction for 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 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 37 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 for the year you discovered the burglary is \$57,000. Figure your theft loss deduction as follows:

1. Loss after insurance	\$2,000
2. Subtract \$100	100
3. Loss after \$100 rule	\$1,900
4. Subtract 10% × \$57,000 AGI	\$5,700
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 (\$5,700).

 If you have a casualty or theft gain in addition to a loss, you will have to make a special computation before you 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, losses in Presidentially declared disaster areas are subject to different rules. See *Disaster Area Losses*, later, for an exception.

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 determined 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 2004. 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 bill and refused to pay it. First Implement later filed suit in court against Robert. In 2005, Robert and First Implement agreed to settle the suit for \$20,000, and the court entered a judgment in favor of First Implement. Robert

paid \$20,000 in June 2005. He can claim the \$20,000 as a loss on his 2005 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 Publication 536 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 have records to support the amount you claim for the loss.

Casualty loss proof. For a casualty loss, your records should show all the following information.

- 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.
- Whether a claim for reimbursement exists for which there is a reasonable expectation of recovery.

Theft loss proof. For a theft loss, your records should show all the following information.

- When you discovered your property was missing.
- That your property was stolen.
- That you were the owner of the property.
- Whether a claim for reimbursement exists for which there is a reasonable expectation of recovery.

Figuring a Gain

A casualty or theft may result in a taxable gain. If you receive an insurance payment 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 \$25,000. Your insurance company reimbursed you \$40,000 for the damaged barn. However, you had legal expenses of \$2,000 to collect that insurance. Your insurance minus your expenses to collect the insurance is more than your adjusted basis in the barn, so you have a gain.

1) Insurance reimbursement	\$40,000
2) Legal expenses	2,000
3) Amount received (line 1 – line 2)	\$38,000
4) Adjusted basis	25,000
5) Gain on casualty (line 3 – line 4)	\$13,000

Other Involuntary Conversions

In addition to casualties and thefts, other events cause involuntary conversions of property. Some of these are discussed 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 a forced sale, the owner being the seller and the condemning authority being the buyer.

Threat of condemnation. Treat the sale of your property under threat of condemnation as a condemnation, provided you have reasonable grounds to believe that your property will be condemned.

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. If your gain is more than the amount you can exclude, but you buy replacement property, you may be able to postpone reporting the excess gain. See *Postponing Gain*, later. (You cannot deduct a loss from the condemnation of your main home.)

More information. 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.

Irrigation Project

The sale or other disposition of property located within an irrigation project to conform to the acreage limits of federal reclamation laws is an involuntary conversion.

Livestock Losses

Diseased livestock. If your 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 8. 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 reporting 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 you sell or exchange livestock (other than poultry) held for draft, breeding, or dairy purposes solely because of drought, flood, or other weather-related conditions, 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 8. If you replace the livestock, you may be able to postpone reporting the gain. See *Postponing Gain*, later.

Example. It is your usual business practice to 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 other livestock (including poultry). See *Sales Caused by Weather-Related Conditions in chapter 3*.

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. Treat the loss as a loss from an involuntary conversion. 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. If you took the investment credit for any of these costs, you may have to recapture all or part of the credit. See Form 4255, *Recapture of Investment Credit*.

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 generally 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. However, you can choose to postpone reporting the gain if you purchase replacement property similar or related in service or use to your destroyed, stolen, or other involuntarily converted property within a specific replacement period.

If you have a gain on damaged property, you can postpone reporting the gain if you spend the reimbursement to restore the property.

To postpone reporting 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.

Example. In 1970, you bought a cottage in the mountains for your personal use at a cost of \$18,000. You made no further improvements or additions to it. When a storm destroyed the cottage this January, the cottage was worth \$250,000. You received \$146,000 from the insurance company in March. You had a gain of \$128,000 (\$146,000 – \$18,000).

You spent \$144,000 to rebuild the cottage. Since this is less than the insurance proceeds received, you must include \$2,000 (\$146,000 – \$144,000) in your income.

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 the following taxpayers.

1. C corporations.
2. Partnerships in which more than 50% of the capital or profits interest is owned by C corporations.
3. Individuals, partnerships (other than those in (2) 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 (3) above, gains cannot be offset by 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 person 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.

Death of a taxpayer. 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 involuntary conversion cannot postpone reporting the gain by buying replacement property.

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 reporting the gain if you meet the other requirements. Property you acquire by gift or inheritance does not qualify as replacement property.

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 or draft animal that replaces a dairy cow.

Soil or other environmental contamination. If, because of soil or other 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.

Weather-related sales of livestock. If you sell or exchange livestock because of weather-related conditions (discussed earlier under *Livestock Losses*) and it is not practical for you to reinvest the sales proceeds in property similar or related in service or use to the livestock, you can treat other property (excluding real property) used for farming purposes, as property similar or related in service or use to the livestock you sold.

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 costs of planting and raising a new crop qualify as replacement costs for the destroyed crop only if you use the crop method of accounting (discussed in chapter 2).

In that case, the costs of bringing the new crop to the same level of maturity as the destroyed crop qualify as replacement costs to the extent they are incurred during the replacement period.

Timber loss. Standing timber you bought with the proceeds from the sale of timber downed as a result of 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 Presidentially declared disaster area. If your destroyed business or income-producing property was located in a Presidentially declared disaster area, any tangible replacement property you acquire for use in any 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 in a statement attached to your tax return, you cannot substitute other qualified replacement property. This is true even if you acquire the other property within the replacement period. 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.

Basis of replacement property. You must reduce the basis of your replacement property (its cost) by the amount of postponed gain. In this way, tax on the gain is postponed until you dispose of the 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 generally ends 2 years after the close of the first tax year in which you realize any part of your gain from the involuntary conversion.

Example. You are a calendar year taxpayer. While you were on vacation, farm equipment that cost \$2,200 was stolen from your farm. You discovered the theft when you returned to your farm on November 11, 2004. Your insurance company investigated the theft and did not settle your claim until January 3, 2005, when they paid you \$3,000. You first realized a gain from the reimbursement for the theft during 2005, so you have until December 31, 2007, to replace the property.

Main home in disaster area. For your main home (or its contents) located in a Presidentially declared disaster area, the replacement period ends 4 years after the close of the first tax year in which you realize any part of your gain from the involuntary conversion. See *Disaster Area Losses*, later.

Weather-related sales of livestock in an area eligible for federal assistance. For the sale or exchange of livestock due to drought, flood, or

other weather-related conditions in an area eligible for federal assistance, the replacement period ends 4 years after the close of the first tax year in which you realize any part of your gain from the sale or exchange. The IRS may extend the replacement period on a regional basis if the weather-related conditions continue for longer than 3 years.

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 generally ends 2 years after the close of the first tax year in which any part of the gain on the condemnation is realized.

Business or investment real property. 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 IRS director 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 reporting 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 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 the following items.

- The replacement property.
- The postponed gain.
- The basis adjustment that reflects the 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 should then attach another statement to your return for the year in which you buy the replacement property. This statement should contain detailed information on the replacement property. If you acquire part of your replacement property in one year and part in another year, you must attach a statement to each year's return. Include in the statement detailed information on the replacement property bought in that year.

Reporting weather-related sales of livestock. If you choose to postpone reporting the gain on weather-related sales or exchanges of livestock, show all 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 the following information and the preceding information on the return for the year in which you replace the livestock.

- The dates you bought the replacement property.
- The cost of the replacement property.
- Description of the replacement property (for example, the number and kind of the replacement livestock).

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, plus extensions. On this amended return, you must report the gain and pay any additional tax due.
- You acquire replacement property within the required replacement period, plus extensions, 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 part of the gain that cannot be postponed and pay any additional tax due.

Disaster Area Losses

Special rules 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.



A list of the areas warranting assistance under the Act for 2004 is available at the Federal Emergency Management Agency (FEMA) web site at www.fema.gov.

This part discusses the special rules for when to deduct a disaster area loss and what tax deadlines may be postponed. For other special rules, see Publication 547.

When to deduct the loss. If you have a deductible loss from a disaster that occurred in a Presidentially declared disaster area, you can choose to deduct that loss on your return or amended return for the tax year immediately preceding the tax year in which the disaster happened. If you make this choice, the loss is treated as having occurred in the preceding year.



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 choice to take your casualty loss for the disaster in the preceding year by the later 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.

Disaster relief grants. Do not include post-disaster relief grants received under the Disaster Relief and Emergency Assistance Act in your income if the grant payments are made to help you meet necessary expenses or serious needs for medical, dental, housing, personal property, transportation, or funeral expenses. Do not deduct casualty losses or medical expenses to the extent they are specifically reimbursed by these disaster relief grants. Unemployment assistance payments under the Act are taxable unemployment compensation.

Qualified disaster relief payments. Qualified disaster relief payments are not included in the income of individuals to the extent any expenses compensated by these payments are not otherwise compensated for by insurance or other reimbursement. These payments are not subject to income tax, self-employment tax, or employment taxes (social security, Medicare, and federal unemployment taxes). No withholding applies to these payments.

Qualified disaster relief payments include payments you receive (regardless of the source) for the following expenses.

- Reasonable and necessary personal, family, living, or funeral expenses incurred as a result of a Presidentially declared disaster.
- Reasonable and necessary expenses incurred for the repair or rehabilitation of a personal residence due to a Presidentially declared disaster. (A personal residence can be a rented residence or one you own.)
- Reasonable and necessary expenses incurred for the repair or replacement of the contents of a personal residence due to a Presidentially declared disaster.

Qualified disaster relief payments include amounts paid by a federal, state, or local government in connection with a Presidentially declared disaster to those affected by the disaster.



Qualified disaster relief payments do not include:

- Payments for expenses otherwise paid for by insurance or other reimbursements, or
- Income replacement payments, such as payments of lost wages, lost business income, or unemployment compensation.

Postponed tax deadlines. The IRS may postpone for up to 1 year certain tax deadlines of taxpayers who are affected by a Presidentially declared disaster. The tax deadlines the IRS may postpone include those for filing income and employment tax returns, paying income and employment taxes, and making contributions to a traditional IRA or Roth IRA.

If any tax deadline is postponed, the IRS will publicize the postponement in your area and publish a news release, revenue ruling, revenue procedure, notice, announcement, or other guidance in the Internal Revenue Bulletin (IRB).

Who is eligible. If the IRS postpones a tax deadline, the following taxpayers are eligible for the postponement.

- Any individual whose main home is located in a covered disaster area (defined next).
- Any business entity or sole proprietor whose principal place of business is located in a covered disaster area.
- Any individual who is a relief worker affiliated with a recognized government or philanthropic organization and who is assisting in a covered disaster area.
- Any individual, business entity, or sole proprietor whose records are needed to meet a postponed deadline, provided those records are maintained in a covered disaster area. The main home or principal place of business does not have to be located in the covered disaster area.
- Any estate or trust that has tax records necessary to meet a postponed tax deadline, provided those records are maintained in a covered disaster area.
- The spouse on a joint return with a taxpayer who is eligible for postponements.
- Any other person determined by the IRS to be affected by a Presidentially declared disaster.

Covered disaster area. This is an area of a Presidentially declared disaster area in which the IRS has decided to postpone tax deadlines for up to one year.

Abatement of interest and penalties. The IRS may abate the interest and penalties on the underpaid income tax for the length of any postponement of tax deadlines.

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. Also use this form if you have a gain from a casualty or theft on trade, business or income-producing property held for more than 1 year and you have to recapture some or all of your gain as ordinary income.

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 the following gains to Schedule D.

- Net gain shown on Form 4797 from an involuntary conversion of business property held for more than 1 year.
- Net gain shown on Form 4684 from the casualty or theft of personal-use property.

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.

12.

Self-Employment Tax

What's New for 2004

Tax rates and maximum net earnings. The maximum net self-employment earnings subject to the social security part (12.4%) of the self-employment tax increased to \$87,900 for 2004. There is no maximum limit on earnings subject to the Medicare part (2.9%).

What's New for 2005

Maximum net earnings. The maximum net self-employment earnings subject to the social security part of the self-employment tax for 2005 will be published in Publications 533 and 553. There is no maximum limit on earnings subject to the Medicare part.

Introduction

Self-employment tax (SE tax) is a social security and Medicare tax primarily for individuals who work for themselves. It is similar to the social security and Medicare taxes withheld from the pay of most 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 13 for information on employment taxes.

SE tax rate. The self-employment tax rate is 15.3%. The rate consists of two parts: 12.4% for social security (old-age, survivors, and disability insurance) and 2.9% for Medicare (hospital insurance).

Topics

This chapter discusses:

- Why you pay self-employment tax
- How to pay self-employment tax
- Who must pay self-employment tax
- Figuring earnings subject to self-employment tax
- Landlord participation in farming
- Methods for figuring net earnings
- Reporting self-employment tax

Useful Items

You may want to see:

Publication

- 533** Self-Employment Tax
- 541** Partnerships

Form (and Instructions)

- 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. Return of Partnership Income
- Sch K-1 (Form 1065)** Partner's Share of Income, Deductions, Credits, etc.

See chapter 16 for information about getting publications and forms.

Why Pay Self-Employment Tax?

Social security benefits are available to self-employed persons just as they are to wage earners. Your payments of SE tax contribute to your coverage under the social security system. Social security coverage provides you with retirement benefits, disability benefits, survivor benefits, and hospital insurance (Medicare) benefits.

How to become insured under social security. 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 (also called quarters of coverage).

Earning credits in 2004. You can earn a maximum of four credits per year. For 2004, you earn one credit for each \$900 of income subject to social security taxes. You need \$3,600 ($\900×4) of self-employment income and wages to earn four credits in 2004. It does not matter whether the income is earned in one quarter or is spread over two or more quarters.

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.



Making false statements to get or to increase social security benefits may subject you to penalties.

The 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 tax 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 your self-employment income.

How To Pay Self-Employment Tax

To pay SE tax, you must have a social security number (SSN) or an individual taxpayer identification number (ITIN). This section explains how to:

- Obtain an SSN or ITIN, and
- Pay your SE tax using estimated tax.



An ITIN does not entitle you to social security benefits.

Obtaining a social security number. If you never had an SSN, apply for one using Form SS-5, Application for a Social Security Card. The application is also available in Spanish. You

can get this form at any Social Security office or by calling 1-800-772-1213.



You can also download Form SS-5 from the Social Security Administration web site at www.ssa.gov.

