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 17 for information on ordering these publications.

The explanations and examples in this publication reflect the Internal Revenue Service’s interpretation of tax laws enacted by Congress, Treasury regulations, and court decisions. However, the information given does not cover every situation and is not intended to replace the law or change its meaning. This publication covers subjects on which a court may have made a decision more favorable to taxpayers than the interpretation of the Service. Until these differing
What's New for 2006

The following items highlight a number of administrative and tax law changes for 2006. They are discussed in more detail throughout the publication. More information on these and other changes can be found in Publication 553, Highlights of 2006 Tax Changes.

Addition to small watershed programs.

The Conservation Service Program has been added to the list of small watershed programs to be able to exclude cost-share payments you receive from this program. See chapter 3.

Standard mileage rate.

The standard mileage rate for the cost of operating your car, van, pickup, or panel truck in 2006 is 44.5 cents a mile for all business miles driven. See chapter 4.

Forestation and reforestation costs.

If you elected to deduct qualifying reforestation costs on a return filed before June 15, 2006, see Forestation and reforestation costs under Capital Expenses in chapter 4.

Increased section 179 deduction dollar limits.

The maximum amount you can elect to deduct for most section 179 property you placed in service in 2006 is $108,000. This limit is reduced by the amount by which the cost of the property placed in service during the tax year exceeds $430,000. For qualified section 179 Gulf Opportunity Zone (GO Zone) property, the maximum section 179 deduction is increased. See chapter 7.

Limited applicability of special deprecation allowances.

You may be able to claim the special depreciation allowances for certain aircraft and certain property with a long production period placed in service or manufactured before January 1, 2007, in areas affected by Hurricanes Katrina, Rita, or Wilma. See chapter 7.

Tax rates and maximum net earnings.

The maximum net self-employment earnings subject to the Medicare part (2.9%) of the social security tax for above addresses.

Publication 378 eliminated.

Publication 378, Fuel Tax Credits and Refunds, is no longer available as a separate product. Publication 510 contains the information on fuel tax credits and refunds previously found in Publication 378. See chapter 14.

Telephone excise tax refund.

This is a one-time credit available only on your 2006 federal tax return. It is a credit of previously paid long-distance federal excise taxes listed on your telephone bill. See the instructions for your 2006 income tax return for how to claim your credit.

Increased charitable contribution deduction for qualified conservation contributions.

Farmers and ranchers who contribute property used in agriculture or livestock production for qualified conservation purposes may be subject to a new limitation on the deduction for these charitable contributions. For more information, see Publication 556, Charitable Contributions.

What's New for 2007

Maximum net earnings.

The maximum net self-employment earnings subject to the social security part of the self-employment tax for 2007 will be published in Publication 553. There is no maximum limit on earnings subject to the Medicare part. See chapter 12.

Redesigned Form 940.

For 2006, we completely redesigned Form 940, Employer's Annual Federal Unemployment (FUTA) Tax Return. You will find that the redesigned form and instructions are easier to read and fill out. Also, IRS now can optically scan the form and will capture data more accurately and efficiently than before. Form 940-EZ is no longer available. If you previously filed Form 940-EZ, you must now use the redesigned Form 940. See chapter 13.

Wage limit for social security tax.

The limit on wages subject to the social security tax for 2007 will be published in Publication 51 (Circular A), Agricultural Employer’s Tax Guide. There is no limit on wages subject to the Medicare tax. See chapter 13.

Reminders

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

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.
• Visit a Volunteer Income Tax Assistance (VITA) or Tax Counseling for the Elderly (TCE) site.

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

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.

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.

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.

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.

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 and for which you paid an advisor a minimum fee, (4) transactions for which you have or a related party has a right to a full or partial refund of fees if a 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, and (5) transactions with asset holding periods of 45 days or less and that result in a tax credit of more than $250,000. For more information, see the Instructions for Form 8886.

Form W-4 for 2007. You should make new Forms W-4 available to your employees and encourage them to check their income tax withholding for 2007. Those employees who owed a large amount of tax or received a large refund for 2006 may need to file a new Form W-4. See Publication 919, How Do I Adjust My Tax Withholding.

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.

Limits on personal casualty or theft losses caused by Hurricanes Katrina, Rita, or Wilma. The following losses to personal use property are not subject to the $100 rule or 10% rule. For more information, see Deduction Limits on Losses of Personal-Use Property, later.

• Losses that arose in the Hurricane Katrina disaster area after August 24, 2005, and that were caused by Hurricane Katrina.
• Losses that arose in the Hurricane Rita disaster area after September 22, 2005, and that were caused by Hurricane Rita.
• Losses that arose in the Hurricane Wilma disaster area after October 22, 2005, and that were caused by Hurricane Wilma.

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:

• Benefits of recordkeeping
• Kinds of 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 17 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 kind of 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 legible. The following table lists acceptable account statements.

<table>
<thead>
<tr>
<th>IF payment is by...</th>
<th>THEN the statement must show the...</th>
</tr>
</thead>
<tbody>
<tr>
<td>Check</td>
<td>• Check number.</td>
</tr>
<tr>
<td></td>
<td>• Amount.</td>
</tr>
<tr>
<td></td>
<td>• Payee’s name.</td>
</tr>
<tr>
<td></td>
<td>• Date the check amount was posted to the account by the financial institution.</td>
</tr>
</tbody>
</table>

Electronic funds transfer

- • Amount transferred.
- • Payee’s name.
- • Date the transfer was posted to the account by the financial institution.

Credit card

- • 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.

Tax returns. Keep copies of your filed tax returns. They help in preparing future tax returns and making computations if you file an amended return. Keep copies of your information returns such as Form 1099, Schedule K-1 and Form W-2.

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. Generally, you must keep your records for at least 3 years from when your tax return was due or filed or within 2 years of the date the tax was paid, whichever is later. However, certain records must be kept for a longer period of time, as discussed below.

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 nontaxable exchange, your basis in that property is the same as the basis of the property you gave up, increased by any money you paid. You must keep the records on the old property, as well as...
on the new property, until the period of limitations expires for the year in which you dispose of the new property in a taxable disposition. See Like-Kind Exchanges in the Gains and Losses chapter.

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.

### Accounting Methods

#### Introduction

You must consistently use an accounting method that clearly shows your income and expenses. You must also figure your taxable income and file an income tax return for an annual accounting period called a tax year. Only accounting methods are discussed in this chapter. For information on accounting periods, see Publication 538, Accounting Periods and Methods, and the instructions for Form 1128, Application To Adopt, Change, or Retain a Tax Year.

### 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 17 for information about getting publications and forms.

#### 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 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 receive approval from the IRS. The crop method of accounting is discussed later under Special Methods of Accounting. How to obtain 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.**

**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 farm corporations, see Internal Revenue Code section 447.

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control of its receipt is subject to substantial restrictions or limitations.

Direct payments and counter-cyclical pay- ments. If you receive direct payments or counter-cyclical payments under Subtitle A or C of the Farm Security and Rural Investment Act of 2002, you will not be considered to have con- structively received 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 off the receipt of income. Instead, you receive income either in the year of production or in the year of sale. If you receive income in this way, you construc- tively receive the income when the debt is can-celled 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 re- cept in the year of sale. However, see the fol- lowing example for an exception to this rule.

Example. Frances Jones, a farmer, was en- titled to receive a $10,000 payment on a grain contract in December 2006. She was told in December that her payment was available. She requested not to be paid until January 2007. However, she must still include this payment in her 2006 income because it was made available to her in 2006.

Debits paid by another person or canceled. If your debits 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 construc- tively receive the income when the debt is can- celed or paid. See Cancellation of Debt in chapter 3.

Example. You are a farmer who uses the cash method and a calendar tax year. You sell grain in December 2006 under a bona fide arms-length contract that calls for payment in 2007. You include the sale proceeds in your 2006 gross income since that is the year the pay- ment 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 2006 income, regardless of when you actually receive pay- ment.

Repayment of income. If you include an amount in income and in a later year you have to repay all or part of it, then you can usually deduct the amount in the year in which you make it. If the repayment is more than $3,000, a special rule applies. For details, see Repay- ments in chapter 11 of Publication 535, Busi- ness Expenses.

Expenses Under the cash method, generally you 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 ad- vance or you may be required to capitalize cer- tain 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.

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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. Supplies acquired for sale or that become a physical part of items held for sale must be included in inventory. Deduct the cost of supplies in the year used or consumed in operations. Do not include incidental supplies in inventory as these are deductible 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. Generally, growing crops are not required to be included in inventory. 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.

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.

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. However, if you value your livestock inventory using the farm-price method, then you must obtain permission from the IRS 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.

Uniform-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 as a class or group. The unit price must assign reasonably approximately the normal costs incurred in producing the animals in such classes. Unit prices and classifications are reflective of the IRS for the year in which you return. You must annually reevaluate your 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 method you have chosen. You cannot change your method without obtaining approval from the IRS.

You must include in 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 that make an adjustment for any animal purchased during the year. It also does not apply to tax payers that must make an adjustment to reasonably approximate the preproductive 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 your grain in December 2006, but you are not paid until January 2007. You must both include the sales proceeds and deduct the costs incurred in producing the grain on your 2006 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 2006. Under this method, you include the sale proceeds in income for 2006 when you receive payment. 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. See Regulations section 1.162-12 for details on deductible expenses of farmers.

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.
- Theft, see chapter 11.

Combination Method

Generally, you can use any combination of cash, accrual, and special methods of account- ing if the combination clearly shows your income and expenses and you use it consistently. How- ever, 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 the accrual method for reporting your expenses, you must use the accrual method for figuring your income.
Change in Accounting Method

Once you have set up your accounting method, generally you must receive approval from the IRS 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 obtain approval, you must file Form 3115. You may also 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 Conservation Security 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.

**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**
- Sales of farm products
- Rents (including crop shares)
- Agricultural program payments

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

<table>
<thead>
<tr>
<th>Item Sold</th>
<th>Schedule F</th>
<th>Form 4797</th>
</tr>
</thead>
<tbody>
<tr>
<td>Farm products raised for sale</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Farm products bought for resale</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Farm products not held primarily for sale, such as livestock held for draft, breeding, sport, or dairy purposes (bought or raised)</td>
<td>X</td>
<td></td>
</tr>
</tbody>
</table>
constructive receipt of the income when your agent receives payment. For a discussion on constructive receipt, see your usual business practice. 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 quality 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.

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 have been raised in the 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.
2. Multiply the result in (1) by the excess of the number of such livestock sold over the number sold because of weather-related conditions.

Example. You are a calendar year taxpayer and you normally sell 100 head of beef cattle a year by the result of drought, you sold 135 head during 2006. You realized $35,100 from the sale. On August 9, 2006, as a result of drought, the affected area was declared a disaster area eligible for federal assistance. The income you can postpone until 2007 is $9,100 ($35,100 ÷ 135 x 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 a weather-related sale of livestock not 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 others’ livestock on your land, you may be able to postpone the receipt of money for the use of your land. 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 the 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 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 use 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 crop as collateral for a CCC loan, you must treat the loan as if it were a sale of the crop and report the 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 tax year in which the loan is received to treating the loan amount as a loan. For more information, see Part I of the instructions for Form 3115.

You can request income tax withhold- ing from CCC loan payments you receive. Use Form W-4V, Voluntary Withholding Request. See chapter 17 for information about ordering the form.

To elect 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 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 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 election, 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.

Form 1099-A. 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.

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 elected 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 amount in gross income of $80 from market gain in 2006. He reports it on Schedule F, line 6a.

- Example 2. Mike has income of $80 from market gain in 2006. 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 2006 on Schedule F, line 4.

Excluded CCC loan. Mike’s basis in the cotton when Tom redeemed it for him was $420. He has no gain or loss on its sale to Tom for that amount.

Included CCC loan. As in Example 1, Mike’s basis in the cotton when Tom redeemed it for him was $420. He has no gain or loss on its sale to Tom for that amount.

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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.

You can request income tax withholdings from crop disaster payments you receive from the federal government. Use Form W-4V, Voluntary Withholding Request. See chapter 17 for information about ordering the form.

Election 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 2006, 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 8a 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 an election under section 451(d) of the Internal Revenue Code and Regulations section 1.451-8.
- 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 election covers all crops representing a single trade or business. If you have more than one farming business, make a separate election 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 elections to postpone reporting insurance proceeds you receive for crops grown on each of your farms.

An election is binding for the year unless the IRS approves your request to change it. To request IRS approval to change your election, write to the IRS at the following address giving your name, address, identification number, the year you made the election, and your reasons for wanting to change it.

Ogden Submission Processing Center
P. O. Box 9841
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.
- 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 pro-
grams for improvements made in connection with a watershed.

• The programs under the Watershed Pro-
tection 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 author-
ized by the Food Security Act of 1985, the Federal Agriculture Improvement and Re-

• The Environmental Quality Incentives Pro-
gram (EQIP) authorized by the Federal Agriculture Improvement and Reform Act of 1996.

• The Wildlife Habitat Incentives Program (WHIP) authorized by the Federal Agricul-
ture Improvement and Reform Act of 1996.

• The Soil and Water Conservation Asis-
tance Program authorized by the Agricu-

• The Agricultural Management Assistance Program authorized by the Agricultural Risk Protection Act of 2000.

• The Conservation Reserve Program au-
thorized 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.

• The Conservation Security Program au-
thorized by the Food Security Act of 1985.

Income realized. The gross income you real-
ize upon getting an improvement under these cost-sharing programs is the value of the im-
provement reduced by the sum of the exclu-
dable 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 improve-
ment) reduced by the sum of the following items.

• Any government payments under a pro-
gram 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 you for rent or for your services.

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

Excludable portion. The excludable por-
tion is the present fair market value of the right to receive annual income from the affected acre-
age of the greater of the following amounts.

1. 10% of the prior average annual income from the affected acreage. The prior aver-
age 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 improve-
ment.

2. $2.50 times the number of affected acres.

The calculation of present fair market value of the right to receive annual in-
come 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 por-
tion is the greater amount, $1,550.

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

\[
\text{Value of cost-sharing improvement} \times 0.10 = 0.10 \times 15,000 = 1,500 \\
\text{Value of right to receive annual income} = 1,550 \\
\text{Amount included in income} = 1,500 + 1,550 = 3,050
\]

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 capi-
tal 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 in-
come.

How to report the exclusion. Attach a state-
ment 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.

Election to exclude payments. You can elect not to exclude all or part of any payments you receive under these programs. If you make this election for all of these payments, none of the above restrictions and rules apply. You must make this election by the due date, including extensions, for filing your return. 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). 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 repealed the marketing quota program for peanuts effective May 13, 2002. As a result, the USDA offered 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 pe-
riod 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 the 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 tax year if you:

• Receive a lump sum payment or

• Elect 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 origi-
nal 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 pur-
chased acreage allotment is the purchase price.
Item 1231 transactions come. Any resulting capital gain is taxed as later. Some or all of the capital gain must be capital or ordinary depending on how you used the quota. You 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, Proceeds From Real Estate Transactions, 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, Interest Income, 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.

Tobacco Quota Buyout Program Payments

The Fair and Equitable Tobacco Reform Act of 2004, Title VI of the American Jobs Creation Act of 2004, terminated the tobacco marketing quota program and the tobacco price support program. As a result, the USDA offered to enter into contracts with eligible tobacco quota holders and growers to provide compensation for the lost value of the quotas and related price support.

If you are an eligible tobacco quota holder, your contract entitles you to receive total payments of $7 per pound of quota in 10 equal annual payments in fiscal years 2005 through 2014. If you are an eligible tobacco grower, your contract entitles you to receive total payments of up to $3 per pound of quota in 10 equal annual payments in fiscal years 2005 through 2014.

Tobacco Quota Holders

Contract payments you receive are considered proceeds from a sale of your tobacco quota as of the date on which you and the USDA enter into the contract. 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 tax year that includes the date you entered into the contract if you elect 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 is zero.

• The basis of a purchased quota is the purchase price.

The basis of a quota received as a gift is generally the same as the donor’s basis. However, under certain circumstances, the basis is increased by the amount of gift taxes paid. If the basis is greater than the fair market value of the quota at the time of the gift, the basis for determining loss is the fair market value.

The basis of an inherited quota is generally the fair market value of the quota at the time of the decedent’s death.

Reduction of basis. You are required to reduce the basis of your tobacco 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 tobacco 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 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-irb/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 tax 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

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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 tax year even if you use the installment method to report the remainder of the gain.

Self-employment income. The tobacco 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 tobacco 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 tobacco quota is not an involuntary conversion.

Form 1099-S. A tobacco 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.

Like-kind exchange of quota. You may postpone reporting the gain or loss from tobacco quota buyout payments by entering into a like-kind exchange if you comply with the requirements of section 1031 and the regulations thereunder. See Notice 2005-57 for more information.

More information. For more information on the taxation of payments to tobacco quota holders, see Notice 2005-57.

Tobacco Growers

Contract payments you receive are determined by reference to the amount of quota under which you produced (or planted) quota tobacco during the 2002, 2003, and 2004 tobacco marketing years and are prorated based on the number of years that you produced (or planted) quota tobacco during those years.

Tobacco 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.
The amount of depreciation rate from the 150% declining balance, half-year convention table (shown in Table A-14 in Appendix B of Publication 946). On July 1, 2006, the cooperative association paid Mr. Brown a $300 cash patronage dividend for buying the machine. Mr. Brown adjusted the basis of the machine and figures his depreciation deduction for 2006 (and later years) as follows.

Cost of machine on July 1, 2005: $2,900
2006 cash dividend: $311
Adjusted basis for depreciation for 2006: $2,589
Depreciation rate: 1 - 6/2 (remaining recovery period as of 1/1/06) = 15.38% x 1.5 = 23.07%
Depreciation deduction for 2006 ($2,289 x 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 the stated dollar amount of the certificates in income when you receive them.

If the dividends relate to a capital asset held for more than 1 year for which a Schedule F, line 10, if you incurred the debt 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. If you are in bankruptcy or 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 can- celed debt in income because the ex- pense 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 bank- ruptcy 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 prop- erty business debt (in the case of a tax- payer 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 insol- vent. See “Bankruptcy” later.

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 can- cellation 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. Other- wise, 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 re- duce the tax benefits under the insolvency rules before applying the rules for qualified farm debt or 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 liabili- ties 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 ex- cluded canceled debt to reduce the following tax benefits in the order and notes received unless you use 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 cancella- tion, and then any NOL carryover to that year. Reduce the NOL or NOL carryover one dollar for each dollar of excluded can- celed debt.
2. General business credit carryover. Re- duce the credit carryover to or from the tax year of the debt cancellation. Reduce the carryover 33⅓ cents for each dollar of ex- cluded canceled debt.
3. Minimum tax credit. Reduce the mini- mum tax credit available at the beginning of the tax year following the tax year of the debt cancellation. Reduce the credit 33⅓ 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 carry- over 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 cancella- tion in the following order:
   a. Real property (except inventory) used in your trade or business or held for in- vestment that secured the canceled debt.
   b. Personal property (except inventory and accounts and notes receivable) used in your trade or business or held for in- vestment that secured the canceled debt.
   c. Other property (except inventory and accounts and notes receivable) used in your trade or business or held for in- vestment.
   d. Inventory and accounts and notes re- ceivable.
   e. Other property.
   f. Reduce the basis one dollar for each dollar of excluded canceled debt. However, the re- duction 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 re- ductions for multiple canceled debts, see Regu- lations section 1.1017-1(b)(2). Also see Minimum tax credit. You can exclude canceled debt from gross income up to the amount by which you are insolvent. Use the amount excluded because of insolvency to reduce any tax benefits, as explained later under Reduction of tax benefits. You must re- duce the tax benefits under the insolvency rules before applying the rules for qualified farm debt or 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

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Recapture of basis reductions. If you re-
duce the basis of property under these provi-
sions and later sell or otherwise dispose of the prop-
erty 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 cancella-
tion. Sections 1245 and 1250 property and the recapture of gain as ordinary income are ex-
plained 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 insolvent 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 farm-

  ing 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 ac-

  tively 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 Pub-

  lication 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 ba-

  ses of the qualified property you hold at the begin-

  ning 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 bene-

  fits 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, mul-

  tiplied 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 car-

  ryover to that year.
5. Any passive activity loss and credit carry-

  overs from the tax year of the debt cancel-

  lation. Any credit carryover is multiplied by 3.
6. Any foreign tax credit carryovers to or from the tax year of the debt cancellation, multi-

  plied 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 re-

  duce 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 or-

  der:

1. Depreciable qualified property. You may elect 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 electing to apply the excluded canceled debt to reduce the basis of depreciable property before reducing tax benefits. You make this election by showing the amount you elect to apply on line 5 of the form.

When to file. You must file Form 982 with your timely filed income tax return (including exten-

  sions) for the tax year in which the cancellation of
debt occurred. If you timely filed your return for the year without electing to apply the ex-

  cluded canceled debt to reduce the basis of
decrpeciable property first, you can still make the election 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 neigh-

  bor 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 Hedg-

  ing (Commodity Futures) in chapter 8 for infor-

  mation on gains and losses from commodity futures and options transactions.

Custom hire (machine work). Pay you re-

  ceive 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 ma-

  chines, is income. If you are not insolvent, the tax was withheld. This rule applies whether you receive the pay in cash, services, or merchan-


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 af-

  fected. You reserved the right to continue farm-

  ing 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 prop-

  erly allocated to the part of the land af-

  fected 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, re-

  duce 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

Chapter 3 Farm Income Page 17
Easement contracts usually describe the affected land using square feet. Your basis may be figure 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 gain 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 live-stock 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, destroyed by fire, flood, or other causes, stolen, 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 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 2005. He deducted $1,000 on his 2005 Schedule F and the entire deduction reduced his tax. The landowner reimbursed him $500 of the cost of the fertilizer in February 2006. The tenant farmer must include $500 in income on his 2006 tax return because the entire deduction decreased his 2005 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 formula for “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 as a tenant farmer.

Serv-
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 18
If your child’s investment income is more than $1,700, 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 529, Tax Rules for Children and Dependents.

Alternative Minimum Tax (AMT)
You can elect 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, Credit for Prior Year Minimum Tax — Individuals, Estates, and Trusts.

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 2006 is 44.5 cents a mile for all business miles driven. See Truck and Car Expenses, later.

Forestation and reforestation costs. If you elected to deduct qualifying reforestation costs on a return filed before June 15, 2006, see Forestation and reforestation costs under Capital Expenses.

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
- Domestic production activities deduction
- Capital expenses
- Nondeductible expenses
- Losses from operating a farm
- Net-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

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, 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 resale (for or 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 2006, 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 2006 is $5,500. Your other deductible farm expenses totaled $10,000 for 2006. Therefore, your deduction for prepaid farm supplies cannot be more than $5,000 (50% of $10,000) for 2006. 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 tests 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 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 deduct 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. Deducing 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.

This rule does not apply to the purchase of commodit y 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 materially distort in income. If you are not entitled, by contract or business custom, to a refund or re-purchase.

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 results in 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 for 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 the employee made to you. 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 farmwork 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.

TIP

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).
- Welfare-to-work credit (Form 8861).
- Work opportunity credit (Form 5884).
- Hurricane Katrina housing credit (Form 5884-A).

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 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 purpose. 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.

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.

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 the loan as not secured by your home. For more information, 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 4 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). However, you cannot deduct federal income tax.

Highway use tax. You can deduct the federal 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, 2006, 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, 2006. Only the cost for the 6 months in 2006 is deductible as an insurance expense on your 2006 calendar year tax return. Deduct $500, which is the premium for 6 months of the 36-month premium period, or 1/6 of $3,000. In both 2007 and 2008, deduct $1,000 (1/3 of $3,000). Deduct the remaining $500 in 2009. Had the policy been effective on January 1, 2006, the deductible expense would have been $1,000 for each of the years 2006, 2007, and 2008, 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 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. For more information, see Deductible Premiums in chapter 6 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 if 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 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 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 the 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 noncourse loan from a third party). For more information, see chapter 6 of Publication 535 and the following revenue procedures.


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 de-

duct part or all of the cost of certain qualifying
property, up to a limit, as a section 179 deduc-
tion 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.
- 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 require-
ments:

- 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 exp-
enses (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 de-
duction 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 de-
preciation (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 deduc-
tion 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 portion of a second line into your home used exclusively for your farm business, are deducti-
ble business expenses.

Truck and Car Expenses

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

Standard mileage rate. Instead of using ac-
tual costs, under certain conditions you can use the standard mileage rate. For 2006, the rate is 44.5 cents a mile for all business use of any vehicle. You can use the standard mileage rate for a car, a light truck, such as a van, pickup, or panel truck, truck tractor, or semi-trailer.

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 if 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 require-
ments under Travel Expenses, later.

More information. For more information on deducting 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 ex-
penses you incur while traveling away from home for your farm business. You cannot de-
duct 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:

- You are away from your regular place of business for more than one week.
- You travel away from your regular place of business for more than one week.
- 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 neces-
sary 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 can deduct only 50% of your business-related meals expenses. You must 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 neces-
sary for you to rest, unless you meet the rules for business entertainment. For information on ent-
tertainment expenses, see chapter 2 of Publica-
tion 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 ev-
idence, 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 allow-
ance 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 gener-
ally can deduct reimbursements you pay to your employees for travel and transportation ex-
enses they incur in the course of your busi-
ness. Employees may be reimbursed under an
accountable or nonaccountable plan. Under an accountable plan, the employee must provide evidence of the 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 11 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.


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 Pre-paid 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 nonform capitalization rules. These rules are discussed in chapter 6.

