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Farmer’s Tax Guide

For use in preparing 2007 Returns

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

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.

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interceptions are resolved by higher court decisions, or in some other way, this publication will continue to present the interpretation of the Service.

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

Comments and suggestions. We welcome your comments about this publication and your suggestions for future editions. You can write to us at the following address:

Internal Revenue Service
Business Forms and Publications Branch
SE:W:CAR:MP:T:B
1111 Constitution Ave. NW, IR-6526
Washington, DC 20224

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

You can email us at taxforms@irs.gov. (The asterisk must be included in the address.) Please put “Publications Comment” on the subject line. Although we cannot respond individually to each email, we do appreciate your feedback and will consider your comments as we revise our tax products.

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

Comments on IRS enforcement actions. The Small Business and Agricultural Regulatory Enforcement Ombudsman and 10 Regional Fairness Boards were established to receive comments from small business about federal agency enforcement actions. The Ombudsman will annually evaluate the enforcement activities of each agency and rate its responsiveness to small business. If you wish to comment on the enforcement actions of the IRS, you can:

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

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

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

What’s New for 2007

The following items highlight a number of administrative and tax law changes for 2007. They are discussed in more detail throughout the publication. More information on these and other changes can be found in Publication 553, Highlights of 2007 Tax Changes. Publication 553 is available at www.irs.gov, click on More Forms and Publications, and then on What’s Hot in Tax Forms, Publications, and Other Tax Products.

Wage limit for social security tax.

Self-employment tax increased to $97,500 for 2007. There is no maximum limit on earnings subject to the Medicare part (2.9%). See chapter 12.

Husband-wife farm. Beginning in 2007, you and your spouse, if you are filing married filing jointly, may be able to make a joint election to be taxed as a qualified joint venture instead of a partnership. See chapter 12.

Kerosene for use in aviation. The ultimate purchaser of kerosene for use in aviation on a farm for farming purposes can claim a credit or refund if they have not waived their right to make the claim. See chapter 14.

What’s New for 2008

Extension of increased section 179 deduction. If you own qualified section 179 GO Zone property acquired on or after August 27, 2005, and placed it in service before January 1, 2008, you may be eligible for an increased section 179 deduction. See chapter 7.

Maximum net earnings. The maximum net self-employment earnings subject to the social security part (12.4%) of the self-employment tax will increase to $102,000 for 2008. There is no maximum limit on earnings subject to the Medicare part. See chapter 12.

Federal unemployment (FUTA) tax rate. Beginning in 2008, the FUTA tax rate is scheduled to decrease from 6.2% to 6.0%. As this publication was prepared for printing, legislation had been introduced that would postpone the decrease. See Publication 553, Highlights of 2007 Tax Changes.

Ordering forms and publications. You can no longer accept a substitute Form W-4 developed by an employee after October 10, 2007. For more information, see Federal Income Tax Witholding in Publication 51 (Circular A) Agricultural Employer’s Tax Guide.

Wage limit for social security tax. The limit on wages subject to the social security tax for 2008 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.

Publication 225 (2007)
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 download Financial Guidelines for Agricultural Producers publication at www.ffsc.org. You can contact Countryside Marketing, Inc. in the following manner.

- Call 262-253-6902.
- Send a fax to 262-253-6903.
- Write to: Farm Financial Standards Council

N78 W14573 Appleton Ave #287
Menomonee Falls, WI 53051.

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.

Chapter 1 Importance of Records Page 3
Kinds of Records To Keep

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

You should set up your recordkeeping system using an accounting method that clearly shows your income for your tax year. See chapter 2. If you are in more than one business, you should keep a complete and separate set of records for each business. A corporation should keep minutes of board of directors’ meetings. Your recordkeeping system should include a summary of your business transactions. This summary is ordinarily made in accounting journals and ledgers. For example, they must show your gross income, as well as your deductions and credits. In addition, you must keep supporting documents. Purchases, sales, payroll, and other transactions you have in your business generate supporting documents such as invoices and receipts. These documents contain the information you need to record in your journals and ledgers.

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

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

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

Excise taxes. See How To Claim a Credit or Refund in chapter 14 for the specific records you must keep to verify your claim for credit or refund of excise taxes on certain fuels.

Assets. Assets are the property, such as machinery and equipment, you own and use in your business. You must keep records to verify the information you need to record 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.

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>
<tr>
<td>Electronic funds transfer</td>
<td>• Amount transferred.</td>
</tr>
<tr>
<td></td>
<td>• Payee’s name.</td>
</tr>
<tr>
<td></td>
<td>• Date the transfer was posted to the account by the financial institution.</td>
</tr>
</tbody>
</table>

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.

2. 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.

Topics

This chapter discusses:

• Cash method
• Accrual method
• Farm inventory
• Special methods of accounting
• Change in accounting method
Useful Items
You may want to see:

Publication
- 538 Accounting Periods and Methods
- 535 Business Expenses

Form (and Instructions)
- 1128 Application To Adopt, Change, or Retain a Tax Year
- 3115 Application for Change in Accounting Method

See chapter 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 farm business when you file your first income tax return that includes a Schedule F. However, you cannot use the crop method for any tax return, including your first tax return, unless you 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, later.

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

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

Accrual method required. The following businesses engaged in farming must use an accrual method of accounting.
1. A corporation (other than a family corporation) that had gross receipts of more than $1,000,000 for any tax year beginning after 1975.
2. A family corporation that had gross receipts of more than $25,000,000 for any tax year beginning after 1985.
3. A partnership with a corporation as a partner.
4. A tax shelter.

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

Family corporation. A family corporation is generally a corporation that meets one of the following ownership requirements.
- Members of the same family own at least 50% of the total combined voting power of all classes of stock entitled to vote and at least 50% of the total shares of all other classes of stock of the corporation.
- Members of two families have owned, directly or indirectly, since October 4, 1976, at least 65% of the total combined voting power of all classes of voting stock and at least 65% of the total shares of all other classes of the corporation’s stock.
- Members of three families have owned, directly or indirectly, since October 4, 1976, at least 50% of the total combined voting power of all classes of voting stock and at least 50% of the total shares of all other classes of the corporation’s stock.

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

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

A “limited partner” is one whose personal liability for partnership debts is limited to the money or other property the partner contributed or is required to contribute to the partnership.

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

Cash Method

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

Income

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

Constructive receipt. Income is constructively received when an amount is credited to your account or made available to you without restriction. You need not have possession of it. If you authorize someone to be your agent and receive income for you, you are considered to have received it when your agent receives it.

Direct payments and counter-cyclical payments. If you received direct payments or counter-cyclical payments under Subtitle A or C of the Farm Security and Rural Investment Act of 2002, you will not be considered to have constructively 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 checks or postpone taking possession of similar property from one tax year to another to avoid paying tax on the income. You must report the income in the year the property is received or made available to you without restriction.

Example. Frances Jones, a farmer, was entitled to receive a $10,000 payment on a grain contract in December 2007. She was told in December that her payment was available. She requested not to be paid until January 2008. However, she must still include this payment in her 2007 income because it was made available to her in 2007.

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

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

Example. You are a farmer who uses the cash method and a calendar tax year. You sell grain in December 2007 under a bona fide arm’s-length contract that calls for payment in 2008. You include the sale proceeds in your 2007 gross income since that is the year payment is received. However, if the contract states 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 2007 income, regardless of when you actually receive payment.
Repayment of income. If you include an amount in income; and in a later year you have to deduct the repayment in the year in which you make it. If the repayment is more than $3,000, a special rule applies. For details, see Repayment in chapter 11 of Publication 536, Business 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 advance or you may be required to capitalize certain costs, as explained under Uniform Capitalization Rules in chapter 6. See chapter 4 for information on how to deduct farm business expenses on your income tax return.

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

Example. On November 1, 2007, you signed and paid $3,600 for a 3-year (36-month) insurance contract for equipment. In 2007, you are allowed to deduct only $200 (2/36 x $3,600) of the cost of the policy that is attributable to 2007. In 2008, you’ll be able to deduct $1,200 (12/36 x $3,600); in 2009, you’ll be able to deduct $1,200 (12/36 x $3,600); and in 2010, you’ll be able to deduct the remaining balance of $1,000.

Accrual Method

Under an accrual method of accounting, generally you report income in the year earned and deduct or capitalize expenses in the year incurred. The purpose of an accrual method of accounting is to correctly match income and expenses.

Income

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

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

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

Expenses

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

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

2. Economic performance has occurred.

Economic performance. Generally, you cannot deduct or capitalize a business expense until economic performance occurs. If your expense is for property or services provided to you, or for your use of property, economic performance occurs as the property or services are provided or as the property is used. If your expense is for property or services you provide to other persons, economic performance occurs as you provide the property or services.

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

Example. Jane, who is a farmer, uses a calendar tax year and an accrual method of accounting. She enters into a contract with Waterworks, Inc. in 2007. The contract states that Jane must pay Waterworks, Inc. $200,000 in December 2007. It further stipulates that Waterworks will install a complete irrigation system, including a new well, by January 1, 2008. Jane pays Waterworks $200,000 in December 2007.

Economic performance for Jane’s liability in the contract occurs as the property and services are provided. Jane incurs the $200,000 cost in 2008.

Special rule for related persons. Business expenses and interest owed to a related person who uses the cash method of accounting are not deductible until you make the payment and the corresponding amount is includible in the related person’s gross income. Determine the relationship for this rule as of the end of the tax year for which the expense or interest would otherwise be deductible. For more information, see Internal Revenue Code section 267.

Farm Inventory

Special rules for farming businesses. Generally, a taxpayer engaged in the trade or business of farming is allowed to use the cash method for its farming business. However, certain corporations (other than S corporations) and partnerships that have a partner that is a corporation must use an accrual method for their farming business. For this purpose, farming does not include the operation of a nursery or sod farm or the raising or harvesting of trees (other than fruit and nut trees).

If you are required to keep an inventory (see below), you should keep a complete record of your inventory as part of your farm records. This record should show the actual count or measurement of the inventory, it should also show all factors that enter into its valuation, including quality and weight, if applicable.

There is an exception to the requirement to use an accrual method for corporations with gross receipts of $1 million or less for each prior tax year after 1975. For family corporations (defined in section 447(d)(2)(C)) engaged in farming, the exception applies if gross receipts were $25 million or less for each prior tax year after 1985. Tax shelters must keep an inventory of their farm products because they are not allowed to use the cash method of accounting. See section 447 and Revenue Procedure 2002–28 for more information.

After an accounting method is selected, the taxpayer must continue to use that method unless permission to change the method of accounting for farm products is obtained from the IRS.

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

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

Supplies. 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 Uniform Capitalization Rules in chapter 6.

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.

Unit-livestock-price method. This method recognizes the difficulty of establishing the exact costs of producing and raising each animal. You group or classify livestock according to type and age and use a standard unit price for each animal within a class or group. The unit price you assign should reasonably approximate the normal costs incurred in producing the animals in such classes. Unit prices and classifications are subject to approval by the IRS on examination of your return. You must annually reevaluate your unit livestock prices and adjust the prices upward or downward to reflect increases or decreases in the costs of raising livestock. IRS approval is not required for these adjustments. Any other changes in unit prices or classifications do require IRS approval.

If you use this method, include all raised livestock in inventory, regardless of whether they are held for sale or for draft, breeding, sport, or dairy purposes. This method accounts only for the animal. 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 animals 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 which must make an adjustment for any animal purchased during the year. It also does not apply to taxpayers that must make an adjustment to reasonably reflect the particular period in the year in which animals are purchased, if necessary to avoid significant distortions in income.

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

Cash Versus Accrual Method

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

Example 1. You are a farmer who uses an accrual method of accounting. You keep your books on the calendar tax year basis. You sell grain in December 2007, but you are not paid until January 2008. You must both include the sale proceeds and deduct the costs incurred in producing the grain on your 2007 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 2007. Under this method, you include the sale proceeds in income for 2008, the year you receive payment. Deduct the costs of producing the grain in the year you paid 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 accounting if the combination clearly shows your income and expenses and you use it consistently. However, the following restrictions apply:

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

Pea and soybean quota buyout program payments expire. The discussion on peanut quota buyout program payments previously included in this chapter was deleted since the compensation period for peanut quota buyout program payments has expired.

Tobacco growers. There are new rules for tobacco growers. See Tobacco Growers, later.