If you have a social security number from the time you were an employee, you must use that number. Do not apply for a new one.

Replacing a lost social security card. 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.

Name change. If your name has changed since you received your social security card, complete Form SS-5 to report a name change.

Obtaining an individual taxpayer identification number. The IRS will issue you an ITIN if you are a nonresident or resident alien and you do not have and are not eligible to get an SSN. To apply for an ITIN, file Form W-7, Application for IRS Individual Taxpayer Identification Number. The application is also available in Spanish. You can get this form by calling 1-800-829-3676.



You can also download Form W-7 from the IRS website at www.irs.gov.

Paying estimated tax. Estimated tax is the method used to pay tax (including SE tax) on income not subject to withholding. You generally have to make estimated tax payments if you expect to owe tax, including SE tax, of \$1,000 or more when you file your return. Use Form 1040-ES, Estimated Tax for Individuals, to figure and pay the tax.

However, if at least two-thirds of your gross income for 2004 or 2005 was from farming and you file your 2005 Form 1040 and pay all the tax due by March 1, 2006, you do not have to pay any estimated tax. For more information about estimated tax for farmers, see Publication 505, Tax Withholding and Estimated Tax .

Penalty for underpayment of estimated tax. You may have to pay a penalty if you do not pay enough estimated tax by its due date.

Who Must Pay Self-Employment Tax?

You must pay SE tax and file Schedule SE (Form 1040) if your net earnings from self-employment were \$400 or more.



The SE tax rules apply no matter how old you are and even if you are already receiving social security or Medicare benefits.

Are you 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.

Share farmer. You are a self-employed farmer under an income-sharing arrangement if both 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.

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.

4-H Club or FFA project. If an individual participates in a 4-H Club or FFA project, any net income received 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 individual 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.

Partners in a partnership. Generally, you are self-employed if you are a member of a partnership that carries on a trade or business.

Limited partner. If you are a limited partner, your partnership earnings are generally not subject to SE tax. However, guaranteed payments you receive for services you perform for the partnership are subject to SE tax and should be reported to you in Box 14 of your Schedule K-1.

Husband and wife partners. You and your spouse may operate a farm as a partnership. If you and your spouse operate a farm as partners, report farm income and expenses on Form 1065, and attach separate Schedules K-1 showing each partner's share of earnings. Each spouse must report his or her share of partnership earnings on Form 1040 and file a separate Schedule SE (Form 1040) to report SE tax.

However, if your spouse is your employee, not your partner, you must withhold and pay social security and Medicare taxes for him or

her. For more information about employment taxes, see chapter 13.

Community income from a partnership. 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 earnings subject to SE tax. Do not treat any of your share as earnings of your spouse.

Figuring Earnings Subject to Self-Employment Tax

Farmer. If you are self-employed as a farmer, use Schedule F (Form 1040) to figure your earnings subject to SE tax. For information about figuring earnings on Schedule F, see chapter 15.

Partnership income or loss. If you are a member of a partnership that carries on a trade or business, the partnership should report your earnings subject to SE tax in box 14, code A, of your Schedule K-1 (Form 1065). Box 14 of Schedule K-1 may also provide amounts for gross farming or fishing income (code B) and gross non-farm income (code C). Use these amounts if you use the farm or nonfarm optional method to figure net earnings from self-employment (see *Methods for Figuring Net Earnings*, later).

If you are a general partner, you may need to reduce these reported earnings by amounts you claim as a section 179 deduction, unreimbursed partnership expenses, or depletion on oil and gas properties.

If the amount reported is a loss, include only the deductible amount when you figure your total earnings subject to SE tax.

For more information, see the Partner's Instructions for Schedule K-1.

For general information on partnerships, see Publication 541.

More than one business. If you have earnings subject to SE tax from more than one trade, business, or profession, you must combine the net profit (or loss) from each to determine your total net earnings subject to SE tax. A loss from one business reduces your profit from another business.

Community income. If any of the income from a farm or business, other than a partnership, is community income under state law, it is included in the earnings subject to SE tax of the spouse carrying on the trade or business.

Lost income payments. Lost income payments received from insurance or other sources for reducing or stopping farming activities are included in earnings subject to SE. These include USDA payments to compensate for lost income resulting from reductions in tobacco quotas and allotments. Even if you are not farming when you receive the payment, it is included in earnings subject to SE tax if it relates to your farm business (even though it is temporarily inactive). A connection exists if it is clear the payment would not have been made but for your conduct of your farm business.

Gain or loss. A gain or loss from the disposition of property that is neither stock in trade nor held primarily for sale to customers is not included in earnings subject to SE tax. It does not matter whether the disposition is a sale, exchange, or involuntary conversion. For example, gains or losses from the disposition of the following types of property are not included in earnings subject to SE tax.

- Investment property.
- Depreciable property or other fixed assets used in your trade or business.
- Livestock held for draft, breeding, sport, or dairy purposes, and not held primarily for sale, regardless of how long the livestock was held, or whether it was raised or purchased.
- Unharvested standing crops sold with land held more than one year.
- 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 included in earnings subject to SE tax if the cutting is treated as a sale or exchange. For more information on electing to treat the cutting of timber as a sale or exchange, see *Timber* in chapter 8.

Wages and salaries. Wages and salaries received for services performed as an employee and covered by social security or railroad retirement are not included in earnings subject to SE tax.

Wages paid in kind to you for agricultural labor, such as commodity wages, are not included in earnings subject to SE tax.

Retired partner. Retirement income received by a partner from his or her partnership under a written plan is not included in earnings subject to SE tax if all the following apply.

- The retired partner performs no services for the partnership during the year.
- The retired partner is owed only the retirement payments.
- The retired partner's share (if any) of the partnership capital was fully paid to the retired partner.
- 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 earnings subject to SE tax. However, income and deductions from farm rentals, including government commodity program payments received by a landowner who rents land, are included if the rental arrangement provides that the landlord will, and 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 earnings subject to SE tax

for the year you sell, exchange, give away, or use the crop shares if you meet one of the four material participation tests (discussed next) at the time the crop shares are produced. Feeding such crop shares to livestock is considered using them. Your gross income for figuring your earnings subject to SE tax 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 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 that, considered in their totality, show 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 a material participant.

Example. Drew Houston agrees to produce a crop on J. Clarke's cotton farm with each receiving half the proceeds. Clarke advises Houston when to plant, spray, and pick the cotton. 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 care of the cotton crop and his regular inspection of the crop 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.

Methods for Figuring Net Earnings

There are three ways to figure your net earnings from self-employment.

1. The regular method.
2. The farm optional method.
3. The nonfarm optional method.

You must use the regular method unless you are eligible to use one or both of the optional methods. See *Figure 12-1*, shown later.

Why use an optional method? You may want to use the optional methods (discussed later) when you have a loss or a small net profit 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. (An optional method may increase your earned income, which could increase your credit.)
- You are entitled to the earned income credit. (An optional method may increase your earned income, which could increase your credit.)
- You are entitled to the additional child tax credit. (An optional method may increase your earned income, which could increase your credit.)

Effects of using an optional method. Using an optional method could increase your SE tax. Paying more SE tax can result in your getting higher benefits when you retire.

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 SE tax or no SE 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 earnings in gross income, regardless of which method you use to determine SE tax.

Regular Method

Multiply your total earnings subject to SE tax 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.

Net earnings figured using the regular method are also called "actual net earnings."

Farm Optional Method

Use the farm optional method only for earnings from a farming business. You can use this method if you meet either of the following tests.

1. Your gross farm income is \$2,400 or less.

2. Your net farm profits are less than \$1,733.

Gross farm income. Your gross farm income is the total of the amounts from:

- Line 11, Schedule F (Form 1040), and
- Box 14, code B, Schedule K-1 (Form 1065), (from farm partnerships).

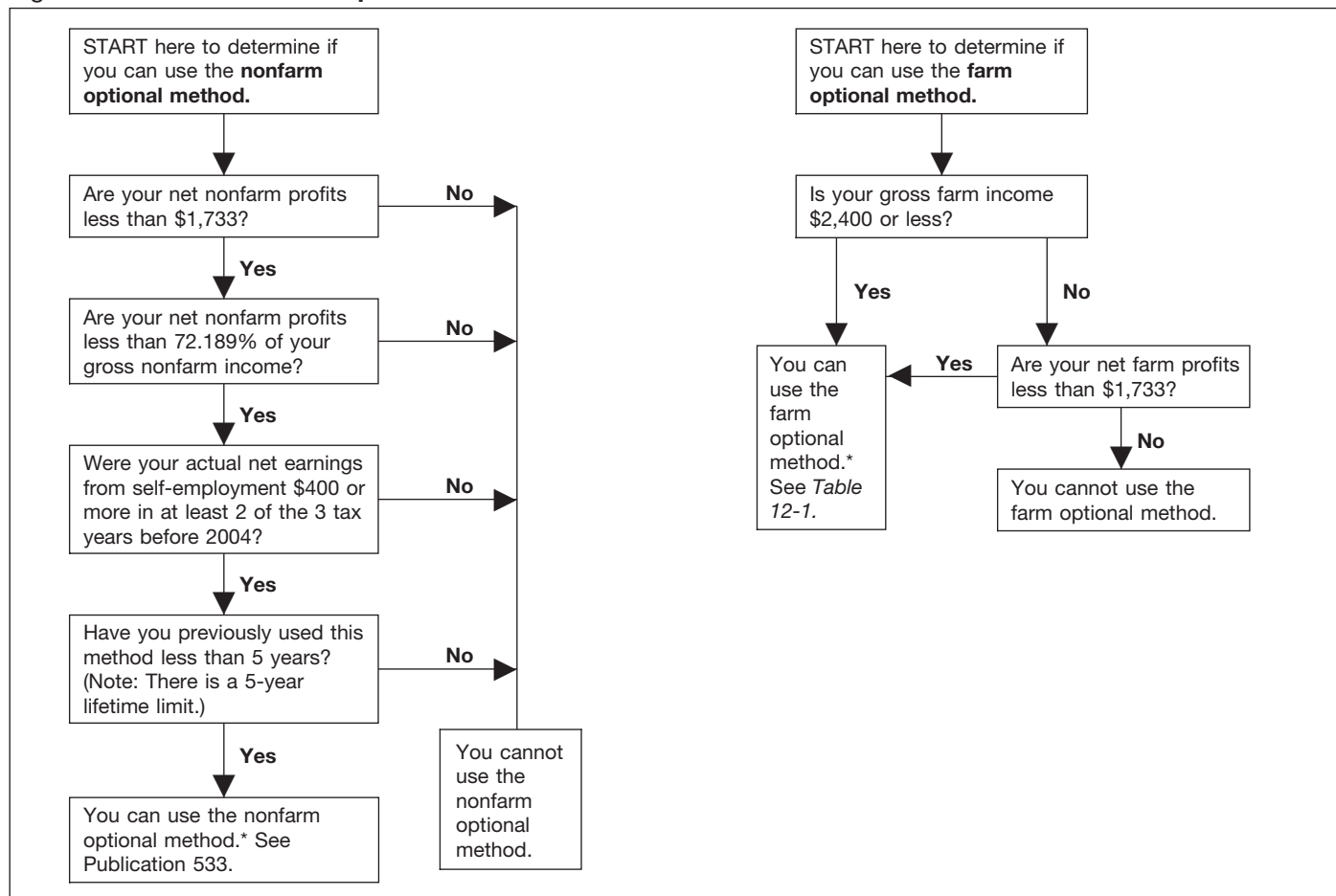
Net farm profits. Net farm profits generally is the total of the amounts from:

- Line 36, Schedule F (Form 1040), and
- Box 14, code A, Schedule K-1 (Form 1065), (from farm partnerships).

However, you may need to adjust the amount reported on Schedule K-1 if you are a general partner or if it is a loss. For more information, see *Partnership income or loss*, earlier.

Figuring farm net earnings. If you meet either of the two tests explained earlier, use Table 12-1, Figuring Farm Net Earnings, to figure your net earnings from self-employment under the farm optional method.

Figure 12-1. Can I Use the Optional Methods?



*If you use both optional methods, see *Using Both Optional Methods* for limit on the amount to report.

Table 12-1. Figuring Farm Net Earnings

IF your gross farm income is ...	THEN your net earnings are equal to...
\$2,400 or less	Two-thirds of your gross farm income.
More than \$2,400	The greater of: <ul style="list-style-type: none"> • \$1,600, or • Actual net earnings.*

* If actual net earnings are greater, you cannot use the farm optional method.

Optional earnings less than actual earnings.

If your gross farm income is \$2,400 or less and your farm net earnings are less than your actual net earnings, you can still use the farm optional method. Your actual net earnings are your net earnings figured using the regular method, explained earlier.

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 less than \$400.

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 earnings subject to SE tax from your nonfarm business. You can use this method even if you do not use the farm optional method for determining your earnings subject to SE tax and even if you have a net loss from your nonfarm business. For more information about the nonfarm optional method, see Publication 533.



You cannot combine farming income with nonfarm income from self-employment to figure your earnings subject to SE tax under either of the optional methods.

Using Both Optional Methods

If you use both optional methods, you must add the net earnings figured under each method to arrive at your total net earnings from self-employment. You can report less than your total actual farm and nonfarm net earnings but not less than actual nonfarm net earnings. If you use both optional methods, you can report no more than \$1,600 as your combined net earnings from self-employment.

Reporting Self-Employment Tax

Use Schedule SE (Form 1040) to figure and report your SE tax. Then, enter the SE tax on line 57 of Form 1040 and attach Schedule SE to Form 1040.

Most taxpayers can use Section A—Short Schedule SE to figure their SE tax. However, certain taxpayers must use Section B—Long Schedule SE. Use the chart on page 1 of Schedule SE (reproduced in chapter 15) to find out which one to use.



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.

Self-employment tax deduction. You can deduct half of your SE tax in figuring your adjusted gross income. This deduction only affects your income tax. It does not affect either your net earnings from self-employment or your SE tax.

To deduct the tax, enter on Form 1040, line 30, the amount shown on the Deduction for one-half of self-employment tax line of the Schedule SE.

Joint return. Even if you file a joint return, you cannot file a joint Schedule SE. This is true whether one spouse or both spouses have earnings subject to SE tax. Your spouse is not considered self-employed just because you are. If both of you have earnings subject to SE tax, each of you must complete a separate Schedule SE. However, if one spouse uses the Short Schedule SE and the other spouse has to use the Long Schedule SE, both can use the same form. 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*.