Example. You use the cash method of accounting. In 2006, you buy 500 baby chicks to raise for resale in 2007. You also buy 50 bushels of winter wheat seed in 2006 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 2006.

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 particularize 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 on Schedule F. However, see Depletion in chapter 2.

Presentations 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 the 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 other deductions.

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

Domestic Production Activities Deduction

You are allowed a deduction for income attributable to domestic production activities. You can deduct 3% of the lesser of your qualified production activities income or your taxable income (adjusted gross income for individuals) for the tax year. Your deduction is limited to 50% of the Form W-2 wages you paid for the tax year.

Qualified production activities income. The excess of your domestic production gross receipts for the tax year over your costs of goods sold and other deductions, expenses, or losses directly allocable to such receipts plus a reasonable portion of other deductions, expenses, and losses that are not directly allocable to such receipts or another class of income is your qualified production activities income. This income is determined on an item-by-item basis.

Domestic production gross receipts. Domestic production gross receipts include gross receipts from any lease, rental, license, sale, exchange, or other disposition of tangible personal property which was manufactured, produced, grown, or extracted by you in whole or in significant part within the United States.

Domestic production gross receipts do not include gross receipts from property leased, licensed, or rented by you for use by any related person. See Internal Revenue Code section 199(c)(7) for the definition of related person.

Income from cooperatives. If you receive a patronage dividend or qualified per-unit retain allocation from a cooperative which is engaged in the manufacturing, production, growth, or extraction in whole or in significant part of any agricultural or horticultural product or in the marketing of agricultural or horticultural products, your income from the cooperative can give rise to a domestic production activities deduction. This deduction amount is reported on Form 1099-PATR, box 6. In order for you to qualify for the deduction, the cooperative is required to send you a written notice designating your portion of the domestic production activities deduction.
More information. For more information on the
domestic production activities deduction,
see the Instructions for Form 8903. Also, see
chapter 16, Sample Return, for an example of
how to figure the domestic production activities
deduction.

Capital Expenses

A capital expense is a payment, or a debt in-
curred, for the acquisition, improvement, or res-
toration 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 inven-
tory certain other expenses. See chapters 2 and
6.

Capital expenses are generally not deducti-
ble, 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 Fertil-
izer and Lime under Deductible Expenses,
earlier.)

• Soil and water conservation expenses. (See chapter 5.)

• The cost of property that qualifies for a deduc-
tion under section 179. (See chapter 7.)

• Business start-up costs. (See Business
start-up costs, later.)

• Forestation and reforestation costs. (See
Forestation and reforestation costs, later.)

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

1. Land and buildings.

2. Additions, alterations, and improvements
to buildings, etc.

3. Cars and trucks.

4. Equipment and machinery.

5. Fences.

6. Draft, breeding, sport, and dairy livestock.

7. Repairs to machinery, equipment, trucks,
and cars that prolong their useful life, in-
crease their value, or adapt them to differ-
ent use.

8. Water wells, including drilling and equip-
ment costs.

9. Land preparation costs, such as:
   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 con-
crete tanks, reservoirs, or dams, and
   i. Building roads.

Business start-up and organizational costs.
You can elect to deduct up to $5,000 of business
start-up costs and $5,000 of organizational
costs paid or incurred after October 22, 2004.
The $5,000 deduction is reduced by the amount
your total start-up or organizational costs ex-
ceed $50,000. Any remaining costs must be amor-
tized. See chapter 7.

You elect to deduct start-up or organiza-
tional costs by claiming the deduction on the
income tax return filed by the due date (including
extensions) for the tax year in which the active
trade or business begins. 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).

Clearly indicate the election on your 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. The election applies
when the original return is filed for the tax year
and all subsequent years.

For more information about start-up and or-
ganizational costs, see chapter 7.

Crop production expenses. The uniform
capitalization rules generally require you to capi-
talize 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 tim-
ber. Do not include the cost of land in the cost of
the timber. You must generally capitalize direct
costs incurred in reforestation. However, you
can elect to deduct some reforestation and for-
estation costs, See Forestation and refor-
estation costs, below. Reforestation 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 plant-
ing 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
recovery. Recover your basis when you sell the
standing trees or cut the timber. See Depletion in chapter 7.

Forestation and reforestation costs.
You can elect to deduct up to $10,000 of qualifying
reforestation costs paid or incurred after Octo-
ber 22, 2004, for each qualified timber property.
Any remaining costs can be amortized over an
84-month period. See chapter 7. If you make an
election to deduct or amortize qualifying refores-
tation costs, you should create and maintain separate accounts for each qualified tim-
ber property. The accounts should include all
reforestation treatments and the dates they were
applied. Any qualified timber property that is
subject to the deduction or amortization elec-
tion cannot be included in any other timber ac-
count for which depletion is allowed. The timber
account you filed the original return is disposed of. For more information, see Notice
2006-47.

You may be able to elect to deduct more than $10,000 of qualifying for-
estation costs if any portion of your timber property is located in certain areas.
For more information, see Publication 4492, Infor-
mation for Taxpayers Affected by Hurricanes
Katrina, Rita, and Wilma.

You elect to deduct reforestation and fore-
estation costs by claiming the deduction on the
income tax return filed by the due date (including
extensions) for the tax year in which the ex-
penses were paid or incurred. If you are filing
Form T, Forest Activities Schedule, also com-
plete Form T, Part IV. If you are not filing Form T,
attach a statement to your return with the follow-
ing information.

• The unique stand identification numbers.

• The total number of acres reforested dur-
ing the tax year.

• The nature of the reforestation treatments.

• The total amounts of the qualified refos-
tation expenditures eligible to be amort-
ized or deducted.

If you elected to deduct qualifying re-
forestation costs on a return that was
filed before June 15, 2006, but did not
complete Part IV of Schedule T or attach
the statement described above, you should do
so with this year’s return.

However, if you timely filed your return for the
year without making the election, you can still
make the election by filing an amended return
within 6 months of the due date of the return
(excluding extensions). Clearly indicate the
election on your 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.

For more information about reforestation
and reforestation costs, see chapter 7.

For more information about timber, see
Agriculture Handbook Number 718, Forest
Landowners’ Guide to the Fed-
eral Income Tax. You can view this publication
on the Internet 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 6 years old, you can
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

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these cases. Expenses incurred for silvicultural practices, such as weeding or clearing, and for commercial 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.

Non-deductible 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, attorney's 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 Non-deductible 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 limits your deduction for losses from most business or income-producing activities, including farming. These 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. The presumption applies to income from farming 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, presumption 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 S 213. 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 S 213 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 S 213 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 your 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 a change in 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 an S corporation carries on a not-for-profit activity, these limits apply at the partnership or S corporation level. They are reported in the partner’s or 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 ero- sion 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 con- servation 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 agricul- tural crop that may also conserve soil.

You must include in income most govern- ment payments for approved conservation prac- tices. 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 distin- guish 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
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, 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 the 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 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 growing 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 under Property Having a Determinable Useful Life 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 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, $5,550 plus $500). Since your deductible share is less than the maximum amount deductible in one year, you can deduct the entire $550 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 2006, you have gross income of $16,000 from two farms. During the year, you incurred $5,300 of deductible soil and water conservation expenses. The total is then subject to the 25% of gross income from farming limit in that year.

<table>
<thead>
<tr>
<th>Table 5-1. Limits on Deducting an Assessment by a Conservation District for Depreciable Property</th>
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<tbody>
<tr>
<td><strong>Total Limit on Deduction for Assessment</strong></td>
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<tr>
<td>10% of:</td>
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<tr>
<td>Total assessment against all members of the district for the property.</td>
</tr>
<tr>
<td>No one taxpayer can deduct more than 10% of the total assessment.</td>
</tr>
<tr>
<td>Any amount over 10% is a capital expense and is added to the basis of your land.</td>
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</tbody>
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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.

Cost Basis

The basis of property you buy is usually its cost. However, if you acquire another farm and return to the business of farming, you can start taking deductions again for the unused carryovers.

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.
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.

**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 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 makes up 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 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 Allocating 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 inven-
tory 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, or
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.
You are not required to capitalize the costs of producing the annual crop because its preproductive period is 2 years or less. 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 that apply to property produced in a farming business, see Regulations section 1.263A-4.

### 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 cost of the property. The result 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.
- Assessments for items such as paving roads and building ditches that increase the value of the property assessed. Do not deduct these expenses as taxes. However, you can deduct as taxes amounts assessed for maintenance or repairs, or for meeting interest charges related to the improvements.

If you make additions or improvements to business property, depreciate the basis of each addition or improvement as separate depreciable property using the 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.

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 7 in Publication 535.

### Decreases to Basis

The following are some items that reduce the basis of property.
- Section 179 deduction.
- Deductions previously allowed or allowable for amortization, depreciation, and depletion.
- Special depreciation allowance on qualified property.
- Alternative motor vehicle credit. See Form 8910.
- Alternative fuel vehicle refueling property credit. See Form 8911.
- Residential energy credits. See Form 5695.
- 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. See Form 8834.
- 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. See Form 6197.
- Some of these items are discussed next. For a more detailed list of items that decrease basis, see Publication 551.

### 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.

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

<table>
<thead>
<tr>
<th>Fruit</th>
<th>Depreciation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Coffee beans</td>
<td></td>
</tr>
<tr>
<td>Currants</td>
<td></td>
</tr>
<tr>
<td>Dates</td>
<td></td>
</tr>
<tr>
<td>Figs</td>
<td></td>
</tr>
<tr>
<td>Grapefruit</td>
<td></td>
</tr>
<tr>
<td>Grapes</td>
<td></td>
</tr>
<tr>
<td>Guavas</td>
<td></td>
</tr>
<tr>
<td>Kiwifruit</td>
<td></td>
</tr>
<tr>
<td>Kumquats</td>
<td></td>
</tr>
<tr>
<td>Lemons</td>
<td></td>
</tr>
<tr>
<td>Limes</td>
<td></td>
</tr>
<tr>
<td>Macadamia nuts</td>
<td></td>
</tr>
<tr>
<td>Mangoes</td>
<td></td>
</tr>
<tr>
<td>Nectarines</td>
<td></td>
</tr>
<tr>
<td>Olives</td>
<td></td>
</tr>
<tr>
<td>Oranges</td>
<td></td>
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<tr>
<td>Papayas</td>
<td></td>
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<tr>
<td>Peaches</td>
<td></td>
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<tr>
<td>Pears</td>
<td></td>
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<tr>
<td>Pecans</td>
<td></td>
</tr>
<tr>
<td>Persimmons</td>
<td></td>
</tr>
<tr>
<td>Pistachio nuts</td>
<td></td>
</tr>
<tr>
<td>Plums</td>
<td></td>
</tr>
<tr>
<td>Pomegranates</td>
<td></td>
</tr>
<tr>
<td>Prunes</td>
<td></td>
</tr>
<tr>
<td>Raspberries</td>
<td></td>
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<tr>
<td>Tangelos</td>
<td></td>
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<tr>
<td>Tangerines</td>
<td></td>
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<tr>
<td>Tangors</td>
<td></td>
</tr>
<tr>
<td>Walnuts</td>
<td></td>
</tr>
</tbody>
</table>

### Decreases to Basis

The following costs decrease the basis of property by the deduction. You can elect to deduct these expenses as miscellaneous itemized deductions or to increase the basis of property by any deductible loss from the sale of property. See chapter 3 for more information on these deductions.
purchase or installation of an energy conserva-
tion measure for a dwelling unit. Reduce the basis of the property by the excluded amount.

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 (pro-
vided 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, Bank-
ruptcy 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 Publication 534, Tax Guide for Small Business.

**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. Examples are discussed next.

**Property changed from personal 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.

If you later sell or dispose of this property, the basis you use will depend on whether you are figuring a gain or loss. The basis for figuring a gain is your adjusted basis in the property when you sell the property. Figure the basis for a loss starting with the smaller of your adjusted basis or the FMV of the property at the time of the change to business or rental use. Then make adjustments (increases and decreases) for the period after the change in the property’s use, as discussed earlier under Adjusted Basis.

The basis for depreciation is the lesser of:

- The basis of the property on the date of the change, or
- Your adjusted basis on the date of the change.

**Property received for services.** If you re-
ceive property for services, include the prop-
erty’s FMV in income. The amount you include in income becomes your basis. If the services were performed for a price agreed on before-
hand, 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 ac-
counting 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 ex-
changed.

If you receive property in exchange for another 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 farm land with an adjusted basis of $3,000 for a tractor that has an FMV of $6,000. You must report a taxable gain of $3,000 for the land. The tractor has a basis of $6,000.

**Involuntary Conversions**

If you receive property as a result of an involun-
ary conversion, such as a casualty, theft, or condemnation, figure the basis of the replace-
ment property you receive using the basis of the converted property.

**Similar or related property.** If the replace-
ment property is similar or related in use to the converted property, the replacement property’s basis is the same as the old prop-
erty’s basis on the date of the conversion. How-
ever, make the following adjustments.

1. Decrease the basis by the following amounts.
   a. Any loss you recognize on the involun-
tary 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 involun-
tary 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 prop-
erty and you buy replacement property similar or related in service or use to the converted prop-
erty, 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 re-
spective costs.

**Basis for depreciation.** Special rules apply in determining and depreciating the basis of

MACRS property acquired in an involuntary con-
version. For information, see Figuring the De-
duction for Property Acquired in a Nontaxable Exchange under Figuring Depreciation under MACRS in chapter 7.

For more information about involuntary con-
versions, 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 ex-
change, 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 invest-
ment 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 chap-
ter 8.

The basis of the property you receive gener-
ally 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 commis-
sions, 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 ba-
sis of $7,500) for property plus $4,000 (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 indi-
rectly 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

Chapter 6 Basis of Assets Page 33
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 Figuring the Deduction for Property Acquired in a Nontaxable Exchange under Figuring Depreciation under MACRS 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 - $10,000 - $3,000). 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.

<table>
<thead>
<tr>
<th>Basis of land traded</th>
<th>$10,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash received (adjusment) 1(a)</td>
<td>$3,000</td>
</tr>
<tr>
<td>Plus: Gain recognized (adjustment) 2(b)</td>
<td>$7,000</td>
</tr>
<tr>
<td>Basis of land received</td>
<td>$10,000</td>
</tr>
</tbody>
</table>

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 greater than donor’s adjusted basis. If the FMV of the property is equal to or greater 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 may 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.

If you received a gift during the tax year, increase your basis in the gift (the donor’s adjusted basis by the amount of the gift tax paid on it) due to the net increase in value of the gift. Figure the increase by multiplying the gift tax paid by the following fraction.

Net increase in value of the gift = Amount of the gift

Fair market value 
Minus: Adjusted basis 
Plus: Gift tax paid
Multiplied by ($30,000 + $38,000) 
Adjusted basis of property to your mother
Your basis in the property

Note. If you received a gift before 1977, your basis in the gift (the donor’s adjusted basis) includes any gift tax paid on it. However, your basis cannot exceed the FMV of the gift when it was given to you.

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.
The maximum amount you can elect to deduct for most section 179 property you placed in service during the tax year is increased. 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.

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 held 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 transferee 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.

Special-use valuation method. Under certain conditions, when a person dies, the executor or personal representative of that person’s estate may elect to use the qualified real property’s FMV at the time of its death rather than the adjusted basis of the property at that time. 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 use 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.

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.

For more information, see Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return, Form 706-A, United States Additional Estate Tax Return, and the related instructions.

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.

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 in 2006 is $108,000. This limit is reduced by the amount by which the cost of the property placed in service during the tax year exceeds $430,000. For qualified section 179 Gulf Opportunity Zone (GO Zone) property, the maximum section 179 deduction is increased. See Dollar Limits under Section 179 Deduction, later.

Limited applicability of special depreciation allowances. You may be able to claim the special depreciation allowances for certain aircraft and certain property with a long production period placed in service or manufactured before January 1, 2007, in areas affected by Hurricane Katrina, Rita, or Wilma. 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 16.

Topics
This chapter discusses:

- Overview of depreciation
- Section 179 deduction
- Claiming the special depreciation allowance
- Figuring depreciation under MACRS
- Additional rules for listed property
- Depreciation
- Amortization

Useful Items
You may want to see:

Publication
- 463 Travel, Entertainment, Gift, and Car Expenses
- 534 Depreciating Property Placed in Service Before 1987
- 535 Business Expenses
- 544 Sales and Other Dispositions of Assets
- 551 Basis of Assets
- 946 How To Depreciate Property

Form (and Instructions)
- T Forest Activities Schedule
- 3115 Application for Change in Accounting Method
- 4562 Depreciation and Amortization
- 4797 Sales of Business Property

See chapter 17 for information about getting publications and forms.

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 permanent records of the depreciated property. They will help you verify the accuracy of the of the deprecia- tion of assets placed in service in the current and previous tax years. 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.

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 is the basis of your depreciable property.
- How to treat repairs and 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 have a useful life that extends substantially beyond the year you place it in service.

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

Example 1. If you use your car for farm business, you can deduct depreciation based on its percentage of use in farming. If you use it for personal activities, you can deduct depreciation based on its percentage of use in personal activities. However, if you use property for personal activities, you can deduct depreciation based on the percentage of business or 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.

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

What Property Cannot Be Depreciated?

Certain property cannot be depreciated, even if the requirements explained earlier are met. 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. Although you cannot depreciate land, you can depreciate certain costs incurred in preparing land for business use. See chapter 1 of Publication 946.
- 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. This property does not have a determinable useful life and generally cannot be depreciated. However, see Amortization, later. Special rules apply to computer software (discussed below).
- Certain term interests (discussed below).
- Computer software. 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 (if applicable), 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 2006 after harvest was over. You begin to depreciate the planter for 2006 because it was ready and available for its specific use in 2006, even though it will not be used until the spring of 2007.

If your planter comes unassembled in December 2006 and is put together in February 2007, it is not placed in service until 2007. You begin to depreciate it in 2007.

If your planter was delivered and assembled in February 2007 but not used until April 2007, it is placed in service in February 2007, because this is when the planter was ready for its specified use. You begin to depreciate it in 2007.

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 (that is, when they bear fruit, nuts, or grapes in quantities sufficient to commercially warrant harvesting).

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. Where 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. Use the methods discussed in Publication 534.
- Certain property owned or used in 1986. See Chapter 1 of Publication 946.
- 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.

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 or other basis. The basis of property you buy is usually 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.

There are times when you cannot use cost as basis. In these situations, the fair market value (FMV) or the adjusted basis of the property may be used.

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.

Basis adjustment for depreciation allowed or allowable. After you place your property in service, you must reduce the basis of the property by the depreciation allowed or allowable.
Section 179 Deduction

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. This is the section 179 deduction. You can elect the section 179 deduction instead of recovering the cost by taking depreciation deductions. 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, how to elect the deduction, and when you may have to recapture the deduction.

For more information, see chapter 2 of Publication 946.

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 single purpose agricultural (livestock) structure is any building or enclosure specifically designed, constructed, and used for the commercial production of livestock for the bulk storage of fungible commodities.
   - A greenhouse specifically designed, constructed, and used for the commercial production of mushrooms.
   - A research facility used in connection with the production of grain or livestock for the bulk storage of fungible commodities.
   - 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 the following uses:

- 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.

- 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.
- Property used directly in the production of fungible commodities.
• 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.

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, farmland cannot qualify as 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. Your cost for the section 179 deduction is limited. See section 179 for most property placed in service during the year.
• Property used by governmental units or and $101,800 for the tractor, a total of $108,000. You purchased the property or... the smaller of:
  
  • The cost of qualified section 179 GO Zone property placed in service during the year.
  
  • The cost of qualified section 179 GO Zone property placed in service during the year.

Qualified section 179 GO Zone property is section 179 property that is also qualified GO Zone property (described later under Claiming the Special Depreciation Allowance).

Limits for sport utility vehicles. The total amount you can elect to deduct for certain sport utility vehicles and certain other vehicles placed in service in 2006 is $25,000. This rule applies to any 4-wheeled vehicle primarily designed or used to carry passengers over public streets, roads, and highways that is rated at more than 6,000 pounds gross vehicle weight and not more than 14,000 pounds gross vehicle weight.

For more information, see chapter 2 of Publication 946.

Limits for passenger automobiles. For a passenger automobile that is placed in service in 2006, the total section 179 and depreciation deduction is limited. See Do the Passenger Automobile Limits Apply, later.

Married individuals. If you are married, how you figure your section 179 deduction depends on whether you file jointly or separately. 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. If you and your spouse file separate returns, you are treated as separate taxpayers for the dollar limit, including the reduction for costs over $430,000. You must allocate the dollar limit (after any reduction) equally between you, 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 $430,000).

  • 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 over and deducted in a later year.

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.

If you deduct only part of the cost of qualifying property as a section 179 deduction, you can generally depreciate the cost you do not deduct.

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

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.

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.

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 $6,800 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.

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).

Dollar Limits

The total amount you can elect to deduct under section 179 for most property placed in service in 2006 is $108,000. 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 $108,000. You do not have to claim the full $108,000.

Example. This year, you bought and placed in service a tractor for $104,000 and a mower for $6,200 for use in your farming business. You elect to deduct the entire $6,200 for the mower and $101,800 for the tractor, a total of $108,000. 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 $2,000. You figure this by subtracting the amount of your section 179 deduction, $101,800, from the cost of the tractor, $104,000.

Reduced dollar limit for cost exceeding $430,000. If the cost of your qualifying section 179 property placed in service in 2006 is over $430,000, you must reduce the dollar limit (but not below zero) by the amount of cost over $430,000. If the cost of your section 179 property placed in service during 2006 is $538,000 or more, you cannot take a section 179 deduction and you cannot carry over the cost that is more than $538,000.

Example. This year, James Smith placed in service machinery costing $508,000. Because this cost is $78,000 more than $430,000, he must reduce his dollar limit to $30,000 ($108,000 – $78,000).

Limits for qualified section 179 GO Zone property. If you placed in service qualified section 179 GO Zone property (described below) in 2006, the amount of property for which you can make the election under section 179 is increased by the smaller of:

• $100,000 or

• The cost of the qualified section 179 GO Zone property placed in service during the year.

The amount for which you can make the election is reduced if the cost of all section 179 property placed in service during the year exceeds $430,000 increased by the smaller of:

• $600,000 or

• The cost of qualified section 179 GO Zone property placed in service during the year.

Depreciation, Depletion, and Amortization

Chapter 7

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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.

<table>
<thead>
<tr>
<th>Step</th>
<th>Action</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Figure taxable income without the section 179 deduction or the other deduction.</td>
</tr>
<tr>
<td>2</td>
<td>Figure a hypothetical section 179 deduction using the taxable income figured in Step 1.</td>
</tr>
<tr>
<td>3</td>
<td>Subtract the hypothetical section 179 deduction figured in Step 2 from the taxable income figured in Step 1.</td>
</tr>
<tr>
<td>4</td>
<td>Figure a hypothetical amount for the other deduction using the amount figured in Step 3 as taxable income.</td>
</tr>
<tr>
<td>5</td>
<td>Subtract the hypothetical other deduction figured in Step 4 from the taxable income figured in Step 1.</td>
</tr>
<tr>
<td>6</td>
<td>Figure your actual section 179 deduction using the taxable income figured in Step 5.</td>
</tr>
<tr>
<td>7</td>
<td>Subtract your actual section 179 deduction figured in Step 6 from the taxable income figured in Step 1.</td>
</tr>
<tr>
<td>8</td>
<td>Figure your actual other deduction using the taxable income figured in Step 7.</td>
</tr>
</tbody>
</table>

**Step 1.** Taxable income figured in the next year is $128,000.

**Step 2.** Using $128,000 as taxable income, XYZ’s hypothetical section 179 deduction is $108,000.

**Step 3.** $20,000 ($128,000 − $108,000).

**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.** $126,000 ($128,000 − $2,000).

**Step 6.** Using $126,000 (from Step 5) as taxable income, XYZ figures the actual section 179 deduction figured in Step 7. Because the taxable income is at least $108,000, XYZ can take a $108,000 section 179 deduction.

**Step 7.** $20,000 ($126,000 − $108,000).

**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 for an unlimited number of years 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.** On February 1, 2006, the XYZ farm corporation purchased and placed in service qualifying section 179 property that cost $108,000. It elects to expense the entire $108,000 cost under section 179. In June, the corporation gave a charitable contribution of $10,000. A corporation’s limit on charitable contributions is 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 $128,000. XYZ figures its section 179 deduction and its deduction for charitable contributions as follows.

- **Step 1.** Taxable income figured in either deduction is $128,000.
- **Step 2.** Using $128,000 as taxable income, XYZ’s hypothetical section 179 deduction is $108,000.
- **Step 3.** $20,000 ($128,000 − $108,000).
- **Step 4.** Using $20,000 (from Step 3) as taxable income, XYZ figures its hypothetical charitable contribution (limited to 10% of taxable income) is $2,000.
- **Step 5.** $126,000 ($128,000 − $2,000).
- **Step 6.** Using $126,000 (from Step 5) as taxable income, XYZ figures the actual section 179 deduction is $28,000 ($108,000 − $80,000), and it elects to expense that amount. Because P’s taxable income from the active conduct of all of its trades or businesses for the year was $30,000, it can deduct the full $28,000. P allocates $10,000 of its section 179 deduction and $18,000 of its taxable income to John, one of its partners.

John also conducts a business as a sole proprietor and in 2006, 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 for his section 179 costs to his sole proprietorship. He carries over $4,000 ($24,000 − $20,000) of the elected section 179 costs to 2007.