Repayment of Commodity Credit Corporation (CCC) loans. Beginning January 1, 2007, the CCC will report market gain associated with the repayment of a CCC loan whether the loan is repaid with cash or CCC certificates. See Commodity Credit Corporation (CCC) Loans, 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 for the year in which 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
- Income from cooperatives
- Cancellation of debt
- Income from other sources
- Income averaging for farmers

Useful Items
You may want to see:
- Publication 4797
  - Familial Income and Expenses
  - Bankruptcy Tax Guide
  - Passive Activity and At-Risk Rules
  - Sch E (Form 1040)
  - Sch F (Form 1040)
  - Sch J (Form 1040)
  - 982
  - 1099-G
  - 1099-PATR
  - 4797
  - 4835
See chapter 17 for information about getting publications and forms.

Schedule F
Report your farm income on Schedule F (Form 1040). Use this schedule to figure the net profit or loss from regular farming operations. Income from farming reported on Schedule F (Form 1040) includes amounts you receive from cultivating, operating, or managing a farm for gain or profit, either as owner or tenant. This includes income from operating a plantation, ranch, range, or orchard.

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

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

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

Example. In 2006, you bought 20 feeder calves for $6,000 for resale. You sold them in 2007 for $11,000. You report the $11,000 sales price, subtract your $6,000 basis, and report the resulting $5,000 profit on your 2007 Schedule F, Part I.

Form 4797. Sales of livestock held for draft, breeding, sport, or dairy purposes may result in ordinary or capital gains or losses, depending on the circumstances. In either case, you should always report these sales on Form 4797 instead of Schedule F. See Livestock under Ordinary or Capital Gain or Loss in chapter 8. Animals you do not hold primarily for sale are considered business assets of your farm.

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

Sales Caused by Weather-Related Conditions
If you sell or exchange more livestock, including poultry, than you normally would in a year because of a drought, flood, or other weather-related condition, you may be able to postpone reporting the gain from the additional animals until the next year. You must meet all the following conditions to qualify.

- Your principal trade or business is farming.
- You use the cash method of accounting.
- You can show that, under your usual business practices, you would not have sold or exchanged the additional animals this year except for the weather-related condition.

The weather-related condition caused an area to be designated as eligible for assistance by the federal government.

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

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 deter- mine the number of animals you would have sold had you followed your usual business prac- tice in the absence of the weather-related condi- tion. 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 busi- ness practices of similarly situated farmers in your general region.

Connection with affected area. The live- stock does not have to be raised or sold in an area affected by a weather-related condition for
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 of gain 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 live-
stock sold. For this purpose, do not treat any postponed gain from the previous year as income received from the sale of live-
stock.
2. Multiply the result in (1) by the excess number of such livestock sold solely be-
cause of weather-related conditions.

Example. You are a calendar year taxpayer and you normally sell 100 head of beef cattle a year. As a result of drought, you sold 135 head during 2007. You realized $70,200 from the sale. On August 9, 2007, as a result of drought, the affected area was declared a disaster area eligible for federal assistance. The income you can postpone until 2008 is $18,200 ($70,200 ÷ 135 = 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 infor-
mation 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 Reve-
rue Code.
- Evidence of the weather-related conditions that forced the early sale or exchange of the livestock and the date, if known, on which an area was designated as eligible for assistance by the federal government because of weather-related conditions.
- A statement explaining the relationship of the area affected by the weather-related condition to your early sale or exchange of the livestock.
- The number of animals sold in each of the 3 preceding years.
- The number of animals you would have sold in the tax year had you followed your normal business practice in the absence of weather-related conditions.
- The total number of animals sold and the number sold because of weather-related conditions during the tax year.
- A computation, as described earlier, of the income to be postponed for each class of livestock.

Generally, you must file the statement and the return by the due date of the return, including extensions. However, for sales or exchanges treated as an involuntary conversion from weather-related sales of livestock in an area eligible for federal assistance (discussed in chapter 11), you can file this statement at any time during the replacement period. For other sales or exchanges, if you timely filed your re-
turn 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 state-
ment 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 ap-
proval of the IRS.

Rents (Including Crop Shares)

The rent you receive for the use of your farmland is generally rental income, not farm income. However, if you materially participate in farming operations on the land, the rent is farm income. See Landlord Participation in Farming in chapter 12.

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

Crop Shares

You must include rent you receive in the form of crop shares in income in the year you convert the shares to money or the equivalent of money. It does not matter whether you use the cash method of accounting or an accrual method of accounting.

If you materially participate in operating a farm from which you receive rent in the form of crop shares or livestock, the rental income is included in self-employment income. (See Landlord Participation in Farming in chapter 12.) Report the rental income on Schedule F.

If you do not materially participate in operat-
ing 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 in-
clude the fair market value of the crop shares in income at that time. You are entitled to a busi-
ness 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.

Commodity Credit Corporation (CCC) Loans

Generally, you do not report loans you receive as income. However, if you pledge part or all of your production to secure a CCC loan, you can treat the loan as if it were a sale of the crop and report the loan proceeds as income in the year you receive them. You do not need approval from the IRS to adopt this method of reporting CCC loans.
Once you report a CCC loan as income for the year received, you generally must report all CCC loans in that year and later years in the same way. However, you can obtain automatic consent to change your method of accounting for loans received from the CCC, from including the loan amount in gross income for the 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 withholding 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.

If 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 301.9101-2” 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, re-deem the pledged commodity, and sell it, you report as income at the time of the sale the proceeds minus your basis in the commodity. If the sale proceeds are less than your basis in the commodity, you can report the difference as a loss on Schedule F.

If you forfeit the pledged crops to the CCC in full payment of the loan, the forfeiture is treated for tax purposes as a sale of the crops. If you did not report the loan proceeds as income for the year you received them, you must include them in your income for the year of the forfeiture.

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

Market Gain

Under the CCC nonrecourse marketing assistance loan program, your repayment amount for a loan secured by your pledge of an eligible commodity is generally based on the lower of the loan rate or the prevailing world market price for the commodity on the date of repayment. If you repay the loan when the world price is lower, the difference between the repayment amount and the original loan amount is market gain.

Whether you use cash or CCC certificates to repay the loan, you will receive a Form CCC-1099-G, CCC Loan and Crop Insurance Proceeds, showing your market gain. 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 and has a zero basis in the commodity. In 2006, Mike pledged 1,000 pounds of cotton as collateral for a CCC loan of $500 (a loan rate of $5.00 per pound). In 2007, he repaid the loan and redeemed the cotton for $420 when the world price was $4.20 per pound (lower than the loan amount). Later in 2007, he sold the cotton for $600.

The market gain on the redemption was $0.80 per pound. Mike reported the $420 market gain of $80 ($0.80 x 1,000 pounds). How he reports this market gain and figures his gain or loss from the sale of the cotton depends on whether he included CCC loans in income in 2006.

Included CCC loan. Mike reported the $500 CCC loan as income in 2006, so he is treated as if he sold the cotton for $500 when he pledged it and repurchased the cotton for $420 when he redeemed it. The $80 market gain is not recognized on the redemption. He reports it for 2007 as an Agricultural program payment on Schedule F, line 6a, but does not include it as a taxable amount on line 6b.

Example 2. The facts are the same as in Example 1 except that, instead of selling the cotton for $600 after redeeming it, Mike entered into an option-to-purchase contract with Tom Merchant before redeeming the cotton. Under that contract, Mike authorized Tom to pay the CCC loan on Mike’s behalf. In 2007, Tom repaid the loan for $420 and immediately exercised his option, buying the cotton for $420. How Mike reports the $80 market gain on the redemption of the cotton and figures his gain or loss from its sale depends on whether he included CCC loans in income in 2006.

Included CCC loan. As in Example 1, Mike is treated as though he sold the cotton for $500 when he pledged it and repurchased it for $420 when Tom redeemed it for him. The $80 market gain is not recognized on the redemption. Mike reports it for 2007 as an Agricultural program payment on Schedule F, line 6a, but does not include it as a taxable amount on line 6b.

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

Excluded CCC loan. As in Example 1, Mike has income of $80 from market gain in 2007. He reports it on Schedule F, lines 6a and 6b. His basis in the cotton on sale to Tom for its sale is $420. He reports the $420 gain as income for 2007 on Schedule F, line 4.

Conservation Reserve Program (CRP)

Under the Conservation Reserve Program (CRP), if you own or operate highly erodable 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.) Cost-share 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 withholding 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 2007, report the amount you received on Schedule F, lines 6a and 6b but do not include it as a taxable amount on line 6b. Check the box on line 6c and attach a statement to your tax return. The statement must include your name, address and contain the following information.

- A statement that you are making an election under section 451(d) of the Internal Revenue Code;
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 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 programs for improvements made in connection with a watershed.

• The programs under the Watershed Protection and Flood Prevention Act.
• The flood prevention projects under the Flood Control Act of 1944.
• The Emergency Watershed Protection Program under the Flood Control Act of 1956.
• Certain programs under the Colorado River Basin Salinity Control Act.
• The Wetlands Reserve Program authorized by the Food Security Act of 1985, the Federal Agriculture Improvement and Reform Act of 1996 and the Farm Security and Rural Investment Act of 2002.
• The Environmental Quality Incentives Program (EQIP) authorized by the Federal Agriculture Improvement and Reform Act of 1996.
• The Wildlife Habitat Incentives Program (WHIP) authorized by the Federal Agriculture Improvement and Reform Act of 1996.
• The Soil and Water Conservation Assistance Program authorized by the Agricultural Risk Protection Act of 2000.
• The Agricultural Management Assistance Program authorized by the Agricultural Risk Protection Act of 2000.
• The Conservation Reserve Program authorized by the Food Security Act of 1985 and the Federal Agriculture Improvement and Reform Act of 1996.
• The Forest Land Enhancement Program authorized under the Farm Security and Rural Investment Act of 2002.

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

value of the improvement by multiplying its fair market value (defined in chapter 6) by a fraction. The numerator of the fraction is the total cost of the improvement (all amounts paid either by you or by the government for the improvement) reduced by the sum of the following items. 

• 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 9941
Ogden, UT 84409
Any government payments under a program not listed earlier.

Any part of a government payment under a program listed earlier that the Secretary of Agriculture has not certified as primarily for conservation.

Any government payment to you for rent or for your services.

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

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

1. 10% of the prior average annual income from the affected acreage. The prior average annual income is the average of the gross receipts from the affected acreage for the last 3 tax years before the tax year in which you started to install the improvement.

2. $2.50 times the number of affected acres.

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

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

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

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

Value of cost-sharing improvement . . . $15,000
Minus: Your share . . . $10,000
Excludable portion . . . . . . . 1,550

Amount included in income . . . . . . . $3,450

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

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

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

1. The dollar amount of the cost funded by the government payment.

2. The value of the improvement.

3. 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 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.

E lecting not 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 created two new types of payments—direct and counter-cyclical payments. You must include these payments on Schedule F, lines 6a and 6b.

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.

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

In all other cases, a portion of each payment may be treated as interest for federal tax purposes. You may be required to reduce your total quota buyout program payment before you calculate your gain or loss. For more information, see Notice 2005-57 on page 267 of Internal Revenue Bulletin 2005-32. This bulletin is available at www.irs.gov/pub/irs-ibs/bu05-32.pdf.

Installation method. You may use the installation method to report a gain if you receive at least one payment after the close of your tax year. Under the installation 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 capital or ordinary depends on how you used the quota.

Quota used in the trade or business of farming. If you used the quota in the trade or business of farming and you held it for more than one year, you report the transaction as a section 1231 transaction on Form 4797. See Section 1231 transactions under Ordinary or Capital
Gain or Loss in chapter B 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) tobacco during the 2002, 2003, and 2004 tobacco marketing years and are prorated based on the number of years that you produced (or planted) tobacco during those years.

**Tobacco Growers’ Settlement Trust Fund Payments**

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

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

**Payment to More Than One Person**

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

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

See chapter 17 for information about ordering Form 1099-G.

**Income From Cooperatives**

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

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

**Patronage Dividends**

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

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

*Do not report as income on line 5b any patronage dividends from buying personal or family items, capital assets, or depreciable property. Personal items include fuel purchased for personal use, basic local telephone service, and personal long distance calls. If you cannot determine what the dividend is for, report it as income on lines 5a and 5b.*

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

Example. On July 1, 2006, Mr. Brown, a patron of a cooperative association, bought a machine for his dairy farm business from the association for $2,900. The machine has a life of 7 years under MACRS (as provided in the Table of Class Lives and Recovery Periods in Appendix B of Publication 946). Mr. Brown files his return on a calendar year basis. For 2006, he claimed depreciation of $311, using the 10.71% depreciation rate from the 150%-declining balance, half-year convention table (shown in Table A-14 in Appendix A of Publication 946). On July 2, 2007, 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 2007 (and later years) as follows:

| Cost of machine on July 1, 2006 | $2,900 |
| Depreciation rate: | 10.71% |
| Adjusted basis for depreciation for 2007 | $2,289 |

Depreciation rate: 1 - 6 1/2 (remaining recovery period as of 1/1/10) = 15.38% × 1.5 = 23.07%

Depreciation deduction for 2007: ($2,289 × 23.07%) = $528

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

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

If the dividends are for selling capital assets or depreciable property during the year you received the dividends, treat them as an additional amount received on the sale.