13.

Employment Taxes

What's New for 2005

Increase to FUTA tax deposit threshold. The Treasury Department recently amended Regulations section 31.6302(c)-3 to increase the accumulated FUTA tax deposit threshold from \$100 to \$500. The \$500 threshold applies to FUTA tax deposits required for taxes reported on Forms 940, 940-EZ, and 940-PR, Employer's Annual Federal Unemployment (FUTA) Tax Return, for tax periods beginning after December 31, 2004.

Additional federal holiday. January 20, 2005, is Inauguration Day and has been designated as a federal holiday for tax purposes. Tax returns due on that day may be filed on the next business day. Also, January 20, 2005, is not a banking day under federal tax deposit rules.

Wage limit for social security tax. The limit on wages subject to the social security tax for 2005 will be published in Publication 51 (Circular A), Agricultural Employer's Tax Guide. There is no limit on wages subject to the Medicare tax.

Household employees. Household employees, such as maids, babysitters, gardeners, or cooks, who perform domestic service on a farm operated for profit are not agricultural employees. However, they may still be employees for social security, Medicare, and federal unemployment taxes. See the instructions for Schedule H (Form 1040).

Reminder

Electronic deposits of taxes. You must use the Electronic Federal Tax Payment System (EFTPS) to make electronic deposits of all depository tax liabilities you incur in 2005 and thereafter if you deposited more than \$200,000 in federal depository taxes in 2003 or you had to use EFTPS in 2004.

See *Electronic Federal Tax Payment System (EFTPS) under Reporting and Paying 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.

You must also pay self-employment tax on your earnings from farming. See chapter 12 for information on self-employment tax.

Topics

This chapter discusses:

- Farm employment
- Family employees
- Crew leaders
- Social security and Medicare taxes
- Income tax withholding
- Advance payment of the earned income credit
- Reporting and paying social security, Medicare, and withheld income taxes
- Federal unemployment (FUTA) tax

Useful Items

You may want to see:

Publication

- 15** (Circular E), Employer's Tax Guide
- 15-A** Employer's Supplemental Tax Guide
- 15-B** Employer's Tax Guide to Fringe Benefits
- 51** (Circular A), Agricultural Employer's Tax Guide
- 926** Household 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 Federal Tax Return for Agricultural Employees
- 8109** Federal Tax Deposit Coupon

See chapter 16 for information about getting publications and forms.

Farm Employment

In general, you are an employer of farm workers if your employees do any of the following types of work.

- Raising or harvesting agricultural or horticultural products on a farm.
- Operating, managing, conserving, improving, or maintaining your farm and its tools and equipment.
- Handling, processing, or packaging any agricultural or horticultural commodity if you produced more than half of the commodity.
- Work related to cotton ginning, turpentine, or gum resin products.

For more information, see Publication 51 (Circular A).

Workers are generally 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, Employer's Supplemental Tax Guide.

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 (EIN). If you have employees, you must have an EIN. If

you do not have an EIN, request one on Form SS-4, Application for Employer Identification Number. The instructions for Form SS-4 provide information on how to apply for an EIN by telephone, internet, fax, or mail. Form SS-4 is available from either the IRS or the Social Security Administration (SSA). See chapter 16 for information about ordering this form.

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 Social Security Administration (SSA). Form SS-5 is available from any SSA office or by calling 1-800-772-1213. It is also available from the SSA's website at www.socialsecurity.gov.

The employee must furnish evidence of age, identity, and U.S. citizenship (or lawful alien status) with the Form SS-5. An employee who is age 18 or older must appear in person with this evidence at an SSA office.

Form I-9. You must verify that each new employee is legally eligible to work in the United States. This includes completing the Form I-9, Employment Eligibility Verification. Form I-9 is available from the U.S. Citizenship and Immigration Services (USCIS) offices or by calling 1-800-870-3676. It is also available from the USCIS website at www.immigration.gov. You can contact the USCIS at 1-800-375-5283 or 1-800-357-2099 for more information.

New hire reporting. You are required to report any new employee to a designated state new hire registry. Many states accept a copy of Form W-4 with employer information added. Call the Office of Child Support Enforcement at 202-401-9267 or visit its website at www.acf.dhhs.gov/programs/cse/newhire for more information.

Family Employees

Generally, the wages you pay to family members who are your employees are subject to employment taxes. However, certain exemptions may apply to wages paid to your child, spouse, or parent.

Exemptions for your child. Payments for the services of your child age 17 or younger who works for you in your trade or business (including a farm) are not subject to social security and Medicare taxes. However, see *Nonexempt services of a child or spouse*, later. Payments for the services of your child age 20 or younger employed by you in other than a trade or business, such as payments for household services in your home, are also not subject to social security or Medicare taxes. Payments for the services of your child age 20 or younger employed by you, whether or not in your trade or business, are not subject to federal unemployment (FUTA) taxes. Although not subject to social security, Medicare, or FUTA tax, the child's wages still may be subject to federal income tax withholding.

Exemptions for your spouse. Payments for the services of your spouse who works for you in your trade or business are subject to federal income tax withholding and social security and Medicare taxes, but not FUTA tax. However, payments for the services of your spouse em-

ployed by you in other than a trade or business, such as payments for household services in your home, are not subject to social security, Medicare, or FUTA taxes.

Nonexempt services of a child or spouse. Payments for the services of your child or spouse are subject to federal income tax withholding as well as social security, Medicare, and FUTA taxes if he or she works for any of the following entities.

- A corporation, even if it is controlled by you.
- A partnership, even if you are a partner. This does not apply to wages paid to your child if each partner is a parent of the child.
- 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 you.

Exemptions for your parent. Payments for the services of your parent employed by you in your trade or business are subject to federal income tax withholding and social security and Medicare taxes. Social security and Medicare taxes do not apply to wages paid to your parent for services not in your trade or business, but they do apply to payments for household services in your home if both the following conditions are satisfied.

- Your child lives in your home and is age 17 or younger or requires adult supervision for at least 4 continuous weeks in a calendar quarter due to a mental or physical condition.
- You are a widow or widower, divorced, or married to a person who, because of a physical or mental condition, cannot care for the child during such period.

Wages you pay to your parent are not subject to FUTA tax, regardless of the type of services provided.

Crew Leaders

If farm workers are provided by a crew leader, the crew leader may be the employer of the workers.

Social security and Medicare taxes. For social security and Medicare tax purposes, the crew leader is the employer of the workers if both of the following requirements are met.

- The crew leader pays (either on his or her own behalf or on behalf of the farmer) the workers for their farm labor.
- The crew leader 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 withholding. If the crew leader is the employer for social security and Medicare tax purposes, the crew leader is the

employer for federal income tax withholding purposes.

Federal unemployment (FUTA) tax. For FUTA tax purposes, the crew leader is the employer of the workers if, in addition to the earlier requirements, either of the following requirements are met.

- The crew leader is registered under the Migrant and Seasonal Agricultural Worker Protection Act.
- 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 the employer of workers furnished by a crew leader in all other situations. In addition, the farmer is 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 the employer in these cases. For information about common-law employees, see section 1 of Publication 15-A.

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.

- You pay the employee \$150 or more in **cash** wages during the year for farm work (the \$150 test).
- 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. Annual cash wages of less than \$150 you pay to a **seasonal** farm worker are not subject to social security and Medicare taxes, even if you pay \$2,500 or more to all your farm workers. However, these wages count toward the \$2,500 test for determining whether other farm workers' wages are subject to social security and Medicare taxes.

A seasonal farm worker is a worker who:

- Works as a hand-harvest laborer,
- Is paid piece rates in an operation usually paid on this basis in the region of employment,
- Commutes daily from his or her permanent home to the farm, and
- Worked in agriculture less than 13 weeks in the preceding calendar year.

See *Family Employees*, earlier, for certain exemptions from social security and Medicare

taxes that apply to your child, spouse, and partner.

Religious exemption. An exemption from social security and Medicare taxes is available to members of a recognized religious sect opposed to insurance. This exemption is available only if both the employee and the employer are members of the sect.

For more information, see Publication 517, *Social Security and Other Information for Members of the Clergy and Religious Workers*.

Cash wages. Only cash wages paid to farm workers are subject to social security and Medicare taxes. 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.socialsecurity.gov for more information.

Noncash wages. Noncash wages include food, lodging, clothing, transportation passes, and other goods and services. Noncash wages paid to farm workers, including commodity wages, are not subject to social security and Medicare taxes. However, they **are** subject to these taxes if the substance of the transaction is a cash payment.

Report the value of noncash wages 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* (unless the substance of the transaction is a cash payment).

Tax rates and social security wage limit. For 2005, the employer and the employee will each pay both the following taxes.

- 6.2% of cash wages for social security tax (old-age, survivors, and disability insurance).
- 1.45% of cash wages for Medicare tax (hospital insurance).

Wage limit. The limit on 2005 wages subject to the social security tax will be published in Publication 51 (Circular A). There is no limit on wages subject to the Medicare tax. All covered wages are subject to the Medicare 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. It 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.

Example. Jane operates a small family fruit farm. She employs day laborers in the picking season to enable her to timely get her crop to market. She does not deduct the employees' share of social security and Medicare taxes from their pay; instead, she pays it on their behalf. When her accountant, Susan, prepares the employees' Forms W-2, she adds each employee's

share of social security and Medicare taxes paid by Jane to the employee's wage income (box 1 of Form W-2), but does **not** include it in box 3 (social security wages) or box 5 (Medicare wages and tips).

Jane paid Mary \$1,000 during the year. Susan enters \$1,076.50 in box 1 of Mary's Form W-2 (\$1,000 wages plus \$76.50 social security and Medicare taxes paid for Mary). She enters \$1,000 in boxes 3 and 5.

Federal Income Tax Withholding

If the cash wages you pay farm workers are subject to social security and Medicare taxes, they are also subject to federal income tax withholding. Although noncash wages are subject to federal income tax, withhold income tax 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.

Form W-4. Generally, the amount of federal 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 federal income tax from the wages of an employee who, by filing Form W-4, certifies that he or she had no federal income tax liability last year and anticipates no liability for the current year.

You should give each new employee a Form W-4 as soon as you hire the employee. Have the employee complete and return the form to you before the first payday. If the employee does not return the completed form to you, you must withhold federal income tax as if the employee is single and claims no withholding allowances.

New Form W-4 for 2005. You should make the 2005 Form W-4 available to your employees and encourage them to check their income tax withholding for 2005. Those employees who owed a large amount of tax or received a large refund for 2004 may want to file a new Form W-4.

How to figure withholding. You can use one of several methods to determine the amount to withhold. The methods are described in Publication 51 (Circular A), which contains tables showing the correct amount of federal income tax you should withhold. Publication 51 (Circular A) also contains additional information about federal income tax withholding.

Nonemployee compensation. Generally, you are not required to withhold federal income 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.

Advance Payment of Earned Income Credit

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 usually required to make advance EIC payments to employees who give you a properly completed Form W-5, but you are not required to make these payments to farm workers paid on a daily basis.

The payment is added to the employee's pay each payday. It is figured from tables in Publication 51 (Circular A). You reduce your liability for federal income tax withholding, social security tax, and Medicare tax by the total advance EIC payments made. For more information, see Publication 51 (Circular A).

Notification. You must provide notification about the EIC to each employee who worked for you at any time during the year and from whom you did not withhold any income tax. However, you do not have to notify employees who claim exemption from federal income tax withholding on Form W-4.

You meet the notification requirement by giving each employee any of the following.

- Form W-2, which contains the notification on the back of Copy B.
- A substitute Form W-2 with the exact EIC wording shown on the back of copy B of Form W-2.
- Notice 797, Possible Federal Tax Refund Due to the Earned Income Credit (EIC).
- 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).

Reporting and Paying Social Security, Medicare, and Withheld Federal Income Taxes

You must withhold federal 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 the employer's share of social security and Medicare taxes.

Form 943. Report withheld federal income tax and social security and Medicare taxes on Form 943. The 2004 form is due by January 31, 2005

(or February 10 if the taxes were timely deposited in full).

Deposits. Generally, you must deposit both the employer and employee shares of social security and Medicare taxes and federal income tax withheld (minus any advance earned income credit payments) during the year. However, you may make payments with Form 943 instead of depositing them if you accumulate less than a \$2,500 tax liability during the year (line 11 of Form 943) and you pay in full with a timely filed return.

For more information on deposit rules, see Publication 51 (Circular A).

Electronic Federal Tax Payment System (EFTPS). You may have to deposit taxes using EFTPS. You must use EFTPS to make deposits of all depository tax liabilities (including social security, Medicare, withheld federal income, excise, and corporate income taxes) you incur in 2005 if you deposited more than \$200,000 in federal depository taxes in 2003. If you first meet the \$200,000 threshold in 2004, you must begin depositing using EFTPS in 2006. Once you meet the \$200,000 threshold, you must continue to make deposits using EFTPS in later years even if subsequent deposits are less than the \$200,000 threshold.

If you must use EFTPS but fail to do so, you may be subject to a 10% penalty.

If you do not have to use EFTPS because you did not meet the \$200,000 threshold, you can voluntarily make deposits using EFTPS. If you are using EFTPS voluntarily, you will not be subject to the 10% penalty if you make a deposit using a paper coupon.

For information about EFTPS, access the IRS website at www.eftps.gov or see Publication 966, Electronic Choices for Paying ALL Your Federal Taxes.

To enroll in EFTPS, call one of the following phone numbers.

- 1-800-945-8400
- 1-800-555-4477

Or to enroll online, visit www.eftps.gov.

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.

- The date the employee requests the form.
- The date you make your final payment of wages to the employee.

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 withheld tax not paid. 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 means voluntarily, consciously, and intentionally. Paying other expenses of the business instead of the taxes due is acting willfully.

Federal Unemployment (FUTA) Tax

You must pay FUTA tax if you meet either of the following tests.

- You paid cash wages of \$20,000 or more to farm workers in any calendar quarter during the current or preceding calendar year.
- 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 exempt services of your spouse, your parents, or your children under age 21. See *Family Employees*, earlier.

Alien farm workers. Wages paid to aliens admitted on a temporary basis to the United States to perform farm work (also known as H-2(A) visa workers) are exempt from FUTA tax. However, include your employment of these workers and the wages you paid them to determine whether you meet either test above.