**How Do You Elect the Deduction?**

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

<table>
<thead>
<tr>
<th>Form 4562 with either of the following:</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Your original tax return (whether or not you filed it timely), or</td>
</tr>
</tbody>
</table>
| • An amended return filed within the time prescribed by law. 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 also include any resulting adjustments to taxable income.

### 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 $430,000, 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 deduction. For more information, see chapter 2 of Publication 946.

**Example.** In 2006, Partnership P placed in service section 179 property with a total cost of $510,000. P must reduce its dollar limit by $80,000 ($510,000 − $430,000). Its maximum section 179 deduction is $28,000 ($108,000 − $80,000), and it elects to expense that amount. Because P’s taxable income from the active conduct of all of its trades or businesses for the year was $30,000, it can deduct the full $28,000. P allocates $10,000 of its section 179 deduction and $18,000 of its taxable income to John, one of its partners.
Revoking an election. An election (or any specification made in the election) to take a section 179 deduction for 2004 can be revoked without IRS approval by filing an amended return. The amended return must be filed within the time prescribed by law. The amended return must also include any resulting adjustments to taxable income (for example, allowable depreciation in that tax year for the item of section 179 property for which the election pertains.) Once made, the revocation is irrevocable.

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 when the property is listed property. 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 allowable depreciation for 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 actually claimed. The result is the amount you must recapture.

Example. In January 2004, 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. He also elected not to claim a special depreciation allowance. He used the property only for personal use. He figures his recapture amount as follows:

<table>
<thead>
<tr>
<th>Section 179 deduction claimed (2004)</th>
<th>$5,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Minus: Allowable depreciation (instead of section 179 deduction):</td>
<td></td>
</tr>
<tr>
<td>2004</td>
<td>$1,250</td>
</tr>
<tr>
<td>2005</td>
<td>1,875</td>
</tr>
<tr>
<td>2006 ($1,250 x 40%)</td>
<td>500</td>
</tr>
<tr>
<td>(business)</td>
<td>3,625</td>
</tr>
<tr>
<td><strong>Recapture amount</strong></td>
<td><strong>$1,375</strong></td>
</tr>
</tbody>
</table>

Paul must include $1,375 in income for 2006. 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).

Recapture for qualified section 179 GO Zone property. If any qualified section 179 GO Zone property ceases to be used in the GO Zone in a later year, you must recapture the benefit of the increased section 179 deduction as "other income."

Claiming the Special Depreciation Allowance
For qualified property (defined below) placed in service in 2006, you can take an additional 50% 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. Figure the special depreciation allowance by multiplying the depreciable basis of the qualified property by 50%.

What Is Qualified Property?
For farmers, qualified property generally is qualified GO Zone property. This is depreciable property that meets the following requirements.

- The property must be acquired by purchase after August 27, 2005, if a binding contract to acquire the property existed before August 28, 2005, the property does not qualify.
- The property must be in service in the GO Zone during the tax year.
- Substantially all of the use of the property must be in the GO Zone in the active conduct of your trade or business.
- The original use of the property within the GO Zone must begin with you.

For more information, including a description of the areas in the GO Zone, and a list of qualified GO Zone property, see chapter 3 of Publication 946.

Extension of placed in service date for certain property. Certain property with a long production period or certain noncommercial aircraft that is either placed in service or manufactured in the GO Zone, the Rita GO Zone, or the Wilma GO Zone, and you were unable to meet the original December 31, 2005, placed-in-service date as a result of Hurricane Katrina, Rita, or Wilma, is qualified property for purposes of the 50% special allowance if it is placed in service before January 1, 2007. For more information, see the Instructions for Form 4562.

How Can You Elect Not To Claim the Allowance?
You can elect, for any class of property, not to deduct the special allowance for all property in such class placed in service during the tax year. To make the election, attach a statement to your return indicating the class of property for which you are making the 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.

If you elect not to have the special allowance apply, the property may be subject to an alternative minimum tax adjustment for depreciation.

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 deprecate property under MACRS determines what depreciation method and recovery period you use. You should use...
Table 7-1. Farm Property Recovery Periods

<table>
<thead>
<tr>
<th>Assets</th>
<th>Recovery Period in Years</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agricultural structures (single purpose)</td>
<td>10</td>
</tr>
<tr>
<td>Automobiles</td>
<td>5</td>
</tr>
<tr>
<td>Calculators and copiers</td>
<td>5</td>
</tr>
<tr>
<td>Cattle (dairy or breeding)</td>
<td>5</td>
</tr>
<tr>
<td>Communication equipment¹</td>
<td>7</td>
</tr>
<tr>
<td>Computer and peripheral equipment</td>
<td>5</td>
</tr>
<tr>
<td>Drainage facilities</td>
<td>15</td>
</tr>
<tr>
<td>Farm buildings²</td>
<td>20</td>
</tr>
<tr>
<td>Farm machinery and equipment</td>
<td>7</td>
</tr>
<tr>
<td>Fences (agricultural)</td>
<td>10</td>
</tr>
<tr>
<td>Goats and sheep (breeding)</td>
<td>5</td>
</tr>
<tr>
<td>Grain bin</td>
<td>7</td>
</tr>
<tr>
<td>Hogs (breeding)</td>
<td>3</td>
</tr>
<tr>
<td>Horses (age when placed in service)</td>
<td>3</td>
</tr>
<tr>
<td>Logging machinery and equipment³</td>
<td>5</td>
</tr>
<tr>
<td>Nonresidential real property</td>
<td>39³</td>
</tr>
<tr>
<td>Office furniture, fixtures, and equipment</td>
<td>7</td>
</tr>
<tr>
<td>Paved lots</td>
<td>15</td>
</tr>
<tr>
<td>Residential rental property</td>
<td>27.5</td>
</tr>
<tr>
<td>Tractor units (over-the-road)</td>
<td>3</td>
</tr>
<tr>
<td>Trees or vines bearing fruit or nuts</td>
<td>10</td>
</tr>
<tr>
<td>Truck (heavy duty, unloaded weight 13,000 lbs or more)</td>
<td>5</td>
</tr>
<tr>
<td>Truck (actual weight less than 13,000 lbs)</td>
<td>5</td>
</tr>
<tr>
<td>Water wells</td>
<td>15</td>
</tr>
</tbody>
</table>

¹ Not including communication equipment listed in other classes.
² Not including single purpose agricultural or horticultural structures.
³ Used by logging and sawmill operators for cutting of timber.

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. 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 discrimina-
tory acts.
- Any tangible property used predominantly outside the United States during the year.

5. 15-year property.
6. 20-year property.
7. 25-year property.
8. Residential rental 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. Also see chapter 6.

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. 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 util-
ties 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 depreci-
ated were discussed earlier in irrigation systems
and water wells under Property Having a Deter-
minal Useful Life.

Which Convention Applies? Under MACRS, averaging conventions estab-
lish 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.

For a detailed explanation of each convention, see Which Convention Applies in chapter 4 of
Publication 946. Also see the Instructions for Form 4562.

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.
• The 150% declining balance method over
a GDS recovery period.
• The straight line method over a GDS re-
covery period.
• The straight line method over an ADS re-
covery period.

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.

<table>
<thead>
<tr>
<th>Depreciation Table</th>
</tr>
</thead>
<tbody>
<tr>
<td>System/Method</td>
</tr>
<tr>
<td>---------------------</td>
</tr>
<tr>
<td>GDS using 150% DB</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>GDS using SL</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>ADS using SL</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>GDS using 200% DB</td>
</tr>
</tbody>
</table>

¹ Elective method
² See section 168(g)(6) of the Internal Revenue Code

Property used in farming business. For per-
sonal property placed in service after 1988 in
a farming business, you must use the 150% de-
clining balance method over a GDS recovery period or you can elect one of the following methods.
• The straight line method over a GDS re-
covery period.
• The straight line method over an ADS re-
covery 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 prop-
erty classes. If you made this election, continue
to use the same method and recovery period for that property.

Real property. You can depreciate real prop-
erty using the straight line method under either GDS or ADS.

Switching to straight line. If you use a de-
clining 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 Fig-
ured, 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.

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 (excluding extensions) for the year you placed the property in service. How-
ever, 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 301.9101-2” 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 elec-
tion on a property-by-property basis for residen-
tial 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 “SL” under column (f) in Part III of Form 4562.

ADS election. As explained earlier under Which Depreciation System (GDS or ADS) Ap-
plies, 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
Appendix B of Publication 946.

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 prop-
erty. Then you are ready to figure your deprecia-
tion deduction. You can figure it in one of two ways.

• You can use the percentage tables pro-
vided 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 convention 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. Unadjusted basis is the same basic 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.

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, which 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 depreciation using the straight line 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 conventions.

The following examples show how to figure depreciation under MACRS using the percentage rates 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. In addition, the property is not qualified property for purposes of 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%).

Table 7-2. 150% Declining Balance Method (Half-Year Convention)

<table>
<thead>
<tr>
<th>Year</th>
<th>3-Year</th>
<th>5-Year</th>
<th>7-Year</th>
<th>20-Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>25.0%</td>
<td>15.00%</td>
<td>10.71%</td>
<td>3.750%</td>
</tr>
<tr>
<td>2</td>
<td>37.5%</td>
<td>25.00%</td>
<td>19.13%</td>
<td>7.142%</td>
</tr>
<tr>
<td>3</td>
<td>62.5%</td>
<td>25.00%</td>
<td>24.49%</td>
<td>9.571%</td>
</tr>
<tr>
<td>4</td>
<td>16.67%</td>
<td>10.00%</td>
<td>14.29%</td>
<td>5.714%</td>
</tr>
<tr>
<td>5</td>
<td>16.66%</td>
<td>10.00%</td>
<td>14.29%</td>
<td>5.713%</td>
</tr>
<tr>
<td>6</td>
<td>16.67%</td>
<td>10.00%</td>
<td>14.29%</td>
<td>5.714%</td>
</tr>
<tr>
<td>7</td>
<td>12.25%</td>
<td>7.50%</td>
<td>9.13%</td>
<td>3.750%</td>
</tr>
<tr>
<td>8</td>
<td>9.13%</td>
<td>6.25%</td>
<td>6.88%</td>
<td>2.943%</td>
</tr>
</tbody>
</table>

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 conventions.

Table 7-3. Straight Line Method (Half-Year Convention)

<table>
<thead>
<tr>
<th>Year</th>
<th>3-Year</th>
<th>5-Year</th>
<th>7-Year</th>
<th>20-Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>16.67%</td>
<td>10.00%</td>
<td>7.14%</td>
<td>2.500%</td>
</tr>
<tr>
<td>2</td>
<td>16.67%</td>
<td>10.00%</td>
<td>7.14%</td>
<td>2.500%</td>
</tr>
<tr>
<td>3</td>
<td>16.67%</td>
<td>10.00%</td>
<td>7.14%</td>
<td>2.500%</td>
</tr>
<tr>
<td>4</td>
<td>16.67%</td>
<td>10.00%</td>
<td>7.14%</td>
<td>2.500%</td>
</tr>
<tr>
<td>5</td>
<td>16.67%</td>
<td>10.00%</td>
<td>7.14%</td>
<td>2.500%</td>
</tr>
<tr>
<td>6</td>
<td>16.67%</td>
<td>10.00%</td>
<td>7.14%</td>
<td>2.500%</td>
</tr>
<tr>
<td>7</td>
<td>16.67%</td>
<td>10.00%</td>
<td>7.14%</td>
<td>2.500%</td>
</tr>
<tr>
<td>8</td>
<td>16.67%</td>
<td>10.00%</td>
<td>7.14%</td>
<td>2.500%</td>
</tr>
</tbody>
</table>

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.

Property acquired in a like-kind exchange or transfer. 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. This applies only to acquired property with the same or a shorter recovery period and the same or more accelerated depreciation method than the property exchanged or converted. The excess basis, if any, of the acquired MACRS property is treated as newly placed in service MACRS property.

Election out. 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 the later of on the date you acquired it, or the time of the disposition of the exchanged or involuntarily converted property. For depreciation purposes, the adjusted basis of the exchanged or involuntarily converted property is treated as if it was disposed of at the time of the exchange or conversion.

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.

Property acquired in a nontaxable transfer. You must depreciate MACRS property acquired by a corporation or partnership in certain non-taxable transfers over the property's remaining recovery period in the transferor's hands, as if the transfer had not occurred. You may 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 non-taxable 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 assets into one or more general asset accounts (GAAs). You can then depreciate all the assets in each account as a single asset. Each account must include only

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assets with the same asset class (if any), recovery period, depreciation method, and convention. You cannot include an asset 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 assets in the GAA. For each GAA, record the depreciation allowance in a separate depreciation reserve account.

There are additional rules for grouping assets in a GAA, figuring depreciation for a GAA, disposing of GAA assets, 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. For more information on depreciation recapture, see chapter 9. Also see chapter 4 of Publication 946.

### Additional 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.

- 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.
- Properly 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.

A truck or van that is a qualified non-personal use vehicle 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, airplanes, motorcycles, and other vehicles used for transporting persons or goods.

**Exceptioned 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 fork lifts.
- Any vehicle designed to carry cargo with a loaded gross vehicle weight of over 14,000 pounds.

For more information, see chapter 5 of Publication 946.

### What Is the Business-Use Requirement?
You can claim the section 179 deduction for listed property and depreciate listed property using GDS and a declining balance method, if on how to treat separate mineral interests.

Deductions for listed property (other than listed property and depreciate listed property section 614 and the related regulations for rules

**Chapter 7**

Depreciation, Depletion, and Amortization

Page 45
industry and the most accurate and reli-
able information you can obtain.

Basis for depletion and total recoverable
units are explained in chapter 9 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.

<table>
<thead>
<tr>
<th>IF you use</th>
<th>THEN the units sold during the year are</th>
</tr>
</thead>
<tbody>
<tr>
<td>The cash method of accounting</td>
<td>The units sold for which you receive payment during the tax year (regardless of the year of sale).</td>
</tr>
<tr>
<td>An accrual method of accounting</td>
<td>The units sold based on your inventories.</td>
</tr>
</tbody>
</table>

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.

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.

Cost depletion for ground water in Ogal-
alla 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
that the ground water is being depleted and the rate
of recharge is so low that, once extracted, the
water would be lost to the taxpayer and immedi-
ately succeeding generations. To figure your
cost depletion deduction, use the guidance pro-
vided in Revenue Procedure 66-11 in Cumula-

Timber Depletion

Depletion takes place when you cut standing
 timber (including Christmas trees). You can fig-
ure your depletion deduction when the quantity
of cut timber is first accurately measured in the
process of exploitation.

Figuring the timber depletion deduction.

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.

Example.

Sam Brown bought a farm that
included standing timber. This year Sam deter-
mined that the standing timber could produce 300,000 units when cut. At that time, the ad-
justed 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 $0.08 ($24,000 ÷ 300,000). His deduction for depletion is $2,160 (27,000 units × $0.08). 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 $0.08. How-
ever, his depletion deduction would have been $1,600 (20,000 units × $0.08) for this year and he would have included the balance of $560 (7,000 units × $0.08) 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
depreciation 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 9 of Publication 535 for a list of the percentages. You can find a complete list in Internal Revenue Code section 613(b).

Taxable income limit.

The percentage deple-
tion deduction cannot be more than 50% (100%
for oil and gas property) of your taxable income from the property figured without the depletion deduction and the domestic production activities
deduction.

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 de-
duction from the gross income from the property.
• Corporations do not deduct charitable con-
tributions from the gross income from the property.
• If, during the year, you disposed of an item of property, you must use the inventory method of accounting for purposes of the taxable income limit.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.

Example.

Sam Brown bought a farm that
included standing timber. This year Sam deter-
mined that the standing timber could produce 300,000 units when cut. At that time, the ad-
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For more information on depletion, see chap-
ter 9 in Publication 535.

Amortization

Amortization is a method of recovering (deduct-
ing) certain capital costs over a fixed period of time. It is similar to the straight line method of deprec-
ation. The amortizable costs discussed in this section include the start-up costs of going into business, reforestation costs, the costs of pollution control facilities, and the costs of sec-

197 intangibles. See chapter 8 in Publica-
tion 535 for more information on these topics.

Business Start-Up Costs

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 deprec-
ation. However, you generally cannot re-
cover other costs until you sell the business or
otherwise go out of business.

Start-up costs are costs for creating an ac-
tive trade or business or investigating the crea-
tion or acquisition of an active trade or business. Start-up costs include any amounts paid or in-
curred in connection with any activity engaged in
to profit and for the production of income before the trade or business begins, in anticipation of the activity becoming an active trade or busi-
ness. You can elect to currently deductible up to
$5,000 of business start-up costs paid or incurred
during the tax year. See Capital Ex-
penses in chapter 4. If this election is made, any
costs that are not currently deductible can be amortized.

Amortization period.
The amortization period for business start-up costs paid or incurred before October 23, 2004, is 60 months or more. 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.

**Reporting requirements.** To amortize your start-up costs that are not currently deductible under the election to deduct, complete Part VI of Form 4562 and attach a statement containing any required information. See the Instructions for Form 4562.

**For more information,** see Starting a Business in chapter 8 of Publication 535.

### Reforestation Costs

You can elect to currently deduct a limited amount of qualifying reforestation costs for each qualified timber property. See Cost Expenses in chapter 4. You can elect to amortize over 84 months any amount not deducted. 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.

**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 woodland 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 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 any required information. See the Instructions for Form 4562.

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 8 of Publication 535.

### Pollution Control Facilities

You can elect to amortize the cost of a certified pollution control facility generally 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.

**Qualifying costs.** Qualifying costs include by claiming depreciation deductions. See chapter 8 in Publication 535 and Internal Revenue Code section 169 and the related regulations. For more information, see Pollution Control Facilities in chapter 8 of Publication 535 and Internal Revenue Code section 169 and the related regulations.

**Certified pollution control facility.** A certified pollution control facility is a new identifiable treatment facility used in connection with a plant or other property generally in operation before 1976 to reduce or control water or atmospheric pollution or contamination. The facility must do one or more of the following:

- Remove or reduce the potential recovery.
- Prevent the creation or emission of pollutants, contaminants, wastes, or heat.
- The facility must also 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 purchased a new $75,000 manure control facility for use in connection with a dairy plant on your farm. The farm has been in operation since you bought it in 1976 and all of the dairy plant was in operation before that date. You have no intention of recovering the cost of the facility through sale of the waste and a federal certifying authority has so certified.

Your manure control facility qualifies for amortization. You can elect to amortize its cost over 60 months. Otherwise, you can capitalize the cost and depreciate the facility.

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 new manure control facility used in connection with your swine operation because you have significantly increased its output or capacity. You can no longer use the deduction for the facility by claiming depreciation deductions.

**More information.** For more information on the amortization of pollution control facilities, see chapter 8 of Publication 535 and Internal Revenue Code section 169 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 (180 months). You are not allowed any other depreciation or amortization deduction for an amortizable section 197 intangible.

Section 197 intangibles include the following assets:

- Goodwill.
- Patents.
- Copyrights.
- Designs.
- Formulas.
- Licenses.
- Permits.
- Covenants not to compete.
- Franchises.
- Trademarks.

See chapter 8 in Publication 535 for more information, including a complete list of assets that are section 197 intangibles and special rules.
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 multi-pie 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 must deduct from gross income.

**Example.** Bill Smith trades an old tractor of his old tractor equal to the difference between the amount realized and the adjusted basis of the property that is more than the amount recognized from the exchange of property.

**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.

**Example.** Bill Smith sells his old tractor for $8,000 and bought a new one for $22,000. He is allowed to postpone reporting the gain or loss from the like-kind exchange. For more information about determining gain or loss, see chapter 6 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.
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 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. Assets that are not in the same class will qualify as like-kind property if they are of the same nature or character.

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 computer processors (asset class 00.13).
4. Airplanes (airframes and engines), except planes used in commercial or contract carrying of passengers or freight, and all helicopter (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 sections 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.ntis.gov. Copies of the manual may be obtained from the National Technical Information Service (NTIS) at the same website or by calling 1-800-553-NTIS (1-800-553-6847) or (703) 605-6000. The cost of the manual is $49 (plus shipping and handling) and the order number is PB2002104130 (which must be typed into the NTIS website searchbox).

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 property. Neither is the exchange of livestock of one sex for livestock of the other sex. An exchange of the assets of a business for the assets of a similar business cannot be treated as an exchange of one property for another property. Whether you engaged in a like-kind exchange depends on an analysis of each asset involved in the exchange.

Partially nontaxable exchange. If, 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). A loss is not deductible.

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.), 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 or more corporations 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 grey pickup truck in your farming business. Your sister used a red pickup truck in her landscaping business. In December 2005, you exchanged your pickup truck, plus $200, for your sister’s pickup truck. At that time, the fair market value (FMV) of your pickup truck was $6,200, and its adjusted basis was $6,000. The FMV of your sister’s pickup truck was $7,200 and its adjusted basis was $1,000. You realized a gain of $1,000 (the $7,200 FMV of your pickup truck, minus your pickup’s $6,000 adjusted basis, minus the $200 you paid). Your sister realized a gain of $6,200 (the $7,000 FMV of the grey pickup truck you exchanged, plus the $200 you paid, minus the $1,000 adjusted basis of the red pickup truck she exchanged with you).

However, because this was a like-kind exchange, you recognized no gain. Your basis in the newly acquired red pickup truck was $6,400 (the $6,000 adjusted basis of the pickup truck you exchanged with her plus the $200 you paid). Your sister recognized gain only to the extent of the money she received, $200. Her basis in the grey pickup truck she received from you was $1,000 (the $1,000 adjusted basis of the red pickup truck she exchanged with you minus the $200 received, plus the $200 gain recognized).

In 2006, you sold the red 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 2006, you must report your $1,000 gain on the 2005 exchange. You also report a loss on the sale as $200 (the adjusted basis of the 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 2006 the $6,000 balance of her gain on the 2005 exchange. Her adjusted basis in the pickup truck she acquired from you is increased to $7,000 ($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 treated as a like-kind exchange. The recipient's basis in the property will be the same as the adjusted basis of the giver immediately before the transfer. The carryover basis rule applies whether the adjusted basis of the transferred property is less than, equal to, or greater than its fair market value at the time of transfer. Consideration paid at the time of transfer is not included in the basis. 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 your trade or business or held for the production of income. 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 a 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 longer than 1 year, the gain or loss resulting from its disposition is long term. Report it in Part I, Schedule D (1040). If you hold a capital asset longer than 1 year, your holding period is longer than 1 year, but if you sold it on June 20, 2006, 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 receive it. If you later sold it, see the section 1231 transactions rule. If you held it for capital asset 1 year, 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 (Form 1040), line 16, is more than the yearly limit (line 21).
- The amount shown on Form 1040, line 41, (your taxable income without your deduction for exemptions), is less than zero.

If either of these situations applies to you for 2006, see Capital Losses under Reporting Capital Gains and Losses in chapter 4 of Publication 550 to figure the amount you can carry over to 2007.

To figure your capital loss carryover from 2006 to 2007, you will need a copy of your 2006 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.

**Increased Section 1202 Exclusion of Gain From Qualified Small Business Stock.** Taxpayers other than corporations generally can exclude from income 50% of their gain from the sale or trade of qualified small business stock held more than 5 years. If the stock is in a corporation that qualifies as an enterprise zone business during substantially all of the time you held the stock, you can exclude 60% of your gain. To claim this increased exclusion, you must have acquired the stock after December 21, 2000. See Publication 954, Tax Incentives for Distressed Communities, and Publication 550 for more information.

**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 noncapital asset. Gain or loss from sales or other dispositions of this property is reported on Schedule F (Form 1040) (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 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 exchanged.

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(s) 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(s) or risk.

For more information on the tax treatment of futures and options contracts, see Commodity
Futures and Section 1256 Contracts Marked to Market in 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 futures hedging transaction with the timing of income, deduction, gain, or loss from the item or items being hedged. There are requirements and limits on the method you can use for certain hedging transactions. See Regulations section 1.446-4(e) for those requirements and limits.

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

1. Cash method.
2. Farm-price method.
3. Unit-livestock-price method.

Once you adopt a method, you must apply it consistently and must have IRS approval before changing it.

Your books and records must describe the accounting method used for each type of hedging transaction. They must also contain any additional identification necessary to verify the application of the accounting method you used for the transaction. You must make the additional identification no more than 35 days after entering into the hedging transaction.

Example of a hedging transaction. You file your income tax returns on the cash method. On July 2, 2006, 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.

The rules discussed here do not apply to the sale of livestock held primarily for breeding and raising purposes. The sale or exchange of livestock is reported on Schedule F, Part I, line 10 .

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 own 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 sell for the fur trade. You take breeders from the herd when they are no longer useful as breeders and sell them. Although these breeders are processed and pelled, 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 sell horses from your racing stable. In 2006, you decided that to prevent your racing stable from getting too large to be effectively operated, you must sell six horses that had been raced at public tracks in 2005. 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:

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.

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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.
Highly erodible cropland. 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, 2006, for $2,150. Expenses of the sale were $125. The cow was bought July 2, 2003, for $1,300. Depreciation (not less than the amount allowable) was $759.

Gross sales price.............. $ 2,150
Cost (basis)..................... $ 1,300

Minus: Depreciation deduction 759

Unrecovered cost

(adjusted basis)................ $ 41

Expense of sale................. $ 25

Gain realized.................. $ 768

Purchased livestock. The gross sales price minus your adjusted basis and any expenses of sale is the gain or loss.