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

Per-Unit Retain Certificates

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

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

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

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

Cancellation of Debt

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

General Rule

Generally, if your debt is canceled or forgiven, other than as a gift or bequest to you, you must include the canceled amount in gross income for tax purposes. Report the 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.
Exclusions

Do not include canceled debt in income in the following situations.
1. The cancellation takes place in a bankruptcy case under title 11 of the U.S. Code.
2. The cancellation takes place when you are insolvent.
3. The canceled debt is a qualified farm debt.
4. The canceled debt is a qualified real property business debt (in the case of a taxpayer other than a C corporation). See chapter 5 in Publication 334.

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

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

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

Bankruptcy and Insolvency

You can exclude a canceled debt from income if you are bankrupt or to the extent you are insolvent.

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

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

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

You can exclude canceled debt from gross income up to the amount by which your liabilities exceed your assets. The canceled debt is more than this amount and the debt qualifies, you can apply the rules for qualified farm debt or qualified real property business debt to the difference. Otherwise, you include the difference in gross income.

Use the amount excluded because of insolvency to reduce any tax benefits, as explained later under Reduction of tax benefits.

Exclusions in situations (2), (3), and (4) do not apply if you are in bankruptcy or are insolvent. Your accountant forgives part of the amount you owe for the accounting services. How you treat the canceled debt depends on your method of accounting.

• Cash method — You do not include the canceled debt in income because payment of the debt would have been deductible as a business expense.
• Accrual method — You include the canceled debt in income because the expense was deductible when you incurred the debt.

Order of reduction.

You must use the excluded canceled debt to reduce the following tax carryovers in the order listed unless you elect to reduce the basis of depreciable property first, as explained later.
1. Net operating loss (NOL). Reduce any NOL for the tax year of the debt cancellation, and then any NOL carryover to that year. Reduce the NOL or NOL carryover one dollar for each dollar of excluded canceled debt.
2. General business credit carryover. Reduce the credit carryover to or from the tax year of the debt cancellation. Reduce the carryover 33 1/3 cents for each dollar of excluded canceled debt.
3. Minimum tax credit. Reduce the minimum tax credit available at the beginning of the tax year following the year of the debt cancellation. Reduce the credit 33 1/3 cents for each dollar of excluded canceled debt.
4. Capital loss. Reduce any net capital loss for the tax year of the debt cancellation, and then any capital loss carryover to that year. Reduce the capital loss or loss carryover one dollar for each dollar of excluded canceled debt.
5. Basis. Reduce the basis of the property you hold at the beginning of the tax year following the tax year of the debt cancellation in the following order.

Reduction of tax benefits.

If you exclude canceled debt from income in a bankruptcy case, you must use the amount canceled to reduce certain tax benefits.

Order of reduction.

You must use the excluded canceled debt to reduce the following tax carryovers in the order listed unless you elect to reduce the basis of depreciable property first, as explained later.
1. Net operating loss (NOL). Reduce any NOL for the tax year of the debt cancellation, and then any NOL carryover to that year. Reduce the NOL or NOL carryover one dollar for each dollar of excluded canceled debt.
2. General business credit carryover. Reduce the credit carryover to or from the tax year of the debt cancellation. Reduce the carryover 33 1/3 cents for each dollar of excluded canceled debt.
3. Minimum tax credit. Reduce the minimum tax credit available at the beginning of the tax year following the year of the debt cancellation. Reduce the credit 33 1/3 cents for each dollar of excluded canceled debt.
4. Capital loss. Reduce any net capital loss for the tax year of the debt cancellation, and then any capital loss carryover to that year. Reduce the capital loss or loss carryover one dollar for each dollar of excluded canceled debt.
5. Basis. Reduce the basis of the property you hold at the beginning of the tax year following the tax year of the debt cancellation in the following order.

a. Real property (except inventory) used in your trade or business or held for investment that secured the canceled debt.

b. Personal property (except inventory and accounts and notes receivable) used in your trade or business or held for investment that secured the canceled debt.

c. Other property (except inventory and accounts and notes receivable) used in your trade or business or held for investment.

d. Inventory and accounts and notes receivable.

Election to reduce the basis of depreciable property first.

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

Passive activity loss and credit carryovers. Reduce the passive activity loss and credit carryovers from the tax year of the debt cancellation. Reduce the loss carryover one dollar for each dollar of excluded canceled debt. Reduce the credit carryover 33 1/3 cents for each dollar of excluded canceled debt.

Foreign tax credit. Reduce the credit carryover to or from the tax year of the debt cancellation. Reduce the carryover 33 1/3 cents for each dollar of excluded canceled debt.

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

Election to reduce the basis of depreciable property first.

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

1. Depreciable real property used in your trade or business or held for investment that secured the canceled debt.

2. Depreciable personal property used in your trade or business or held for investment that secured the canceled debt.

3. Other depreciable property used in your trade or business or held for investment.
4. Real property held as inventory if you elect to treat it as depreciable property on Form 982.

The amount you apply cannot be more than the total adjusted bases of all the depreciable properties. Depreciable property for this purpose means any property subject to depreciation, but only if a new acquisition of basis will reduce the depreciation or amortization otherwise allowable for the period immediately following the basis reduction. You make this reduction before reducing the other tax benefits listed earlier. If the excluded canceled debt is more than the depreciable basis you elect to reduce first, use the difference to reduce the other tax benefits. In figuring the limit on the basis reduction in (5), Basis, use the remaining adjusted bases of your properties after making this election. See Form 982, later, for information on how to make this election. If you make this election, you can revoke it only with the consent of the IRS.

Recapture of basis reductions. If you reduce the basis of property under these provisions and later sell or otherwise dispose of the property at a gain, the part of the gain due to this basis reduction is taxable as ordinary income under the depreciation recapture provisions. Treat any property that is not section 1245 or section 1250 property as section 1245 property. For section 1250 property, determine the straight-line depreciation adjustments as though there were no basis reduction for debt cancellation. Sections 1245 and 1250 property and the recapture of gain as ordinary income are explained in chapter 9.

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

Qualified Farm Debt
You can exclude from income a canceled debt that is qualified farm debt owed to a qualified person. This exclusion applies only if you were solvent when the debt was canceled or, if you were insolvent, only to the extent the canceled debt is to that extent 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 business.
- At least 50% of your total gross receipts for the 3 tax years preceding the year of debt cancellation were from your farming business.

Qualified person. This is a person who is actively and regularly engaged in the business of lending money. A qualified person includes any federal, state, or local government, or any of their agencies or subdivisions. The USDA is a qualified person. A qualified person does not include any of the following.

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

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

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

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

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

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

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

Reduction of tax benefits. If you exclude canceled debt from income under the qualified farm debt rules, you must use the excluded debt to reduce tax benefits. (If you also excluded canceled debt under the insolvency rules, you reduce the amount of the tax benefits remaining after the 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 (5), Basis. Instead, follow the special rules explained next.

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

1. Depreciable qualified property. You may 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 extensions) 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 excluded canceled debt to reduce the basis of depreciable 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 neighbor build a barn and receive a cow for your work, you must report the fair market value of the cow as ordinary income. Your basis for property you receive in a barter transaction is usually the fair market value that you include in income. If you pay someone with property, see Property for services under Labor Hired in chapter 4.

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

Commodity futures and options. See Hedging a Debt: Futures in chapter 6. Also see hedging on gains and losses from commodity futures and options transactions.

Custom hire (machine work). Pay you receive for contract work or custom work that you or your hired help performed off your land for others, or for the use of your property or machinery, is income to you whether or not income tax was withheld. This rule applies whether you receive the pay in cash, services, or merchandise. Report this income on Schedule F, Part I, line 9.
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 “base years” are defined in the instructions for Schedule J (Form 1040).

Who can use income averaging?

You can use income averaging to figure your tax for any year in which you were engaged in a farming business as an individual, a partner in a partnership, or a shareholder in an S corporation. Services performed as an employee are disregarded in determining whether an individual is engaged in a farming business. However, a shareholder of an S corporation engaged in a farming business may treat compensation received from the corporation that is attributable to the farming business as farm income. You do not need to have been engaged in a farming business in any base year.

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

Elected Farm Income (EFI)

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

Income from your farming business is the sum of any farm income or gain minus any farm expenses or losses allowed as deductions in figuring your taxable income. However, it does not include gain from the sale or other disposition of land.

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

Liquidation of a farming business. If you (or your partnership or S corporation) liquidate your farming business, gains on property sold within a reasonable time after operations stop can be designated as EFI. A period of 1 year after stopping operations is a reasonable time. After that, what is a reasonable time depends on the facts and circumstances.
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 2007 is 48.5 cents a mile for all business miles driven. See Truck and Car Expenses, later.

Welfare-to-work credit. For employees starting work after December 31, 2006, the welfare-to-work credit was combined with the work opportunity credit. Use Form 5884, Work Opportunity Credit, to claim a credit for an employee who began work for you during 2007. Use Form 8861, Welfare-to-Work Credit, for an employee who began work for you during 2006. See Employment Credits, later.

Domestic production activities deduction percentage increases. Starting in 2007, the domestic production activities deduction percentage increased from 3% to 6%. For more information, see Domestic Production Activities Deduction, later.

Introduction

You can generally deduct the current costs of operating your farm. Current costs are expenses you do not have to capitalize or include in inventory costs. However, your deduction for the cost of livestock feed and certain other supplies may be limited. If you have an operating loss, you may not be able to deduct all of it.

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 use and two-thirds for business use.
electricity for personal purposes and two-thirds of farm expenses because of a change in tract. This limit on the deduction for prepaid farm supplies expense does not apply if the property on the date of transfer had a basis of less than $5,000 ($5,500 for 2007). Your other deductible farm expenses for those specified in the contract or business custom, to a refund or re-supply. 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. Capacity for services. If you transfer property to an employee in payment for services, you can deduct as wages paid the fair market value of the property on the date of transfer. If the employer pays you anything for the property, deduct as wages the fair market value of the property minus the payment by the employee for the property. Treat the wages deducted as an amount received for the property. You may have a gain or loss to report if the property’s adjusted basis on the date of transfer is different from its fair market value. Any gain or loss has the same character the exchanged property had in your hands. For more information, see chapter 8.

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Child as an employee. You can deduct reason- able wages or other compensation you pay to your child for doing farmwork if a true em- ployer-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 16 or older. For more informa- tion, see Family Employees in chapter 13.

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

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

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

Spouse as an employee. You can deduct reasonable wages or other compensation you pay to your spouse if a true employer-employee relationship exists between you and your spouse. Wages you pay to your spouse are subject to social security and Medicare taxes. For more information, see Family Employees in chapter 13.

Nondeductible Pay

You cannot deduct wages paid for certain household work, construction work, and mainte- nance of your home. However, those wages may be subject to the employment taxes dis- cussed 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 these wages.

Maintaining your home. If your farm em- ployee spends some time maintaining or repairing your home, the wages and employment taxes you pay for that work are nondeductible per- sonal 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 remain- ing time to work on your farm. You cannot de- duct 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 fol- lowing are employment credits and their related forms.

• Work opportunity credit (Form 5884).

The welfare-to-work credit was com- bined with the work opportunity credit. Use Form 5884, Work Opportunity Credit, to claim a credit for an employee who began work for you during 2007. Use Form 8861, Welfare-to-Work Credit, to claim the credit for an employee who began work for you during 2006.

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 re- painting, 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 obli- gations 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 origi- nal lender through another loan, advance, or other arrangement similar to a loan. You can, however, deduct the interest when you start making payments on the new loan.

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

Accrual method. If you use an accrual method of accounting, you can deduct only in- terest that has accrued during the tax year. How- ever, 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 infor- mation, see Accrual Method in chapter 2.

Allocation of interest. If you use the pro- ceeds of a loan for more than one purpose, you must allocate the interest on that loan to each use. Allocate the interest to the following catego- ries.

• 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 disburse- ments to specific uses.

The easiest way to trace disburse- ments is to keep the proceeds of a particular loan separate from any other funds.

Secured loan. The allocation of loan pro- ceeds 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 allo- cate the loan proceeds and 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 Publica- tion 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 busi- ness 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 the different methods to apply 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 de- duct 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.