Commodity wages. Payments in kind for farm labor are not cash 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 may still be allowed the full 5.4% credit.

If you do not pay the state tax, you cannot take the credit. 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 Publication 51 (Circular A).

Reporting and Paying FUTA Tax

The FUTA tax is imposed on you as the employer. It must not be collected or deducted from the wages of your employees.

Form 940. Report FUTA tax on Form 940, Employer's Annual Federal Unemployment (FUTA) Tax Return. The 2004 form is due January 31, 2005 (or February 10, 2005, if you deposit the tax on time and in full).

Form 940-EZ. You can use Form 940-EZ, a simplified version of Form 940, if you meet all the following tests.

- You paid unemployment contributions to only one state.

- You paid all state unemployment contributions by the due date of Form 940 or 940-EZ.
- All wages subject to FUTA tax were also subject to your state's unemployment tax.
- Your state has not been designated a "credit reduction state" by the U.S. Department of Labor.

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 following month. 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 \$100 or less, you can either make a deposit or pay it with your return by the January 31, 2005, due date.



For tax periods beginning after December 31, 2004, the accumulated FUTA tax deposit threshold increases from \$100 to \$500.

Electronic deposit requirement. If you are subject to the electronic deposit requirement, you must use EFTPS to deposit FUTA tax. See *Reporting and Paying Social Security, Medicare, and Withheld Income Taxes*, earlier, for a discussion of the requirement for making deposits electronically.

14.

Excise Taxes

Reminders

Dyed diesel fuel and dyed kerosene. Dyed diesel fuel and dyed kerosene used for a nontaxable use (such as use on a farm for farming purposes) are not taxed. However, the tax applies if these fuels are used for a taxable use (such as in operating a highway vehicle on the highway). In addition, a penalty is imposed on a person who uses dyed diesel fuel or dyed kerosene for a taxable use and knows or has reason to know the fuel was dyed. For more information, 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 credit or refund of the excise tax on that fuel. Farmers **cannot** claim a credit or refund 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 the 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 nontaxable uses of fuel for which a farmer may claim a credit or refund are generally the following.

- Use 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 14-1 presents an overview of credits and refunds that may be claimed 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 or other than as a fuel
- 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 2005

Form (and Instructions)

- ☐ **720** Quarterly Federal Excise Tax Return
- ☐ **4136** Credit for Federal Tax Paid on Fuels
- ☐ **8849** Claim for Refund of Excise Taxes

See chapter 16 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 can claim only a credit for the tax on gasoline, gasohol, and aviation gasoline used on a farm for farming purposes. You can 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.

Fuel is used on a farm for farming purposes only if used in carrying on a trade or business of farming, on a farm in the United States, and for farming purposes.

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 cat-

Table 14-1. 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 or Use Other Than as a Fuel ¹
Gasoline and gasohol	Credit only	Credit or refund	None
Aviation gasoline	Credit only	None	None
Undyed diesel fuel and undyed kerosene	Credit or refund by registered ultimate vendor only	Credit or refund ²	Credit or refund ²
Dyed diesel fuel and dyed kerosene	None	None	None
Aviation fuel	Credit or refund	None	Credit or refund

¹For a use other than as fuel in a propulsion engine.

²Applies to undyed kerosene not sold from a blocked pump or, under certain circumstances, for blending with undyed diesel fuel to be used for heating purposes.

tle. 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.

Farming purposes. As the owner, tenant, or operator and the ultimate purchaser of fuel that you purchased, you use the 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 and its tools and 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 so treated during the tax year. The more-than-one-half test applies separately to each commodity. Commodity means a single raw product. For example, apples and peaches are two separate commodities.
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 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 list items (1) or (2), above, you are considered to be the ultimate purchaser who used the fuel on a

farm for farming purposes. Therefore, 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 list items (1) or (2), no one can claim the credit or refund for fuel used on your farm for those other services.

Example. Farm owner Haleigh Blue hired custom operator Tyler Steele to cultivate the soil on her farm. Tyler used 200 gallons of gasoline that he purchased to perform the work on Haleigh's 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. Haleigh can claim the credit for the 200 gallons of gasoline used by Tyler 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 used by Brown because they were not used for a farming purpose included in list items (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 equally share the cost of gasoline used on the farm, each can claim a credit for the tax on half the fuel used.

Undyed diesel fuel and undyed kerosene. If undyed diesel fuel or undyed kerosene is used on a farm for farming purposes, the credit or refund is allowed only to the registered ultimate vendor. You **cannot** claim a credit or refund 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 purposes. To claim

a credit or refund of tax, the person 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, can claim the credit or refund for the fuel (other than for undyed diesel fuel or undyed kerosene). Or you can waive your right to the credit or refund and allow the applicator to make the claim. If you waive your right, the applicator is treated as having used the fuel on a farm for farming purposes and can claim the credit or refund. See *How To Claim a Credit or Refund*, later.

To waive your right to the credit or refund, you must take the following actions.

- Before the applicator files his or her claim, sign an irrevocable agreement stating that you knowingly give up your right to the credit or refund. You can authorize an agent, such as a cooperative, to sign the waiver for you.
- Identify clearly the period the waiver covers.

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 can be a separate document or it can 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.

The effective period of the waiver cannot extend beyond your taxable year. When the period covered by the waiver extends beyond the applicator's tax year, the applicator can only claim a credit or refund for the part of the waiver period that includes the applicator's tax year. The applicator must wait until the next tax year to file a claim for the part of the waiver period that extends beyond the applicator's tax year.

While no specific form is required, an acceptable waiver of your right to claim a credit or refund is shown in *Table 14-2*.

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.

Table 14-2. 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>

Table 14–3. 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 or kerosene 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 or kerosene 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

You must give the vendor a signed certificate, which should be substantially the same as the sample certificate shown in *Table 14-3*. You can include the certificate as part of any business records you normally keep to document a sale and purchase.



Farmers cannot claim a credit or refund for the tax on undyed kerosene or undyed diesel fuel sold for use on a farm for farming purposes or undyed kerosene sold from a blocked pump. Only the registered ultimate vendor can claim the credit or refund under these circumstances.

Fuels Used in Off-Highway Business Use

You may be eligible to claim a credit or refund for the excise tax on fuel used in an off-highway business use.

Off-highway business use. This is any use of fuel in a trade or business or in an 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.

Examples. Off-highway business use includes the use of fuels in any of the following ways.

- In stationary machines such as generators, compressors, power saws, and similar equipment.
- For cleaning purposes.
- In forklift trucks, bulldozers, and earthmovers.

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, see Publication 378.

Fuels Used for Household Use or Other Than as a Fuel

You may be eligible to claim a credit or refund for the excise tax on undyed kerosene used for home use or used other than as a fuel. This applies to undyed kerosene you purchased and used in your home for heating, lighting, and cooking. Home use is considered a use other than as a fuel in a propulsion engine. It is not considered an off-highway business use.

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 use, you could be subject to the excise tax and a penalty. For example, if a truck used on a farm for farming purposes is also used on the highway (even though in connection with operating the farm), tax applies to the gallons of diesel fuel used (or sold for use) in operating the truck on the highways.

You can buy **undyed** diesel fuel and **undyed** kerosene tax free from a registered ultimate vendor for use on a farm for farming purposes. 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 included in items (1) and (2) listed earlier under *Farming purposes*.

Table 14-4. Claiming a Credit or Refund of Excise Taxes

This table 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, Credit for Federal Tax Paid on Fuels	Form 8849, Claim for Refund of Excise Taxes
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 ¹

¹You may carryover an amount less than \$750 to the next quarter.

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. The basic rules for claiming credits and refunds are listed in *Table 14-4*.



Keep at your principal place of business all records needed to enable the IRS to verify that you are the person entitled to claim a credit or refund and the amount you claimed. You do not have to use any special form, but the records should establish 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 separately show 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 may claim a refund during the year instead of waiting until you file your tax return.

Credit only. You can claim the following taxes only as a credit.

- Tax on gasoline you used on a farm for farming purposes.
- Tax on fuels you used for nontaxable uses if the total for the tax year is less than \$750.
- Tax on fuel you did not include in any claim for refund previously filed for any quarter of the tax year.

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 the "Other payments from" line of your 2004 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.

Partnership. Partnerships (other than electing large partnerships) claim the credit by including a statement on Schedule K-1 (Form 1065), Partner's Share of Income, Deductions, Credits, etc., showing each partner's share of the number of gallons of each fuel sold or used for a nontaxable use, the type of use, and the applicable credit per gallon. 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 the "Other payments" line of Form 1065-B, U.S. Return of Income for Electing Large Partnerships.

Other entities. Corporations, S corporations, farmers' cooperative associations, and trusts make the claim on the line for "credit for Federal tax paid on fuels" of the applicable income tax return.

When to claim a credit. You can claim a fuel tax credit on your income tax return for the year you used the fuel.



You may be able to make a fuel tax claim on an amended income tax return for the year you used the fuel. Generally you must file an amended return by the later of 3 years from the date you filed your original return or within 2 years from the date you paid the income tax.

Claiming a Refund

You make a claim for refund of the excise tax on fuel on **Form 8849**.

Do not claim a refund on Form 8849 for any excise tax for which you have filed or will file a claim on Schedule C (Form 720) or Form 4136.

You may 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 on all fuels used for a nontaxable use during that quarter or any prior quarter (for which no other claim has been filed) during the tax year.

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 using Form 4136. Only one claim can be filed for a quarter.



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 tax.

How to file a quarterly claim. File the claim for refund 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 claimed the total cost of the fuel (including the excise taxes) 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 amount 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 amount 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 amount in gross income for the tax year in which you receive the credit.

Example. Sharon Brown, a cash basis farmer, filed her 2004 Form 1040 on March 3, 2005. On her Schedule F, she deducted the total cost of gasoline (including \$110 of excise taxes) used on the farm for farming purposes. Then, on Form 4136, she claimed the \$110 as a credit. Sharon reports the \$110 as other income on line 10 of her 2005 Schedule F.

Accrual method. If you use an accrual method, include the amount of credit or refund in gross income for the tax year in which you used the fuels. It does not matter whether you filed for a quarterly refund or claimed the entire amount as a credit.

Example. Patty Green, an accrual basis farmer, files her 2004 Form 1040 on April 15, 2005. On Schedule F, she deducts the total cost of gasoline (including \$155 of excise taxes) she used on the farm for farming purposes during 2004. On Form 4136, Patty claims the \$155 as a credit. She reports the \$155 as other income on line 10 of her 2004 Schedule F.

15.

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 2 for an explanation of the cash method and other methods of accounting.

Rounding off to whole dollars. You may round off cents to whole dollars on your return and schedules. If you do round to whole dollars, you must round all amounts. To round, drop amounts under 50 cents and increase amounts from 50 to 99 cents to the next dollar (for example, \$1.39 becomes \$1 and \$2.50 becomes \$3).

If two or more amounts must be added to figure the amount 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 profit 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 personal or business-related 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 Form 1040, line 40. If this is the case, see *Losses From Operating a Farm* in chapter 4.

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. 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. (Farm income is discussed in chapter 3.) He uses this information to complete Part I of Schedule F.

Line items. He fills in all applicable items of farm income.

Line 1. In 2004, he sold steers he had bought for resale. He enters sales of \$27,192.

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, \$20,669, 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 livestock held for draft, breeding, sport, or dairy purposes. He reports those sales on Form 4797.

Line 4. He enters the income he received during 2004 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, \$263,018, includes sales of all of the following.

Milk	\$233,874
Steers and calves he raised*	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	\$263,018

* Raised other than for draft, breeding, sport, or dairy purposes.

Lines 5a and 5b. He reports the \$33 he received from cooperatives on line 5a. Since this is the dollar amount of a qualified written notice of allocation paid as part of a patronage dividend, he enters \$33 as the taxable amount on line 5b.

Lines 6a and 6b. He received Farm Service Agency (FSA) cost-sharing payments of \$438 on a soil conservation project (diversion channels) completed in 2004. 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) generally reports such payments to the recipient on Form 1099-G. The entire \$438 has been included on Schedule F, line 14, 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 on lines 7b and 7c in the year of forfeiture.

Line 9. He reports his \$1,258 of income from custom harvesting.

Line 10. On his 2003 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 2004 income on line 10 because he deducted the total cost of gasoline (including the \$142 of excise taxes) as a farm business expense in 2003. He also includes \$250 he received as a director of the local milk marketing cooperative and \$175 received for firewood he cut and sold in 2004.

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. (Farm business expenses are discussed in chapter 4.) This gives him his deductible expenses, which he enters in Part II of Schedule F.

Line items. He 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 2004 was \$2,659. He uses his family car 60% for business (determined by records at year end). It cost \$2,307 to operate the car in 2004. He can deduct \$1,384 for the car ($\$2,307 \times .60$). He enters a total of \$4,043 ($\$2,659 + \$1,384$) 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 2004. The amount listed here includes the full cost of the government cost-sharing project, which he has reported as income on line 6b. He continues the policy elected in previous years of deducting annual soil and water conservation expenses. The expenses are consistent with a conservation plan approved by the Natural Resources Conservation Service of the USDA. The amount was not more than 25% of Mr. Brown's gross income from farming, so the entire amount is deductible. See chapter 5 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 \$141,061 depreciation from Form 4562, discussed later.

Line 18. He enters the \$18,019 cost of feed bought for consumption by his livestock in 2004. 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 on 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 4.

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. He deducts his home mortgage interest 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 that would reduce the amount of wages entered. For those wages paid that were subject to social security and Medicare taxes, 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 13 for information on employment taxes.

Line 26b. He enters only the \$2,400 cash rent paid 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 or the cost of repairs on his home. He prepared Form 1099-MISC for the farm machinery repairs because the repair shop is a limited liability company (LLC) that is not classified as a corporation. He sent Copy A to the IRS with Form 1096 and gave copy B to the owner of the repair shop. If the repair shop had been a corporation, Mr. Brown would not have had to file a Form 1099-MISC. He does not have to file a Form 1099-MISC for the building repair because he paid less than \$600.

Line 28. He enters the \$2,132 cost of seeds and plants used in farming. He deducts these costs each 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 2004, 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 because this tax was included in the cost for supplies he deducted on line 30. He also did not include the gasoline tax on the gasoline bought for farm use, including the gasoline used in his trucks and family car for farm business, because these taxes were included in the costs for gasoline he deducted on lines 21 and 12. He included his share of social security and Medicare taxes paid for agricultural employees. He filed Form 943 (not shown) in January 2005, reporting these taxes for calendar year 2004.