Example. A seller sold a breeding cow on January 8, 2006, for $2,150. Expenses of the sale were $125. The cow was bought July 2, 2003, for $1,300. Depreciation (not less than the amount allowable) was $759.

Gross sales price.............. $ 2,150
Cost (basis)..................... $ 1,300

Minus: Depreciation deduction 759

Unrecovered cost

(adjusted basis)................ $ 41

Expense of sale................. $ 25

Gain realized.................. $ 768

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 business. Amounts realized from these minor sales, and the expenses incurred in cutting, hauling, or preparing the timber for sale, are ordinary farm income and expenses reported on Schedule F.

Different rules apply if you owned the timber longer than 1 year and choose to treat timber as a capital asset. You are the owner of the timber. You held the timber longer than 1 year life in saturated soil. Timber for a period of more than 1 year before its disposal.

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 in 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.

Election under section 631(a) may be revoked.

If you had previously made an election to treat cutting of timber as a sale or exchange under section 631(a), you may revoke this election without the consent of the IRS for any tax year ending after October 22, 2004. The prior election (and revocation) is disregarded for purposes of making a subsequent election. See Form 1 (Timber) for more information.

Gain or loss. Your gain or loss on the cutting of standing timber is the difference between its adjusted basis for depletion and its 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 of the individual or other unit of property.

The rule on disposal of timber under a contract is discussed below. Depletion of timber is discussed in chapter 7.

Cutting contract. You must treat the disposal of standing timber under a cutting contract as a section 1231 transaction if all the following apply. 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 (defined below).

Outright sales of timber by landowners qualify for capital gains treatment if the timber was held for more than a year before the date of disposal. The holding period is computed from the date on which the property was transferred to the landowner under a contract with a retained economic interest.

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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 a capital gain or as ordinary gain. You figure your gain as follows.

FMV of timber January 1, 2006........ $1,400,000
Adjustment for depletion........... 160,000
Section 1231 gain.................. $1,240,000

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 (defined below).

The type and rule above prints on all proofs including departmental reproduction proofs. MUST be removed before printing.
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 sublessee 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 nonbusiness property, other than casualty or theft losses, are not deductible. If you receive payments for your farm in installments, your gain is taxed over the period of years the payments are received, unless you choose not to use the installment method of reporting the gain. See chapter 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 the 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 fair market value 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 Internal Revenue Code section 743(b). Internal Revenue Code section 743(b) 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 any 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 Internal Revenue Code section 355.

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 Regulations section 1.338-6(b)(2)(iii) for exceptions that apply to debt instruments 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 the fair market value of the farm, the amount paid for the assets described in (4) and (6) must be included on the farm’s return.

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). Gain from the sale of assets used in your farming business is a capital gain. However, tree stumps held by an investor who is not primarily for sale to customers in the farm business are treated as nonbusiness assets. The amount paid under Internal Revenue Code section 743(b) is taxed as a capital gain.

Example. You sell your farm, including your principal residence, which you have owned since December 1998, and realize a gain on the sale as follows:

<table>
<thead>
<tr>
<th></th>
<th>Farm With Home Only</th>
<th>Farm Without Home Only</th>
</tr>
</thead>
<tbody>
<tr>
<td>Selling price</td>
<td>$182,000</td>
<td>$142,000</td>
</tr>
<tr>
<td>Cost (or other basis)</td>
<td>40,000</td>
<td>10,000</td>
</tr>
<tr>
<td>Gain</td>
<td>$142,000</td>
<td>$132,000</td>
</tr>
</tbody>
</table>

You must report the $142,000 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. You should report any recognized gain or loss on the sale of your home in the year of the sale. You cannot wait until you have sold enough of the farm to recoup its entire cost before reporting gain or loss.

Adjusted basis of the part sold. This is the property 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 $50,000 (1/10 of $500,000), 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 3/5 (75%) of the total assessed valuation. Multiply the $700,000 total purchase price by 75% to figure basis of amount Ann realized is $170,000. This is the deemed cost (cost not depreciated) of the fence on the 60 acres of land. The unadjusted basis of the 60 acres you sold would then be $52,500 (1/10 of $525,000).

Sale of your home. Your home is a capital asset and not properly 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.

Example. Ann paid $200,000 for land and $525,000 for the 600 acres of land. The unadjusted basis of the 60 acres sold would then be $210,000. The result is the same.

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.
   a. You are married and file a joint return for the year.
   b. Either you or your spouse meets the ownership test.
   c. Both you and your spouse meet the use test.

d. 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. If you have a deductible loss, you generally must report as ordinary income on Form 1040, line 21. For more information on basis, see chapter 6.

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.

Cancelling 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).
Type of property or less 1 year also applies to leasehold improvements the lessee's adjusted basis when abandoned. This rule property is a capital asset. The loss is the property is deductible as an ordinary loss, even if the Table 9-1.

Introduction

The abandonment of property is a disposition of your 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. However, if the property is later foreclosed on or repossessed, gain or loss is figured as discussed, earlier, under Foreclosure or Repossession. If 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, abandonments of property, and debt cancellations occurring in 2006, these forms should be sent to you by January 31, 2007.

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 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

Table 8-1. Worksheet for Foreclosures and Repossessions

(Keep for your records)

<table>
<thead>
<tr>
<th>Part 1</th>
<th>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.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Enter amount of debt canceled by the transfer of property.</td>
</tr>
<tr>
<td>2.</td>
<td>Enter the fair market value of the transferred property.</td>
</tr>
<tr>
<td>3.</td>
<td>Income from cancellation of debt.* Subtract line 2 from line 1. If less than zero, enter zero.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Part 2</th>
<th>Figure your gain or loss from foreclosure or repossession.</th>
</tr>
</thead>
<tbody>
<tr>
<td>4.</td>
<td>Enter the smaller of line 1 or line 2. Also include any proceeds you received from the foreclosure sale. (If you are not personally liable for the debt, enter the amount of debt canceled by the transfer of property.)</td>
</tr>
<tr>
<td>5.</td>
<td>Enter the adjusted basis of the transferred property.</td>
</tr>
<tr>
<td>6.</td>
<td>Gain or loss from foreclosure or repossession. Subtract line 5 from line 4.</td>
</tr>
</tbody>
</table>

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

- The debt is qualified real property business debt (see chapter 5 of Publication 334).
- You are insolvent or bankrupt (see chapter 3).

Abandonment

Abandonment of property is a disposition of a 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. 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, abandonments of property, and debt cancellations occurring in 2006, these forms should be sent to you by January 31, 2007.

Table 9-1. Where to First Report Certain Items on Form 4797

<table>
<thead>
<tr>
<th>Type of property</th>
<th>Held 1 year or less</th>
<th>Held more than 1 year</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Dediciable trade or business property:</td>
<td>Part II</td>
<td>Part III (1245, 1250)</td>
</tr>
<tr>
<td>a Sold at a gain</td>
<td>Part II</td>
<td>Part I</td>
</tr>
<tr>
<td>b Sold at a loss</td>
<td>Part II</td>
<td>Part III (1252)</td>
</tr>
<tr>
<td>2 Farmland held less than 10 years for which soil, water, or land clearing expenses were deducted:</td>
<td>Part II</td>
<td>Part I</td>
</tr>
<tr>
<td>a Sold at a gain</td>
<td>Part II</td>
<td>Part III (1255)</td>
</tr>
<tr>
<td>b Sold at a loss</td>
<td>Part II</td>
<td>Part I</td>
</tr>
<tr>
<td>3 All other farmland</td>
<td>Part III (1255)</td>
<td></td>
</tr>
<tr>
<td>4 Disposition of cost-sharing payment property described in section 126</td>
<td>Part II</td>
<td>Part III (1245)</td>
</tr>
<tr>
<td>5 Cattle and horses used in a trade or business for draft, breeding, dairy, or sporting purposes:</td>
<td>Part II</td>
<td>Part II</td>
</tr>
<tr>
<td>a Sold at a gain</td>
<td>Part II</td>
<td>Part III (1245)</td>
</tr>
<tr>
<td>b Sold at a loss</td>
<td>Part II</td>
<td>Part I</td>
</tr>
<tr>
<td>c Raised cattle and horses sold at a gain</td>
<td>Part II</td>
<td>Part I</td>
</tr>
<tr>
<td>6 Livestock other than cattle and horses used in a trade or business for draft, breeding, dairy, or sporting purposes:</td>
<td>Part II</td>
<td>Part II</td>
</tr>
<tr>
<td>a Sold at a gain</td>
<td>Part II</td>
<td>Part III (1245)</td>
</tr>
<tr>
<td>b Sold at a loss</td>
<td>Part II</td>
<td>Part I</td>
</tr>
<tr>
<td>c Raised livestock sold at a gain</td>
<td>Part II</td>
<td>Part I</td>
</tr>
</tbody>
</table>
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, rams, 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 business, it is property held mainly for sale to customers.

Treatment as ordinary or capital. To determine the treatment of section 1231 gains and losses, combine all your section 1231 gains and losses for the year.

• If you have a net section 1231 gain, it is an ordinary gain.

• 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 2006, 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 2001 through 2005 he had the following section 1231 gains and losses.

<table>
<thead>
<tr>
<th>Year</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>2007</td>
<td>$0</td>
</tr>
<tr>
<td>2002</td>
<td>-</td>
</tr>
<tr>
<td>2003</td>
<td>($2,500)</td>
</tr>
<tr>
<td>2004</td>
<td>$0</td>
</tr>
<tr>
<td>2005</td>
<td>$1,800</td>
</tr>
</tbody>
</table>

Ben uses this information to figure how to report his net section 1231 gain for 2006 as shown below.

1) Net section 1231 gain (2006) ......... $2,000
2) Net section 1231 loss (2003) ($2,500)
3) Net section 1231 gain (2005) 1,800
4) Remaining net section 1231 loss ....... ($700)
5) Gain treated as capital gain ........... $1,300

His remaining net section 1231 loss from 2003 is completely recaptured in 2006.

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.

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.
Depreciation and amortization.

Depreciation claimed on other property or claimed by other taxpayers. The gain treated as ordinary income part of the gain. 7. Any basis reduction for the investment credit (or any basis increase for a credit recapture). 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.

Storage facilities (except buildings and structural components) used in distributing petroleum or any primary product of petroleum.

Buildings and structural components. Section 1245 property does not include build- ings 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 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 if 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.

Depreciation and amortization 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. 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.

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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 (1040), Profit or Loss From Farming, 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 2006 for $80,000. Her adjusted basis at the time of sale was $60,000. She bought the orchard in 1999, but the trees did not produce a crop until 2002. Her preproductive expenses were $6,000. She elected out of 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 a 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, like land, 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 Depreciation Recapture in chapter 3 of Publication 544.

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 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.

**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 4, 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 Regulations section 1.1252-2.

**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 acquired it, the percentage is 100%. If you dispose of the land within the 6th through 9th year after you acquired 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 acquired it, the percentage is 0%, and the entire gain is a section 1231 gain.

**Example.** You acquired farmland on January 19, 1999. On October 3, 2006, you sold the land at a $30,000 gain. Between January 1 and October 3, 2006, you make soil and water conservation expenditures of $15,000 for the land that are fully deductible in 2006. The applicable percentage is 40% since you sold the land within the 8th year after you acquired 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 any gain as ordinary income and treat the balance as a section 1231 gain. If you choose not to exclude these payments, you will not have to recognize ordinary income under this provision.

**Amount to report as ordinary income.** You report as ordinary income the lesser of the following amounts:

- The applicable percentage of the total excluded cost-sharing payments.
- The gain on the disposition of the property.

You do not report ordinary income under this rule to the extent the gain is recognized as ordinary income under sections 1231 through 1254, 1256, and 1257 of the Internal Revenue Code. However, you do report as ordinary income under this rule a gain or a part of a gain regardless of any contrary provisions (including nonrecognition provisions) under any other section of the Internal Revenue Code.

**Applicable percentage.** The applicable percentage of the excluded cost-sharing payments to be reported as ordinary income is based on the length of time you held 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

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 installation method. You cannot use the install- ment method to report a loss. You can choose to report all of your gain in the year of sale.

Installation 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:
- Installation sale of a farm
- Installation method
- Figuring installment sale income
- Payments received or considered received

Useful Items
You may want to see:
Publication
- 523 Selling Your Home
- 535 Business Expenses
- 537 Installment Sales
- 538 Accounting Periods and Methods
- 4797 Sales of Business Property
- 6252 Installment Sale Income

See chapter 17 for information about getting publications and forms.

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, later.

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 and chapter 9 for a discussion of property used in the business.) 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 installation method, any depreciation recapture under section 1245 or 1250 of the Internal Revenue Code is generally taxable as ordinary income in the year of the sale. See Depreciation recapture, later. This applies even if no payments are received in that year.

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. See Inventory, later, for information on the sale of farm property where inventory items are included in the assets sold.

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 an instalment 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, or considered received, because of related party resales, 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 its gain or loss on the disposition. If the holder and the 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.

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.

However, if you timely file your tax return for the year the sale takes place without making the election, you still can 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.

Revoking the election. Once made, the election cannot be revoked only with IRS approval. A revocation is retroactive.


Figuring Installment Sale Income
Each payment on an installment sale usually consists of the following three parts.
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.

Do not include stated interest, untrated interest, any amount recomputed or recharacterized as interest, or original issue discount. See Unstated interest, later.

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 made based 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:

1. The selling price, minus
2. The mortgages, debts, and other liabilities assumed or taken by the buyer
3. The amount by which the mortgages, debts, and other liabilities assumed or taken by the buyer exceed 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 compensation.

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 $6,000. Prepare Form 4797 first in order to compute your gain. Your gross profit percentage is 25% ($1,500 ÷ $6,000). 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.

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 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 also will change. You then must 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 instalments.

Interest income.
Return of your adjusted basis in the property.
Gain on the sale.

In each year you receive a payment, you must include in income both the interest part and 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 installment sale 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 untrated 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
2. Enter your adjusted basis for the property
3. Enter your selling expenses
4. Enter any depreciation recapture
5. Add lines 2, 3, and 4
6. Subtract line 5 from line 1. If zero or less, enter 0
7. This is your adjusted basis for installment sale purposes
8. Divide line 6 by line 7. This is your gross profit percentage

Selling price. The selling price is the total cost of the property to the buyer. It includes:

• Any money you are to receive,

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Example. In 2004, 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 2006. Your gross profit percentage is 60%. You reported a gain of $12,000 on each payment received in 2004 and 2005.

In 2006, you and the buyer agreed to reduce the purchase price to $85,000 and payments during 2006, 2007, and 2008 are reduced to $20,000 each, plus 12% interest, beginning in 2006. Your gross profit percentage is 60%. You reported a gain of $12,000 on each payment received in 2004 and 2005.

You sell property with an adjusted basis of $19,000. You have selling expenses of $1,000. The buyer assumes your mortgage of $15,000 and agrees to pay you $1,000 annually (plus 8% interest) over the next 3 years.

Worksheet B. New Gross Profit Percentage — Selling Price Reduced Keep for Your Records

Example — Worksheet B. New Gross Profit Percentage — Selling Price Reduced Keep for Your Records

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. However, as discussed later, the buyer’s assumption of your debt is treated as a recovery of basis, rather than as a payment, in many cases.

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.

Example. The selling price for your property is $9,000. The buyer will pay you $1,000 (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 portion 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.
Debt not payable on demand. Any evi- dence of debt you receive from the buyer that is not payable on demand is not considered a payment. This is true even if the debt is guaran- teed by a third party, including a government agency.

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 both having a reasonable knowledge of all the neces- sary facts.

Third-party note. If the property the buyer gives you is a third-party note (or other obliga- tion of a third party), you are considered to have received a payment equal to the note’s FMV. Because the FMV of 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. The excess of the note’s face value over its FMV is interest. Excluded from interest in determining the selling price of the property. However, see Exception under Prop- erty used as a payment, earlier.

Example. You sold real estate in an install- ment 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 interest taxed as ordinary income.

Bond. A bond or other evidence of debt you receive from the buyer that is payable on de- mand or readily tradable in an established se- curities market is treated as a payment in the year you receive it. For more information on the amount you should treat as a payment, see Exception, under Property used as a payment, earlier.

If you receive a government or corporate bond for a sale before October 22, 2004, and the bond has interest coupons attached or can be readily traded in an established securities mar- ket, you are considered to have received pay- ment equal to the bond’s FMV. However, 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 in- cluded 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.

Unstated interest. An installment sale con- tract may provide that each deferred payment on the sale will include interest or that there will be an interest payment in addition to the princi- pal payment. Interest provided in the contract is called stated interest.

If an installment sale contract does not pro- vide for adequate stated interest, part of the stated principal amount of the contract may be recharacterized as interest. If Internal Revenue Code section 483 applies to the contract, this interest is called unstated interest.

If Internal Revenue Code section 1274 ap- plies to the contract, this interest is called origi- nal issue discount (OID). In general, an installment sale contract pro- vides for adequate stated interest if the stated interest rate (based on an appropriate compounding period) is at least equal to the applica- ble federal rate (AFR). The AFRs 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 IRS website 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. Per- sonal-use property is any property in which sub- stantially all of its use by the buyer is not in connection with a trade or business or an invest- ment 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 Dis- count (OID) in Publication 537.

Example

On January 3, 2006, you sold your farm, includ- ing 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 2006. Your selling expenses were $15,000.

Adjusted basis and depreciation. The ad- justed basis and depreciation claimed on each asset sold are as follows:

- **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

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livestock and produce held for sale were sold in 2005 in anticipation of selling the farm. The section 179 deduction was not claimed on any asset.

**Selling Price Expense Adjusted Basis Gain**

<table>
<thead>
<tr>
<th>Home</th>
<th>$50,000</th>
<th>$2,500</th>
<th>$30,000</th>
<th>$17,500</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>125,000</td>
<td>6,250</td>
<td>61,250</td>
<td>57,500</td>
</tr>
<tr>
<td>Buildings</td>
<td>25,000</td>
<td>2,750</td>
<td>28,500</td>
<td>23,750</td>
</tr>
<tr>
<td>Truck</td>
<td>5,000</td>
<td>250</td>
<td>4,750</td>
<td>4,500</td>
</tr>
<tr>
<td>Equip.</td>
<td>17,000</td>
<td>850</td>
<td>9,189</td>
<td>6,961</td>
</tr>
<tr>
<td>Tractor</td>
<td>23,000</td>
<td>1,150</td>
<td>12,661</td>
<td>10,517</td>
</tr>
<tr>
<td>Cattle**</td>
<td>5,000</td>
<td>250</td>
<td>4,750</td>
<td>4,500</td>
</tr>
<tr>
<td>Cattle***</td>
<td>20,000</td>
<td>1,000</td>
<td>18,167</td>
<td>17,167</td>
</tr>
</tbody>
</table>

* Owned and used as main home for at least 2 years

**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 recapture depreciation 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 on the cattle. 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 cattle 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.

| Farm land | $125,000 | $67,500 | $57,500 |
| Buildings | 55,000  | 31,250  | 23,750  |
| Truck | 5,000   | 4,500   | 250    |
| Cattle* | 5,000   | 4,250   | 750    |
| Cattle** | 20,000  | 1,000   | 18,167 |

* Held less than 2 years

**Section 1231 gains.** The ordinary income for 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 the 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 contract 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:

| Farm land | (57,500 ÷ 140,000) | 41.0714% |
| Buildings | (23,750 ÷ 140,000) | 16.9643% |
| Truck | (250 ÷ 140,000) | 0.1786% |

The cattle used for breeding and held for less than 2 years report them as ordinary or capital gains. Since the gain of $18,167 is less than the depreciation of $1,977 is recapture in- come because it is less than the gain. The remaining gain of $750 is reported on the installment method.

**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 payment on July 1). The installment sale part of the total payments received in 2006 is $42,000 ($75,000 ÷ 56%).

**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.

**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.

**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 $28,000 gain on the cattle held less than 2 years is ordinary income reported in Part II of Form 4797. See Schedule D in chapter 9.

**Installment income for years after 2006.** You figure installment income for the years after 2006 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:

<table>
<thead>
<tr>
<th>Income</th>
<th>Farm land</th>
<th>$41,071.4% × $28,000</th>
<th>$11,100</th>
</tr>
</thead>
<tbody>
<tr>
<td>Buildings</td>
<td>16.9643% × $28,000</td>
<td>$4,750</td>
<td></td>
</tr>
<tr>
<td>Truck</td>
<td>0.1786% × $28,000</td>
<td>50</td>
<td></td>
</tr>
<tr>
<td>Cattle*</td>
<td>0.5357% × $28,000</td>
<td>150</td>
<td></td>
</tr>
</tbody>
</table>

**Total installment income** $16,250

* Held less than 2 years

**In this example, no gain ever is 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 from this sale with section 1231 gains and losses from other sales 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** | $82,250 |

**Gain reported in 2006 (year of sale)** $24,675

**Gain reported in 2007:**

| Year | $28,000 × 58.75% | 16,450 |

**Gain reported in 2009:**

| Year | $28,000 × 58.75% | 16,450 |

**Gain reported in 2010:**

| Year | $14,000 × 58.75% | 8,225 |

**Total gain reported** $82,250
Casualties, Thefts, and Condemnations

Introduction
This chapter explains the tax treatment of casualties, thefts, and condemnations. A casualty occurs when property is damaged, destroyed, or lost due to a sudden, unexpected, or unusual event. A theft occurs when property is stolen. A condemnation occurs when private property is legally taken for public use without the owner's consent. A casualty, theft, or condemnation may result in a deductible loss or taxable gain on your federal income tax return. You may have a deductible loss or 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 17 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 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, truck, or farm equipment 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 (explained below).
- 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 below).

Family pet. Loss of property due to damage by a family pet is not deductible as a casualty loss unless the requirements discussed earlier under Casualty are met.

Example. The ornamental fruit trees in your yard were damaged when your horse stripped the bark from them. Some of the trees were completely girdled and died. Because the damage was not unexpected and unusual, the loss is not deductible.

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 diseases 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 or purposeful 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 bought for resale. Casually or theft losses of livestock or produce bought for resale 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 resale 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. Casually and theft losses of property used in your farm business usually result in deductible losses. If a fire or storm destroys 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 have a basis in the animal and therefore may be able to claim a deduction if either of the following situations applies to your animal:

- 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 lose 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 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

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 ba-sis (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 estab-

lish decreases in FMV.

An appraisal to determine the difference be-tween the FMV of the property immediately before a casualty or theft and immediately after-ward 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 exces-

- 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 ex-

penses due to a casualty or theft, such as ex-
penses 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 $26,000. 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.

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 $1,200 $2,000 8) Total deductible casualty loss $3,200

Exception for personal-use real property. In figuring a casualty loss on personal-use real property, the entire property (including any improvements, such as buildings, trees, and shrubs) is treated as one item. Figure the loss using the smaller of the following:

• The decrease in FMV of the entire property.
• The adjusted basis of the entire property.

Example. You bought a farm in 1960 for $20,000. The adjusted basis of the residential part is now $16,000. In 2006, 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 ............... $16,000 2) FMV before the storm .......... $130,000 3) FMV after the storm .......... $126,000 4) Decrease in FMV (line 2 – line 3) .......... $4,000 5) Loss before insurance (lesser of line 1 or line 4) .......... $4,000 6) Minus: Insurance ............... $4,000 7) Amount of loss ............... $0

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 or theft 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 personal-use property that you incur 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 tax 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 tax 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 of the reimbursement in your income and you cannot deduct any additional 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

The $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 38 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:


You do not have a theft loss deduction because your loss ($1,900) is less than 10% of your adjusted gross income ($17,000).

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

Generally, you can deduct casualty losses that are not reimbursable only in the tax year in which they occur. You generally can deduct theft losses that are not reimbursable only in the year you discover your property was stolen. However, losses in Presidentially declared disaster areas are subject to different rules. See Disaster Area Losses, later, for an exception.

If you are not sure whether part of your casualty or theft loss will be reimbursed, do not deduct that part until the tax year when you...
become reasonably certain that it will not be reimbursed.

**Leased property.** If you lease property from someone else, you may 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 2006. 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 2007, 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 2007. He can claim the $20,000 as a loss on his 2007 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 and 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.

**Thrift 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.

**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 and 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.

**Thift 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.

### 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 replace your 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.

**Postponing Gain.** 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 5. 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 exclusion, see Publication 544.

**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 5.

**Example.** It is your usual business practice to sell live 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.

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 or Exchanges Between Related Persons in chapter 3.

Tree Seedlings

If, because of an abnormal drought, the failure of planted tree seedlings is greater than normally anticipated to you or a deductible loss, you can deduct the loss from your income. See Deductible Losses under chapter 2 of Publication 544.

Related Persons

If a related person (discussed later) sold, or exchanged the property for use in any business is treated as similar or related in service or use to the destroyed, stolen, or other involuntarily converted property within a specific replacement period.

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 Nonrefundable Loss from Involuntary Conversion.

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 the property, or other involuntarily converted property. If you receive money or unlike property as reimbursement, you can choose to postpone reporting the 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 within a specific replacement period.

If you were in a new or 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 unpaid 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 May. 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 casually, 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 replacement property you acquire for use in any business is treated as similar or related in service or use to the destroyed, stolen, or other involuntarily converted property within a specific replacement period.

Owner-user. If you are an owner-user, similar or related in service or use means that replacement property you acquire for use in any business is treated as similar or related in service or use to the destroyed, stolen, or other involuntarily converted property within a specific replacement period.

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. Examples of property that functions in the same way as the property it replaces include livestock 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 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 planning and raising a new 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, earth- quakes, 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.