Fertilizer and Lime

You can deduct in the year paid or incurred the cost of fertilizer, lime, and other materials ap- plied to farmland to enrich, neutralize, or condi- tion 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 de- duct 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
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 use tax on highway motor vehicles paid on a truck or truck tractor used in your farm business. For information on the tax itself, including information on vehicles subject to the tax, see the instructions for Form 2290, Heavy Highway Vehicle Use Tax Return.

Self-employment tax deduction.

You can deduct one-half of your self-employment tax in figuring your adjusted gross income on Form 1040. For more information, see chapter 12.

Insurance

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

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

Insurance to secure a loan.

If you take out a policy on your life or the life of another person with a financial interest in your farm business to get or protect a business loan, you can 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, 2007, 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, 2007. Only the cost for the 6 months in 2007 is deductible as an insurance expense on your 2007 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 2008 and 2009, deduct $1,000 (1/3 of $3,000). Deduct the remaining $500 in 2010. Had the policy been effective on January 1, 2007, the deductible expense would have been $1,000 for each of the years 2007, 2008, and 2009, 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 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 amounts in which you are eligible to participate in a subsidized health plan maintained by your employer or your spouse’s employer.

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

For more information, see Deductible Premiums in chapter 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 fair rental value of the farm home in which you live.

Lease or Purchase

If you lease a farm building or equipment, you must determine whether or not the agreement must be treated as a conditional sales contract rather than a lease. If the agreement is treated as a conditional sales contract, the payments under the agreement (so far as they do not represent interest or other charges) are payments for the purchase of the property. You do not deduct these payments as rent, but capitalize the cost of the property and recover this cost through depreciation.

Example.

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

Conditional sales contract.

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

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

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 lessee 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 nonre- course loan from a third party). For more information, see chapter 3 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 ex- penses (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 cost of a second line into your home used exclusively for your farm business, are deductible business expenses.

Truck and Car Expenses

You can deduct the actual cost of operating a truck or car in your farm business. Only 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 2007, the rate is 48.5 cents a mile for all business miles driven. You use the standard mileage rate for a car or a light truck, such as a van, pickup, or panel truck, you own or lease.

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

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

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

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

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

More information. For more information on deductible travel 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:

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

If you meet these requirements and can prove the time, place, and business purpose of your travel, you can deduct your ordinary and 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 ordinarily can deduct only 50% of your business-related meals expenses. You can deduct the cost of your meals while traveling on business only if your business trip is overnight or long enough to require you to stop for sleep or rest to properly perform your duties. You cannot
deduct any of the cost of meals if it is not neces- 
sary for you to rest, unless you meet the rules for 
business entertainment. For information on en-
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-
cally can deduct reimbursements you pay to your 
employees for travel and transportation ex-
penses they incur in the conduct of your busi-
ness. Employees may be reimbursed under an 
accountable or nonaccountable plan. Under an 
accountable plan, the employee must provide 
evidence of expenses. Under a nonaccountable 
plan, no evidence of expenses is required. If you 
reimburse expenses under an accountable plan, 
deduct them as travel and transportation ex-
penses. If you reimburse expenses under a nonaccountable plan, you must report the reim-
bursements as wages on Form W-2 and deduct 
them as wages. For more information, see chap-
ter 11 of Publication 535.

Marketing Quota Penalties 
You can deduct as Other expenses on Schedule 
F penalties you pay for marketing crops in ex-
cess of farm marketing quotas. However, if you 
do not pay the penalty, but instead the pur-
chaser 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 arrange-
ment is not taxable income to the tenant.

Items Purchased for Resale 
If you use the cash method of accounting, you 
orudinarily deduct the cost of livestock and other 
items purchased for resale only in the year of 
sale. You deduct this cost, including freight 
charges for transporting the livestock to the 
farm, in Part I of Schedule F. However, see 
Chickens, seeds, and young plants, later.

Example. You use the cash method of 
accounting. In 2007, you buy 50 steers you will sell 
in 2008. You cannot deduct the cost of the steers 
on your 2007 tax return. You deduct their 
cost in Part I of your 2008 Schedule F.

Chickens, seeds, and young plants. If you 
are a cash method farmer, you can deduct the 
cost of hens and baby chicks bought for com-
mercial egg production, or for raising and resale, 
as an expense in Part II of Schedule F if paid when 
you do this consistently and it does not distin-
guish income. You also can deduct the cost of 
seeds and young plants bought for further devel-
opment and cultivation before sale as an ex-
pense 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 
productive period of more than 2 years, un-
less you can elect out of the uniform capitaliza-
tion rules. These rules are discussed in chapter 
6.

Example. You use the cash method of ac-
counting. In 2007, you buy 500 baby chicks to 
raise for resale in 2008. You also buy 50 bushels 
of winter wheat seed in 2007 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 2007.

Electioin 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 informa-
tion, 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 deduct-
ing the cost in the first year you buy egg-laying 
hens, pullets, chicks, or seeds and young plants.

Although you must use the same method for 
egg-laying hens, pullets, and chicks, you can 
use a different method for seeds and young 
plants. Once you use a particular method for any 
of these items, use it for those items until you get 
IRS approval to change your method. For more 
information, see Change in Accounting Method 
in chapter 2.

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

• Accounting fees.

• Advertising.

• Chemicals.

• Custom hire (machine work).

• Dues to co-operatives.

• Educational expenses (to maintain and im-
prove 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 in farming.

• Tying material and containers.

• Veterinary fees and medicine.

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

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

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

Domestic Production Activities Deduction 
You are allowed a deduction for income attribu-
table to domestic production activities. You can 
deduct 6% of the lesser of your qualified produc-
tion 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 that are properly allocable to domestic production gross receipts.

Qualified production activities income. The excess of your domestic production gross receipts for the tax year over the sum of your cost of goods sold and other expenses, losses, or deductions (other than the domestic production activities deduction) allocable to such receipts 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 the following activities:

- The lease, license, or rental of property by you for use by any related person.
- The lease, license, rental, sale, exchange, or other disposition of land.

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 incurred, for the acquisition, improvement, or restoration of an asset that is expected to last more than one year. You include the expense in the basis of the asset. Uniform capitalization rules also require you to capitalize or include in inventory certain other expenses. See chapters 2 and 6.

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

- The cost of fertilizer, lime, etc. (See Fertilizer and Lime under Deductible Expenses, earlier.)
- Soil and water conservation expenses. (See chapter 5.)
- The cost of property that qualifies for a deduction under section 179. (See chapter 7.)
- 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, increase their value, or adapt them to different use.
8. Water wells, including drilling and equip- ping costs.
9. Land preparation costs, such as:
   a. Clearing land for farming,
   b. Leveling and conditioning land,
   c. Purchasing and planting trees,
   d. Building irrigation canals and ditches,
   e. Laying irrigation pipes,
   f. Installing drain tile,
   g. Modifying channels or streams,
   h. Constructing earthen, masonry, or concrete tanks, reservoirs, or dams, and
   i. Building roads.

Business start-up 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 exceed $50,000. Any remaining costs must be amortized. See chapter 7. You elect to deduct start-up or organizational costs by claiming the deduction on the business start-up and organizational costs return and write “Filed pursuant to section 301.9100-2” at the top of the amended return. The election applies when figuring taxable income for the current tax year and all subsequent years.

For more information about start-up and organizational 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 productive 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 may generally capitalize the direct costs incurred in reforestation. However, you can elect to deduct some reforestation and refes-toration costs. See Forestation and reforesta-tion costs, below. Reforestion 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 seedings.

You can choose to capitalize certain indirect reforestation costs. These capitalized amounts are your basis for the timber. Recover your basis when you sell the timber or take depletion allowances when you cut the timber. See Depletion in chapter 7.

Forestation and reforestation costs. You can elect to deduct up to $10,000 of qualifying reforestation costs paid or incurred after October 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 reforesta-tion costs, you should create and maintain separate timber 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 should be maintained until the timber is disposed of. For more information, see Notice 2006-47.

You may be able to elect to deduct more than $10,000 of qualifying refor-estation costs if any portion of your timber property is located in certain areas. For more information, see Publication 4882, Infor-mation for Taxpayers Affected by Hurricanes Katrina, Rita, and Wilma.

You elect to deduct forestation and refes-toration 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 complete Form T, Part IV. If you are not filing Form T, attach a statement to your return with the following information.

- The unique stand identification numbers.
- The total number of acres reforested during the tax year.
- The nature of the reforestation treatments.
- The total amounts of the qualified reforestation expenditures eligible to be amortized or deducted.

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 "File pursuant to section 301.5100-2" at the top of the amended return. File the amended return at the same address you filed the original return.

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

For more information about timber, see Agriculture Handbook Number 718, Forest Landowners’ Guide to the Federal 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 more than 6 years old, capitalize expenses incurred for planting and stump culture and add them to the basis of the standing trees. Recover these expenses as part of your adjusted basis when you sell the standing trees or as depletion allowances when you cut the trees. For more information, see Timber depletion under Depletion in chapter 7.

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

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

Personal, Living, and Family Expenses

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

Other Nondeductible Items

You cannot deduct the following items on your tax return.

- Loss of growing plants, produce, and crops.
- Losses of plants, produce, and crops raised for sale are generally not deductible. However, you may have a deductible loss on plants with a preproductive period of more than 2 years. See chapter 11 for more information.
- Repayment of loans. You cannot deduct the repayment of a loan. However, if you use the proceeds of a loan for farm business expenses, you can deduct the interest on the loan. See Interest, earlier.
- Estate, inheritance, legacy, succession, and gift taxes. You cannot deduct estate, inheritance, legacy, succession, and gift taxes.
- Loss of livestock. You cannot deduct as a loss the value of raised livestock that die if you deducted the cost of raising them as an expense.
- Losses from sales or exchanges between related persons. You cannot deduct losses from sales or exchanges of property between you and certain related persons, including your spouse, brother, sister, ancestor, or lineal descendant. For more information, see chapter 2 of Publication 544, Sales and Other Dispositions of Assets.
- Cost of raising unharvested crops. You cannot deduct the cost of raising unharvested crops sold with land owned more than one year if you sell both at the same time and to the same person. Add these costs to the basis of the land. 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.

Nondeductible Expenses

You cannot deduct personal expenses and certain other items on your tax return even if they relate to your farm. Club dues and membership fees. Generally, you cannot deduct amounts you pay or incur for membership in any club organized for business, pleasure, recreation, or any other social purpose. This includes country clubs, golf and athletic clubs, hotel clubs, sporting clubs, airline clubs, and clubs operated to provide meals under circumstances generally considered to be conducive to business discussions.

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

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

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

Losses From Operating a Farm

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

- The at-risk limits.
- The passive activity limits.

The following discussions explain these limits.

If your deductible loss after applying these limits is more than your other income for the year, you may have a net operating loss. See Publication 536, Net Operating Losses (NOLs) for Individuals, Estates, and Trusts.

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

At-Risk Limits

The at-risk rules limit your deduction for losses from most business or income-producing activities, including farming. 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 profit until 5 (or 7) years have passed since you started farming. You must file Form 5213.

If your business or investment activity passes this 3- (or 2-) years-of-profit test, presume it is carried on for profit. This means the limits discussed here do not apply. You can take all your business deductions from the activity on Schedule F, even for the years that you have a loss. You can rely on this presumption in every case, unless the IRS shows it is not valid.

If you fail the 3- (or 2-) years-of-profit test, you still may be considered to operate your farm for profit by considering the factors listed earlier. Using the presumption later.

If you are starting out in farming and do not have 3 (or 2) years showing a profit, you may want to take advantage of this presumption later, after you have had the 5 (or 7) years of experience allowed by the test.

You can choose to do this by filing Form 5213. Filing this form postpones any determinations that your farming activity is not carried on for profit until 5 (or 7) years have passed since you first started farming. You must file Form 5213 within 3 years after the due date of your return for the year in which you first carried on the activity, or, if earlier, within 60 days after receiving a written notice from the IRS proposing to disallow deductions attributable to the activity.

The benefit gained by making this choice is that the IRS will not immediately question whether your farming activity is engaged in for profit. Accordingly, it will not limit your deductions. Rather, you will gain time to earn a profit in 3 (or 2) out of the first 5 (or 7) years you carry on the farming activity. If you show 3 (or 2) years of profit at the end of this period, your deductions are not limited under these rules. If you do not have 3 (or 2) years of profit (and cannot otherwise show that you operated your farm for profit), the limit applies retroactively to any year in the 5-year (or 7-year) period with a loss. Filing Form 5213 automatically extends the period of limitations on any year in the 5-year (or 7-year) period to 2 years after the due date of return for the last year of the period. The period is extended only for deductions of the activity and any related deductions that might be affected.