He does not deduct, on Schedule F, his state income tax or the taxes on his home and the part of 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 personal utilities. He also cannot deduct the cost of basic local telephone service (including any taxes) for the first telephone line to his home.

Line 33. He enters \$3,251, the total paid during 2004 for veterinary fees (\$1,855), 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 (\$230,500) from the amount on line 11 (\$286,648). His net farm profit, entered on line 36, is \$56,148. He also enters that amount on Form 1040, line 18, and on Schedule SE (Form 1040), Section A, line 1. 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 1994 and fully depreciated in 1999. No depreciation is allowed for 2004.

Depreciation record. He records information on his depreciable property in a book that he can use to figure his depreciation allowance for sev-

eral years. He uses the Depreciation Worksheet from the Form 4562 instructions to figure his 2004 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 allocated 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 allocation on the purchase date in proportion to (but not in excess of) the FMVs of the assets and in the required asset 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 (no office claimed) 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 Accelerated Cost Recovery System (ACRS) method for his machine shed placed in service in 1986. He chose the following systems for all of his assets placed in service in the year indicated using the Modified Accelerated Cost Recovery System (MACRS) and the half-year convention.

- 2000 - straight line Alternative Depreciation System (ADS).
- 2001, 2002, and 2004 -150% declining balance General Depreciation System (GDS).

Depreciable property. One of his purchased dairy cows (#42) was killed by lightning in July 2004. Two other purchased cows (#52 and #60) were sold in 2004. 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 2004.

He has other breeding and dairy cows he raised. He did not claim depreciation on them since his basis in the cows is zero for income tax purposes.

During 2004 the Browns owned two family cars. One of them was not used for farm business so Mr. Brown cannot deduct depreciation on it. Based on his written records, he determined at the end of the year 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 2004. He must list each item separately to keep track of its basis. The pickup truck and car purchased in 2001 are listed property in the 5-year property class.

New assets. Mr. Brown added three assets to his farming business in 2004.

1. In January, he completed and placed in service a dairy facility designed specifically for the production of milk and to house, feed, and care for dairy cattle (single purpose livestock structure). The construction of the dairy facility began in 2003. 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 July, he acquired a new tractor (tractor #5) by trading tractor #2 and paying \$33,729 cash. The adjusted basis of tractor #2 was \$1,378 when it was traded. The new tractor has a basis of \$35,107 (\$33,729 + \$1,378). Mr. Brown makes a new entry on his Depreciation Worksheet for the exchanged basis (the \$1,378 carryover basis of tractor #2). He chooses to take the 50% special depreciation allowance on the exchanged basis. After reducing this basis by the allowance (\$689), the remaining basis (\$689) is depreciated over the remaining life of tractor #2, using the same depreciation method and recovery period. The depreciation for the last six months of the year is \$34.45 for the exchanged basis. Mr. Brown made a new entry on his Depreciation Worksheet to depreciate the \$33,729 of new excess basis in tractor #5 over the new 7-year life of tractor #5. 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 2004 and depreciated the rest of the new excess basis.



Temporary regulations were issued to provide more flexibility for computing depreciation deductions when property is acquired in a like-kind exchange. These regulations are reflected in the transactions above. For details, see chapter 7 and the Instructions for Form 4562.

Line items. Form 4562 is completed by referring to the Depreciation Worksheet.

Line 2. Mr. Brown enters \$162,229 on line 2. This is the total cost of all section 179 property placed in service in 2004. In figuring his cost, he does not include the portion of the new basis in the acquired tractor that was carried over from 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 and dairy equipment) 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 and the dairy equipment. He enters his cost basis of \$33,729 for the tractor and \$72,000 for the dairy equipment, in column (b). He then enters the tentative deduction, \$30,000 for the tractor and \$72,000 for the dairy equipment, in column (c). However, this amount is subject to the business income limit on line 11. (The total cost of his section 179 property (\$162,229) did not exceed the investment limit, \$410,000, and he is therefore subject to the maximum dollar limit, \$102,000.)

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 \$102,000 on lines 11 and 12. See chapter 7 for information on the section 179 deduction.

Line 14. He enters \$31,454 for the special depreciation allowance for the properties that qualify.

The allowance is an additional 50% of the qualified property's cost or basis (after subtracting the section 179 deduction). However, instead of claiming the 50% allowance, taxpayers can elect to claim the 30% allowance or elect not to claim any special allowance.

Line 16. He enters \$312 for his other depreciation. The \$312 is for the asset depreciated under ACRS (alternate method).

Line 17. He enters \$2,708. This is his MACRS depreciation for assets placed in service from 2000 through 2002 and the exchanged basis of the tractor received in the like-kind exchange.

Line 19. All property placed in service in 2004 in each class is combined and entered in Part III. 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 21. He enters his depreciation deduction for listed property, \$2,244, on line 21. This is the total shown on line 28 of the form. He has two depreciable assets that are listed property—the car used 60% for business and the pickup truck purchased in 2001. 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 22. He enters the total depreciation on line 22 and carries the total, \$141,061 to Schedule F, line 16.

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 24a and 24b of Section A and lines 30 through 36 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, \$56,148. All the income, losses, and deductions listed on Schedule F are included in determining net earnings from farm self-employment (see the types of self-employment income listed in chapter 12). 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 one or more other businesses 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 \$51,853 on line 4.

Lines 5 and 6. He multiplies line 4 by 15.3% and enters \$7,934 on line 5. This is his self-employment tax for 2004. He also enters \$7,934 on line 57 of Form 1040. He enters \$3,967 on line 6 and also on Form 1040, line 30 (deduction for one-half of his self-employment tax).

Form 4684-Casualties and Thefts

Mr. Brown's only business casualty occurred on July 7 when a dairy cow he purchased 4 years ago was killed by lightning. He shows the loss from the casualty on page 2 of Form 4684. Only page 2 is shown, because page 1 is for nonbusiness casualties.

He prints his name, his wife's name, and his identifying number at the top of page 2.

Part I. He prints 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. Line 20 is more than line 21, so he skips line 22. On lines 23 and 24, he enters the FMVs before and after the casualty (\$500 and \$0, respectively), 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. He owned the cow for more than one year, so he identifies the casualty on line 34 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 (Form 1040) and Section B of Form 4684, Mr. Brown fills in Form 4797 to report the sales of business property. See Table 9-1 in chapter 9 for the types of property 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 2004 at a gain. They consisted of a truck, a mower, and a purchased dairy cow, #60. He has information about their cost and depreciation in his records. Only the dairy cow appears on the Depreciation Worksheet. The truck and mower were fully depreciated.

He sold the truck on July 9, the mower on August 12, and the cow on October 28. Since the gains on these items were gains from dispositions of depreciable personal property, as explained in chapter 9, he must determine the part of the gain for each item 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.

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 the cow 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 Part II, line 13.

He subtracts line 31 from line 30 and enters -0- on line 32. He has no long-term capital gain on the dispositions. All his gain is ordinary income.

Part I. All 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 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 9-1 in chapter 9 for where to report items on Form 4797.

He combines the gains and loss on line 2(g) and enters \$12,740 on line 7(g). He has no nonrecaptured net section 1231 losses from prior years, so 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. Based on the instructions for line 7, he enters \$12,740 as a long-term capital gain on Schedule D, line 11(f).

Part II. Mr. Brown enters on line 10 the \$250 gain from the sale of a raised dairy heifer held less than 24 months for breeding purposes. He had previously entered the \$852 gain from Part III, line 31, on line 13 and the \$148 loss from Form 4684 on line 14. He totals lines 10 through 16 and enters \$954 on line 17. He carries the

gain from line 17 to line 18b and shows it as ordinary income on Form 1040, line 14.

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 2004 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 (f) on line 1.

Lines 8 and 10. He enters in column (f) on line 8 his \$745 long-term gain on the sale of Circle Corporation stock held more than one year. He includes the gross sales price in column (d) on lines 8 and 10.

Line 11. Mr. Brown had previously entered on line 11 the gain from line 7(g) of Form 4797.

Line 15. He combines the column (f) amounts on lines 8 and 11 and enters the result on line 15.

Line 16. In Part III, he combines lines 7 and 15 and enters his total capital gain on line 16. He also enters this amount on Form 1040, line 13.

After he completes his Form 1040 through line 42, he will use the Qualified Dividends and Capital Gain Tax Worksheet (in the Form 1040 instructions) and the Schedule J (Form 1040), Income Averaging for Farmers and Fishermen, to determine which one yields the lowest tax.

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. He also checks the box in column (4) for his youngest son who is a qualifying child for the child tax credit.

Line 7. Mrs. Brown worked part time as a substitute teacher for the county school system during 2004. She also worked for Mr. Brown on the farm during 2004. 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 9a. 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 2004. Therefore, he constructively received it and correctly included it in his income for 2004. He enters the \$220 in ordinary dividends he received from the Circle Real Estate Investment Trust on line 9a. They

are not qualified dividends so he made no entry on line 9(b).

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 Schedule F, Part I, lines 5a and 5b.

He did not receive more than \$1,500 in interest or \$1,500 in dividends and none of the other conditions listed at the beginning of the Schedule B instructions applied, so 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 16.
- His other gain on line 14 from Form 4797, line 18b.
- 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, \$80,082.

Line 30. He has already entered one-half of his self-employment tax, \$3,967, which he figured on Schedule SE.

Line 31. He paid premiums of \$7,200 during 2004 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, \$7,200, on line 31.

Line 35. He adds the amounts on lines 23 through 34a and enters the total, \$11,167, on line 35.

Lines 36 and 37. He subtracts line 35 from line 22 to get his adjusted gross income and enters the result, \$68,915, on line 36 and also on line 37 of page 2.

Form 1040, Page 2

Mr. Brown fills in the following lines on page 2 of Form 1040.

Line 39. He enters \$15,000 from his Schedule A (Form 1040), which is not shown, because the total of his itemized deductions is larger than the \$9,700 standard deduction for his filing status (married filing jointly).

Lines 40, 41, and 42. He subtracts the \$15,000 on line 39 from the \$68,915 on line 37 and enters the result, \$53,915 on line 40. He enters \$15,500 ($5 \times \$3,100$) on line 41 and subtracts this amount from the amount on line 40 to get a taxable income of \$38,415 on line 42.

Line 43. He enters \$3,568 from Schedule J, line 22. For information on how he figured his tax using income averaging, see *Schedule J (Form 1040)*, later.

Line 45. Mr. Brown determined that they do not owe alternative minimum tax (line 44). Therefore, he enters on line 45 the same tax shown on line 43.

Line 51. 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, \$1,000, on line 51.

Lines 55 and 56. He adds the amounts on lines 46 through 54 and enters the total, \$1,000, on line 55. He subtracts that amount from the tax on line 45 and enters \$2,568 on line 56.

Line 57. He has already entered the \$7,934 self-employment tax he figured on Schedule SE.

Line 62. He adds the amounts on lines 56 through 61 and enters \$10,502, which is the total tax for 2004.

Line 63. He enters the income tax withheld from Mrs. Brown's wages, \$1,435, as shown on the Forms W-2 she received. He attaches a copy of her Forms W-2 to the front of Form 1040.

Line 64. He did not make 2004 estimated tax payments since two-thirds of his gross income for 2003 was from farming. He was sure that at least two-thirds of his gross income for 2004 would again be from farming. Farmers who meet either of these conditions do not have to make 2004 estimated tax payments. If he files his Form 1040 and pays the tax due no later than March 1, 2005, he will not be penalized for failure to pay estimated taxes. He makes no entry on line 64.

Line 65. The Browns are not entitled to claim the earned income credit on line 65, because their adjusted gross income is more than \$35,458.

Line 67. The Browns are not entitled to claim the additional child tax credit because they received the maximum amount of child tax credit they were entitled to on line 51.

Line 69. Mr. Brown enters his credit for \$350 of federal excise tax on gasoline used in 2004. He checks box "b" and attaches Form 4136 (not shown) to his return, showing how he figured the credit. He must report the credit as other income on his Schedule F for 2005, because his deduction for the total cost of gasoline (including the \$350 of excise taxes) as a farm business expense on Schedule F reduced his 2004 taxes.

Lines 70 and 74. He adds the amounts on lines 63 through 69 and enters the total, \$1,785, on line 70. He subtracts that figure from the amount on line 62. The balance, \$8,717, is entered on line 74.

Schedule J (Form 1040) Income Averaging for Farmers and Fishermen

In 2004, Mr. Brown's taxable income, \$38,415, is substantially higher than in each of the 3 previous years. His taxable income amounts were only \$2,500, \$1,050, and \$700 for 2003, 2002, and 2001, respectively. He elects to use income averaging by completing Schedule J to figure his tax.

He prints his name, his wife's name, and his identifying number at the top of Schedule J.

First, he uses the Qualified Dividends and Capital Gain Tax Worksheet in the Form 1040

instructions to figure his tax without regard to income averaging. Next, he uses Schedule J to figure his tax using income averaging.

Line items. He fills in the lines on Schedule J.

Line 1. He enters \$38,415, his taxable income from line 42 of Form 1040.

Line 2. He enters the part of his farm income he is electing to average, \$24,117. He elects to treat this elected farm income as all coming out of his \$56,148 of ordinary farm income from Schedule F. He could have elected to treat up to \$12,740 of it as coming out of his gain from the sale of farm assets (other than land) that are reported in Part I of Form 4797. Reducing his ordinary income by this amount 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 \$14,298 on line 3.

Line 4. Because he has capital gains and losses this year, he computes the tax on \$14,298 using the Qualified Dividends and Capital Gain Tax Worksheet and enters the result, \$758, on line 4. In this example, he decided to treat the elected farm income as all coming from his ordinary income. However, he could have made a different election to use some or all of the capital gains for 2004. In that case, the calculation for this line would have been made by reducing his capital gains for 2004 by the amount included in elected farm income and, unless all of the capital gains for 2004 were included in elected farm income, using the Qualified Dividends and Capital Gain Tax Worksheet to compute the tax on line 4.