Basic 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

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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, 2005. Your insurance company investigated the theft and did not settle your claim until January 3, 2006, when they paid you $3,000. You first realized a gain from the reimbursement for the theft during 2006, so you have until December 31, 2008, 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.

Property in the Hurricane Katrina disaster area. For property located in the Hurricane Katrina disaster area that was destroyed, damaged, stolen, or condemned after August 24, 2005, as a result of Hurricane Katrina, the replacement period ends 5 years after the close of the first tax year in which any part of your gain is realized. This 5-year replacement period applies only if substantially all of the use of the replacement property is in the Hurricane Katrina disaster area.

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. But see Property in the Hurricane Katrina disaster area earlier for an exception.

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 the reasons you give are reasonable cause for not making the replacement within the regular period.

How To Postpone Gain

You postpone reporting your gain by reporting your claim on your return for the year in which 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 turn 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 turn 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 that includes 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 Robert T. Stafford Disaster Relief and Emergency Assistance Act.

A list of the areas warranting assistance under the Act 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 Robert T. Stafford 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 and are not subject 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.

Qualified disaster mitigation payments. Qualified disaster mitigation payments made under the Robert T. Stafford Disaster Relief and Emergency Assistance Act or the National Flood Insurance Act (as in effect on April 15, 2005) are the IRS has decided to postpone tax deadlines, the following taxpayers are affected by a Presidentially declared disaster. (A personal residence does not have to be located in a covered disaster area. 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 involuntariness conversions.

Form 4684. Use this form to report your gains and losses from casualties and thefts.

Form 4797. Use this form to report involuntariness 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 report gain from sale of personal-use property that you reported on Form 1040.

Schedule D (Form 1040). Use this form to report gain from sale of personal-use property that you reported on Form 1040.

Schedule F (Form 1040). Use this form to report gain from sale of personal-use property that you reported on Form 1040.

Sold property under hazard mitigation program. Generally, if you sell or otherwise transfer property, you must recognize any gain or loss for tax purposes unless the property is your main home. You report the gain or deduct the loss on your tax return for the year you realize it. (You cannot deduct a loss on personal-use property unless the loss resulted from a casualty, as discussed earlier.) However, if you sell or otherwise transfer property to the Federal government, a state or local government, or an Indian tribal government under a hazard mitigation program, you can choose to postpone reporting the gain if you buy qualifying replacement property within a certain period of time. See Postponing Gain earlier for the rules that apply.

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, excise, and employment tax returns, paying income, excise, 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 1 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.

Self-Employment Tax

What’s New for 2006

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 $94,200 for 2006. There is no maximum limit on earnings subject to the Medicare part (2.9%).
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 Sched-ule SE (Form 1040).

Farmers who have employees may have to pay the employer’s share of social security and Medicare taxes, as well. See chapter 13 for information on employment taxes.

Self-employment 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 pay self-employment tax
• How to pay self-employment tax
• Who must pay self-employment tax
• Figuring self-employment earnings
• Landlord participation in farming
• Methods for figuring net earnings
• Reporting self-employment tax

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 re-tirement 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 2006. You can earn a maximum of four credits per year. For 2006, you earn one credit for each $970 of combined wages and self-employment earnings subject to social security tax. You need $3,880 ($970 x 4) of combined wages and self-employment earn-ings subject to social security tax to earn four credits in 2006. 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 or visit the SSA website at www.ssa.gov.

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 earn-ings. Generally, the SSA will give you credit only for self-employment earnings 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 earnings 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 earnings.

Useful Items
You may want to see:
Publication
❑ 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 17 for information about getting publications and forms.

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 partner-ship, 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.

Caution
Making false statements to get or to increase social security benefits may subject you to penalties.

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.

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 2006 or 2007 was from farming and you file your 2007 Form 1040 and pay all the tax due by March 3, 2008, you do not have to pay any estimated tax. For more information about estimated tax for farmers, see chapter 15.

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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 owned by another person, and if you 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 landowner has the right to direct or control your performance of service.

Example. A share farmer produces a crop on land belonging to another person. 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 crop 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 profit or loss from the crops is reported to Schedule F (Form 1040) and included in self-employment earnings.

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 income is 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 (Form 1065).

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 property. If you are a partner and your distributive share of any income or loss from a trade or business is community property, treat your share as your self-employment earnings. Do not treat any of your share as self-employment earnings of your spouse.

Figuring Self-Employment Earnings

Farmer. If you are self-employed as a farmer, use Schedule F (Form 1040) to figure your self-employment earnings. For information about figuring profit or loss on Schedule F (Form 1040), see chapter 16.

Partnership income or loss. If you are a member of a partnership that carries on a trade or business, the partnership should report your self-employment earnings on Form 1040, see chapter 16. The partnership should also file a separate Schedule K-1 (Form 1065) for each partner.

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. The amount reported is a loss, include only the deductible amount when you figure your total self-employment earnings.

More than one business. If you have self-employment earnings from more than one trade, business, or profession, you generally must combine the net profit or loss from each to determine your total self-employment earnings. A loss from one business reduces your profit from another business. However, do not combine earnings from farm and nonfarm businesses if you are using one of the optional methods to figure net earnings.

Community property. If any of the income from a farm or business, other than a partnership, is community property under state law, it is included in the self-employment earnings 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 self-employment earnings. 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 self-employment earnings if it relates to your farming 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 self-employment earnings. 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 self-employment earnings:

- 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 self-employment earnings 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 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 self-employment earnings.

Wages paid in kind to you for agricultural labor, such as commodity wages, are not included in self-employment earnings.

Retired partner. Retirement income received by a partner from his or her partnership under a written plan is not included in self-employment earnings if all the following apply:

- The retired partner performs no services for the partnership.
- 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 self-employment earnings. These include rental income from property leased as a site to commercial enterprises. However, if your tenant is farming or raising livestock on rented land, your rental income from the tenant is included in self-employment earnings if the tenant’s farming activities are substantial and are not nominal or occasional. For more information about landlord participation in farming, see Publication 541, Depreciation Methods for Figuring Net Income, and Publication 946, Farming.
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 disability or retirement benefits.
- 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 additional child tax 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 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.)

Effects of using an optional method. Using an optional method could increase your SE tax. Paying more SE tax may result in you getting higher social security disability or retirement benefits.

Using More than $1,600

You incur child or dependent care expenses. As a result, the amount shown in line 4 of Table 12-1, Figuring Farm Net Earnings, to figure your net earnings from self-employment (see later) when you have a loss or a small net profit is based on your actual self-employment earnings. 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 his self-employment earnings.

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 his self-employment earnings.
about the nonfarm optional method, see Publication 334.

You cannot combine farm and nonfarm self-employment earnings to figure your net earnings under either of the optional methods.

Using Both Optional Methods

If you use both optional methods, you must add the net earnings figured under the 3rd 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 58 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 16) 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 27, the amount shown on line B. Deduction for one-half of self-employment tax 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 self-employment earnings. Your spouse is not considered self-employed just because you are. If both of you have self-employment earnings, 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.

What’s New for 2007

Redesigned Form 940. For 2006, we completely redesigned Form 940, Employer’s Annual Federal Unemployment (FUTA) Tax Return. You will find that the redesigned form and instructions are easier to read and fill out. Also, IRS now can optically scan the form and will capture data more accurately and efficiently than before. Form 940-EZ is no longer available. If you previously filed Form 940-EZ, you must now use the redesigned Form 940.

Wage limit for social security tax. The limit on wages subject to the social security tax for

Figure 12-1. Can I Use the Optional Methods?

<table>
<thead>
<tr>
<th>START here to determine if you can use the nonfarm optional method.</th>
<th>START here to determine if you can use the farm optional method.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Are your net nonfarm profits less than $1,733?</td>
<td>Is your gross farm income $2,400 or less?</td>
</tr>
<tr>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Are your net nonfarm profits less than 72.189% of your gross nonfarm income?</td>
<td>You can use the farm optional method. See Table 12-1.</td>
</tr>
<tr>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Were your actual net earnings from self-employment $400 or more in at least 2 of the 3 tax years before this year?</td>
<td>You cannot use the farm optional method.</td>
</tr>
<tr>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Have you previously used this method less than 5 years? (Note: There is a 5-year lifetime limit.)</td>
<td>You cannot use the nonfarm optional method.* See Publication 334.</td>
</tr>
<tr>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>No</td>
<td>No</td>
</tr>
</tbody>
</table>

*If you use both optional methods, see Using Both Optional Methods for limit on the amount to report.
In general, you are an employer of farmworkers with the Internal Revenue Service. If your employees do any of the following types of work, you may be subject to the tax:

- Raising or harvesting agricultural or horticultural commodities.
- Operating, managing, conserving, improving, or maintaining your farm and its tools and equipment or services pertaining to hurricane labor.
- Handling, processing, or packaging any agricultural or horticultural commodity that you produced more than half of the commodity for a group of up to 20 unincorporated operators, all of the commodity.
- Work related to cotton ginning, turpentine, or gum resin products.

Additionally, you may be subject to social security and Medicare taxes.

**Reminder**

Electronic deposits of taxes. You must use the Electronic Federal Tax Payment System (EFTPS) to make electronic deposits of all deposits of taxes you incur in 2007 and thereafter if you deposited more than $200,000 in federal deposits in 2005 or you had to use EFTPS in 2006. See Electronic Federal Tax Payment System (EFTPS) under Reporting and Paying Social Security, Medicare, and Withheld Income Taxes.

**Important Dates**

You should take the action indicated on or before the dates listed. Due dates for deposits of withheld federal income taxes, social security taxes, and Medicare taxes are not listed here. For these dates, see Publication 509, Tax Calendar for 2007.

**Note.** If any date shown below falls on a Saturday, Sunday, or legal holiday, the due date is the next business day. For example, if you deposit on a date that falls on a Saturday, the due date is the next business day. If the deposit is made on a federal holiday, the due date is the next business day.

**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.

**By January 31**

- File Form 943, Employer's Annual Federal Tax Return for Agricultural Employees, with the Internal Revenue Service. If you deposited all Form 943 taxes when due, you have 10 additional days to file.
- Furnish each employee with a completed Form W-2, Wage and Tax Statement.
- Furnish each recipient to whom you paid $600 or more in nonemployee compensation with a completed Form 1099 (for example, Form 1099-MISC, Miscellaneous Income).
- File Form 940, Employer's Annual Federal Unemployment (FUTA) Tax Return. But if you deposited all the FUTA tax when due, you have 10 additional days to file.

**By February 15**

- Ask for a new Form W-4 or Forms W-4(SP) from each employee who claimed exemption from federal income tax withholding last year.

**On February 16**

- Begin withholding federal income tax for any employee who previously claimed exemption from federal income tax withholding but has not given you a new Form W-4 for the current year. If the employee does not give you a new Form W-4, withhold as if he or she is single, with zero withholding allowances. The Form W-4 previously given to you claiming exemption is now expired.

**By February 28**

- File Forms 1099 and 1096, Copy A of all Forms 1099 with Form 1096, Annual Summary and Transmittal of U.S. Information Returns, with the IRS. For electronically filed returns, see By March 31 below.

**By March 31**

- File electronic Forms W-2 and 1099, File electronic Forms W-2 with the SSA and Forms 1099 with the IRS. See Social Security’s Employer’s W-2 Reporting Instructions and Information webpage at www.socialsecurity.gov/employer for more information about filing forms W-2 and W-2c electronically.

**By April 30, July 31, October 31, and January 31**

- Deposit FUTA taxes. Deposit FUTA tax due if it is more than $500.

**Before December 1**

- Remind employees to submit a new Form W-4 if their withholding allowances have changed or will change for the next year.

**On December 31**

- Form W-5, Earned Income Credit Advance Payment Certificate, expires. Employees who want to receive advance payments of the earned income credit for the next year must give you a new Form W-5.

**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 (FUTA) 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 15 for information on self-employment tax.

**Topics**

This chapter discusses:

- Farm employment
- Family employees
- Crew leaders
- Social security and Medicare taxes
- Federal income tax withholding
- Advance payment of earned income credit
- Reporting and paying social security, Medicare, and withheld federal 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 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 17 for information about getting publications and forms.

**Farm Employment**

In general, you are an employer of farmworkers 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 or services pertaining to hurricane labor.
- Handling, processing, or packaging any agricultural or horticultural commodity if you produced more than half of the commodity for a group of up to 20 unincorporated operators, all 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 are an employer, 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. You may also apply for an EIN online by visiting the IRS website at www.irs.gov/smallbiz.

**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.social-security.gov.

The employee must furnish evidence of age, identity, and U.S. citizenship or lawful immigration status permitting employment 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.uscis.gov. You can contact the USCIS office at 202-775-2975 or visit its website at www.uscis.gov 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.hhs.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 under age 18 who works for you in your trade or business (including a farm) are not subject to social security and Medicare taxes. Payments for the services of your child under age 21 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 under age 21 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 employed 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 or trust, 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.

- You have a child living in your home who is under age 18 or has a physical or mental condition that requires care by an adult for at least 4 continuous weeks in a calendar quarter.
- You are a widow or widower; or divorced and not remarried; or have a spouse in the home who, because of a physical or mental condition, cannot care for your child for at least 4 continuous weeks in the quarter.

Wages you pay to your parent are not subject to FUTA tax, regardless of the type of services provided.

**Crew Leaders**

If farmworkers 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 wages to 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 farmworkers 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 farmwork 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 farmwork (the $150 test).
- You pay cash and noncash wages of $2,500 or more during the year to all your employees for farmwork (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 farmworker are not subject to social security and Medicare taxes, even if you pay $2,500 or more to all your farmworkers. However, these wages count toward the $2,500 test for determining whether Chapter 13 Employment Taxes
other farmworkers’ wages are subject to social security and Medicare taxes. A seasonal farmworker 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 employ-
  ment,
- Commutes daily from his or her perma-
  nent home to the farm, and
- Worked in agriculture less than 13 weeks in the preceding calendar year.

See Family Employees, earlier, for certain ex-
  emptions from social security and Medicare taxes that apply to your child, spouse, and par-
  ent.

Religious exemption. An exemption from social security and Medicare taxes is available to members of a recognized religious sect op-
  posed to public insurance. This exemption is available only if both the employee and the em-
  ployer are members of the sect.

For more information, see Publication 517, Social Security and Other Information for Mem-
  bers of the Clergy and Religious Workers.

Cash wages. Only cash wages paid to farmworkers 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 employ-
  ees for social security benefit purposes. Pay-
  ments not subject to these taxes, such as commodity wages, do not contribute to your employees’ social security coverage. For infor-
  mation 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 farmworkers, 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 non-
  cash 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 2007, 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 insur-
  ance).
- 1.45% of cash wages for Medicare tax (hospital insurance).

Wage limit. The limit on 2007 wages sub-
  ject 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.

Federal Income Tax Withholding

If the cash wages you pay to farmworkers are subject to social security and Medicare taxes, they are also subject to federal income tax with-
  holding. 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 withholding 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 em-
  ployee’s marital status and withholding allo-
  wances 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 allow-
  ance 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. (For Spanish-speaking employees, you may use Form W-4(SP) which is the Spanish translation of Form W-4.) 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 2007. You should make the 2007 Form W-4 available to your employees and encourage them to check their income tax withholding for 2007. Those employees who owed a large amount of tax or received a large refund for 2006 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 Publica-
  tion 51 (Circular A), which contains tables show-
  ing the correct amount of federal income tax you should withhold. Publication 51 (Circular A) also contains additional information about federal in-
  come 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 with-
  hold under the backup withholding rules. Get the Instructions for Form 1099-MISC for details.

Advance Payment of Earned Income Credit

An employee who is eligible for the earned in-
  come 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 com-
  pleted Form W-5, Earned Income Credit Ad-
  vance Payment Certificate. You are usually required to make advance EIC payments to em-
  ployees who give you a properly completed Form W-5, but you are not required to make these payments to farmworkers paid on a daily basis.

The EIC 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 ad-
  vance EIC payments made. For more informa-
  tion, 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 federal 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 giv-
  ing each employee any of the following:

- Form W-2, which contains the EIC notifi-
  cation 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 re-
  quirements and claiming the EIC, see Notice 2015, 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. Your 2006 Form 943 is due by January 31, 2007 (or February 12, 2007 if you made deposits on time in full payment of the taxes due for the year).

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 2007 if you deposited more than $200,000 in federal depository taxes in 2006. If you first meet the $200,000 threshold in 2006, you must begin depositing using EFTPS in 2008. 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, The Secure Way to Pay Your Federal Taxes. To enroll in EFTPS, you may call 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 federal 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 federal 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.

Consequences of treating an employee as an independent contractor. If you classify an employee as an independent contractor and your have no reasonable basis for doing so, you may be held liable for employment taxes for that worker. See Publication 15-A for more information.

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 making deposits electronically.
• You paid cash wages of $20,000 or more to farmworkers in any calendar quarter during the current or preceding calendar year.
• You employed 10 or more farmworkers 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 you must begin depositing using EFTPS in your spouse, your parents, or your children under age 21. See Family Employees, earlier.

Alien farmworkers. Wages paid to aliens admitted on a temporary basis to the United States to perform farmwork (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 wages you pay to 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 2006 form is due January 31, 2007 (or February 12, 2007, if you timely deposited the full amount of your 2006 FUTA tax).

Deposits. If at the end of any calendar quarter you owe, but have not yet deposited, more than $500 in FUTA tax for the year, you must make a deposit by the end of the following month. If the undeposited tax is $500 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 $500 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 $500 or less, you can either make a deposit or pay it with your return by the January 31, 2007, due date.

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 Federal Income Taxes, earlier, for a discussion of the requirement for making deposits electronically.

14.

Excise Taxes

What’s New for 2006

Alternative fuel. Effective after September 30, 2006, there will be a tax on the sale or use of any liquid, other than gas oil, fuel oil, or any product taxable under Internal Revenue Code section 4081. Also effective after that date, two new credits will be available: the alternative fuel credit and the alternative fuel mixture credit. See Pub. 510, Excise Taxes for 2006, for a list of these fuels and when the credits may be available.

Publication 378 eliminated. Publication 378, Fuel Tax Credits and Refunds, is no longer available as a separate product. Publication 510 contains the information on fuel tax credits and refunds previously found in Publication 378.

Telephone excise tax refund. This is a one-time credit available only on your 2006 federal tax return. It is a credit of previously paid...
long-distance federal excise taxes listed on your telephone bill. See the instructions for your 2006 income tax return for how to claim your credit.

Reminders

Aerial applicator waiver is no longer required. The aerial applicator waiver is no longer required to be provided by the farmer. For aviation gasoline, the aerial applicator is the claimant.

Kerosene for use in aviation. A registered ultimate vendor that sells kerosene for use in aviation on a farm for farming purposes is the only person 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 those fuels.

Farmers must claim refunds for undyed diesel fuel and undyed kerosene. For sales of undyed diesel fuel or undyed kerosene (other than kerosene for use in aviation), refunds or credits for fuel used on a farm for farming purposes must be claimed by the farmer. See Schedule 1 of Form 8849 and Form 4136.

Leaking Underground Storage Tank (LUST) tax is included on sales of dyed diesel fuel and dyed kerosene. The $0.001 LUST tax is or operator and the ultimate purchaser of fuel.

You may want to see:

- Publication 510 Excise Taxes for 2007
- Form (and Instructions) 720 Quarterly Federal Excise Tax Return
- 4136 Credit for Federal Tax Paid on Fuels
- 8849 Claim for Refund of Excise Taxes

Useful Items

See chapter 17 for information about getting whether you can claim a credit or refund. You may also be eligible to claim a credit or refund for the tax on undyed diesel fuel, undyed kerosene, and alternative fuel. You cannot claim a credit or refund for the tax on dyed diesel fuel, dyed kerosene, and alternative fuel.

Fuel Used Purposes Business Use Fuel 1
---

Gasoline
Credit only
Credit or refund
None

Aviation gasoline
Credit only
None
None

Undyed diesel fuel and undyed kerosene
Credit or refund by the farmer only
Credit or refund 2
Credit or refund 2

Kerosene for use in aviation
Credit or refund by the registered ultimate vendor only
None
None

Dyed diesel fuel and dyed kerosene
None
None
None

*1 Applies 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.

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 and aviation gasoline used on a farm for farming purposes. You are the only person that can claim a credit or refund for the tax on undyed diesel fuel, undyed kerosene, and alternative fuel. You cannot claim a credit or refund for the tax on dyed diesel fuel, dyed kerosene, and alternative fuel.

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.

Farms. A farm includes livestock, dairy, fish, poultry, fruit, fur-bearing animals, and truck farms, orchards, plantations, ranches, nurseries, ranges, and feed yards for fattening cattle. It also includes structures such as greenhouses used primarily for raising agricultural or horticultural commodities. A fish farm is an area where fish are grown or raised — not merely caught or harvested.

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), earlier, you are considered to be the ultimate purchaser for the fuel you use on a farm for farming purposes. Therefore, you can still claim the credit or refund for the fuel so used. However, see Custom application of fertilizer and pesticide, later. If the other person performs any other services for you on your farm for...
Dyed Diesel Fuel and Dyed Kerosene

The $0.01 LUST tax is included on sales of dyed diesel fuel and dyed kerosene and is not refundable. You must continue to use dyed diesel fuel and dyed kerosene 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 used on a public highway or in an off-highway business use, the registered ultimate vendor is the claimant. 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.

Example. A registered ultimate vendor is the person that actually paid the tax on the dyed diesel fuel or dyed kerosene used for farming purposes. For aviation gasoline, the aerial applicator is the claimant. For kerosene used in a trade or business or in an in come-producing activity, the use must not be in a highway vehicle or used to register 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 510.

The table below gives the basic rules for claiming a credit or refund of excise taxes on fuels used for a nontaxable use.

<table>
<thead>
<tr>
<th>Credit</th>
<th>Refund</th>
</tr>
</thead>
<tbody>
<tr>
<td>Which form to use</td>
<td>Form 4136, Credit for Federal Tax Paid on Fuels</td>
</tr>
<tr>
<td>Form 8849, Claim for Refund of Excise Taxes, and Schedule 1 (Form 8849)</td>
<td></td>
</tr>
<tr>
<td>Type of form</td>
<td>Annual</td>
</tr>
<tr>
<td>Quarterly</td>
<td></td>
</tr>
<tr>
<td>When to file</td>
<td>With your income tax return</td>
</tr>
<tr>
<td>By the last day of the quarter following the last quarter included in the claim</td>
<td></td>
</tr>
<tr>
<td>Amount of tax</td>
<td>Any amount</td>
</tr>
<tr>
<td>$750 or more 1</td>
<td></td>
</tr>
</tbody>
</table>

1 You may carryover an amount less than $750 to the next quarter.

Fuel not used for farming. You do not use fuel on a farm for farming purposes when you use it in any of the following ways:

- Off the farm, such as on the highway or in noncommercial aviation, even if the fuel is used in transporting livestock, feed, crops, or equipment.
- For personal use, such as mowing the lawn.
- In processing, packaging, freezing, or canning operations.
- In processing crude gum into gum spirits of turpentine or gum resin or in processing maple sap into maple syrup or maple sugar.

All-terrain vehicles (ATVs). Fuel used in ATVs on a farm for farming purposes, discussed earlier, is eligible for a credit or refund of excise taxes on the fuel. Fuel used in ATVs for nonfarming purposes is not eligible for a credit or refund of the taxes. If ATVs are used both for farming and nonfarming purposes, only that portion of the fuel used for farming purposes is eligible for the credit or refund.

Example. Farm owner Haleigh Blue hired custom operator Tyler Steele to cultivate the soil on her farm. Tyler used 200 gallons of undyed diesel fuel that he purchased to perform the work on Haleigh’s farm. In addition, Haleigh hired contractor Brown to pack and store her apple crop. Brown bought 25 gallons of undyed diesel fuel to use in packing the apples. Haleigh can claim the credit for the 200 gallons of undyed diesel fuel 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, including undyed diesel fuel or undyed 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 or her tenant equally share the cost of gasoline on the farm, each can claim a credit for the tax on half the fuel used.

Undyed diesel fuel, undyed kerosene, and kerosene used in aviation. The farmer is the only person that can make a claim for credit or refund for the tax on undyed diesel fuel or undyed kerosene used for farming purposes. Also see Dyed Diesel Fuel and Dyed Kerosene, later.

If kerosene is used in aviation, the registered ultimate vendor is the claimant. 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.

Dyed Diesel Fuel and Dyed Kerosene

The type and rule above prints on all proofs including departmental reproduction proofs. MUST be removed before printing.
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. A recordkeeping information sheet, Form 583, is available from the IRS or your local IRS office.

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 return the following year. You must file Form 8849 to claim a refund.

Credit only. You can claim the following taxes only as a credit.

- Tax on gasoline and aviation gasoline you used on a farm for farming purposes.
- Tax on fuels (including undyed diesel fuel used on the farm for farming purposes) used for a nontaxable use during that quarter or any prior quarter (for which no other claim has been filed) during the tax year.
- 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 or will file a claim on Schedule C (Form 720) or Form 4136. You can claim a fuel tax credit on your income tax return for the year you used the fuel. You can claim a fuel tax credit on your income tax return for the year you used the fuel. You make a claim for refund of the excise tax on fuel on Form 8849.

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.

When to claim a credit. You may be able to make a fuel tax claim on an amended income tax return 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.

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.