Limit on deductions and losses. If your activity is not carried on for profit, take deductions only in the following order, only to the extent stated in the three categories, and, if you are an individual, only if you itemize them on Schedule A (Form 1040).

Category 1. Deductions you can take for personal as well as for business activities are allowed in full. For individuals, all nonbusiness deductions, such as those for home mortgage interest, taxes, and casualty losses (see chapter 11), belong in this category. For the limits that apply to mortgage interest, see Publication 936.

Category 2. Deductions that do not result in an adjustment to the basis of property are allowed next, but only to the extent your gross income from the activity is more than the deductions you take (or could take) under the first category. Most business deductions, such as those for fertilizer, feed, insurance premiums, utilities, wages, etc., belong in this category.

Category 3. Business deductions that decrease the basis of property are allowed last, but only to the extent the gross income from the activity is more than deductions you take (or could take) under the first two categories. The deductions for depreciation, amortization, and the part of a casualty loss an individual could not deduct in category (1) belong in this category. Where more than one asset is involved, divide depreciation and these other deductions proportionally among those assets.

Individuals must claim the amounts in categories (2) and (3) above as miscellaneous deductions on Schedule A (Form 1040). They are subject to the 2%-of-adjusted-gross-income limit. See Publication 529, Miscellaneous Deductions, for information on this limit.

Partnerships and S corporations. If a partnership or S corporation carries on a not-for-profit activity, these limits apply at the partnership or S corporation level. They are reflected in the individual shareholder’s or partner’s distributive shares.

More information. For more information on not-for-profit activities, see Not-for-Profit Activities in chapter 1 of Publication 535.
5. Soil and Water Conservation Expenses

Introduction
If you are in the business of farming, you can choose to deduct certain expenses for soil or water conservation or for the prevention of erosion of land used in farming. Otherwise, these are capital expenses that must be added to the basis of the land. (See chapter 6 for information on determining basis.) Conservation expenses for land in a foreign country do not qualify for this special treatment.

The deduction cannot be more than 25% of your gross income from farming. See 25% Limit on Deduction, later.

Ordinary and necessary expenses that are otherwise deductible are not soil and water conservation expenses. These include interest and taxes, the cost of periodically clearing brush from productive land, the regular removal of sediment from a drainage ditch, and expenses paid or incurred primarily to produce an agricultural crop that may also conserve soil.

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

To get the full deduction to which you are entitled, you should maintain your records in a way that clearly distinguish between your ordinary and necessary farm business expenses and your soil and water conservation expenses.

Topics
This chapter discusses:
- Business of farming
- Plan certification
- Conservation expenses
- Assessment by conservation district
- 25% Limit on deduction
- Choosing to deduct
- Sale of a farm
- Business of Farming

For purposes of soil and water conservation expenses, you are in the business of farming if you cultivate, operate, or manage a farm for profit, either as owner or tenant. You are not farming if you are engaged only in forestry or the growing of timber.

Farm defined. A farm includes stock, dairy, poultry, fish, fruit, and truck farms. It also includes plantations, ranches, ranges, and orchards. A fish farm is an area where fish and other marine animals are grown or raised and artificially fed, protected, etc. It does not include an area where they are merely caught or harvested. A plant nursery is a farm for purposes of deducting soil and water conservation expenses.

Farm rental. If you own a farm and receive farm rental payments based on farm production, either in cash or crop shares, you are in the business of farming. If 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 land. You must capitalize the expenses and add them to the basis of the land.

Plan Certification
You can deduct soil and water conservation expenses only if they are consistent with a plan approved by the Natural Resources Conservation Service (NRCS) of the Department of Agriculture. If no such plan exists, the expenses must be consistent with a soil conservation plan of a comparable state agency. Keep a copy of the plan with your books and records to support your deductions.

Conservation plan. A conservation plan includes the farming conservation practices approved for the area where your farmland is located. There are three types of approved plans:
- NRCS individual site plans. These plans are issued individually to farmers who request assistance from NRCS to develop a conservation plan designed specifically for their farmland.
- NRCS county plans. These plans include a listing of farming conservation practices approved for the county where the farmland is located. You can deduct expenses for conservation practices not included in 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:

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 farmland from someone who was using it in farming immediately before you acquired the land, soil and water conservation expenses you incur on it will be treated as made on land used in farming at the time the expenses were paid or incurred. You can deduct soil and water conservation expenses for this land if your use of it is substantially a continuation of its use in farming. The new farming activity does not have to be the same as the old farming activity. For example, if you buy land that was used for grazing cattle and then prepare it for use as an apple orchard, you can deduct your conservation expenses.

Land not used for farming. If your conservation expenses benefit both land that does not qualify as land used for farming and land that does qualify, you must allocate the expenses. For example, if the expenses benefit 200 acres of your land, but only 120 acres of this land are...
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 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:

- If the amount you pay or incur for any year is more than the limit, you can deduct for that year only 10% of your deductible share of the cost.
- You can deduct the remainder in equal amounts over the next 9 tax years.

- 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 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 you 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 expense.

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

<table>
<thead>
<tr>
<th>Total Limit on Deduction for Assessment</th>
<th>Yearly Limit on Deduction for Assessment</th>
<th>Yearly Limit for All Conservation Expenses</th>
</tr>
</thead>
<tbody>
<tr>
<td>10% of:</td>
<td>$500 + 10% of:</td>
<td>25% of:</td>
</tr>
<tr>
<td>Total assessment against all members of the district for the property.</td>
<td>Your deductible share of the cost to the district for the property.</td>
<td>Your gross income from farming.</td>
</tr>
<tr>
<td>• No one taxpayer can deduct more than 10% of the total assessment.</td>
<td>• If the amount you pay or incur for any year is more than the limit, you can deduct for that year only 10% of your deductible share of the cost.</td>
<td>• Limit for all conservation expenses, including assessments for depreciable property.</td>
</tr>
<tr>
<td>• Any amount over 10% is a capital expense and is added to the basis of your land.</td>
<td>• You can deduct the remainder in equal amounts over the next 9 tax years.</td>
<td>• Amounts greater than 25% can be carried to the following year and added to that year’s expenses.</td>
</tr>
<tr>
<td>• If an assessment is paid in installments, each payment must be prorated between the conservation expense and the capital expense.</td>
<td></td>
<td>The total is then subject to the 25% of gross income from farming limit in that year.</td>
</tr>
</tbody>
</table>
and water conservation expense this year, subject to the 25% of gross income from farming for the year on the deduction, discussed later.

**Example 2.** Assume the same facts in Example 1 except that $1,850 of the $2,400 assessment is for digging drainage ditches and $550 is for depreciable equipment. The total amount assessed by the district against all its members for depreciable equipment is $5,500. The total amount you can deduct for the depreciable equipment is limited to 10% of this amount, or $550.

The maximum amount you can deduct this year for the depreciable equipment is $555 (10% of your deductible share of the total assessment, $55, plus $500). Since valuable is share 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 dispositions 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 2007, you have gross income of $16,000 from two farms. During the year, you incurred $5,300 of deductible soil and water conservation expenses for one of the farms. However, your deduction is limited to 25% of $16,000, or $4,000. The $1,300 excess ($5,300 - $4,000) is carried over to 2008 and added to deductible soil and water conservation expenses made in that year. The total of the 2007 carryover plus 2008 expenses is deductible in 2008, subject to the limit of 25% of your gross income from farming in 2008. Any expenses over the limit in that year are carried to 2009 and later years.

**Net operating loss.** The deduction for soil and water conservation expenses is included when figuring a net operating loss (NOL) for the year. If the NOL is carried to another year, the soil and water conservation deduction included in the NOL is not subject to the 25% limit in the year to which it is carried.

### Choosing To Deduct

You can choose to deduct soil and water conservation expenses on your tax return for the first year you pay or incur these expenses. If you choose to deduct them, you must deduct the total allowable amount in the year they are paid or incurred. If you do not choose to deduct the expenses, you must capitalize them.

**Change of method.** If you want to change your method of treating soil and water conservation expenses, or you want to treat the expenses for a particular project or a single farm in a different manner, you must get the approval of the IRS. To get this approval, you must submit a 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:

Department of the Treasury 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.

### Basis of Assets

#### Introduction

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

Your original basis in property is adjusted (increased or decreased) by certain events. For example, if you make improvements to the property, increase your basis. If you take deductions for depreciation, or casualty losses, or claim certain credits, reduce your basis.

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

#### Topics

This chapter discusses:

- Cost basis
- Adjusted basis
- Basis other than cost

#### Useful Items

You may want to see:

- Publication 535 Business Expenses
- Publication 544 Sales and Other Dispositions of Assets
- Publication 551 Basis of Assets
- Publication 946 How To Depreciate Property

See chapter 17 for information about getting publications and forms.

### Useful Items

**Publication**

- Publication 535 Business Expenses
- Publication 544 Sales and Other Dispositions of Assets
- Publication 551 Basis of Assets
- Publication 946 How To Depreciate Property
Cost Basis

The basis of property you buy is usually its cost. Cost is the amount you pay in cash, debt obligations, other property, or services. Your cost includes amounts you pay for sales tax, freight, installation, and testing. The basis of real estate and business assets will include other items. Basis generally does not include interest payments. However, see Carrying charges and Capitalized interest in chapter 4 of Publication 535.

You also may have to capitalize (add to basis) certain other costs related to buying or producing property. Under the uniform capitalization rules, discussed later, you may have to capitalize direct costs and certain indirect costs of producing property.

Loans with low or no interest. If you buy property on a time-payment plan that charges little or no interest, the basis of your property is your stated purchase price minus the amount considered to be unstated interest. You generally have unstated interest if your interest rate is less than the applicable federal rate. See the discussion of unstated interest in Publication 537, Installment Sales.

Real Property

Real property, also called real estate, is land and generally anything built on, growing on, or attached to land. If you buy real property, certain fees and other expenses you pay are part of your cost basis in the property. Some of these expenses are discussed next.

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

Fair market value (FMV). FMV is the price at which property would change hands between a willing buyer and a willing seller, neither having to buy or sell, and both having reasonable knowledge of all necessary facts. Sales of similar property on or about the same date may help in figuring the FMV of the property.

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

Real estate taxes. If you pay real estate taxes the seller owed on real property you bought, and the seller did not reimburse you, treat those taxes as part of your basis. If you reimburse the seller for taxes the seller paid for you, you generally can deduct that amount from the FMV. Whether or not you reimburse the seller, do not include that amount in the basis of your property.

Settlement costs. Your basis includes the settlement fees and closing costs for buying the property. See Pub 551 for a detailed list of items you can and cannot include in basis.

Do not include fees and costs for getting a loan on the property. Also, do not include amounts placed in escrow for the future payment of items such as taxes and insurance.

Points. If you pay points to get a loan (including a mortgage, second mortgage, or line-of-credit), do not add the points to the basis of the related property. You may be able to deduct the points currently or over the term of the loan. For more information about deducting points, see Points in chapter 4 of Publication 535.

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

Example. If you buy a farm for $100,000 cash and assume a mortgage of $400,000, your basis is $500,000.

Constructing assets. If you build property or have assets built for you, your expenses for this construction are part of your basis. Some of these expenses include the following costs:

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

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

- Employee wages paid for the construction work, reduced by any employment credits allowed.
- Depreciation on equipment you own while it is used in the construction.
- Operating and maintenance costs for equipment used in the construction.
- Business supplies and materials used in the construction.

Do not include the value of your own labor, or any other labor you did not pay for, in the basis of any property you construct.

Allocating the Basis

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

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

Farming business acquired. If you buy a group of assets that makes up a farming business, you may have to allocate the purchase price among the assets. Generally, reduce the purchase price by any estate 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 inventory costs, rather than claim them as a current deduction. You recover these costs through depreciation, amortization, or cost of goods sold when you use, sell, or otherwise dispose of the property.

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

1. Produce real or tangible personal property, or
2. Acquire property for resale. However, this rule does not apply to personal property if your average special rules you must use for the 3-year tax 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 subject to the uniform capitalization rules if the property is produced for personal use.

In a farming business, you produce property if you raise or grow any agricultural or horticultural commodity, including plants and animals.

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

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

**Animals.** An animal produced in a farming business includes any stock, poultry or other bird, and fish or other sea life. The direct and indirect costs of producing plants or animals include preparatory costs, the preproductive period costs. Preparatory costs. Preparatory costs include the acquisition costs of the seed, seedling, plant, or animal. For plants, preproductive period costs include the costs of items such as irrigation, pruning, frost protection, spraying, and harvesting. For animals, preproductive period costs include the costs of items such as feed, maintaining pasture or pen areas, breeding, veterinary services, and bedding.