Lines 5, 9, and 13. He enters his taxable income from 2001, 2002, and 2003 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, \$8,039, 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 for the appropriate year and enters the results on lines 8, 12, and 16, respectively. In this example, he decided to treat the elected farm income as all coming from his ordinary income for 2004 and he added one-third of the elected farm income to the ordinary income of each of the previous 3 years. His income is taxed at no more than a 15% rate for each year. However, if he had made a different election to use some or all of the capital gains for 2004, one-third of that amount would be treated as capital gains for each of the previous 3 years and the tax on lines 8, 12, and 16 would be calculated using the appropriate Schedule D. The gains would be taxed at the appropriate capital gains rate for the previous years.

Line 17. He adds the amounts on lines 4, 8, 12, and 16 and enters the total, \$4,032, on line 17.

Lines 18, 19, and 20. He enters his tax from his 2001, 2002, and 2003 returns on lines 18, 19, and 20, respectively.

Line 21. He adds the amounts on lines 18, 19, and 20 and enters the total, \$464, on line 21.

Line 22. He subtracts the amount on line 21 from the amount on line 17 and enters \$3,568 on line 22. The tax on this line is less than the \$3,703 of tax he figured using the Qualified Dividends and Capital Gain Tax Worksheet. Therefore, he enters on line 43 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 at the bottom of page 2 of Form 1040. (If they had paid a preparer to do their tax return, the preparer would also sign the return and provide the information requested at the bottom of the page.) Mr. Brown prints in his name, his wife's name, and their address in the label section. He writes his and his wife's social security numbers in the boxes next to the label section.

He writes a check payable to the United States Treasury for the full amount on line 74 of Form 1040. On the check, he writes his social security number, their telephone number, and "2004 Form 1040." His name and address are printed on the check. Mr. Brown could have chosen instead to pay his taxes by credit card (American Express® Card, Discover® Card, MasterCard® card, or Visa® card). For information about how to pay by credit card, see the Form 1040 Instructions.

After making a copy of their complete return for his records, he assembles the various forms and schedules behind Form 1040 in the following order, based on the Attachment Sequence Number shown in the upper right corner of each schedule or form and included after each item listed below.

1. Schedule A. (07) (not shown)
2. Schedule D. (12)
3. Schedule F. (14)
4. Schedule SE. (17)
5. Schedule J. (20)
6. Form 4136. (23) (not shown)
7. Form 4684. (26)
8. Form 4797. (27)
9. Form 4562. (67)
10. Form 8824. (109) (not shown)

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.

Label

(See instructions on page 16.)

Use the IRS label. Otherwise, please print or type.

Label Here

For the year Jan. 1–Dec. 31, 2004, or other tax year beginning , 2004, ending , 20
Your first name and initial Last name
Walter A. Brown
If a joint return, spouse's first name and initial Last name
Jane W. Brown
Home address (number and street). If you have a P.O. box, see page 16. Apt. no.
RR1 Box 25
City, town or post office, state, and ZIP code. If you have a foreign address, see page 16.
Hometown, VA 22870

OMB No. 1545-0074
Your social security number
543 : 00 : 2111
Spouse's social security number
543 : 00 : 1222

Important!
You must enter your SSN(s) above.

Presidential Election Campaign

Note. Checking "Yes" will not change your tax or reduce your refund. Do you, or your spouse if filing a joint return, want \$3 to go to this fund?
[X] Yes [] No [X] Yes [] No

Filing Status

Check only one box.

- 1 [] Single
2 [X] Married filing jointly (even if only one had income)
3 [] Married filing separately. Enter spouse's SSN above and full name here.
4 [] Head of household (with qualifying person). (See page 17.) If the qualifying person is a child but not your dependent, enter this child's name here.
5 [] Qualifying widow(er) with dependent child (see page 17)

Exemptions

If more than five dependents, see page 21.

6a [X] Yourself. If someone can claim you as a dependent, do not check box 6a
6b [X] Spouse
6c Dependents:
(1) First name Last name (2) Dependent's social security number (3) Dependent's relationship to you (4) [X] if qualifying child for child tax credit (see page 18)
Michael Brown 579 : 00 : 9999 Son [X]
Matthew Brown 579 : 00 : 9998 Son []
Sarah Brown 579 : 00 : 9997 Daughter []
6d Total number of exemptions claimed 5

Income

Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld.

If you did not get a W-2, see page 19.

Enclose, but do not attach, any payment. Also, please use Form 1040-V.

Table with 22 rows for income reporting. Line 7: 8,950; Line 8a: 375; Line 9a: 220; Line 13: 13,435; Line 14: 954; Line 18: 56,148; Line 22: 80,082

Adjusted Gross Income

Table with 13 rows for adjusted gross income adjustments. Line 30: 3,967; Line 31: 7,200; Line 35: 11,167; Line 36: 68,915

Tax and Credits

Standard Deduction for—
• People who checked any box on line 38a or 38b or who can be claimed as a dependent, see page 31.
• All others:
Single or Married filing separately, \$4,850
Married filing jointly or Qualifying widow(er), \$9,700
Head of household, \$7,150

37 Amount from line 36 (adjusted gross income)
38a Check if: [] You were born before January 2, 1940, [] Blind. Total boxes checked 38a
b If your spouse itemizes on a separate return or you were a dual-status alien, see page 31 and check here 38b
39 Itemized deductions (from Schedule A) or your standard deduction (see left margin)
40 Subtract line 39 from line 37
41 If line 37 is \$107,025 or less, multiply \$3,100 by the total number of exemptions claimed on line 6d. If line 37 is over \$107,025, see the worksheet on page 33
42 Taxable income. Subtract line 41 from line 40. If line 41 is more than line 40, enter -0-
43 Tax (see page 33). Check if any tax is from: a [] Form(s) 8814 b [] Form 4972
44 Alternative minimum tax (see page 35). Attach Form 6251
45 Add lines 43 and 44
46 Foreign tax credit. Attach Form 1116 if required
47 Credit for child and dependent care expenses. Attach Form 2441
48 Credit for the elderly or the disabled. Attach Schedule R
49 Education credits. Attach Form 8863
50 Retirement savings contributions credit. Attach Form 8880
51 Child tax credit (see page 37)
52 Adoption credit. Attach Form 8839
53 Credits from: a [] Form 8396 b [] Form 8859
54 Other credits. Check applicable box(es): a [] Form 3800 b [] Form 8801 c [] Specify
55 Add lines 46 through 54. These are your total credits
56 Subtract line 55 from line 45. If line 55 is more than line 45, enter -0-

Table with 2 columns: Line number and Amount. Values include 68,915, 15,000, 53,915, 15,500, 38,415, 3,568, 3,568, 1,000, 2,568.

Other Taxes

57 Self-employment tax. Attach Schedule SE
58 Social security and Medicare tax on tip income not reported to employer. Attach Form 4137
59 Additional tax on IRAs, other qualified retirement plans, etc. Attach Form 5329 if required
60 Advance earned income credit payments from Form(s) W-2
61 Household employment taxes. Attach Schedule H
62 Add lines 56 through 61. This is your total tax

Table with 2 columns: Line number and Amount. Values include 7,934, 10,502.

Payments

If you have a qualifying child, attach Schedule EIC.

63 Federal income tax withheld from Forms W-2 and 1099
64 2004 estimated tax payments and amount applied from 2003 return
65a Earned income credit (EIC)
b Nontaxable combat pay election
66 Excess social security and tier 1 RRTA tax withheld (see page 54)
67 Additional child tax credit. Attach Form 8812
68 Amount paid with request for extension to file (see page 54)
69 Other payments from: a [] Form 2439 b [] Form 4136 c [] Form 8885
70 Add lines 63, 64, 65a, and 66 through 69. These are your total payments

Table with 2 columns: Line number and Amount. Values include 1,435, 350, 1,785.

Refund

Direct deposit? See page 54 and fill in 72b, 72c, and 72d.

71 If line 70 is more than line 62, subtract line 62 from line 70. This is the amount you overpaid
72a Amount of line 71 you want refunded to you
b Routing number
c Type: [] Checking [] Savings
d Account number
73 Amount of line 71 you want applied to your 2005 estimated tax

Table with 2 columns: Line number and Amount. Values include 8,717.

Amount You Owe

74 Amount you owe. Subtract line 70 from line 62. For details on how to pay, see page 55
75 Estimated tax penalty (see page 55)

Third Party Designee

Do you want to allow another person to discuss this return with the IRS (see page 56)? [] Yes. Complete the following. [] No
Designee's name, Phone no., Personal identification number (PIN)

Sign Here

Joint return? See page 17. Keep a copy for your records.

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.
Your signature, Date, Your occupation, Daytime phone number
Spouse's signature. If a joint return, both must sign. Date, Spouse's occupation

Paid Preparer's Use Only

Preparer's signature, Date, Check if self-employed, Preparer's SSN or PTIN
Firm's name (or yours if self-employed), address, and ZIP code, EIN, Phone no.



**SCHEDULE D
(Form 1040)**

Department of the Treasury
Internal Revenue Service (99)

Capital Gains and Losses

▶ Attach to Form 1040. ▶ See Instructions for Schedule D (Form 1040).

▶ Use Schedule D-1 to list additional transactions for lines 1 and 8.

OMB No. 1545-0074

2004

Attachment
Sequence No. **12**

Name(s) shown on Form 1040

Walter A. & Jane W. Brown

Your social security number

543 : 00 : 211

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-6 of the instructions)	(e) Cost or other basis (see page D-6 of the instructions)	(f) Gain or (loss) Subtract (e) from (d)
1 25 Shares HT Corp	12-3-03	3-6-04	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 lines 1 and 2 in column (d)	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 Capital Loss Carryover Worksheet on page D-6 of the instructions	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-6 of the instructions)	(e) Cost or other basis (see page D-6 of the instructions)	(f) Gain or (loss) Subtract (e) from (d)
8 40 Shares Circle Corp	10-16-84	6-5-04	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 lines 8 and 9 in column (d)	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				12,740 -
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 of the instructions	13				
14 Long-term capital loss carryover. Enter the amount, if any, from line 13 of your Capital Loss Carryover Worksheet on page D-6 of the instructions	14				()
15 Net long-term capital gain or (loss). Combine lines 8 through 14 in column (f). Then go to Part III on the back	15				13,485 -

For Paperwork Reduction Act Notice, see Form 1040 instructions.

Cat. No. 11338H

Schedule D (Form 1040) 2004

Part III Summary

<p>16 Combine lines 7 and 15 and enter the result. If line 16 is a loss, skip lines 17 through 20, and go to line 21. If a gain, enter the gain on Form 1040, line 13, and then go to line 17 below . . .</p>	16	13,435	-
<p>17 Are lines 15 and 16 both gains? <input checked="" type="checkbox"/> Yes. Go to line 18. <input type="checkbox"/> No. Skip lines 18 through 21, and go to line 22.</p>			
<p>18 Enter the amount, if any, from line 7 of the 28% Rate Gain Worksheet on page D-7 of the instructions ▶</p>	18	- 0 -	
<p>19 Enter the amount, if any, from line 18 of the Unrecaptured Section 1250 Gain Worksheet on page D-8 of the instructions ▶</p>	19	- 0 -	
<p>20 Are lines 18 and 19 both zero or blank? <input checked="" type="checkbox"/> Yes. Complete Form 1040 through line 42, and then complete the Qualified Dividends and Capital Gain Tax Worksheet on page 34 of the Instructions for Form 1040. Do not complete lines 21 and 22 below. <input type="checkbox"/> No. Complete Form 1040 through line 42, and then complete the Schedule D Tax Worksheet on page D-9 of the instructions. Do not complete lines 21 and 22 below.</p>			
<p>21 If line 16 is a loss, enter here and on Form 1040, line 13, the smaller of:</p> <ul style="list-style-type: none"> • The loss on line 16 or • (\$3,000), or if married filing separately, (\$1,500) } 	21	())
<p>Note. When figuring which amount is smaller, treat both amounts as positive numbers.</p>			
<p>22 Do you have qualified dividends on Form 1040, line 9b? <input type="checkbox"/> Yes. Complete Form 1040 through line 42, and then complete the Qualified Dividends and Capital Gain Tax Worksheet on page 34 of the Instructions for Form 1040. <input type="checkbox"/> No. Complete the rest of Form 1040.</p>			

**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

2004

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 2004? 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	27,192	—		
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			20,669	—
4	Sales of livestock, produce, grains, and other products you raised	4			263,018	—
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 2004	8a			8b Taxable amount	
c	If election to defer to 2005 is attached, check here <input type="checkbox"/>	8d			8d	
	8d Amount deferred from 2003					
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			286,648	—

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	141,061	—	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	3,251	—
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					35	230,500	—
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					36	56,148	—
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.			

Self-Employment Tax

▶ **Attach to Form 1040.** ▶ **See Instructions for Schedule SE (Form 1040).**

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 ; 2111

Who Must File Schedule SE

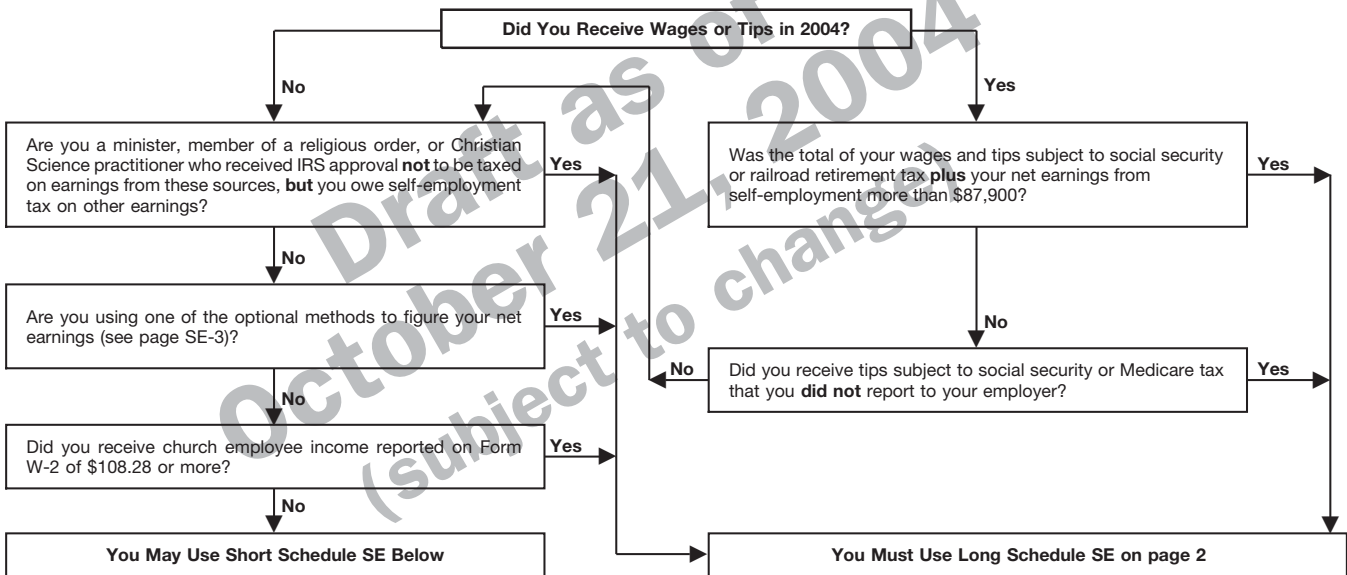
You must file Schedule SE if:

- 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 57.