When to claim a credit. You may be able to make a fuel tax claim on an amended income tax return 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, files her 2006 Form 1040 on March 3, 2007. 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 2007 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 2006 Form 1040 on April 15, 2007. On Schedule F, she deducts the total cost of gasoline (including $155 of excise taxes) she used on the farm for farming purposes during 2006. On Form 4136, Patty claims the $155 as a credit. She reports the $155 as other income on line 10 of her 2006 Schedule F.

Estimated Tax
Introduction
You are not required to pay estimated tax if you expect to owe less than $1,000 (after subtracting your credits and income tax withhold- ing). If you are a qualified farmer, defined later, you are not subject to the special rules covered in this chapter for paying estimated tax.

Topics
This chapter discusses:

- Special estimated tax rules for qualified farmers
- Estimated tax penalty

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 in- come 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, files her 2006 Form 1040 on March 3, 2007. 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 2007 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 2006 Form 1040 on April 15, 2007. On Schedule F, she deducts the total cost of gasoline (including $155 of excise taxes) she used on the farm for farming purposes during 2006. On Form 4136, Patty claims the $155 as a credit. She reports the $155 as other income on line 10 of her 2006 Schedule F.
Useful Items
You may want to see:

Publication

- 505 Tax Withholding and Estimated Tax
- Form (and Instructions)
- 1040-ES Estimated Tax for Individuals
- 2210-F Underpayment of Estimated Tax by Farmers and Fishermen

See chapter 17 for information about getting publications and forms.

Special Estimated Tax Rules for Qualified Farmers

Special rules apply to the payment of estimated tax by individuals who are qualified farmers. If you are not a qualified farmer as defined next, see Publication 505 for the estimated tax rules that apply.

Qualified Farmer

An individual is a qualified farmer for 2006 if at least two-thirds of his or her gross income from all sources for 2005 or 2006 was from farming. See Gross Income, next, for information on how to figure your gross income from all sources and see Gross Income From Farming, later, for information on how to figure your gross income from farming. See also Percentage From Farming, later, for information on how to determine the percentage of your gross income from farming.

Gross Income

Gross income is all income you receive in the form of money, goods, property, and services that is not exempt from income tax. On a joint return, you must add your spouse’s gross income to your gross income. To decide whether two-thirds of your gross income for 2006 was from farming, use your gross income the total of the following income (not loss) amounts from your tax return:

- Wages, salaries, tips, etc. from Form 1040, line 7.
- Taxable interest from Form 1040, line 8a.
- Ordinary dividends from Form 1040, line 9a.
- Taxable refunds, credits, or offsets of state and local income taxes from Form 1040, line 10.
- Alimony from Form 1040, line 11.
- Gross business income from Schedule C (Form 1040), line 7.
- Gross business receipts from Schedule C-EZ (Form 1040), line 1.
- Capital gains from Form 1040, line 13, including gains from Schedule D (Form 1040). Losses are not netted against gains.
- Gains on sales of business property from Form 1040, line 14.
- Taxable IRA distributions, pensions, annuities, and social security benefits.
- Gross rental income from Schedule E (Form 1040), line 3.
- Gross royalty income from Schedule E (Form 1040), line 4.
- Taxable net income from an estate or trust reported on Schedule E (Form 1040), line 37.
- Income from a Real Estate Mortgage Investment Conduit reported on Schedule E (Form 1040), line 39.
- Gross farm rental income from Form 4835, line 7.
- Gross farm income from Schedule F (Form 1040), line 11.
- Your distributive share of gross income from a partnership, or limited liability company treated as a partnership, from Schedule K-1 (Form 1065).
- Your pro rata share of gross income from an S corporation, from Schedule K-1 (Form 1120S).
- Unemployment compensation from Form 1040, line 19.
- Other income reported on Form 1040, line 21, not included with any of the items listed above.

Gross Income From Farming

Gross income from farming is income from cultivating the soil or raising agricultural commodities. It includes the following amounts:

- Income from operating a stock, dairy, poultry, bee, fruit, or truck farm.
- Income from a plantation, ranch, nursery, range, orchard, or oyster bed.
- Crop shares for the use of your land.
- Gains from sales of draft, breeding, dairy, or sporting livestock.

For 2006, gross income from farming is the total of the following amounts from your tax return:

- Gross farm income from Schedule F (Form 1040), line 11.
- Gross farm rental income from Form 4835, line 7.
- Gross farm income from Schedule E (Form 1040), Parts II and III. See the instructions for line 42.
- Gains from the sale of livestock used for draft, breeding, sport, or dairy purposes reported on Form 4797.

For more information about income from farming, see chapter 3.

Farming income does not include any of the following:

- Wages you receive as a farm employee.
- Income you receive from contract grain harvesting and hauling with workers and machinery you furnish.
- Gains you receive from the sale of farm land and depreciable farm equipment.

Percentage From Farming

Figure your gross income from all sources, discussed earlier. Then figure your gross income from farming, discussed above. Divide your farm gross income by your total gross income to determine the percentage of gross income from farming.

Example 1. Jane Smith had the following total gross income and farm gross income amounts in 2006.

<table>
<thead>
<tr>
<th>Gross Income</th>
<th>Total</th>
<th>Farm</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxable interest</td>
<td>$3,000</td>
<td></td>
</tr>
<tr>
<td>Dividends</td>
<td>500</td>
<td></td>
</tr>
<tr>
<td>Rental income (Sch E)</td>
<td>$4,500</td>
<td></td>
</tr>
<tr>
<td>Farm income (Sch F)</td>
<td>$75,000</td>
<td></td>
</tr>
<tr>
<td>Gain (Form 4797)</td>
<td>5,000</td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$125,000</td>
<td>$80,000</td>
</tr>
</tbody>
</table>

Schedule D showed gain from the sale of dairy cows carried over from Form 4797 ($5,000) in addition to a loss from the sale of corporate stock ($2,000). However, that loss is not netted against the gains to figure Ms. Smith’s total gross income or her gross farm income. Her gross farm income is 64% of her total gross income ($80,000 + $125,000 = 0.64). Therefore, based on her 2006 income, she does not qualify to use the special estimated tax rules for qualified farmers, discussed next, since 67.9% (at least two-thirds) of her gross income is from farming ($95,000 + $140,000 = 0.679).

Example 2. Assume the same facts as in Example 1 except that Ms. Smith’s farm income from Schedule F was $90,000 instead of $75,000. This made her total gross income $140,000 ($3,000 + $500 + $41,500 + $90,000 + $5,000) and her farm gross income $95,000 ($90,000 + $5,000). She qualifies to use the special estimated tax rules for qualified farmers, discussed next, since 67.9% (at least two-thirds) of her gross income is from farming ($95,000 + $140,000 = 0.679).

Special Rules for Qualified Farmers

The following special estimated tax rules apply if you are a qualified farmer for 2006.
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 filing jointly with his wife, Jane. 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).

1040-ES to figure the amount of your required annual payment. Apply the following special rules for qualified farmers to the worksheet.

1. On line 14a, multiply line 13c by 66 2/3% (.6667).
2. On line 14b, enter 100% of the tax shown on your 2005 tax return regardless of the amount of your adjusted gross income.

For this purpose, the "tax shown on your 2005 tax return" is the amount on line 62 of your 2005 return modified by certain adjustments. For more information, see Total tax for 2005 under Required Annual Payment in chapter 2 of Publication 505.

Estimated Tax Penalty for 2006

If you do not pay all your required estimated tax for 2006 by January 16, 2007, or file your 2006 return and pay the tax by March 1, 2007, you should use Form 2210-F, Underpayment of Estimated Tax by Farmers and Fishermen, to determine if you owe a penalty. If you owe a penalty but do not file Form 2210-F with your return and pay the penalty, you will get a notice from the IRS. You should pay the penalty as instructed by the notice.

If you file your return by April 16, 2007, and pay the bill within 21 calendar days (10 business days if the bill is $100,000 or more) after the notice date, the IRS will not charge you interest on the penalty. Do not ignore a penalty notice, even if you think it is in error. You may get a penalty notice even though you filed your return on time, attached Form 2210-F, and followed the rules for qualified farmers to the worksheet.

If you are a qualified farmer and must pay estimated tax for 2006, use the worksheet on Form 1040-ES to figure the amount of your required annual payment. Apply the following special rules for qualified farmers to the worksheet.

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, U.S. Individual Income Tax Return, line 41. If this is the case, see Losses From Operating a Farm in chapter 4.

Preparing the Return

Schedule F (Form 1040), Profit or Loss From Farming

The first step in preparing Mr. Brown’s income tax return is to determine his net farm profit or loss on Schedule F (1040). The income and expenses shown on this Schedule F (1040) are taken from his farm receipt and expense records. Data for the depreciation and section 179 deductions are taken from Form 4562, Depreciation and Amortization, 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 (1040)(not shown). This indicates that his principal source of farm income is from dairy farming.
Schedule F (1040) - 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 (1040).

Line items. He fills in all applicable items of farm income.

Line 1. In 2006, he sold steers he had bought for resale. He enters sales of $13,596.

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, $7,073, 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, Sales of Business Property.

Line 4. He enters the income he received during 2006 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.

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Milk</td>
<td>$233,874</td>
</tr>
<tr>
<td>Steers and calves</td>
<td>$2,914</td>
</tr>
<tr>
<td>Vegetables</td>
<td>$1,457</td>
</tr>
<tr>
<td>Corn ($7,296)</td>
<td>$8,844</td>
</tr>
<tr>
<td>Wheat ($6,543)</td>
<td>$24,772</td>
</tr>
</tbody>
</table>

Total reported on line 4 $263,018

Mr. Brown records his farm payments 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 (1040).

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 2006 was $1,090, which he enters on line 12. (Depreciation is reported on line 16.)

Line 13. The $3,879 on this line is the amount he paid for all chemicals purchased during the year.

Line 14. He deducts the $6,781 spent on diversions channels in 2006. 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 $8,055 on this line is the amount he paid to 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 $33,837 depreciation from Form 4562, discussed later.

Line 17. He enters the $50,814 cost of feed bought for consumption by his livestock in 2006. 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 18. He enters $6,544. This is the amount paid for fertilizer and lime.

Line 20. He deducts the $2,906 he paid for trucking and milk marketing expenses.

Line 21. He deducts the $6,216 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 $3,362 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 $7,738 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 (1040), Itemized Deductions, which is not shown.

Line 24. He enters the $26,368 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 employee 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 the 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 25b. He enters only the $9,660 cash rent paid for the use of land he rented from a neighbor. Mr. Green. He did not deduct cash 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 $13,504 he enters includes $12,952 for repairs to farm machinery and $552 for repairs to 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 not 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 $5,875 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 $7,433 paid for live-stock supplies and other supplies, including bedding.

Line 31. He enters $3,201 for taxes paid during 2006, 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 for farm business, because these taxes were included in the costs for gasoline he deducted on lines 21 and 12. He

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included his share of social security and Medi- care taxes paid for agricultural employees. He filed Form 543, Employer’s Annual Federal Tax Return for Agricultural Employees (not shown), in January 2007, reporting these taxes for calen- dar year 2006.

He does not deduct, on Schedule F (1040), his state income tax or the taxes on his home and the part of his land not used for farming. He deduced $2,499 of interest on Schedule A (1040), which is not shown. He does not deduct any federal income tax paid during the year.

**Line 32.** He enters $5,504 for the cost of water, gasoline, 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 $8,508, the total paid during 2006 for veterinary fees ($3,607), live- stock medicines ($2,402), and breeding fees ($2,499). 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 ex- penses. These include: on $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 Univer- sity. 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 ($216,425) from the amount on line 11 ($280,082). His net farm profit, entered on line 36, is $63,657. He also enters that amount on Form 1040, line 18, and on Schedule SE (1040), Section A, line 1. Because he shows a net profit each year separately to keep track of its basis, he follows the practice of writing a depreciation record showing their bases.

**Methods of depreciation.** He chose the al- ternate 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.

- 2002 - straight line Alternative Deprecia- tion System (ADS).

**Depreciable property.** One of his purchased dairy cows (#42) was killed by lightning in July 2006. Two other purchased cows (#45 and #60) were sold in 2006. The cows were depreciated under MACRS (ADS), using a half-year conven- tion. Therefore, he can claim a half-year’s de- preciation for each cow in 2006.

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.

The Depreciation Worksheet contains an itemized list of Mr. Brown’s assets for which he is deducting depreciation in 2006. He must list each item separately to keep track of its basis. The pickup truck is listed property in the 5-year property class.

**New assets.** Mr. Brown added three assets to his farming business in 2006:

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 pur- pose livestock structure). The construction of the dairy facility began in 2005. The building is depreciated separately from the milking equipment it houses. The cost of the building is $28,250 and it is 10-year property under MACRS. The cost of the equipment is $72,000 and it is 7-year prop- erty under MACRS.
2. In February, he made improvements to his machine shed for a total cost of $650. The improvements are depreciated as if they were a separate building with a 20-year recovery period.

**Line items.** Form 4562 is completed by refer- ring to the Depreciation Worksheet.

**Line 2.** Mr. Brown enters $100,250 on line 2. This is the total cost of all section 179 property placed in service in 2006. The dairy facility and equipment qualify as section 179 property. How- ever, the machine shed improvement does not qualify because it is not a single purpose agricul- tural or horticultural structure.

**Line 6.** He enters the description of the property (dairy equipment) he is electing to ex- pense under section 179. His cost basis for the section 179 deduction is limited to the cash he paid for the dairy equipment. He enters his cost basis of $72,000 for the dairy equipment in col- umn (b). He then enters the tentative deduction of only $22,635 (it is not always advantageous to claim the maximum section 179 deduction al- lowed) 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 ($100,250) did not exceed the investment credit, $430,000, and he is there- fore subject to the maximum dollar limit, $108,000. The remaining balance, $49,365, is depreciated on line 19.

**Lines 11 and 12.** His taxable income from his farming business (without including the sec- tion 179 deduction and the self-employment tax deduction) exceeds the maximum dollar limit on line 5. He enters $108,000 on line 11 and he enters $22,635 on line 12. See chapter 7 for information on the section 179 deduction.

**Line 17.** He enters $2,593. This is his MACRS depreciation for assets placed in serv- ice from 2002 through 2004.

**Line 19.** All property placed in service in 2006 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 bal- ance method under MACRS.

**Line 21.** He enters his depreciation deduc- tion for listed property, $1,179, on line 21. This is the total shown on line 28 of the form. He has one depreciable asset (the pickup truck pur- chased in 2003) that is listed property. The other truck, which he sold this year, was fully depreci- ated.

**Line 22.** He enters the total depreciation on line 22 and carries the total, $33,837, to Sched- ule F (1040), 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 Sec- tion 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. 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.

**Form 8903 Domestic Production Activities Deduction**

The following example of Form 8903 was pre- pared using the small business simplified overall method. See the instructions for Form 8903 for more information.
The domestic production activities deduction (DPAD) is generally 3% of the lesser of a taxpayer’s qualified production activities income for the tax year or an individual taxpayer’s adjusted gross income (also adjusted gross income for an estate or trust; taxable income for all other taxpayers) for the tax year. However, the DPAD generally cannot be more than 50% of the Form W-2 wages paid to employees of the taxpayer.

Entries. Mr. Brown prints his name, his wife’s name, and his identifying number at the top of Form 8903.

Lines 1 through 4. On line 1, Mr. Brown enters $301,763, his total gross receipts comprised of the following:
- $280,082 from line 11 of his Schedule F.
- Plus his cost or other basis, $6,523, from line 2 of his Schedule F.
- Plus $15,158 ($13,160 + 303 + 255 + 700 + 70 + 670) from Form 4797 (total gross sales price).

Because he is using the small business simplified overall method, he skips lines 2 and 3. All of Mr. Brown’s gross receipts are treated as domestic production gross receipts since he has determined that less than 5% of his gross receipts are non-domestic production gross receipts.

This means that, using the small business simplified overall method, all of his costs of goods sold and deductions can be apportioned to his domestic production gross receipts. Therefore, on line 4 he enters $224,264, his total allocable costs comprised of the following:
- His total expenses of $216,425, from line 35 of his Schedule F.
- Plus his total cost or other basis of items bought for resale, $6,523, from line 2 of his Schedule F.
- Plus his total adjusted basis of other items sold, $1,316 ($225 + 912 + 514 + 5 + 588), from Form 4797.

Lines 6 through 8. He subtracts line 5 from line 1 and enters the result, $77,499, on lines 6 and 8. He skips line 7 because he is not a shareholder, partner, or beneficiary of an entity which passed qualified production activity income through to him.

Line 9. He figures adjusted gross income without the domestic production activities deduction by completing lines 1 through 38 (skip- ping line 35) of Form 1040 and enters $61,357 on line 9.

Line 10. He enters $61,357, the smaller of line 8 or line 9. comes from the casualty on page 2 of Form 4684. Only the insurance from this casualty is reported on Form 4797.

Schedule SE (Form 1040) Self-Employment Tax

After figuring his net farm profit on page 1 of Schedule F (1040), Mr. Brown figures his self-employment tax. To do this, he figures his net earnings from farm self-employment on Short Schedule SE (1040), Section A. He is not required to use Long Schedule SE (1040), Section B. First he prints his name (as shown on his Form 1040) and his social security number at the top of Schedule SE (1040). Only his name and social security number go on Schedule SE (1040). His wife does not have self-employment income. If she had self-employment income, she would file her own Schedule SE (1040).

Line 1. He enters his net farm profit, $63,657. All the income, losses, and deductions listed on Schedule F (1040) 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 $58,787 on line 4.

Lines 5 and 6. He completes the calculations on line 5 and enters $4,994 on line 5. This is his self-employment tax for 2006. He also enters $8,994 on line 58 of Form 1040. He enters $4,497 on line 6 and also on Form 1040, line 27 (the 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 22. He enters his adjusted basis in the cow, $257, on line 23 and the $109 insurance payment he received for the cow on line 24. Line 23 is more than line 24, so he skips line 25. On lines 26 and 27, he enters the FMVs before and after the casualty ($500 and $0, respectively), and he shows the difference, $500, on line 28. He enters the amount from line 23 on line 29, subtracts line 24 from line 29, and enters $148 on lines 30 and 31.

Part II. He owned the cow for more than 1 year, so he identifies the casualty on line 37 and enters $148 on lines 37 (b), (j), 40, and 41a, and on Form 4797. Part II, line 14.

Form 4797 Sales of Business Property

After completing Schedule F (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 2006 at a gain. They consisted of a truck, a mower, and a purchased dairy cow #60. He has information about their cost and deprecia- tion 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 corre- sponding property columns to the properties on those lines. He completes lines 20 through 25b (or 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 25b.

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 25b. 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 #82. Because he sold purchased dairy cow #82 at a cost, 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 (1040), line 11.

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 (1040) 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 (1040).

Entries. He enters the required information in the appropriate columns.

- **Lines 1 and 3.** He has no short-term transactions to report so he skips Part I of Schedule D (1040).
- **Lines 8 and 10.** He enters in column (f) on line 8 his $14,000 long-term loss (using brackets to indicate the loss) on the sale of Circle Corporation stock held more than 1 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 capital total loss of lines 16 and 21. He also enters this amount on Form 1040, line 13. The loss amounts are always written in brackets to distinguish the loss.

After he completes his Form 1040 through line 43, he will use the Schedule J (1040), Income Averaging for Farmers and Fishermen, to determine if it yields the lowest tax.

Form 1040, Page 1
Mr. Brown is filing a joint return with his wife.

**Line items.** He fills in all applicable items on page 1 of Form 1040.

- **Line 7.** Mrs. Brown worked for Mr. Brown on the farm during 2006. He enters on line 7 her total wages, $8,950, as shown on the Form W-2 that he gave her.
- **Lines 8a and 9a.** He did not actually receive cash payment for the interest he listed on line 8a ($955). It was credited to his account so that he could have withdrawn it in 2006. Therefore, he constructively received it and correctly included it in his income for 2006.

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 (1040), 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 (1040) instructions applied, so he is not required to complete Schedule B (1040).

- **Lines 13, 14, and 18.** He previously entered the following items:
  - His capital loss on line 13 from Schedule D (1040), line 21.
  - His other gain on line 14 from Form 4797, line 18b.
  - His net farm profit on line 18 from Schedule F (1040), line 36.

- **Line 22.** He adds the amounts on lines 22 through 21 and enters the total, $72,896.
- **Line 27.** He has already entered one-half of his self-employment tax, $4,497, which he figured on Schedule SE (1040).
- **Line 29.** He paid premiums of $7,042 during 2006 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, $7,042, on line 29.
- **Line 35.** He enters $1,841 on line 35 from Form 8903, line 19.
- **Line 36.** He adds the amounts on lines 32 through 31(a) and 32 through 35 and enters the total, $13,380, on line 36.
- **Lines 37 and 38.** He subtracts line 36 from line 22 to get his adjusted gross income and enters the result, $59,516, on line 37 and also on line 38 of page 2.

Form 1040, Page 2
Mr. Brown fills in the following lines on page 2 of Form 1040.

- **Line 40.** He enters $15,000 from his Schedule A (1040), which is not shown, because the total of his itemized deductions is larger than the $10,300 standard deduction for his filing status (married filing jointly).
- **Lines 41, 42, and 43.** He subtracts the $15,000 on line 40 from the $59,516 on line 38 and enters the result, $44,516, on line 41. He enters $6,600 ($3,300) on line 42 and subtracts this amount from the amount on line 41 to get a taxable income of $37,916 on line 43.
- **Line 44.** He enters $3,792 from Schedule J (1040), line 22. For information on how he figured his tax using income averaging, see Schedule J (Form 1040), Income Averaging for Farmers and Fishermen, later.
- **Lines 46 through 56.** Mr. Brown determined that he and his wife do not owe alternative minimum tax (line 45). Therefore, he enters on line 46 the same tax shown on line 44. Nor is he claiming any of the credits on lines 47 through 55, so the same tax is also shown on line 57.

- **Line 58.** He has already entered the $8,994 self-employment tax he figured on Schedule SE (1040).
- **Line 63.** He adds the amounts on lines 57 through 62 and enters $12,786, which is the total tax for 2006.

- **Line 64.** He enters the income tax withheld from Mrs. Brown’s wages, $1,435, as shown on her Form W-2. He attaches a copy of her Form W-2 to the front of Form 1040.

- **Line 65.** Mr. Brown is a qualified farmer for purposes of the estimated tax rules because his income from farming was at least two-thirds of his and Mrs. Brown’s total income for 2005 or 2006. In accordance with the special estimated tax rules for farmers, Mr. Brown did not have to make a 2006 estimated tax payment (which would have been due on January 16, 2007) because they intended to file their 2006 tax return and pay the tax in full by March 1, 2007. See chapter 15 for more information on special estimated tax rules for qualified farmers.

- **Line 66(a).** The Browns are not entitled to claim the earned income credit on line 66 because their adjusted gross income exceeds the maximum for claiming the credit.

- **Line 70.** Mr. Brown enters his credit for $350 of federal excise tax on gasoline used in 2006. 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 (1040) for 2007 because his deduction for the total cost of gasoline (including the $350 of excise taxes) as a farm business expense on Schedule F (1040) reduced his 2006 taxes.

- **Lines 72 and 76.** He adds the amounts on lines 64 through 71 and enters the total, $1,785, on line 72. He subtracts that figure from the amount on line 63. The balance, $11,001, he entered on line 76.

Schedule J (Form 1040) Income Averaging for Farmers and Fishermen
In 2006, Mr. Brown’s taxable income, $37,916, is substantially higher than in each of the 3 previous years. His taxable income amounts were only $11,128, $667, and $1,535 as shown on Form 1040 for 2003, 2004, and 2005, 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 (1040).

**Line items.** He fills in the lines on Schedule J (1040).

- **Line 1.** He enters $37,916, his taxable income from line 43 of Form 1040 tax return.

- **Line 2.** He enters the part of his farm income he is electing to average, $27,189. He elects to treat this elected farm income as all coming out of ordinary farm income. His ordinary farm income is $60,114 ($63,657 of ordinary income from Schedule F (1040), plus $954 of net ordinary gain from Form 4797, minus the $4,497...
Lines 18, 19, and 20. He enters his tax from his 2003, 2004, and 2005 returns on lines 18, 19, and 20, respectively.

Line 21. He adds the amounts on lines 18, 19, and 20 and enters the total, $575, on line 21.

Line 22. He subtracts the amount on line 21 from the amount on line 17 and enters $3,792 on line 22. The tax on this line is less than the $4,959 of tax he figured using the 2006 tax tables. Therefore, he enters on line 44 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 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 76 of Form 1040. On the check, he writes his social security number, their telephone number, and “2006 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 8903. (143)

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 due.
### Form 1040

**U.S. Individual Income Tax Return**

<table>
<thead>
<tr>
<th>Label</th>
<th>2006</th>
<th>IRS Use Only—Do not write or staple in this space.</th>
</tr>
</thead>
<tbody>
<tr>
<td>For the year Jan. 1-Dec. 31, 2006, or other tax year beginning</td>
<td></td>
<td>OMB No. 1545-0074</td>
</tr>
</tbody>
</table>

- Your name and initial: Brown
- Last name: Jane
- Address: 123 Main St, Anytown, USA
- Home address: 456 Park Ave, City, NY 10001
- City, town or post office, state, and ZIP code: Anytown, NY 10001
- Your social security number: 543-21-0000
- Spouse’s social security number: 543-22-1222

#### Election Campaign
- Head of household (with qualifying person): Jane W.
- Marital status: Married filing jointly
- Qualifying widow(er) with dependent child: Jane W.
- Qualifying child: John B.