**Exceptions.** In a farming business, the uniform capitalization rules do not apply to:

1. Any animal,
2. Any plant with a preproductive period of 2 years or less,
3. Any costs of replanting certain plants lost or damaged due to casualty.

Exceptions (1) and (2) do not apply to a corporation, partnership, or tax shelter required to use an accrual method of accounting. See **Accrual method required** under Accounting Methods in chapter 2.

In addition, you can elect not to use the uniform capitalization rules for plants with a preproductive period of more than 2 years. If you make this election, special rules apply. The election cannot be made by a corporation, partnership, or tax shelter required to use an accrual method of accounting. This election also does not apply to any costs incurred for the planting, cultivation, maintenance, or development of any citrus or almond grove (or any part thereof) within the first 4 years the trees were planted.

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

**Example.** You grow trees that have a preproductive period of more than 2 years. The trees produce an annual crop. You are an individual and the uniform capitalization rules apply to your farming business. You must capitalize the direct costs and an allocable part of indirect costs incurred due to the production of the trees. You are not required to capitalize the costs of producing the annual crop because its preproductive period is 2 years or less.

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

**More information.** For more information on the uniform capitalization rules 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 depreciation expense. For example, amounts paid for incidental repairs or maintenance are deductible as business expenses and are not added to basis. However, you can elect to deduct or to capitalize certain other costs. See chapter 7 in Publication 535.

**Deducing 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 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.
• 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.
• 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 section 1016 of the Internal Revenue Code and 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. **Depreciation.** Decrease the basis of property by the depreciation you deducted, or could have deducted, on your tax returns under the method of depreciation you chose. If you took less depreciation than you could have or you did not take a depreciation deduction, reduce the basis by the full amount of depreciation you could have taken. If you deducted more depreciation than you should have, decrease your basis by the amount you should have deducted plus the part of the excess depreciation you deducted that actually reduced your tax liability for the year.

See chapter 7 for information on figuring the depreciation you should have claimed.

In decreasing your basis for depreciation, take into account the amount deducted on your tax returns as depreciation and any depreciation you must capitalize under the uniform capitalization rules.

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

You must increase your basis in the property by the amount you spend on clean-up costs (such as debris removal) and repairs that restore the property to its pre-casualty condition. To make this determination, compare the repaired property to the property before the casualty.
Easements. The amount you receive for granting an easement is usually considered to be proceeds from the sale of an interest in the real property. It reduces the basis of the affected part of the property. If the amount received is more than the basis of the part of the property affected by the easement, reduce your basis in that part to zero and treat the excess as a recognized gain. See Easements and rights-of-way in chapter 3.

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

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. If the debt includes any indebtedness for which you are liable or which attaches to property you hold.

You can exclude your canceled debt from income if the debt is any of the following.
1. Debt canceled in a bankruptcy case or when you are insolvent.
2. Qualified farm debt.
3. Qualified real property business debt (provided you are not a C corporation).

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

For more information about canceled debt in a bankruptcy case, see Publication 908, Bankruptcy Tax Guide. For more information about insolvent 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 proceeds for a price agreed on beforehand, it will be accepted as the FMV of the property if there is no evidence to the contrary.

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

Taxable Exchanges

A taxable exchange is one in which the gain is taxable, or the loss is deductible. A taxable gain or deductible loss also is known as a recognized gain or loss. A taxable exchange occurs when you receive cash or get property that is not similar or related in use to the property exchanged.

Example. You trade a tract of farmland with an adjusted basis of $3,000 for a tractor that has an FMV of $6,000. You must report a taxable gain of $3,000 for the land. The tractor has a basis of $6,000.

Involuntary Conversions

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

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

1. Decrease the basis by the following amounts.
   a. Any loss you recognize on the involuntary conversion.
   b. Any money you receive that you do not spend on similar property.

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

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

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

Basis for depreciation. Special rules apply in determining and depreciating the basis of MACRS property acquired in an involuntary conversion. For information, see Figuring the Depreciation for Property Acquired in a Nontaxable Exchange under Figuring Depreciation Under MACRS in chapter 7.

For more information about involuntary conversions, see chapter 11.

Nontaxable Exchanges

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

Example. You traded a truck you used in your farming business for a new smaller truck to...
use in farming. The adjusted basis of the old truck was $10,000. The FMV of the new truck is $14,000. Because this is a nontaxable exchange, you do not recognize any gain, and your basis in the new truck is $10,000, the same as the adjusted basis of the truck you traded.

**Like-Kind Exchanges**

The exchange of property for the same kind of property is the most common type of nontaxable exchange. For an exchange to qualify as a like-kind exchange, you must hold for business or investment purposes both the property you transfer and the property you receive. There must also be an exchange of like-kind property. For more information, see Like-Kind Exchanges in chapter 8.

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

**Example.** You trade a machine (adjusted basis of $8,000) for another like-kind machine (FMV of $9,000). You use both machines in your farming business. The basis of the machine you receive is $8,000, the same as the machine traded.

**Exchange expenses.** Exchange expenses generally are the closing costs that you pay. They include such items as brokerage commissions, attorney fees, and deed preparation fees. Add them to the basis of the like-kind property you receive.

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

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

**Special rules for related persons.** If a like-kind exchange takes place directly or indirectly between related persons and either party disposes of the property within 2 years after the exchange, the exchange no longer qualifies for like-kind exchange treatment. Each person must report any gain or loss not recognized on the original exchange unless the loss is not deductible under the related party rules. Each person reports it on the tax return filed for the year in which the later disposition occurred. If this rule applies, the basis of the property received in the original exchange will be its FMV. For more information, see chapter 8.

**Exchange of business property.** Exchanging the property of one business for the property of another business generally 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 + $3,000 − $10,000). Include your gain in income (recognize gain) only to the extent of the cash received. Your basis in the land you received is figured as follows.

- Basis of land traded: $10,000
- Minus: Cash received (adjustment 1(a)): $3,000
- Plus: Gain recognized (adjustment 2(b)): $3,000
- Basis of land received: $10,000

**Example 2.** You trade a truck (adjusted basis of $22,750) for another truck (FMV of $20,000) and $10,000 cash. You realize a gain of $7,250. This is the FMV of the truck received plus the cash minus the basis of the truck you traded ($20,000 + $10,000 − $22,750). You include all the gain in your income (recognize gain) because the gain is less than the cash you received. Your basis in the truck you received is figured as follows.

- Adjusted basis of truck traded: $22,750
- Minus: Cash received (adjustment 1(a)): $10,000
- Plus: Gain recognized (adjustment 2(b)): $7,250
- Basis of truck received: $20,000

**Allocation of basis.** If you receive like-kind and unlike properties in the exchange, allocate the basis first to the unlike property, other than money, up to its FMV on the date of the exchange. The rest is the basis of the like-kind property.

**Sale and Purchase**

If you sell property and buy similar property in two mutually dependent transactions, you may have to treat the sale and purchase as a single nontaxable exchange.

**Example.** You used a tractor on your farm for 3 years. Its adjusted basis is $2,000 and its FMV is $4,000. You are interested in a new tractor, which sells for $15,500. Ordinarily, you would trade your old tractor for the new one and pay the dealer $11,500. Your basis for depreciating the new tractor would then be $13,500 ($11,500 + $2,000, the adjusted basis of your old tractor). However, you want a higher basis for depreciating the new tractor, so you agree to pay the dealer $15,500 for the new tractor if he will pay you $4,000 for your old tractor. Because the two transactions are dependent on each other, you are treated as having exchanged your old tractor for the new one and paid $11,500 ($15,500 − $4,000). Your basis for depreciating the new tractor is $13,500, the same as if you traded the old tractor.

**Property Received as a Gift**

To figure the basis of property you receive as a gift, you must know its adjusted basis (defined earlier) to the donor just before it was given to you. You also must know its FMV at the time it was given to you and any gift tax paid on it.

**FMV equal to or 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 must increase or
If you receive 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. (See Adjusted Basis, earlier.)

If you use the donor’s adjusted basis for figuring a gain and 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, taxes occurred that would increase or decrease your basis.

If you sell the land for $120,000, you will have a $20,000 gain because you must use the donor’s adjusted basis at the time of the gift ($100,000) as your basis to figure a gain. If you sell the land for $70,000, you will have a $10,000 loss because you must use the FMV at the time of the gift ($80,000) as your basis to figure a loss.

If the sales price is between $80,000 and $100,000, you have neither gain nor loss. For instance, if the sales price was $90,000 and you tried to figure a gain using the donor’s adjusted basis ($100,000), you would get a $10,000 loss. If you then tried to figure a loss using the FMV ($80,000), you would get a $10,000 gain.

Business property. If you hold the gift as business property, your basis for figuring any depreciation, depletion, or amortization deductions is the same as the donor’s adjusted basis plus minus any required adjustments to basis while you hold the property.

Property Transferred From a Spouse

The basis of property transferred to you or transferred in trust for your benefit by your spouse is the same as your spouse’s adjusted basis. The same rules apply to a transfer by your former spouse if the transfer is incident to divorce. However, for property transferred in trust, adjust your basis for any gain recognized by your spouse or former spouse if the liabilities assumed plus the liabilities to which the property is subject are more than the adjusted basis of the property transferred.

The transferor must give you the records needed to determine the adjusted basis and holding period of the property as of the date of the transfer.

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

Inherited Property

Your basis in property you inherit from a deceased individual 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 value qualified real property at other than its FMV. If so, the executor or personal representative elects this method of valuation for estate tax purposes, this value is the basis of the property for the qualified heirs. The qualified heirs should be able to get the necessary value from the executor or personal representative of the estate.

If you are a qualified heir who received special-use valuation property, increase your basis by any gain recognized by the estate or trust because of post-death appreciation. Post-death appreciation is the property’s FMV on the date of distribution minus the property’s FMV either on the date of the individual’s death or on the alternate valuation date. Figure all FMVs without regard to the special-use valuation.

You may be liable for an additional estate tax if, within 10 years after the death of the decedent, you transfer the property or the property stops being used as a farm. This tax does not apply if you dispose of the property in a like-kind exchange or in an involuntary conversion in which all of the property transferred is 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.

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, United States Additional Estate Tax Return, 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, 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 or from a corporation 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
Chapter 16

To claim depreciation on property, you must use filled-in Form 4562 and related discussion in Depreciation. For pre-1987 property, see Publication 542, Corporations.

534. Depreciating Property Placed in Service Before 1987

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

Useful Items

You may want to see:

Publication

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

Form (and Instructions)

- T Forest Activities Schedule
- 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 depreciation 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.

Leased property.

You can depreciate leased property only if you retain the incidents of ownership in the property. This means you bear the burden of exhaustion of the capital investment in the property. Therefore, if you lease property from someone to use in your trade or business or for the production of income, you generally cannot depreciate its cost because you do not retain the incidents of ownership. You can, however, depreciate any capital improvements you make to the leased property. See Additions and Improvements under Which Recovery Period Applies in chapter 4 of Publication 946.

If you lease property to someone, you generally can depreciate its cost even if the lessee (the person leasing from you) has agreed to preserve, replace, renew, and maintain the property. However, you cannot depreciate the cost of the property if the lease provides that the lessee is to maintain the property and return to you the same property or its equivalent in value at the expiration of the lease in the same condition and value as when leased.

Life tenant.

Generally, if you hold business or investment property as a life tenant, you can depreciate it as if you were the absolute owner of the property. See Certain term interests in property, later for an exception.

Property Used in Your Business or Income-Producing Activity

To claim depreciation on property, you must use it in your business or income-producing activity.
If you use property to produce income (investment use), the income must be taxable. You cannot deduct depreciation on property that you use solely for personal activities. However, if you use property for business or investment purposes and for personal purposes, you can deduct depreciation based only on the percentage of business or investment use.

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

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

**Property Having a Determinable Useful Life**

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

**Irrigation systems and water wells.** Irrigation systems and wells used in a trade or business can be depreciated if their useful life can be determined. You can depreciate irrigation systems and well systems composed of masonry, concrete, tile, metal, or wood. In addition, you can depreciate costs for moving dirt to construct irrigation systems and water wells composed of these materials. However, land preparation costs for center pivot irrigation systems are not depreciable.

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

**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 2007 after harvest was over. You begin to depreciate the planter for 2007 because it was ready and available for its specific use in 2007, even though it will not be used until the spring of 2008.

If your planter comes unassembled in December 2007 and is put together in February 2008, it is not placed in service until 2008. You begin to depreciate it in 2008.