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), box 14, code A	1	56,148	-
2	Net profit or (loss) from Schedule C, line 31; Schedule C-EZ, line 3; Schedule K-1 (Form 1065), box 14, code A (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	56,148	-
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	51,853	-
5	Self-employment tax. If the amount on line 4 is: <ul style="list-style-type: none"> • \$87,900 or less, multiply line 4 by 15.3% (.153). Enter the result here and on Form 1040, line 57. • More than \$87,900, multiply line 4 by 2.9% (.029). Then, add \$10,899.60 to the result. Enter the total here and on Form 1040, line 57. 	5	7,934	-
6	Deduction for one-half of self-employment tax. Multiply line 5 by 50% (.5). Enter the result here and on Form 1040, line 30	6	3,967	-

**SCHEDULE J
(Form 1040)**

Department of the Treasury
Internal Revenue Service (99)

**Income Averaging for
Farmers and Fishermen**

▶ Attach to Form 1040.

▶ See Instructions for Schedule J (Form 1040).

OMB No. 1545-0074

2004

Attachment
Sequence No. **20**

Name(s) shown on Form 1040

WALTER A. & JANE W. BROWN

Social security number (SSN)

543 00 211

1	Enter the taxable income from your 2004 Form 1040, line 42		1	38,415	-
2	Enter your elected farm income (see page J-1). Do not enter more than the amount on line 1		2	24,117	-
3	Subtract line 2 from line 1		3	14,298	-
4	Figure the tax on the amount on line 3. Use the 2004 Tax Table, Tax Computation Worksheet, Qualified Dividends and Capital Gain Tax Worksheet, or the Schedule D Tax Worksheet, whichever applies		4	758	-
5	If you used Schedule J to figure your tax for 2003, enter the amount from line 11 of your 2003 Schedule J. If you used Schedule J for 2002 but not 2003, enter the amount from line 15 of your 2002 Schedule J. If you used Schedule J for 2001 but not 2002 nor 2003, enter the amount from line 3 of your 2001 Schedule J. Otherwise, enter the taxable income from your 2001 Form 1040, line 39; Form 1040A, line 25; or Form 1040EZ, line 6. If zero or less, see page J-1		5	700	-
6	Divide the amount on line 2 by 3.0		6	8,039	-
7	Combine lines 5 and 6. If zero or less, enter -0-		7	8,739	-
8	Figure the tax on the amount on line 7 using 2001 tax rates (see page J-3)		8	1,311	-
9	If you used Schedule J to figure your tax for 2003, enter the amount from line 15 of your 2003 Schedule J. If you used Schedule J for 2002 but not 2003, enter the amount from line 3 of your 2002 Schedule J. Otherwise, enter the taxable income from your 2002 Form 1040, line 41; Form 1040A, line 27; or Form 1040EZ, line 6. If zero or less, see page J-4		9	1,050	-
10	Enter the amount from line 6		10	8,039	-
11	Combine lines 9 and 10. If less than zero, enter as a negative amount		11	9,089	-
12	Figure the tax on the amount on line 11 using 2002 tax rates (see page J-4)		12	909	-
13	If you used Schedule J to figure your tax for 2003, enter the amount from line 3 of your 2003 Schedule J. Otherwise, enter the taxable income from your 2003 Form 1040, line 40; Form 1040A, line 27; or Form 1040EZ, line 6. If zero or less, see page J-6		13	2,500	-
14	Enter the amount from line 6		14	8,039	-
15	Combine lines 13 and 14. If less than zero, enter as a negative amount		15	10,539	-
16	Figure the tax on the amount on line 15 using 2003 tax rates (see page J-6)		16	1,054	-
17	Add lines 4, 8, 12, and 16		17	4,032	-
18	If you used Schedule J to figure your tax for 2003, enter the amount from line 12 of your 2003 Schedule J. If you used Schedule J for 2002 but not 2003, enter the amount from line 16 of your 2002 Schedule J. If you used Schedule J for 2001 but not 2002 nor 2003, enter the amount from line 4 of your 2001 Schedule J. Otherwise, enter the tax from your 2001 Form 1040, line 40*; Form 1040A, line 26*; or Form 1040EZ, line 11		18	107	-
19	If you used Schedule J to figure your tax for 2003, enter the amount from line 16 of your 2003 Schedule J. If you used Schedule J for 2002 but not 2003, enter the amount from line 4 of your 2002 Schedule J. Otherwise, enter the tax from your 2002 Form 1040, line 42*; Form 1040A, line 28*; or Form 1040EZ, line 10		19	106	-
20	If you used Schedule J to figure your tax for 2003, enter the amount from line 4 of your 2003 Schedule J. Otherwise, enter the tax from your 2003 Form 1040, line 41*; Form 1040A, line 28*; or Form 1040EZ, line 10		20	251	-
21	Add lines 18 through 20		21	464	-
22	Subtract line 21 from line 17. Also include this amount on Form 1040, line 43		22	3,568	-

*Do not include tax from Form 4972 or 8814 or from recapture of an education credit. Also, do not include alternative minimum tax from Form 1040A.

Caution. Your tax may be less if you figure it using the 2004 Tax Table, Tax Computation Worksheet, Qualified Dividends and Capital Gain Tax Worksheet, or the Schedule D Tax Worksheet. Attach Schedule J only if you are using it to figure your tax.

Name(s) shown on tax return. Do not enter name and identifying number if shown on other side.

WALTER A. & JANE W. BROWN

Identifying number

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). Use a separate line for each property lost or damaged from the same casualty or theft.

Property A DAIRY COW #42 HOMETOWN, VA 6-22-00
 Property B _____
 Property C _____
 Property D _____

		Properties			
		A	B	C	D
20	Cost or adjusted basis of each property	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.	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.				
23	Fair market value before casualty or theft	500	-		
24	Fair market value after casualty or theft.	- 0 -			
25	Subtract line 24 from line 23	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.	257	-		
27	Subtract line 21 from line 26. If zero or less, enter -0-	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)				148 -

Part II Summary of Gains and Losses (from separate Parts I)

(a) Identify casualty or theft

(b) Losses from casualties or thefts

(i) Trade, business, rental or royalty property

(ii) Income-producing and employee property

(c) Gains from casualties or thefts includible in income

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 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.	38a	(148 -)		
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 Note: Partnerships, enter the amount from line 38a, 38b, or line 39 on Form 1065, Schedule K, line 11. S corporations, enter the amount from line 38a or 38b on Form 1120S, Schedule K, line 10.	39			

Sales of Business Property
(Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2))

Department of the Treasury
Internal Revenue Service (99)

▶ Attach to your tax return. ▶ See separate instructions.

Name(s) shown on return
WALTER A. & JANE W. BROWN

Identifying number
543-00-2111

1 Enter the gross proceeds from sales or exchanges reported to you for 2004 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20 (see instructions).

1

Part I Sales or Exchanges of Property Used in a Trade or Business and Involuntary Conversions From Other Than Casualty or Theft—Most Property Held More Than 1 Year (see instructions)

(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 2000	2004	13,160	- 0 -	325	12,835
Dairy Cow #52	7-15-00	2-3-04	303	514	912	(95)
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:						7 12,740
Partnerships (except electing large partnerships) and S corporations. Report the gain or (loss) following the instructions for Form 1065, Schedule K, line 10, or Form 1120S, Schedule K, line 9. Skip lines 8, 9, 11, and 12 below.						
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, 11, and 12 below.						
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-. 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 (see instructions)						9

Part II Ordinary Gains and Losses

10 Ordinary gains and losses not included on lines 11 through 16 (include property held 1 year or less):						
RAISED Dairy Heifer	10-2-03	3-3-04	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 Combine lines 10 through 16						17 954
18 For all except individual returns, enter the amount from line 17 on the appropriate line of your return and skip lines a and b below. For individual returns, complete lines a and b below:						
a 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 18a." See instructions						18a
b Redetermine the gain or (loss) on line 17 excluding the loss, if any, on line 18a. Enter here and on Form 1040, line 14.						18b 954

For Paperwork Reduction Act Notice, see page 8 of the instructions.

Cat. No. 13086I

Form **4797** (2004)

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	6-22-94	7-9-04
B Mower	4-21-93	8-12-04
C Purchased Dairy Cow #60	2-21-01	10-28-04
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.)	20	700	70	670	
21 Cost or other basis plus expense of sale	21	4,390	1,200	1,200	
22 Depreciation (or depletion) allowed or allowable	22	4,390	1,200	612	
23 Adjusted basis. Subtract line 22 from line 21	23	- 0 -	- 0 -	588	
24 Total gain. Subtract line 23 from line 20	24	700	70	82	
25 If section 1245 property:					
a Depreciation allowed or allowable from line 22	25a	4,390	1,200	612	
b Enter the smaller of line 24 or 25a	25b	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)	26a				
b Applicable percentage multiplied by the smaller of line 24 or line 26a (see instructions)	26b				
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	26c				
d Additional depreciation after 1969 and before 1976	26d				
e Enter the smaller of line 26c or 26d	26e				
f Section 291 amount (corporations only)	26f				
g Add lines 26b, 26e, and 26f	26g				
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	27a				
b Line 27a multiplied by applicable percentage (see instructions)	27b				
c Enter the smaller of line 24 or 27b	27c				
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)	28a				
b Enter the smaller of line 24 or 28a	28b				
29 If section 1255 property:					
a Applicable percentage of payments excluded from income under section 126 (see instructions)	29a				
b Enter the smaller of line 24 or 29a (see instructions)	29b				

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	

Depreciation and Amortization
(Including Information on Listed Property)

Department of the Treasury
Internal Revenue Service

▶ See separate instructions. ▶ Attach to your tax return.

Name(s) shown on return WALTER A. & JANE W. BROWN	Business or activity to which this form relates FARMING	Identifying number 543-00-2111
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Part I Election To Expense Certain Property Under Section 179
Note: If you have any listed property, complete Part V before you complete Part I.

1 Maximum amount. See page 2 of the instructions for a higher limit for certain businesses	1	\$102,000
2 Total cost of section 179 property placed in service (see page 3 of the instructions)	2	162,229. –
3 Threshold cost of section 179 property before reduction in limitation	3	\$410,000
4 Reduction in limitation. Subtract line 3 from line 2. If zero or less, enter -0-	4	– 0 –
5 Dollar limitation for tax year. Subtract line 4 from line 1. If zero or less, enter -0-. If married filing separately, see page 3 of the instructions.	5	102,000. –
(a) Description of property (b) Cost (business use only) (c) Elected cost		
6 TRACTOR	33,729. –	30,000. –
DAIRY EQUIPMENT	72,000. –	72,000. –
7 Listed property. Enter the amount from line 29	7	
8 Total elected cost of section 179 property. Add amounts in column (c), lines 6 and 7	8	102,000. –
9 Tentative deduction. Enter the smaller of line 5 or line 8.	9	102,000. –
10 Carryover of disallowed deduction from line 13 of your 2003 Form 4562	10	– 0 –
11 Business income limitation. Enter the smaller of business income (not less than zero) or line 5 (see instructions)	11	102,000. –
12 Section 179 expense deduction. Add lines 9 and 10, but do not enter more than line 11	12	102,000. –
13 Carryover of disallowed deduction to 2005. Add lines 9 and 10, less line 12 ▶	13	– 0 –

Note: Do not use Part II or Part III below for listed property. Instead, use Part V.

Part II Special Depreciation Allowance and Other Depreciation (Do not include listed property.)

14 Special depreciation allowance for qualified property (other than listed property) placed in service during the tax year (see page 3 of the instructions)	14	31,454. –
15 Property subject to section 168(f)(1) election (see page 4 of the instructions)	15	
16 Other depreciation (including ACRS) (see page 4 of the instructions)	16	312. –

Part III MACRS Depreciation (Do not include listed property.) (See page 5 of the instructions.)

Section A

17 MACRS deductions for assets placed in service in tax years beginning before 2004	17	2,708. –
18 If you are electing under section 168(i)(4) to group any assets placed in service during the tax year into one or more general asset accounts, check here ▶ <input type="checkbox"/>		

Section B—Assets Placed in Service During 2004 Tax Year Using the General Depreciation System

(a) Classification of property	(b) Month and year placed in service	(c) Basis for depreciation (business/investment use only—see instructions)	(d) Recovery period	(e) Convention	(f) Method	(g) Depreciation deduction
19a 3-year property						
b 5-year property						
c 7-year property		1,864. –	7	HY	150DB	200. –
d 10-year property		28,250. –	10	HY	150DB	2,119. –
e 15-year property						
f 20-year property		650. –	20	HY	150DB	24. –
g 25-year property			25 yrs.		S/L	
h Residential rental property			27.5 yrs.	MM	S/L	
			27.5 yrs.	MM	S/L	
i Nonresidential real property			39 yrs.	MM	S/L	

Section C—Assets Placed in Service During 2004 Tax Year Using the Alternative Depreciation System

20a Class life				S/L	
b 12-year			12 yrs.	S/L	
c 40-year			40 yrs.	MM	S/L

Part IV Summary (see page 8 of the instructions)

21 Listed property. Enter amount from line 28	21	2,244. –
22 Total. Add amounts from line 12, lines 14 through 17, lines 19 and 20 in column (g), and line 21. Enter here and on the appropriate lines of your return. Partnerships and S corporations—see instr.	22	141,061. –
23 For assets shown above and placed in service during the current year, enter the portion of the basis attributable to section 263A costs	23	

Part V Listed Property (Include 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** 24a, 24b, 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 9 of the instructions for limits for passenger automobiles.)