#### Exemptions
- Total number of exemptions claimed: 3

#### Income
- Wages, salaries, tips, etc.: $59,516
- Tax-exempt interest: $0
- Ordinary dividends: $954
- Business income or loss: $0
- Capital gain or (loss): $-1,260
- Rental real estate, royalties, partnerships, S corporations, trusts, etc.: $0
- Farm income or (loss): $0
- Unemployment compensation: $0
- Social security benefits: $0
- Total income: $72,036

#### Adjusted Gross Income
- Archer MSA deduction: $0
- Certain business expenses of reservists, performing artists, and fee-basis government officials: $0
- Health savings account deduction: $0
- Self-employed SEP, SIMPLE, and qualified plans: $0
- Self-employed health insurance deduction: $7,042
- Penalties on early withdrawal of savings: $0
- Alimony received: $0
- IRA deduction: $0
- Student loan interest deduction: $0
- Jury duty pay: $0
- Domestic production activities deduction: $1,841
- Total adjustments to income: $0
- Adjusted gross income: $72,036

### Note
- For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see page 79.

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The type and rule above prints on all proofs including departmental reproduction proofs. MUST be removed before printing.
Form 1040 (2006)

Page 2

The type and rule above prints on all proofs including departmental reproduction proofs. MUST be removed before printing.

**Form 1040 (2006)**

**Amounts and Form 8888.** See page 60

**Refund Payments**

**Taxes and Credits**

**Standard Deduction for—**
- People who checked any box on line 39a or 39b or who can be claimed as a dependent, see page 34.
- All others: Single or Married filing separately, $5,150. Married filing jointly or Qualifying widow(er), $10,300

**Primary Taxes**

**Other Taxes**

**Refund**

**Prepare or Use Only**

**Sign Here**

**Designee's name**

**Preparer's name**

**Date**

**Daytime phone number**

**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.**

**Amount of line 73 you want refunded to you. If Form 8888 is attached, check here**

**Amount you owe. Subtract line 72 from line 63. For details on how to pay, see page 61**

**Estimated tax penalty (see page 62)**

**Do you want to allow another person to discuss this return with the IRS (see page 62)?**

**Yes. Complete the following. No**
## SCHEDULE D
(Form 1040)

**Capital Gains and Losses**

OMB No. 1545-0074

Department of the Treasury
Internal Revenue Service

Name(s) shown on Form 1040
Walter A. & Jane W. Brown

10-16-85 6-5-06 1,000 15,000 (14,000

---

**Part I**
Short-Term Capital Gains and Losses—Assets Held One Year or Less

<table>
<thead>
<tr>
<th>(a) Description of property</th>
<th>(b) Date acquired (Mo., day, yr.)</th>
<th>(c) Date sold (Mo., day, yr.)</th>
<th>(d) Sales price (see page D-6 of the instructions)</th>
<th>(e) Cost or other basis (see page D-7 of the instructions)</th>
<th>(f) Gain or (loss) Subtract (e) from (d)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

2 Enter your short-term totals, if any, from Schedule D-1, line 2

3 Total short-term sales price amounts. Add lines 1 and 2 in column (d) . . . . . . . . . . . . . . . . .

4 Short-term gain from Form 8292 and short-term gain or (loss) from Forms 4684, 6781, and 8824

5 Net short-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s)

6 Short-term capital loss carryover. Enter the amount, if any, from line 10 of your Capital Loss Carryover Worksheet on page D-7 of the instructions

7 Net short-term capital gain or (loss). Combine lines 1 through 6 in column (f) . . . . . . . . . . . .

---

**Part II**
Long-Term Capital Gains and Losses—Assets Held More Than One Year

<table>
<thead>
<tr>
<th>(a) Description of property</th>
<th>(b) Date acquired (Mo., day, yr.)</th>
<th>(c) Date sold (Mo., day, yr.)</th>
<th>(d) Sales price (see page D-6 of the instructions)</th>
<th>(e) Cost or other basis (see page D-7 of the instructions)</th>
<th>(f) Gain or (loss) Subtract (e) from (d)</th>
</tr>
</thead>
<tbody>
<tr>
<td>8</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

9 Enter your long-term totals, if any, from Schedule D-1, line 9

10 Long-term sales price amounts. Add lines 8 and 9 in column (d) . . . . . . . . . . . .

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

12 Net long-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s)

13 Capital gain distributions. See page D-1 of the instructions

14 Long-term capital loss carryover. Enter the amount, if any, from line 15 of your Capital Loss Carryover Worksheet on page D-7 of the instructions

15 Net long-term capital gain or (loss). Combine lines 8 through 14 in column (f). Then go to Part III on the back . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . .

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For Paperwork Reduction Act Notice, see Form 1040 instructions.
Cat. No. 11338H
Schedule D (Form 1040) 2006
### Part III Summary

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>16</td>
<td>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, or Form 1040NR, line 14. Then go to line 17 below.</td>
<td>(1,260)</td>
</tr>
<tr>
<td>17</td>
<td>Are lines 15 and 16 both gains?</td>
<td></td>
</tr>
<tr>
<td>Yes</td>
<td>Go to line 18.</td>
<td></td>
</tr>
<tr>
<td>No</td>
<td>Skip lines 18 through 21, and go to line 22.</td>
<td></td>
</tr>
<tr>
<td>18</td>
<td>Enter the amount, if any, from line 7 of the 28% Rate Gain Worksheet on page D-8 of the instructions.</td>
<td></td>
</tr>
<tr>
<td>19</td>
<td>Enter the amount, if any, from line 18 of the Unrecaptured Section 1250 Gain Worksheet on page D-9 of the instructions.</td>
<td></td>
</tr>
<tr>
<td>20</td>
<td>Are lines 18 and 19 both zero or blank?</td>
<td></td>
</tr>
<tr>
<td>Yes</td>
<td>Complete Form 1040 through line 43, or Form 1040NR through line 40. Then complete the Qualified Dividends and Capital Gain Tax Worksheet on page 38 of the Instructions for Form 1040 (or in the Instructions for Form 1040NR). Do not complete lines 21 and 22 below.</td>
<td></td>
</tr>
<tr>
<td>No</td>
<td>Complete Form 1040 through line 43, or Form 1040NR through line 40. Then complete the Schedule D Tax Worksheet on page D-10 of the instructions. Do not complete lines 21 and 22 below.</td>
<td></td>
</tr>
<tr>
<td>21</td>
<td>If line 16 is a loss, enter here and on Form 1040, line 13, or Form 1040NR, line 14, the smaller of:</td>
<td></td>
</tr>
<tr>
<td>- The loss on line 16 or</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- ($3,000), or if married filing separately, ($1,500)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Note.</td>
<td>When figuring which amount is smaller, treat both amounts as positive numbers.</td>
<td></td>
</tr>
<tr>
<td>22</td>
<td>Do you have qualified dividends on Form 1040, line 9b, or Form 1040NR, line 10b?</td>
<td></td>
</tr>
<tr>
<td>Yes</td>
<td>Complete Form 1040 through line 43, or Form 1040NR through line 40. Then complete the Qualified Dividends and Capital Gain Tax Worksheet on page 38 of the Instructions for Form 1040 (or in the Instructions for Form 1040NR).</td>
<td></td>
</tr>
<tr>
<td>No</td>
<td>Complete the rest of Form 1040 or Form 1040NR.</td>
<td></td>
</tr>
</tbody>
</table>
### Part I Farm Income—Cash Method

Complete Parts I and II (Accrual method. Complete Parts II and III, and Part I, line 11.)

Do not include sales of livestock held for draft, breeding, sport, or dairy purposes. Report these sales on Form 4797.

<table>
<thead>
<tr>
<th>Item</th>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Sales of livestock and other items you bought for resale</td>
<td>12,036</td>
</tr>
<tr>
<td>2</td>
<td>Cost or other basis of livestock and other items reported on line 1</td>
<td>6,623</td>
</tr>
<tr>
<td>3</td>
<td>Subtract line 2 from line 1</td>
<td>5,413</td>
</tr>
<tr>
<td>4</td>
<td>Sales of livestock, produce, grains, and other products you raised</td>
<td>253,018</td>
</tr>
<tr>
<td>5a</td>
<td>Cooperative distributions (Form(s) 1099-PATR)</td>
<td>1,149</td>
</tr>
<tr>
<td>5b</td>
<td>Taxable amount</td>
<td>1,149</td>
</tr>
<tr>
<td>6a</td>
<td>Agricultural program payments (see page F-3)</td>
<td>6,781</td>
</tr>
<tr>
<td>6b</td>
<td>Taxable amount</td>
<td>6,781</td>
</tr>
<tr>
<td>7</td>
<td>Commodity Credit Corporation (CCC) loans (see page F-3)</td>
<td>7a</td>
</tr>
<tr>
<td>b</td>
<td>CCC loans reported under election</td>
<td>665</td>
</tr>
<tr>
<td>8</td>
<td>Crop insurance proceeds and federal disaster payments (see page F-3)</td>
<td>7b</td>
</tr>
<tr>
<td>a</td>
<td>Amount received in 2006</td>
<td>7c</td>
</tr>
<tr>
<td>9</td>
<td>Custom hire (machine work) income</td>
<td>92</td>
</tr>
<tr>
<td>10</td>
<td>Other income, including federal and state gasoline or fuel tax credit or refund (see page F-3)</td>
<td>10</td>
</tr>
<tr>
<td>11</td>
<td>Gross income. Add amounts in the right column for lines 3 through 10. If you use the accrual method, enter the amount from Part II, line 51</td>
<td>280,082</td>
</tr>
</tbody>
</table>

### Part II Farm Expenses—Cash and Accrual Method

Do not include personal or living expenses such as taxes, insurance, or repairs on your home.

<table>
<thead>
<tr>
<th>Item</th>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>12</td>
<td>Car and truck expenses (see page F-4). Also attach Form 4962</td>
<td>1,090</td>
</tr>
<tr>
<td>13</td>
<td>Chemicals</td>
<td>3,279</td>
</tr>
<tr>
<td>14</td>
<td>Conservation expenses (see page F-4).</td>
<td>6,781</td>
</tr>
<tr>
<td>15</td>
<td>Custom hire (machine work)</td>
<td>5,095</td>
</tr>
<tr>
<td>16</td>
<td>Depreciation and section 179 expense deduction not claimed elsewhere (see page F-4)</td>
<td>33,637</td>
</tr>
<tr>
<td>17</td>
<td>Employee benefit programs other than on line 25</td>
<td>30</td>
</tr>
<tr>
<td>18</td>
<td>Feed</td>
<td>50,614</td>
</tr>
<tr>
<td>19</td>
<td>Fertilizers and lime</td>
<td>6,544</td>
</tr>
<tr>
<td>20</td>
<td>Freight and trucking.</td>
<td>2,795</td>
</tr>
<tr>
<td>21</td>
<td>Gasoline, fuel, and oil</td>
<td>6,216</td>
</tr>
<tr>
<td>22</td>
<td>Insurance (other than health)</td>
<td>3,562</td>
</tr>
<tr>
<td>23</td>
<td>Interest</td>
<td>297</td>
</tr>
<tr>
<td>a</td>
<td>Mortgage (paid to banks, etc.)</td>
<td>3,175</td>
</tr>
<tr>
<td>b</td>
<td>Other</td>
<td>7,738</td>
</tr>
<tr>
<td>24</td>
<td>Labor hired (less employment costs)</td>
<td>20,568</td>
</tr>
<tr>
<td>25</td>
<td>Pension and profit-sharing plans</td>
<td>1,090</td>
</tr>
<tr>
<td>26</td>
<td>Rent or lease (see page F-5)</td>
<td>1,090</td>
</tr>
<tr>
<td>26a</td>
<td>a Vehicles, machinery, and equipment</td>
<td>92</td>
</tr>
<tr>
<td>26b</td>
<td>b Other (land, animals, etc.)</td>
<td>9,660</td>
</tr>
<tr>
<td>26c</td>
<td>c Repair and maintenance</td>
<td>13,804</td>
</tr>
<tr>
<td>26d</td>
<td>d Seeds and plants</td>
<td>5,675</td>
</tr>
<tr>
<td>26e</td>
<td>e Storage and warehousing</td>
<td>665</td>
</tr>
<tr>
<td>26f</td>
<td>f Supplies</td>
<td>7,433</td>
</tr>
<tr>
<td>26g</td>
<td>g Taxes</td>
<td>3,201</td>
</tr>
<tr>
<td>26h</td>
<td>h Utilities</td>
<td>6,504</td>
</tr>
<tr>
<td>26i</td>
<td>i Veterinary, breeding and medicine</td>
<td>8,907</td>
</tr>
<tr>
<td>26j</td>
<td>j Other expenses (specify):</td>
<td>8,907</td>
</tr>
<tr>
<td>30</td>
<td>Other expenses (specify):</td>
<td>8,907</td>
</tr>
<tr>
<td>31</td>
<td>Total expenses. Add lines 12 through 34f. If line 34f is negative, see instructions</td>
<td>216,425</td>
</tr>
</tbody>
</table>

### Schedule F (Form 1040) 2006

Attach Form 1040NR, line 19. If you file Form 1040NR, enter the loss on Form 1040NR, line 19.

- If you file Form 1040NR, enter the loss on Form 1040NR, line 19.
- If you file Form 1040NR, enter the profit on Form 1040, line 18, and also on Schedule SE, line 1.

For Paperwork Reduction Act Notice, see page F-7 of the instructions.
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 58.

May I Use Short Schedule SE or Must I Use Long Schedule SE?

Note. Use this flowchart only if you must file Schedule SE. If unsure, see Who Must File Schedule SE, above.

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 .
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, code J1. 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 .
3. Combine lines 1 and 2 .
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 .
5. Self-employment tax. If the amount on line 4 is:
   - $94,200 or less, multiply line 4 by 15.3% (.153). Enter the result here and on Form 1040, line 58.
   - More than $94,200, multiply line 4 by 2.9% (.029). Then, add $11,680.80 to the result. Enter the total here and on Form 1040, line 58.
6. Deduction for one-half of self-employment tax. Multiply line 5 by 50% (.5). Enter the result here and on Form 1040, line 27 .
The type and rule above prints on all proofs including departmental reproduction proofs. MUST be removed before printing.

---

**SCHEDULE J (Form 1040)**

**Department of the Treasury Internal Revenue Service**

**Income Averaging for Farmers and Fishermen**

**2006**

**Attach to Form 1040 or Form 1040NR.**

**See Instructions for Schedule J (Form 1040).**

**Cat. No. 25513Y**

**Schedule J (Form 1040) 2006**

---

**Name(s) shown on return:**

<table>
<thead>
<tr>
<th>Name(s) shown on return</th>
<th>Social security number (SSN)</th>
</tr>
</thead>
<tbody>
<tr>
<td>WALTER A. &amp; JANE W. BROWN</td>
<td>37,916 –</td>
</tr>
</tbody>
</table>

---

**For Paperwork Reduction Act Notice, see Form 1040 or Form 1040NR instructions.**

**Schedule J (Form 1040)**

---

1. Enter the taxable income from your 2006 Form 1040, line 43, or Form 1040NR, line 40.
2. Enter your elected farm income (see page J-1). Do not enter more than the amount on line 1.
3. Subtract line 2 from line 1.
4. Figure the tax on the amount on line 3 using the 2006 tax rates (see page J-2).
5. If you used Schedule J to figure your tax for:
   - 2005, enter the amount from your 2005 Schedule J, line 11.
   - 2004 but not 2005, enter the amount from your 2004 Schedule J, line 15.
   - Otherwise, enter the taxable income from your 2003 Form 1040, line 40; Form 1040A, line 27; Form 1040EZ, line 6; or Form 1040NR, line 38. If zero or less, see page J-2.
6. Divide the amount on line 2 by 3.0.
7. Combine lines 5 and 6. If zero or less, enter 0–.
8. Figure the tax on the amount on line 7 using the 2003 tax rates (see page J-3).
9. If you used Schedule J to figure your tax for:
   - 2005, enter the amount from your 2005 Schedule J, line 15.
   - 2004 but not 2005, enter the amount from your 2004 Schedule J, line 3.
   - Otherwise, enter the taxable income from your 2004 Form 1040, line 42; Form 1040A, line 27; Form 1040EZ, line 6; or Form 1040NR, line 39. If zero or less, see page J-3.
10. Enter the amount from line 6. Combine lines 9 and 10. If less than zero, enter as a negative amount.
11. Figure the tax on the amount on line 11 using the 2004 tax rates (see page J-4).
12. If you used Schedule J to figure your tax for:
   - 2005, enter the amount from your 2005 Schedule J, line 15.
   - 2004 but not 2005, enter the amount from your 2004 Schedule J, line 3.
   - Otherwise, enter the taxable income from your 2004 Form 1040, line 42; Form 1040A, line 27; Form 1040EZ, line 6; or Form 1040NR, line 39.
   - Otherwise, enter the tax from your 2003 Schedule J, line 3.
   - Otherwise, enter the tax from your 2003 Form 1040, line 41; Form 1040A, line 28; Form 1040EZ, line 10; or Form 1040NR, line 39.
13. Enter the amount from line 8. Combine lines 12 and 13. If less than zero, enter as a negative amount.
14. Figure the tax on the amount on line 13 using the 2005 tax rates (see page J-5).
15. Add lines 4, 8, 12, and 16.
16. If you used Schedule J to figure your tax for:
   - 2005, enter the amount from your 2005 Schedule J, line 12.
   - 2004 but not 2005, enter the amount from your 2004 Schedule J, line 16.
   - Otherwise, enter the tax from your 2003 Form 1040, line 41; Form 1040A, line 28; Form 1040EZ, line 10; or Form 1040NR, line 40.
   - Otherwise, enter the tax from your 2002 Schedule J, line 4.
   - Otherwise, enter the tax from your 2002 Form 1040, line 44; Form 1040A, line 28; Form 1040EZ, line 10; or Form 1040NR, line 41.
17. Add lines 14 through 20.
18. Add lines 14 through 20. Figure the tax on the amount on line 15 using the 2005 tax rates (see page J-6).
19. If you used Schedule J to figure your tax for:
   - 2005, enter the amount from your 2005 Schedule J, line 16.
   - 2004 but not 2005, enter the amount from your 2004 Schedule J, line 4.
   - Otherwise, enter the tax from your 2004 Form 1040, line 43; Form 1040A, line 28; Form 1040EZ, line 10; or Form 1040NR, line 40.
20. Add lines 18 through 20. Figure the tax on the amount on line 17. Include this amount on Form 1040, line 44 or Form 1040NR, line 41.
21. Subtract line 21 from line 17. Also include this amount on Form 1040, line 44 or Form 1040NR, line 41.
22. Tax. Subtract line 21 from line 17. Also include this amount on Form 1040, line 44 or Form 1040NR, line 41.

Caution: Your tax may be less if you figure it using the 2006 Tax Table, Tax Computation Worksheet, Qualified Dividends and Capital Gain Tax Worksheet, Schedule D Tax Worksheet, or Foreign Earned Income Tax Worksheet. Attach Schedule J only if you are using it to figure your tax.
Form 4684 (2006)

**S E C T I O N  B — B u s i n e s s  a n d  I n c o m e - P r o d u c i n g  P r o p e r t y**

**P a r t  I  C a s u a l t y  o r  T h e f t  G a i n  o r  L o s s** (U s e  a  s e p a r a t e  P a r t  I  f o r  e a c h  c a s u a l t y  o r  t h e f t.)

Describes 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**
- **Identifying number**: 543-00-2211
- **Name(s) shown on tax return**: WALTER A. & JANE W. BROWN
- **Identifying number**: 543-00-2211

<table>
<thead>
<tr>
<th>Property</th>
<th>A</th>
<th>B</th>
<th>C</th>
<th>D</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property A</td>
<td>DAIRY COW #42</td>
<td>HOMETOWN, VA</td>
<td>6-22-02</td>
<td></td>
</tr>
</tbody>
</table>

#### 22. Description of properties
- **Property A**
  - **Cost or adjusted basis of each property**: 297
  - **24. Insurance or other reimbursement (whether or not you filed a claim)**: 109
  - **25. Gain from casualty or theft**: If line 24 is more than line 23, enter the difference here and on line 32 or line 37, column (c), except as provided in the instructions for line 34. Also, skip lines 26 through 30 for that column. See the instructions for line 4 if line 24 includes insurance or other reimbursement you did not claim, or you received payment for your loss in a later tax year.
  - **26. Fair market value before casualty or theft**: 500
  - **27. Fair market value after casualty or theft**: 0
  - **28. Subtract line 27 from line 26**: 500
  - **29. Enter the smaller of line 23 or line 28**: 257
  - **30. Subtract line 24 from line 29**: 148
  - **31. Casualty or theft loss. Add the amounts on line 30. Enter the total here and on line 32 or line 37 (see instructions)**: 148

#### Part II Summary of Gains and Losses (from separate Parts I)

(a) Identify casualty or theft

<table>
<thead>
<tr>
<th>(a)</th>
<th>(b)</th>
<th>(c)</th>
<th>(d)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Trade, business, rental or royalty property</td>
<td>Losses from casualties or thefts</td>
<td>Income-producing and employee property</td>
<td>Gains from casualties or thefts includible in income</td>
</tr>
</tbody>
</table>

**Casualty or Theft of Property Held One Year or Less**

<table>
<thead>
<tr>
<th>32.</th>
<th>33.</th>
<th>34.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Totals. Add the amounts on line 32</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

| 35. Combine line 33, 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 |

**Casualty or Theft of Property Held More Than One Year**

<table>
<thead>
<tr>
<th>36. Casualty or theft gains from Form 4797, line 32</th>
<th>37. COW KILLED BY LIGHTNING</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>

| 38. Total losses. Add amounts on line 37, columns (b)(ii) and (b)(iii) |
|-----|-----|

| 39. Total gains. Add lines 36 and 37, column (c) |
|-----|-----|

| 40. Add amounts on line 38, columns (b)(ii) and (b)(iii) |
|-----|-----|

| 41. If the loss on line 40 is more than the gain on line 39: |
|-----|-----|
| a. Combine line 38, column (b)(ii) and line 39, 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 38, column (b)(ii) here. Individuals, enter the amount from income-producing property on Schedule A (Form 1040), line 27, or Schedule A (Form 1040NR), line 16, and enter the amount from property used as an employee on Schedule A (Form 1040), line 22 or Schedule A (Form 1040NR), line 11. Estates and trusts, partnerships, and S corporations, see instructions |

| 41a. (148) |

| 41b. (148) |

| 42. If the loss on line 40 is less than or equal to the gain on line 39, combine lines 39 and 40 and enter here. Partnerships (except electing large partnerships), see the note below. All others, enter this amount on Form 4797, line 3 |

| 42. Note: Partnerships, enter the amount from line 41a, 41b, or line 42 on Form 1065, Schedule K, line 11. S corporations, enter the amount from line 41a or 41b on Form 1120S, Schedule K, line 10 |

Form 4684 (2006)
WALTER A. & JANE W. BROWN 543-00-2111

RAISED Cows

Dairy Cow #52

Before 2002    7-15-02     2006     2-3-06

13,160  303

– 0 – 514 325

912 12,835 95 (95)

RAISED Dairy Heifer 10-2-05 3-3-06 255 – 0 – 5 250

852 954

(148)

954

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)

<table>
<thead>
<tr>
<th>Description of property</th>
<th>Date acquired (mo., day, yr.)</th>
<th>Date sold (mo., day, yr.)</th>
<th>Gross sales price</th>
<th>Depreciation claimed or allowable since acquisition</th>
<th>Cost or other basis, plus improvements and expense of sale</th>
<th>Gain or (loss)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2 RAISED Cows</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dairy Cow #52</td>
<td>7-15-02</td>
<td>2-3-06</td>
<td>15,180</td>
<td>– 0 –</td>
<td>525</td>
<td>12,655</td>
</tr>
</tbody>
</table>

Part II  Ordinary Gains and Losses (see instructions)

<table>
<thead>
<tr>
<th>Description of property</th>
<th>Date acquired (mo., day, yr.)</th>
<th>Date sold (mo., day, yr.)</th>
<th>Gross sales price</th>
<th>Depreciation claimed or allowable since acquisition</th>
<th>Cost or other basis, plus improvements and expense of sale</th>
<th>Gain or (loss)</th>
</tr>
</thead>
<tbody>
<tr>
<td>RAISED Dairy Heifer</td>
<td>10-2-05</td>
<td>3-3-06</td>
<td>255</td>
<td>– 0 –</td>
<td>5</td>
<td>250</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Description of property</th>
<th>Date acquired (mo., day, yr.)</th>
<th>Date sold (mo., day, yr.)</th>
<th>Gross sales price</th>
<th>Depreciation claimed or allowable since acquisition</th>
<th>Cost or other basis, plus improvements and expense of sale</th>
<th>Gain or (loss)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loss, if any, from line 7</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gain, if any, from line 7 or amount from line 8, if applicable</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gain, if any, from line 8</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net gain or (loss) from Form 4684, lines 34 and 41a</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ordinary gain from installment sales from Form 6252, line 25 or 36</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ordinary gain or (loss) from like-kind exchanges from Form 8824</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Combine lines 10 through 16</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>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:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>a If the loss on line 11 includes a loss from Form 4684, line 38, 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.</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>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.</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

For Paperwork Reduction Act Notice, see separate instructions.
### Part II  Gain From Disposition of Property Under Sections 1245, 1250, 1252, 1254, and 1255

**(see instructions)**

<p>| | | | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>A</strong></td>
<td><strong>B</strong></td>
<td><strong>C</strong></td>
<td><strong>D</strong></td>
<td></td>
</tr>
<tr>
<td>Truck</td>
<td>Mower</td>
<td>Purchased Dairy Cow #60</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

These columns relate to the properties on lines 19A through 19D.