If your planter was delivered and assembled in February 2008 but not used until April 2008, it is placed in service in February 2008, because this is when the planter was ready for its specified use. You begin to depreciate it in 2008.

**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. When this occurs, your basis for depreciation is your initial cost for the immature livestock.

**Idle Property**

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

**Cost or Other Basis Fully Recovered**

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

**Retired From Service**

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

- You sell or exchange the property.

- You convert the property to personal use.

- You abandon the property.

- You transfer the property to a supplies or scrap account.

- The property is destroyed.

For information on abandonment of property, see chapter 8. For information on destroyed property, see chapter 11 and Publication 547, Casualties, Disasters, and Thefts.
Can You Use MACRS To Depreciate Your Property?

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

You cannot use MACRS to depreciate the following property.

- Property you placed in service before 1987. 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, whichever is greater. Depreciation allowed is depreciation you actually deducted (from which you received a tax benefit). Depreciation allowable is depreciation you are entitled to deduct.

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

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

For more information, see chapter 6.

How Do You Treat Repairs and Improvements?

You generally deduct the cost of repairing business property in the same way as any other business expense. However, if a repair or replacement increases the value of your property, makes it more useful, or lengthens its life, you must treat it as an improvement and depreciate it. Treat improvements as separate depreciable property. See chapter 1 of Publication 946 for more information.

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

Example. You repair a small section on a corner of the roof of a barn that you rent to others. You deduct the cost of the repair as a business expense. However, if you replace the entire roof, the new roof is considered to be an improvement because it increases the value and lengthens the life for the property. You depreciate the cost of the new roof.

Do You Have To File Form 4562?

Use Form 4562 to claim your deduction for depreciation and amortization. You must complete and attach Form 4562 to your tax return if you claim any of the following.

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

For more information, see the Instructions for Form 4562.

How Do You Correct Depreciation Deductions?

If you deducted an incorrect amount of depreciation in any year, you may be able to make a correction by filing an amended return for that year. You can file an amended return to correct the amount of depreciation claimed for any property in any of the following situations.

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

If you are not allowed to make the correction on an amended return, you may be able to change your accounting method to claim the correct amount of depreciation. See the Instructions for Form 3115.

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. An integral part of manufacturing, production, or extraction of furnishing transportation, communications, electricity, gas, water, or sewage disposal services,
   b. A research facility used in connection with any of the activities in (a) above, or
   c. A facility used in connection with any of the activities in (a) for the bulk storage of fungible commodities.
3. Single purpose agricultural (livestock) or horticultural structures.
4. Storage facilities (except buildings and their structural components) used in connection with distributing petroleum or any primary product of petroleum.
5. Off-the-shelf computer software that is readily available for purchase by the general public, is subject to a nonexclusive license, and has not been substantially modified.

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

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

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

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

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

Agricultural structure. A single purpose agricultural (livestock) structure is any building or enclosure specifically designed, constructed, and used for both the following reasons.
• To house, raise, and feed a particular type of livestock and its produce.
• To house the equipment, including any replacements, needed to house, raise, or feed the livestock.

For this purpose, livestock includes poultry. Single purpose structures are qualifying property if used, for example, to breed chickens or hogs, produce milk from dairy cattle, or produce feeder cattle or pigs, broiler chickens, or eggs. The facility must include, as an integral part of the structure or enclosure, equipment necessary to house, raise, and feed the livestock.

Horticultural structure. A single purpose horticultural structure is either of the following.
• A greenhouse specifically designed, constructed, and used for the commercial production of plants.
• A structure specifically designed, constructed, and used for the commercial production of mushrooms.

Use of structure. A structure must be used only for the purpose that qualified it. For example, a hog barn will not be qualifying property if you use it as your house. Similarly, if you use part of your greenhouse to sell plants, it will not qualify as a greenhouse. If a structure includes work space, the work space can be used only for the following activities.
• Stocking, caring for, or collecting livestock or plants or their produce.
• Maintaining the enclosure or structure.
• Maintaining or replacing the equipment or stock enclosed or housed in the structure.

Property Acquired by Purchase
To qualify for the section 179 deduction, your property must have been acquired by purchase. For example, property acquired by gift or inheritance does not qualify. Property acquired from a related person (that is, your spouse, ancestors, or lineal descendants) is not considered acquired by purchase.

Example. Ken is a farmer. He purchased two tractors from his father. He placed both tractors in service in the same year he bought them. The tractors do not qualify as section 179 property because Ken and his father are related persons. He cannot claim a section 179 deduction for the cost of these machines.

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, farmers cannot elect the section 179 deduction for the following properties.
• Certain property you lease to others (if you are a noncorporate lessor).
• Certain property used predominantly to furnish lodging or in connection with the furnishing of lodging.
• Air conditioning or heating units.
• Property used by a tax-exempt organization (other than a tax-exempt farmers’ cooperative) unless the property is used mainly in a taxable unrelated trade or business.
• Property used by governmental units or foreign persons or entities (except property used under a lease with a term of less than 6 months).

How Much Can You Deduct?

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

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 $8,000 for a new pickup truck costing $15,000. They received a $5,000 trade-in allowance and paid $10,000 cash for the new pickup truck.

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 2007 is $125,000. 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 $125,000. You do not have to claim the full $125,000.

Example. This year, you bought and placed in service a tractor for $120,000 and a mower for $6,200 for use in your farming business. You elect to deduct the entire $6,200 for the mower and $118,800 for the tractor, a total of $125,000. 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 $1,200. You figure this by subtracting the amount of your section 179 deduction, $118,800, from the cost of the tractor, $120,000.

Reduced dollar limit for cost exceeding $500,000. If the cost of your qualifying section 179 property placed in service in 2007 is over $500,000, you must reduce the dollar limit (but not below zero) by the amount of cost over $500,000. If the cost of your section 179 property placed in service during 2007 is $625,000 or more, you cannot take a section 179 deduction and you cannot carry over the cost that is more than $625,000.
Limits for qualified section 179 GO Zone property. If you placed in service qualified section 179 GO Zone property (described below) in 2007, 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 $500,000 increased by the smaller of:

- $600,000 or
- 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 2007 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 2007, 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 re-decussion 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 two taxpayers.

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.

1. Figure your actual section 179 deduction.
2. Figure the hypothetical section 179 deduction using the taxable income figured in Step 1.
3. Subtract the hypothetical section 179 deduction figured in Step 2 from the taxable income figured in Step 1.
4. Figure a hypothetical amount for the other deduction using the amount figured in Step 3 as taxable income.
5. Subtract the hypothetical other deduction figured in Step 4 from the taxable income figured in Step 1.
6. Figure your actual section 179 deduction using the taxable income figured in Step 5.
7. Subtract your actual section 179 deduction figured in Step 6 from the taxable income figured in Step 1.
8. Figure your actual other deduction using the taxable income figured in Step 7.Using $20,000 (from Step 7) as taxable income, the following steps.

Example. This year, James Smith placed in service machining costing $550,000. Because this cost is $500,000 more than $50,000, he must reduce his dollar limit to $75,000 ($125,000 − $50,000).

Example. On February 1, 2007, the XYZ farm corporation purchased and placed in service qualifying section 179 property that cost $125,000. It elected to expense the entire $125,000 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 $145,000. XYZ figures its section 179 deduction and its deduction for charitable contributions as follows.

Step 1. Taxable income figured without either deduction is $145,000.
Step 2. Using $145,000 as taxable income, XYZ’s hypothetical section 179 deduction is $125,000.
Step 3. $20,000 ($145,000 − $125,000).
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. $143,000 ($145,000 − $2,000).
Step 6. Using $143,000 (from Step 5) as taxable income, XYZ figures the actual section 179 deduction. Because the taxable income is at least $125,000, XYZ can take a $125,000 section 179 deduction.
Step 7. $20,000 ($145,000 − $125,000).
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.** Last year, Joyce Jones placed in service a machine that cost $8,000 and elected to deduct $8,000 under section 179. The taxable income from her business (determined without regard to both a section 179 deduction for the cost of the machine and the self-employment tax deduction) was $6,000. Her section 179 deduction was limited to $6,000. The $2,000 cost that was not allowed as a section 179 deduction (because of the business income limit) is carried to this year.

This year, Joyce placed another machine in service that cost $9,000. Her taxable income from business (determined without regard to both a section 179 deduction for the cost of the machine and the self-employment tax deduction) is $10,000. Joyce can deduct the full cost of the machine ($9,000) but only $1,000 of the carryover from last year because of the business income limit. She can carry over the balance of $1,000 to next year.

**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 $500,000, you do not include any of the cost of section 179 property placed in service by the partnership or S corporation. After you apply the dollar limit, you apply the business income limit to any remaining section 179 costs. For more information, see chapter 2 of Publication 946.

**Example.** In 2007, Partnership P placed in service section 179 property with a total cost of $850,000. Partnership P must reduce its dollar limit by $80,000 ($850,000 – $770,000). Its maximum section 179 deduction is $45,000 ($125,000 – $80,000), and it elects to expense that amount. Because P's taxable income from the active conduct of all its trades or businesses for the year was $50,000, it can deduct the full $45,000. Partnership P allocates $20,000 of its section 179 deduction and $25,000 of its taxable income to John, one of its partners.

John also conducts a business as a sole proprietor and in 2007, 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 $20,000 allo- cated from P, plus the $14,000 of his sole propri- etorship's section 179 costs. However, John's deduction is limited to his business taxable income in- come of $30,000 ($25,000 from P plus $5,000 from his sole proprietorship). He carries over $4,000 ($34,000 – $30,000) of the elected sec- tion 179 costs to 2008.

**How Do You Elect the Deduction?**

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

- If you elect the deduction for listed property, complete Part V of Form 4562 before completing Part I.

File Form 4562 with either of the following:

- Your original tax return (whether or not you filed it timely), or
- 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.

**Revolving an election.** An election (or any specification made in the election) to take a section 179 deduction for 2007 can be revoked without IRS approval by filing an amended re- turn. 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 depreci- ation 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 in- crease the basis of the property by the recapture amount. Recovery periods for property are dis- cussed later.

If you sell, exchange, or otherwise dis- pose of the property, do not figure the recapture amount under the rules ex- plained in this discussion. Instead, use the rules for recapturing depreciation explained in chap- ter 9 under Section 1245 Property.

If 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 de- preciation 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 actu- ally claimed. The result is the amount you must recapture.

**Example.** In January 2005, 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 to deduct all $10,000 section 179 deduction for the property and also elected not to claim a special deprecia- tion allowance. He used the property only for business in 2005 and 2006. During 2007, he used the property 40% for business and 60% for personal use. He figures his recapture amount as follows.

Section 179 deduction claimed (2005) $5,000

**Minus:** Allowable depreciation (instead of section 179 deduction): 2005 ........................ $1,250 2006 ............................ 1,875 2007 ($1,250 × 40%) ........................... 500 3,625 — Recapture amount ................................ $3,175

Paul must include $1,375 in income for 2007.

**Where to report recapture.** Report any re- capture 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 2007, 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 quali- fied GO Zone property. This is depreciable prop- erty that meets the following requirements.

- The property must be acquired by purchase after August 27, 2005. If a bind- ing contract to acquire the property existed...
before August 28, 2005, the property does not qualify.

- The property must be placed 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.

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.

When Must You Recapture an Allowance

When you dispose of property for which you claimed a special depreciation allowance, any gain on the disposition is generally recaptured (including in income) as ordinary income up to the amount of the special depreciation allowance previously allowed or allowable. For more information, see chapter 3 of Publication 946.

Important: To be sure you can use MACRS to figure depreciation for your property, see Can You Use MACRS To Depreciate Your Property, earlier.

This part explains how to determine which MACRS depreciation system applies to your property. It also discusses the following information that you need to know before you can figure depreciation under MACRS.

- Property’s recovery class.
- Placed-in-service date.
- Basis for depreciation.
- Recovery period.
- Convention.
- Depreciation method.

Finally, this part explains how to use this information to figure your depreciation deduction.

Which Depreciation System (GDS or ADS) Applies?

Your use of either the General Depreciation System (GDS) or the Alternative Depreciation System (ADS) to depreciate property under MACRS determines what depreciation method and recovery period you use. You should use GDS unless you are specifically required by law to use ADS or you elect to use ADS.

Required use of ADS. You must use ADS for the following property.

- All property used predominantly in a farming business and placed in service in any tax year during which an election not to apply the uniform capitalization rules to certain farming costs is in effect.
- Listed property used 50% or less in a qualified business use. See Additional Rules for Listed Property later.
- Any tax-exempt use property.
- Any tax-exempt bond-financed property.
- Any property imported from a foreign country for which an Executive Order is in effect because the country maintains trade restrictions or engages in other discriminatory acts.
- Any tangible property used predominantly outside the United States during the year.