24a Do you have evidence to support the business/investment use claimed? **Yes** **No** **24b** 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	
25 Special depreciation allowance for qualified listed property placed in service during the tax year and used more than 50% in a qualified business use (see page 8 of the instructions)							25		
26 Property used more than 50% in a qualified business use (see page 8 of the instructions):									
CAR	1-6-01	60 %	12,350. -	7,410. -	5	150DB/HY	1,065. - *	- 0 -	
PICKUP TRUCK	5-18-01	100 %	7,076. -	7,076. -	5	150DB/HY	1,179. -	- 0 -	
PICKUP TRUCK	6-22-95	100 %							
27 Property used 50% or less in a qualified business use (see page 8 of the instructions):									
		%				S/L -			
		%				S/L -			
		%				S/L -			
28 Add amounts in column (h), lines 25 through 27. Enter here and on line 21, page 1.							28	2,244. -	
29 Add amounts in column (i), line 26. Enter here and on line 7, page 1.								29	- 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)		(b)		(c)		(d)		(e)		(f)	
	Vehicle 1	Vehicle 2	Vehicle 3	Vehicle 4	Vehicle 5	Vehicle 6	Yes	No	Yes	No	Yes	No
30 Total business/investment miles driven during the year (do not include commuting miles—See page 2 of the instructions)	6,270	11,350	2,350									
31 Total commuting miles driven during the year	- 0 -	- 0 -	- 0 -									
32 Total other personal (noncommuting) miles driven	4,180	- 0 -	- 0 -									
33 Total miles driven during the year. Add lines 30 through 32	10,450	11,350	2,350									
34 Was the vehicle available for personal use during off-duty hours?	✓		✓		✓							
35 Was the vehicle used primarily by a more than 5% owner or related person?	✓		✓		✓							
36 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 (see page 10 of the instructions).

	Yes	No
37 Do you maintain a written policy statement that prohibits all personal use of vehicles, including commuting, by your employees?		
38 Do you maintain a written policy statement that prohibits personal use of vehicles, except commuting, by your employees? See page 10 of the instructions for vehicles used by corporate officers, directors, or 1% or more owners		
39 Do you treat all use of vehicles by employees as personal use?		
40 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?		
41 Do you meet the requirements concerning qualified automobile demonstration use? (See page 11 of the instructions.)		

Note: If your answer to 37, 38, 39, 40, or 41 is "Yes," do 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
42 Amortization of costs that begins during your 2004 tax year (see page 11 of the instructions):					
43 Amortization of costs that began before your 2004 tax year.					43
44 Total. Add amounts in column (f). See page 12 of the instructions for where to report.					44

Depreciation Worksheet

Description of Property	Date Placed in Service	Cost or Other Basis	Business/Investment Use %	Section 179 Deduction and Special allowance	Depreciation Prior Years	Basis for Depreciation	Method/Convention	Recovery Period	Rate or Table %	Depreciation Deduction
STRAIGHT LINE										
BARN	1-8-78	6,400	100%		6,400	0 ⁵	SL	25		0
SILO	1-2-80	16,000	"		16,000	0 ⁵	SL	20		0
ALTERNATE ACRS										
MACHINE SHED	1-2-86	6,000	100%		5,676	6,000	Mod SL	19	5.2	312
MACRS										
TRACTOR #2 (traded 7/04)	1-8-00	7,297	100%	5,000	804	2,297	SL/HY	10	10.0	114.85 ¹
DAIRY COW #42 (killed 7/04)	6-22-00	600	"		300	600	SL/HY	7	14.29	42.87 ²
DAIRY COW #52 (sold 2/04)	7-15-00	900	"		450	900	SL/HY	7	14.29	64.31 ²
DAIRY COW #54	9-9-00	1,200	"		600	1,200	SL/HY	7	14.29	171.48
CAR (listed property)	1-6-01	12,350	60%		4,334	7,410	150DB/HY	5	16.66	1,065.- ³
DAIRY COW #60 (sold 10/04)	2-21-01	1,200	100%		538	1,200	150DB/HY	7	12.25	73.50 ²
PLOW	4-6-01	4,821	100%		1,599	4,821	150DB/HY	10	10.02	483.06
PICKUP TRUCK (listed property)	5-18-01	7,076	"		4,129	7,076	150DB/HY	5	16.66	1,178.86
DAIRY COW #61	9-1-01	1,400	"		628	1,400	150DB/HY	7	12.25	171.50
TRACTOR #4	10-12-01	13,483	"	5,000	2,814	8,483	150DB/HY	10	10.02	849.99
MILK TANK	1-4-02	11,500	100%	10,000	448	1,500	150DB/HY	7	15.03	225.45
MANURE SPREADER	5-3-02	3,400	"		1,015	3,400	150DB/HY	7	15.03	511.02
DAIRY FACILITY BUILDING	1-9-04	56,500	100%	28,250	- 0 -	28,250	150DB/HY	10	7.50	2,118.75
DAIRY FACILITY EQUIPMENT	1-9-04	72,000	"	72,000	- 0 -	- 0 -				
MACHINE SHED IMPROVEMENT	2-20-04	1,300	"	650	- 0 -	650	150DB/HY	20	3.75	24.38
TRACTOR #5 (excess basis)	7-8-04	33,729	"	31,865	- 0 -	1,864	150DB/HY	7	10.71	199.63 ⁴
TRACTOR #5 (exchanged basis)	1-8-00	1,378	"	689		689	SL/HY	10	10.0	34.45 ¹
TOTAL										7,641.10

¹ Depreciation for 1st six months (\$114.85) using \$2,297 as the depreciable basis. Depreciation for last six months (\$54.45). The exchanged basis is listed separately as the exchanged basis for tractor #5, but depreciated over the remaining life of tractor #2 using the same depreciation method and recovery period.

² Depreciation limited to half-year
³ Limited deduction for passenger automobile
⁴ Half-year depreciation for tractor #5
⁵ Adjusted basis

16.

How To Get Tax Help

You can get help with unresolved tax issues, 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.

Contacting your Taxpayer Advocate. If you have attempted to deal with an IRS problem unsuccessfully, you should contact your Taxpayer Advocate.

The Taxpayer Advocate independently 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 toll free at 1-877-777-4778.
- Call, write, or fax the Taxpayer Advocate office in your area.
- Call 1-800-829-4059 if you are a TTY/TDD user.
- Visit www.irs.gov/advocate.

For more information, see Publication 1546, The Taxpayer Advocate Service of the IRS—How To Get Help With Unresolved Tax Problems.

Free tax services. To find out what services are available, get Publication 910, IRS 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.



Internet. You can access the IRS website 24 hours a day, 7 days a week, at www.irs.gov to:

- *E-file* your return. Find out about commercial tax preparation and *e-file* services available free to eligible taxpayers.
- Check the status of your 2004 refund. Click on *Where's My Refund*. Be sure to wait at least 6 weeks from the date you filed your return (3 weeks if you filed electronically). Have your 2004 tax return available because you will need to know your filing status and the exact whole dollar amount of your refund.
- Download forms, instructions, and publications.
- Order IRS products online.

- Research your tax questions online.
- Search publications online by topic or keyword.
- View Internal Revenue Bulletins (IRBs) published in the last few years.
- Figure your withholding allowances using our Form W-4 calculator.
- Sign up to receive local and national tax news by email.
- Get information on starting and operating a small business.



Fax. You can get over 100 of the most requested forms and instructions 24 hours a day, 7 days a week, by fax. Just call 703-368-9694 from the telephone connected to your fax machine. When you call, you will hear instructions on how to use the service. The items you request will be faxed to you.

For help with transmission problems, call 703-487-4608.

Long-distance charges may apply.



Phone. Many services are available by phone.

- *Ordering forms, instructions, and publications.* Call 1-800-829-3676 to order current-year forms, instructions, and publications and prior-year forms and instructions. You should receive your order within 10 days.
- *Asking tax questions.* Call the IRS with your tax questions at 1-800-829-1040.
- *Solving problems.* You can get face-to-face help solving tax problems every business day in IRS Taxpayer Assistance Centers. An employee can explain IRS letters, request adjustments to your account, or help you set up a payment plan. Call your local Taxpayer Assistance Center for an appointment. To find the number, go to www.irs.gov/localcontacts or look in the phone book under *United States Government, Internal Revenue Service*.
- *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 and press 2 to listen to pre-recorded messages covering various tax topics.
- *Refund information.* If you would like to check the status of your 2004 refund, call 1-800-829-4477 and press 1 for automated refund information or call 1-800-829-1954. Be sure to wait at least 6 weeks from the date you filed your return (3 weeks if you filed electronically). Have your 2004 tax return available because you will need to know your filing status and the exact whole dollar amount of your refund.

Evaluating the quality of our telephone services. To ensure that IRS representatives give accurate, courteous, and professional answers,

we use several methods to evaluate the quality of our telephone services. One method is for a second IRS representative to sometimes listen in on or record telephone calls. Another is to ask some callers to complete a short survey at the end of the call.



Walk-in. Many products and services are available on a walk-in basis.

- *Products.* You can walk in to many post offices, libraries, and IRS offices to pick up certain forms, instructions, and publications. Some IRS offices, libraries, grocery stores, copy centers, city and county government offices, credit unions, and office supply stores have a collection of products available to print from a CD-ROM or photocopy from reproducible proofs. Also, some IRS offices and libraries have the Internal Revenue Code, regulations, Internal Revenue Bulletins, and Cumulative Bulletins available for research purposes.
- *Services.* You can walk in to your local Taxpayer Assistance Center every business day to ask tax questions or get help with a tax problem. An employee can explain IRS letters, request adjustments to your account, or help you set up a payment plan. You can set up an appointment by calling your local Center and, at the prompt, leaving a message requesting Everyday Tax Solutions help. A representative will call you back within 2 business days to schedule an in-person appointment at your convenience. To find the number, go to www.irs.gov/localcontacts or look in the phone book under *United States Government, Internal Revenue Service*.



Mail. You can send your order for forms, instructions, and publications to the Distribution Center nearest to you and receive a response within 10 business days after your request is received. Use the address that applies to your part of the country.

- **Western part of U.S.:**
Western Area Distribution Center
Rancho Cordova, CA 95743-0001
- **Central part of U.S.:**
Central Area Distribution Center
P.O. Box 8903
Bloomington, IL 61702-8903
- **Eastern part of U.S. and foreign addresses:**
Eastern Area Distribution Center
P.O. Box 85074
Richmond, VA 23261-5074



CD-ROM for tax products. You can order Publication 1796, IRS Federal Tax Products CD-ROM, and obtain:

- Current-year forms, instructions, and publications.
- Prior-year forms and instructions.
- Frequently requested tax forms that may be filled in electronically, printed out for submission, or saved for recordkeeping.

- Internal Revenue Bulletins.

Buy the CD-ROM from National Technical Information Service (NTIS) at www.irs.gov/cdorders for \$22 (no handling fee) or call 1-877-233-6767 toll free to buy the CD-ROM for \$22 (plus a \$5 handling fee). The first release is available in early January and the final release is available in late February.



CD-ROM for small businesses. Publication 3207, The Small Business Resource Guide, CD-ROM 2004, is a must for every small business owner or any

taxpayer about to start a business. This handy, interactive CD contains all the business tax forms, instructions, and publications needed to successfully manage a business. In addition, the CD provides other helpful information, such as how to prepare a business plan, finding financing for your business, and much more. The design of the CD makes finding information easy

and quick and incorporates file formats and browsers that can be run on virtually any desktop or laptop computer.

It is available in early April. You can get a free copy by calling 1-800-829-3676 or by visiting www.irs.gov/smallbiz.

Tax Publications for Business Taxpayers

See *How To Get Tax Help* 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)
- 334 Tax Guide for Small Business (For Individuals Who Use Schedule C or C-EZ)
- 509 Tax Calendars for 2005
- 553 Highlights of 2004 Tax Changes
- 910 Guide to Free Tax Services

Employer's Guides

- 15 (Circular E), Employer's Tax Guide
- 15-A Employer's Supplemental Tax Guide
- 15-B Employer's Tax Guide to Fringe Benefits
- 51 (Circular A), Agricultural Employer's Tax Guide
- 80 (Circular SS), Federal Tax Guide For Employers in the U.S. Virgin Islands, Guam, American Samoa, and the Commonwealth of the Northern Mariana Islands
- 926 Household Employer's Tax Guide

Specialized Publications

- 225 Farmer's Tax Guide
- 378 Fuel Tax Credits and Refunds
- 463 Travel, Entertainment, Gift, and Car Expenses
- 505 Tax Withholding and Estimated Tax

- 510 Excise Taxes for 2005
- 515 Withholding of Tax on Nonresident Aliens and Foreign Entities
- 517 Social Security and Other Information for Members of the Clergy and Religious Workers
- 527 Residential Rental Property
- 533 Self-Employment Tax
- 534 Depreciating Property Placed in Service Before 1987
- 535 Business Expenses
- 536 Net Operating Losses (NOLs) for Individuals, Estates, and Trusts
- 537 Installment Sales
- 538 Accounting Periods and Methods
- 541 Partnerships
- 542 Corporations
- 544 Sales and Other Dispositions of Assets
- 551 Basis of Assets
- 556 Examination of Returns, Appeal Rights, and Claims for Refund
- 560 Retirement Plans for Small Business (SEP, SIMPLE, and Qualified Plans)
- 561 Determining the Value of Donated Property
- 583 Starting a Business and Keeping Records
- 587 Business Use of Your Home (Including Use by Daycare Providers)
- 594 The IRS Collection Process
- 595 Tax Highlights for Commercial Fishermen
- 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 Distressed Communities
- 1544 Reporting Cash Payments of Over \$10,000
- 1546 The Taxpayer Advocate Service of the IRS—How To Get Help With Unresolved Tax Problems

Spanish Language Publications

- 1SP Derechos del Contribuyente
- 179 Circular PR Guía Contributiva Federal Para Patronos Puertorriqueños
- 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 Tax Help* 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 number when ordering.

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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, Deductions, Credits, etc.	11520
940-EZ 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
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Sch SE Self-Employment Tax*	11358	8300 Report of Cash Payments Over \$10,000 Received in a Trade or Business*	62133
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1040X Amended U.S. Individual Income Tax Return*	11360	8606 Nondeductible IRAs*	63966
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Sch K-1 Partner's Share of Income, Deductions, Credits, etc.*	11394		
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