<table>
<thead>
<tr>
<th></th>
<th>Property A</th>
<th>Property B</th>
<th>Property C</th>
<th>Property D</th>
</tr>
</thead>
<tbody>
<tr>
<td>20</td>
<td>Gross sales price (Note: See line 1 before completing)</td>
<td>700</td>
<td>70</td>
<td>670</td>
</tr>
<tr>
<td>21</td>
<td>Cost or other basis plus expense of sale</td>
<td>4,390</td>
<td>1,200</td>
<td>4,390</td>
</tr>
<tr>
<td>22</td>
<td>Depreciation (or depletion) allowed or allowable</td>
<td>4,390</td>
<td>1,200</td>
<td>4,390</td>
</tr>
<tr>
<td>23</td>
<td>Adjusted basis. Subtract line 22 from line 21</td>
<td>0</td>
<td>0</td>
<td>588</td>
</tr>
<tr>
<td>24</td>
<td>Total gain. Subtract line 23 from line 20</td>
<td>700</td>
<td>70</td>
<td>588</td>
</tr>
</tbody>
</table>

If section 1245 property:

- a. Depreciation allowed or allowable from line 22
- b. Enter the smaller of line 24 or 25a

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>25a</td>
<td>4,390</td>
<td>670</td>
</tr>
<tr>
<td>25b</td>
<td>700</td>
<td>70</td>
</tr>
</tbody>
</table>

If section 1250 property: If straight line depreciation was used, enter -0- on line 26g, except for a corporation subject to section 291.

- a. Additional depreciation after 1975 (see instructions)
- b. Applicable percentage multiplied by the smaller of line 24 or line 26a (see instructions)
- c. Subtract line 26a from line 24. If residential rental property, line 24 is not more than line 26a, skip lines 26c and 26d
- d. Additional depreciation after 1969 and before 1976
- e. Enter the smaller of line 26c or 26d
- f. Section 291 amount (corporations only)
- g. Add lines 26b, 26e, and 26f

<p>| | | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>26a</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>26b</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>26c</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>26d</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>26e</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>26f</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>26g</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

If section 1252 property: Skip this section if you did not dispose of farmland or if this form is being completed for a partnership (other than an electing large partnership).

- a. Soil, water, and land clearing expenses
- b. Line 27a multiplied by applicable percentage (see instructions)
- c. Enter the smaller of line 24 or 27b

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>27a</td>
<td></td>
<td></td>
</tr>
<tr>
<td>27b</td>
<td></td>
<td></td>
</tr>
<tr>
<td>27c</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

If section 1254 property:

- a. Intangible drilling and development costs, expenditures for development of mines and other natural deposits, and mining exploration costs (see instructions)
- b. Enter the smaller of line 24 or 28a

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>28a</td>
<td></td>
<td></td>
</tr>
<tr>
<td>28b</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

If section 1255 property:

- a. Applicable percentage of payments excluded from income under section 126 (see instructions)
- b. Enter the smaller of line 24 or 29a (see instructions)

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>29a</td>
<td></td>
<td></td>
</tr>
<tr>
<td>29b</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Summary of Part III Gains.** Complete property columns A through D through line 29b before going to line 30.

<p>| | | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>30</td>
<td>Total gains for all properties. Add property columns A through D, line 24</td>
<td></td>
<td>852</td>
</tr>
<tr>
<td>31</td>
<td>Add property columns A through D, lines 25b, 26g, 27c, 28b, and 29b. Enter here and on line 13</td>
<td></td>
<td>852</td>
</tr>
<tr>
<td>32</td>
<td>Subtract line 31 from line 30. Enter the portion from casualty or theft on Form 4684, line 36. Enter the portion from other than casualty or theft on Form 4797, line 6</td>
<td></td>
<td>-0-</td>
</tr>
</tbody>
</table>

### Part IV  Recapture Amounts Under Sections 179 and 280F(b)(2) When Business Use Drops to 50% or Less

**(see instructions)**

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>33</td>
<td>Section 179 expense deduction or depreciation allowable in prior years</td>
<td></td>
</tr>
<tr>
<td>34</td>
<td>Recomputed depreciation (see instructions)</td>
<td></td>
</tr>
<tr>
<td>35</td>
<td>Recapture amount. Subtract line 34 from line 33. See the instructions for where to report</td>
<td></td>
</tr>
</tbody>
</table>

Form 4797 (2006)
### Part I - Election To Expense Certain Property Under Section 179

<table>
<thead>
<tr>
<th></th>
<th>Description of property</th>
<th>Cost (business use only)</th>
<th>Elected cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>6</td>
<td>DAIRY EQUIPMENT</td>
<td>72,000–</td>
<td>22,635–</td>
</tr>
</tbody>
</table>

Note: If you have any listed property, complete Part V before you complete Part I.

#### Part II - Special Depreciation Allowance and Other Depreciation
(Do not include listed property.)(See instructions.)

<table>
<thead>
<tr>
<th></th>
<th>Classification of property</th>
<th>Method</th>
<th>Recovery period</th>
<th>Convention</th>
<th>Depreciation deduction</th>
</tr>
</thead>
<tbody>
<tr>
<td>1A</td>
<td>3-year property</td>
<td>5-periode</td>
<td>7</td>
<td>HY</td>
<td>150DB</td>
</tr>
<tr>
<td>1B</td>
<td>5-year property</td>
<td>5-periode</td>
<td>10</td>
<td>HY</td>
<td>150DB</td>
</tr>
<tr>
<td>1C</td>
<td>7-year property</td>
<td>5-periode</td>
<td>20</td>
<td>HY</td>
<td>150DB</td>
</tr>
<tr>
<td>1D</td>
<td>10-year property</td>
<td>5-periode</td>
<td>25yr</td>
<td>L/M</td>
<td>5/L</td>
</tr>
<tr>
<td>1E</td>
<td>15-year property</td>
<td>5-periode</td>
<td>27.5yr</td>
<td>M/M</td>
<td>5/L</td>
</tr>
<tr>
<td>1F</td>
<td>20-year property</td>
<td>5-periode</td>
<td>39yr</td>
<td>M/M</td>
<td>5/L</td>
</tr>
</tbody>
</table>

#### Part III - MACRS Depreciation
(Do not include listed property.)(See instructions.)

<table>
<thead>
<tr>
<th></th>
<th>Classification of property</th>
<th>Method</th>
<th>Recovery period</th>
<th>Convention</th>
<th>Depreciation deduction</th>
</tr>
</thead>
<tbody>
<tr>
<td>17</td>
<td>MACRS deductions for assets placed in service in tax years beginning before 2006</td>
<td>5-periode</td>
<td>66</td>
<td>HY</td>
<td>150DB</td>
</tr>
</tbody>
</table>

#### Section A - Assets Placed in Service During 2006 Tax Year Using the General Depreciation System

- **Classification of property:**
  - (a) Nonresidential real property
  - (b) Residential rental property
  - (c) Plan assets
  - (d) Nonresidential real property

#### Section B - Assets Placed in Service During 2006 Tax Year Using the General Depreciation System

- **Classification of property:**
  - (a) Nonresidential real property
  - (b) Residential rental property
  - (c) Plan assets
  - (d) Nonresidential real property

#### Summary (see instructions)

- **Listed property:**
  - (a) Total, add amounts from line 12, lines 14 through 17, lines 19 and 20 in column (g), and line 21.
  - (b) Total, enter the portion of the basis attributable to section 263A costs.
The type and rule above prints on all proofs including departmental reproduction proofs. MUST be removed before printing.

| Form 4562 (2006) | Page 2 |

### 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 the instructions for limits for passenger automobiles.)

<table>
<thead>
<tr>
<th>24a</th>
<th>Do you have evidence to support the business/investment use claimed?</th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>24b</td>
<td>If &quot;Yes,&quot; is the evidence written?</td>
<td>Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

25 Special allowance for qualified New York Liberty or Gulf Opportunity Zone property placed in service during the tax year and used more than 50% in a qualified business use (see instructions).

<table>
<thead>
<tr>
<th>26</th>
<th>Property used more than 50% in a qualified business use:</th>
</tr>
</thead>
</table>

**PICKUP TRUCK 100**

<table>
<thead>
<tr>
<th>Date placed in service</th>
<th>Basis for depreciation (business/investment use only)</th>
<th>Recovery period</th>
<th>Method/Convention</th>
<th>Basis for depreciation (business/investment use only)</th>
<th>Elected section 179 cost</th>
<th>Cost or other basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>5-18-03</td>
<td>7,076. -</td>
<td>5</td>
<td>IOD/WHT</td>
<td>1,179. -</td>
<td>- 0 -</td>
<td>1,179. -</td>
</tr>
</tbody>
</table>

**PICKUP TRUCK 100**

<table>
<thead>
<tr>
<th>Date placed in service</th>
<th>Basis for depreciation (business/investment use only)</th>
<th>Recovery period</th>
<th>Method/Convention</th>
<th>Basis for depreciation (business/investment use only)</th>
<th>Elected section 179 cost</th>
<th>Cost or other basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>6-22-96</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>6-22-96</td>
</tr>
</tbody>
</table>

#### 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.

<table>
<thead>
<tr>
<th>30</th>
<th>Total business/investment miles driven during the year (do not include commuting miles)</th>
<th>11,350</th>
</tr>
</thead>
<tbody>
<tr>
<td>31</td>
<td>Total commuting miles driven during the year</td>
<td>- 0 -</td>
</tr>
<tr>
<td>32</td>
<td>Total other personal (noncommuting) miles driven</td>
<td>- 0 -</td>
</tr>
<tr>
<td>33</td>
<td>Total miles driven during the year. Add lines 30 through 32</td>
<td>11,350</td>
</tr>
<tr>
<td>34</td>
<td>Was the vehicle available for personal use during off-duty hours?</td>
<td>✓</td>
</tr>
<tr>
<td>35</td>
<td>Was the vehicle used primarily by a more than 5% owner or related person?</td>
<td>✓</td>
</tr>
<tr>
<td>36</td>
<td>Is another vehicle available for personal use?</td>
<td>✓</td>
</tr>
</tbody>
</table>

#### 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 instructions).

<table>
<thead>
<tr>
<th>37</th>
<th>Do you maintain a written policy statement that prohibits all personal use of vehicles, including commuting, by your employees?</th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>38</td>
<td>Do you maintain a written policy statement that prohibits personal use of vehicles, except commuting, by your employees?</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>39</td>
<td>Do you treat all use of vehicles by employees as personal use?</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>40</td>
<td>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?</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>41</td>
<td>Do you meet the requirements concerning ‘all-fleet automobile demonstration use’? (See instructions.)</td>
<td>Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

**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

<table>
<thead>
<tr>
<th>42</th>
<th>Amortization of costs that begins during your 2006 tax year (see instructions):</th>
</tr>
</thead>
<tbody>
<tr>
<td>43</td>
<td>Amortization of costs that began before your 2006 tax year.</td>
</tr>
<tr>
<td>44</td>
<td>Total. Add amounts in column (f). See the instructions for where to report.</td>
</tr>
</tbody>
</table>
## Depreciation Worksheet

<table>
<thead>
<tr>
<th>Description of Property</th>
<th>Date Placed in Service</th>
<th>Cost or Other Basis</th>
<th>Business/Investment Use %</th>
<th>Section 179 Deduction and Special allowance</th>
<th>Depreciation Prior Years</th>
<th>Basis for Depreciation</th>
<th>Method/Convention</th>
<th>Recovery Period</th>
<th>Rate or Table %</th>
<th>Depreciation Deduction</th>
</tr>
</thead>
<tbody>
<tr>
<td>STRAIGHT LINE</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>BARN</td>
<td>1-8-78</td>
<td>6,400</td>
<td>100%</td>
<td></td>
<td>6,400</td>
<td>0°</td>
<td>SL</td>
<td>25</td>
<td></td>
<td>– 0 –</td>
</tr>
<tr>
<td>SILO</td>
<td>1-2-80</td>
<td>16,000</td>
<td>&quot;</td>
<td></td>
<td>16,000</td>
<td>0°</td>
<td>SL</td>
<td>20</td>
<td></td>
<td>– 0 –</td>
</tr>
<tr>
<td>ALTERNATE ACRE</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>MACHINE SHED</td>
<td>1-2-86</td>
<td>6,000</td>
<td>100%</td>
<td></td>
<td>6,000</td>
<td>– 0 –</td>
<td>Mod SL</td>
<td>18</td>
<td></td>
<td>– 0 –</td>
</tr>
<tr>
<td>MACHRS</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>DAIRY COW #42</td>
<td>6-22-02</td>
<td>600</td>
<td>&quot;</td>
<td></td>
<td>300</td>
<td>600</td>
<td>SL/HY</td>
<td>7</td>
<td>14.29</td>
<td>42.87</td>
</tr>
<tr>
<td>DAIRY COW #52 (sold 2/06)</td>
<td>7-15-02</td>
<td>300</td>
<td>&quot;</td>
<td></td>
<td>450</td>
<td>900</td>
<td>SL/HY</td>
<td>7</td>
<td>14.29</td>
<td>64.31</td>
</tr>
<tr>
<td>DAIRY COW #54</td>
<td>9-9-02</td>
<td>1200</td>
<td>&quot;</td>
<td></td>
<td>600</td>
<td>1,200</td>
<td>SL/HY</td>
<td>7</td>
<td>14.29</td>
<td>171.48</td>
</tr>
<tr>
<td>DAIRY COW #50</td>
<td>6-2-06</td>
<td>1,200</td>
<td>100%</td>
<td></td>
<td>5,35</td>
<td>1,200</td>
<td>150DB/HY</td>
<td>7</td>
<td>12.25</td>
<td>73.50</td>
</tr>
<tr>
<td>FLOW</td>
<td>4-6-03</td>
<td>4,821</td>
<td>&quot;</td>
<td></td>
<td>4,821</td>
<td>4,821</td>
<td>150DB/HY</td>
<td>10</td>
<td>10.02</td>
<td>4,830.06</td>
</tr>
<tr>
<td>PICKUP TRUCK (listed property)</td>
<td>5-15-03</td>
<td>7,076</td>
<td>&quot;</td>
<td></td>
<td>7,076</td>
<td>7,076</td>
<td>150DB/HY</td>
<td>5</td>
<td>16.66</td>
<td>1,178.86</td>
</tr>
<tr>
<td>DAIRY COW #61</td>
<td>9-1-03</td>
<td>1,400</td>
<td>&quot;</td>
<td></td>
<td>628</td>
<td>1,400</td>
<td>150DB/HY</td>
<td>7</td>
<td>12.25</td>
<td>171.50</td>
</tr>
<tr>
<td>TRACTOR #4</td>
<td>10-12-03</td>
<td>15,483</td>
<td>&quot;</td>
<td></td>
<td>5,000</td>
<td>2,814</td>
<td>150DB/HY</td>
<td>10</td>
<td>10.02</td>
<td>849.99</td>
</tr>
<tr>
<td>MILK TANK</td>
<td>1-4-04</td>
<td>11,500</td>
<td>100%</td>
<td></td>
<td>11,500</td>
<td>1,500</td>
<td>150DB/HY</td>
<td>7</td>
<td>16.03</td>
<td>225.45</td>
</tr>
<tr>
<td>MANURE SPREADER</td>
<td>5-3-04</td>
<td>3,400</td>
<td>&quot;</td>
<td></td>
<td>1,015</td>
<td>3,400</td>
<td>150DB/HY</td>
<td>7</td>
<td>16.03</td>
<td>511.02</td>
</tr>
<tr>
<td>DAIRY FACILITY BUILDING</td>
<td>1-3-06</td>
<td>28,250</td>
<td>100%</td>
<td></td>
<td>– 0 –</td>
<td>– 0 –</td>
<td>150DB/HY</td>
<td>10</td>
<td>7.50</td>
<td>2,118.75</td>
</tr>
<tr>
<td>DAIRY FACILITY EQUIPMENT</td>
<td>1-3-06</td>
<td>72,000</td>
<td>&quot;</td>
<td></td>
<td>22,635</td>
<td>49,365</td>
<td>150DB/HY</td>
<td>7</td>
<td>10.71</td>
<td>5,226.59</td>
</tr>
<tr>
<td>MACHINE SHED IMPROVEMENT</td>
<td>2-20-06</td>
<td>650</td>
<td>&quot;</td>
<td></td>
<td>– 0 –</td>
<td>– 0 –</td>
<td>150DB/HY</td>
<td>20</td>
<td>3.75</td>
<td>24.31</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td><strong>11,202.16</strong></td>
</tr>
</tbody>
</table>

1. Depreciation limited to half-year
2. Adjusted basis
### Domestic Production Activities Deduction

**Form 8903**

#### Attach to your tax return. See separate instructions.

<table>
<thead>
<tr>
<th>Name(s) as shown on return</th>
<th>Identifying number</th>
</tr>
</thead>
<tbody>
<tr>
<td>WALTER A. AND JANE W. BROWN</td>
<td>543-00-2111</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Line</th>
<th>Description</th>
<th>Formula</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Domestic production gross receipts (DPGR)</td>
<td></td>
<td>301,763</td>
</tr>
<tr>
<td>2</td>
<td>Allocable cost of goods sold. If you are using the small business simplified overall method, skip lines 2 and 3</td>
<td>– O –</td>
<td>– 0 –</td>
</tr>
<tr>
<td>3</td>
<td>If you are using the section 861 method, enter deductions and losses definitely related to DPGR. Estates and trusts, see instructions. All others, skip line 3</td>
<td>– O –</td>
<td>– 0 –</td>
</tr>
<tr>
<td>4</td>
<td>If you are using the section 861 method, enter your pro rata share of deductions and losses not definitely related to DPGR. All others, see instructions</td>
<td>224,264</td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>Add lines 2 through 4</td>
<td></td>
<td>224,264</td>
</tr>
<tr>
<td>6</td>
<td>Subtract line 5 from line 1</td>
<td></td>
<td>77,499</td>
</tr>
</tbody>
</table>
| 7    | Qualified production activities income from pass-through entities: | \[
\text{if you are a—} \quad \text{Then enter the total qualified production activities income from—} \\
\begin{align*}
\text{a Shareholder} & : \quad \text{Schedule K-1 (Form 1120S), box 14, code O} \\
\text{b Partner} & : \quad \text{Schedule K-1 (Form 1065), box 13, code U} \\
\text{c Beneficiary} & : \quad \text{Schedule K-1 (Form 1065-B), box 9, code Z2} \\
\end{align*}
\] | – 0 – |
| 8    | Qualified production activities income. Add lines 6 and 7. If zero or less, enter –0– here, skip lines 9 through 15, and enter –0– on line 16 |  | – 0 – |
| 9    | Income limitation (see instructions): | \[
\begin{align*}
\text{● Individuals, estates, and trusts. Enter your adjusted gross income figured without the domestic production activities deduction} \\
\text{● All others. Enter your taxable income figured without the domestic production activities deduction (tax-exempt organizations, see instructions)}
\end{align*}
\] | – 0 – |
| 10   | Enter the smaller of line 6 or line 9. If zero or less, enter –0– here, skip lines 11 through 15, and enter –0– on line 16 |  | – 0 – |
| 11   | Enter 3% of line 10 |  | 1,841 |
| 12   | Form W-2 wages (see instructions) |  | 26,368 |
| 13   | Form W-2 wages from pass-through entities: | \[
\text{if you are a—} \quad \text{Then enter the total Form W-2 wages from—} \\
\begin{align*}
\text{a Shareholder} & : \quad \text{Schedule K-1 (Form 1120S), box 12, code R} \\
\text{b Partner} & : \quad \text{Schedule K-1 (Form 1065), box 13, code V} \\
\text{c Beneficiary} & : \quad \text{Schedule K-1 (Form 1065-B), box 9, code S3} \\
\end{align*}
\] | – 0 – |
| 14   | Add lines 12 and 13 |  | 26,368 |
| 15   | Form W-2 wage limitation. Enter 50% of line 14 |  | 13,184 |
| 16   | Enter the smaller of line 11 or line 15 |  | 1,841 |
| 17   | Domestic production activities deduction from cooperatives. Enter deduction from Form 1099-PATR, box 6 | – O – | – 0 – |
| 18   | Expanded affiliated group allocation (see instructions) | – O – | 1,841 |
| 19   | Domestic production activities deduction. Combine lines 16 through 18 and enter the result here and on Form 1040, line 35; Form 1120, line 25; Form 1120-A, line 21; or the applicable line of your return | – 0 – | 1,841 |

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*For Paperwork Reduction Act Notice, see separate instructions.*

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Chapter 16  Sample Return  Page 103
17.

How To Get Tax Help

You can get help with unresolved tax issues, order free publications and forms, ask tax questions, and get 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. The Taxpayer Advocate Service is an independent organization within the IRS whose employees assist taxpayers who are experiencing economic harm, who are seeking help in resolving tax problems that have not been resolved through normal channels, or who believe that an IRS system or procedure is not working as it should.

You can contact the Taxpayer Advocate Service by calling toll-free 1-877-777-4778 or TTY/TDD 1-800-829-4059 to see if you are eligible for assistance. You can also call or write to your local taxpayer advocate, whose phone number and address are listed in your local telephone directory and in Publication 1546, The Taxpayer Advocate Service of the IRS - How to Get Help With Unresolved Tax Problems. You can file Form 911, Application for Taxpayer As- sociate Order, or ask an IRS employee to complete it on your behalf. For more information, go to www.irs.gov/advocate.

Low income tax clinics (LITCs). LITCs are independent organizations that provide low income taxpayers with representation in federal tax controversies with the IRS for free or for a nominal charge. The clinics also provide tax education and outreach for taxpayers with limited English proficiency or who speak English as a second language. Publication 4134, Low Income Taxpayer Clinic List, provides information on clinics in your area. It is available at www.irs.gov or at your local IRS office.

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 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 at www.irs.gov 24 hours a day, 7 days a week 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 2006 refund. Click on Where's My Refund? Wait at least 6 weeks from the date you filed your return (3 weeks if you filed electronically). Have your 2006 tax return available because you will need to know your social security number, your filing status, and the exact whole dollar amount of your refund.
- Download forms, instructions, and publica-
tions.
- 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 withholding calculator.
- Sign up to receive local and national tax news by email.
- Get information on starting and operating a small business.

Phone. Many services are available by phone.

- Ordering forms, instructions, and publica-
tions. 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 make the number, go to www.irs.gov/localcon-
tacts or look in the phone book under United States Government, Internal Revenue Service.
- TY/TDD equipment. If you have access to TT/TDD equipment, call 1-800-829-4059 to ask tax questions or to order forms and publications.
- TeleTax topics. Call 1-800-829-4477 to listen to pre-recorded messages covering various tax topics.
- Refund information. To check the status of your 2006 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 2006 tax return available because you will need to know your social security number, your filing status, and the exact whole dollar amount of your refund.

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 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 for personal, face-to-face tax help. An employee can explain IRS letters, request adjustments to your tax account, or help you set up a payment plan. If you need to resolve a tax problem, have questions about how the tax law applies to your individual tax return, or you’re more comfortable talking with someone in person, visit your local Taxpayer Assistance Center where you can spread out your records and talk with an IRS representa-
tive face-to-face. No appointment is neces-
sary, but if you prefer, you can call your local Center and leave a message requesting an appointment to resolve a tax account issue. A representative will call you back within 2 business days to schedule an in-person appointment at your con-

Mail. You can send your order for forms, instructions, and publications to the address below. You should receive a response within 10 business days after your request is received.

CD for tax products. You can order Publication 1796, IRS Tax Products CD, and obtain:

- A CD that is released twice so you have the latest products. The first release ships in January and the final release ships in March.
- Current-year forms, instructions, and publica-
tions.
- Prior-year forms, instructions, and publica-
tions.
- Bonus: Historical Tax Products DVD - Ships with the final release.
- Tax Map: an electronic research tool and finding aid.
- Tax law frequently asked questions.
- Tax Topics from the IRS telephone re-
sponse system.
• Fill-in, print, and save features for most tax forms.
• Internal Revenue Bulletins.
• Toll-free and email technical support.

Buy the CD from National Technical Information Service (NTIS) at www.irs.gov/cdorders for $25 (no handling fee) or call 1-877-CDFORMS (1-877-233-6767) toll free to buy the CD for $25 (plus a $5 handling fee). Price is subject to change.

**CD for small businesses.** Publication 3207, The Small Business Resource Guide CD for 2006, is a must for every small business owner or any taxpayer about to start a business. This year’s CD includes:

• Helpful information, such as how to prepare a business plan, find financing for your business, and much more.
• All the business tax forms, instructions, and publications needed to successfully manage a business.
• Tax law changes for 2006.
• Tax Map: an electronic research tool and finding aid.
• Web links to various government agencies, business associations, and IRS organizations.
• “Rate the Product” survey—your opportunity to suggest changes for future editions.

• A site map of the CD to help you navigate the pages of the CD with ease.
• An interactive “Teens in Biz” module that gives practical tips for teens about starting their own business, creating a business plan, and filing taxes.

An updated version of this CD is available each year in early April. You can get a free copy by calling 1-800-829-3676 or by visiting www.irs.gov/smallbiz.
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To help us develop a more useful index, please let us know if you have ideas for index entries. See "Comments and Suggestions" in the "Introduction" for the ways you can reach us.

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