If you are required to use ADS to depreciate your property, you cannot claim the special depreciation allowance.

ELECTING ADS. Although your property may qualify for GDS, you can elect to use ADS. The election generally must cover all property in the same property class placed in service during the year. However, the election for residential rental property and nonresidential real property can be made on a property-by-property basis. Once you make this election, you can never revoke it.

You make the election by completing line 20 in Part III of Form 4562.

Which Property Class Applies Under GDS?

The following is a list of the nine property classes under GDS.

1. 3-year property.
2. 5-year property.
3. 7-year property.
4. 10-year property.
5. 15-year property.
6. 20-year property.
7. 25-year property.
8. Residential rental property.

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 in your 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 any credits and deductions allocable to the property. The following are examples of some of the credits and deductions that reduce basis.

- 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.

For additional credits and deductions that affect basis, see section 1016 of the Internal Revenue Code.
Table 7-1. Farm Property Recovery Periods

<table>
<thead>
<tr>
<th>Assets</th>
<th>Recovery Period in Years</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>GDS</td>
</tr>
<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 equipment</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 buildings</td>
<td>20</td>
</tr>
<tr>
<td>Farm machinery and equipment</td>
<td>7</td>
</tr>
<tr>
<td>Fences (agricultural)</td>
<td>7</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></td>
</tr>
<tr>
<td>Breeding and working (12 years or less)</td>
<td>7</td>
</tr>
<tr>
<td>Breeding and working (more than 12 years)</td>
<td>3</td>
</tr>
<tr>
<td>Racing horses (more than 2 years)</td>
<td>3</td>
</tr>
<tr>
<td>Horticultural structures (single purpose)</td>
<td>10</td>
</tr>
<tr>
<td>Logging machinery and equipment</td>
<td>5</td>
</tr>
<tr>
<td>Nonresidential real property</td>
<td>39</td>
</tr>
<tr>
<td>Office furniture, fixtures, and equipment (not calculators, copiers, or typewriters)</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>
</tbody>
</table>
| Water wells                                 | 15  | 20  

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.
4 For property placed in service after May 12, 1993; for property placed in service before May 13, 1993, the recovery period is 31.5 years.

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.
- A 20-year recovery period under GDS.

However, if the house trailer is not mobile (its wheels have been removed and permanent utilities and pipes attached to it), use one of the following recovery periods.
- A 25-year recovery period under ADS.

Water wells. Water wells used to provide water for raising poultry and livestock are land improvements. If they are depreciable, use one of the following recovery periods.
- A 15-year recovery period under GDS.
- A 20-year recovery period under ADS.

The types of water wells that can be depreciated were discussed earlier in Irrigation systems and water wells under Property Having a Deter- minable Useful Life.

Which Convention Applies?

Under MACRS, averaging conventions establish when the recovery period begins and ends. The convention you use determines the number of months for which you can claim depreciation in the year you place property in service and in the year you dispose of the property. Use one of the following conventions.
- The half-year convention.
- The mid-month convention.
- The mid-quarter convention.

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 recovery period.
- The straight line method over an ADS recovery 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>System/Method</th>
<th>Type of Property</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDS using 150% DB</td>
<td>All property used in a farming business (except real property)</td>
</tr>
<tr>
<td></td>
<td>Nonfarm 3-, 5-, 7-, and 10-year property</td>
</tr>
<tr>
<td>GDS using SL</td>
<td>Nonresidential real property</td>
</tr>
<tr>
<td></td>
<td>Residential rental property</td>
</tr>
<tr>
<td></td>
<td>Trees or vines bearing fruit or nuts</td>
</tr>
<tr>
<td></td>
<td>All 3-, 5-, 7-, 10-, 15-, and 20-year property</td>
</tr>
<tr>
<td>ADS using SL</td>
<td>Property used predominantly outside the U.S.</td>
</tr>
<tr>
<td></td>
<td>Farm property used when an election not to apply the uniform capitalization rules is in effect</td>
</tr>
<tr>
<td></td>
<td>Tax-exempt property</td>
</tr>
<tr>
<td></td>
<td>Tax-exempt bond-financed property</td>
</tr>
<tr>
<td></td>
<td>Imported property</td>
</tr>
<tr>
<td></td>
<td>Any property for which you elect to use this method</td>
</tr>
<tr>
<td>GDS using 200% DB</td>
<td>Nonfarm 3-, 5-, 7-, and 10-year property</td>
</tr>
</tbody>
</table>

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

Property used in farming business. For personal 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 recovery period.

The straight line method over an ADS recovery period.

For property placed in service before 1999, you could have elected to use the 150% declining balance method using the ADS recovery periods for certain property classes. If you made this election, continue to use the same method and recovery period for that property.

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

Switching to straight line. If you use a declining balance method, you switch to the straight line method in the year it provides an equal or greater deduction. If you use the MACRS percentage tables, discussed later under How Is the Depreciation Deduction Figured, you do not need to determine in which year your deduction is greater using the straight line method. The tables have the switch to the straight line method built into their rates.

Fruit or nut trees and vines. Depreciate trees and vines bearing fruit or nuts under GDS using the straight line method over a 10-year recovery period.

ADS required for some farmers. If you elect not to apply the uniform capitalization rules to any plant shown in Table 6-1 of chapter 6 and produced in your farming business, you must use ADS for all property you place in service in any year the election is in effect. See chapter 6 for a discussion of the uniform capitalization rules to farm property.

Election of a different method. As shown in the Depreciation Table, you can elect a different method for depreciation for certain types of property. You must make the election by the due date of the return (including extensions) for the year you placed the property in service. However, if you timely filed your return for the year without making the election, you can still make the election by filing an amended return within 6 months of the due date of your return (excluding extensions). Attach the election to the amended return and write “Filed pursuant to section 301.9100-2” on the election statement. File the amended return at the same address you filed the original return. Once you make the election, you cannot change it.

If you elect to use a different method for one item in a property class, you must apply the same method to all property in that class placed in service during the year of the election. However, you can make the election on a property-by-property basis for residential rental and nonresidential real property.

Straight line election. Instead of using the declining balance method, you can elect to use the straight line method over the GDS recovery period. Make the election by entering “S/L” under column (f) in Part III of Form 4562.

If you elect to use a different method for one item in a property class, you must apply the same method to all property in that class placed in service during the year of the election. However, you can make the election on a property-by-property basis for residential rental and nonresidential real property.

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 your 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 150% DB method and half-year convention. Table 7-2 has the percentages for 3-, 5-, 7-, and 20-year property. The percentages are based on the 150% declining balance method with a change to the straight line method. This table covers only the half-year convention and the first 8 years for 20-year property. See Appendix A in Publication 946 for complete MACRS tables, including tables for the mid-quarter and mid-month convention.

The following examples show how to figure depreciation under MACRS using the percentages in Table 7-2.

Example 1. During the year, you bought an item of 7-year property for $10,000 and placed it in service. You do not elect a section 179 deduction for this property. 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 for a deduction 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 elected not to claim the special depreciation allowance. The barn is 20-year property and you use the table percentages to figure your deduction. You figure this year’s depreciation by multiplying $20,000 (unadjusted basis) by 3.75% to get $750. For next year, your depreciation will be $1,443.80 ($20,000 × 7.219%).

Figuring depreciation using the straight line method and half-year convention. The following table has the straight line percentages for 3-, 5-, 7-, and 20-year property using the half-year convention. The table covers only the first 8 years for 20-year property. See Appendix A in Publication 946 for complete MACRS tables, including tables for the mid-quarter and mid-month convention.
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 x 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 involuntary conversion.** You generally must depreciate the carryover basis of MACRS property acquired in a like-kind exchange or involuntary conversion over the remaining recovery period of the property exchanged or involuntarily converted. You also generally continue to use the same depreciation method and convention used for the exchanged or involuntarily converted property. This applies only to acquired property and 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 must continue to use the same depreciation method and convention as the transferor. You can depreciate the part of the property’s basis in excess of its carryover basis (the transferor’s adjusted basis in the property) as newly purchased MACRS property. For information on the kinds of nontaxable transfers covered by this rule, see chapter 4 of Publication 946.

**How Do You Use General Asset Accounts?**

To make it easier to figure MACRS depreciation, you can group separate 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 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 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.
- Property generally used for entertainment, recreation, or amusement.
- Computers and related peripheral equipment unless used only at a regular business establishment and owned or leased by the person operating the establishment.
- Cellular telephones (or similar telecommunications 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 unladen 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.

**Tip**

A truck or van that is a qualified nonpersonal 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, boats, airplanes, motorcycles, and other vehicles used for transporting persons or goods.

**Exception.** 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.
When to claim timber depletion. You acquire timber as a sale or exchange as explained in Publication 535. 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.

<table>
<thead>
<tr>
<th>Step</th>
<th>Action</th>
<th>Result</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Divide your property’s basis for depletion by total recoverable units.</td>
<td>Rate per unit.</td>
</tr>
<tr>
<td>2</td>
<td>Multiply the rate per unit by units sold during the tax year.</td>
<td>Cost depletion deduction.</td>
</tr>
</tbody>
</table>

Cost depletion for ground water in Ogalaia Formation. Farmers who extract ground water from the Ogalaia 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 immediately succeeding generations. To figure your cost depletion deduction, use the guidance provided in Revenue Procedure 66-11 in Cumulative Bulletin 1966-1.

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

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.
Amortization

Amortization is a method of recovering (deducting) certain capital costs over a fixed period of time. It is similar to the straight line method of depreciation. The amortizable costs discussed in this section include the start-up costs of getting into business, reforestation costs, the costs of pollution control facilities, and the costs of section 197 intangibles. See chapter 8 in Publication 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 depreciation deductions. However, you generally cannot recover other costs until you sell the business or otherwise go out of business.

Start-up costs are costs for creating an active trade or business or investigating the creation or acquisition of an active trade or business. Start-up costs include any amounts paid or incurred in connection with any activity engaged in for profit and for the production of income before the trade or business begins. In anticipation of the activity becoming an active trade or business, you can elect to currently deduct up to $5,000 of business start-up costs paid or incurred during the tax year. See Capital Expenses 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 Capital 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 gross income. See chapter 8 of Publication 535 for more information on these topics.

Qualified timber property. Qualified timber property is property that contains trees in significant commercial quantities. It can be a woodlot or other site that you own or lease. The property qualifies only if it meets all the following requirements:

- It is located in the United States.
- It is held for the growing and cutting of timber you will either use in, or sell for use in, the commercial production of timber products.
- It consists of at least one acre planted with tree seedlings in the manner normally used in forestation or reforestation.

Qualified timber property does not include property on which you have planted shelter belts or ornamental trees, such as Christmas trees.

Amortization period. The 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(a) of the Internal Revenue Code.” 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.

You can claim a special depreciation allowance on a certified pollution control facility that is qualified property even if you elect to amortize its cost rather than capitalize the costs and depreciate the facility. You must reduce its cost (amortizable basis) by the amount of any special allowance you claim.
Certified pollution control facility. A certi-
ﬁed 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 so by removing, changing, disposing, storing, or preventing the creation or emission of pollu-
tants, 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 facil-
ities.

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 con-
nection 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 recov-
ering the cost of the facility through sale of the
waste and a federal certifying authority has so certi-
fied.

Your manure control facility qualiﬁes for amor-
tization. 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 in-
crease the output or capacity, extend the useful
life, or reduce the total operating costs of the plant or other property. Also, it must not signiﬁ-
cantly 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, however, recover the cost of 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 section 169 of the Internal Revenue Code and the related regulations.

Section 197 Intangibles

You must generally amortize over 15 years the capitalized costs of section 197 intangibles you acquired after August 10, 1993. You must amor-
tize these costs if you hold the section 197 intangible in connection with your farming busi-
ness or in an activity engaged in for the produc-
tion of income. Your amortization deduction each year is the applicable part of the intangi-
ble’s adjusted basis (for purposes of determin-
ing 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 infor-
mation, including a complete list of assets that are section 197 intangibles and special rules.

8. Gains and Losses

Introduction

This chapter explains how to ﬁgure, and report on your tax return, your gain or loss on the disposition of your property or debt and whether such gain or loss is ordinary or capital. Ordinary gain is taxed at the same rates as wages and interest income while capital gain is generally taxed at lower rates. Dispositions discussed in this chapter include sales, exchanges, foreclos-
ures, repossessions, cancelled debts, hedging transactions, and elections to treat cutting of timber as a sale or exchange.

Topics

This chapter discusses:
• Sales and exchanges
• Ordinary or capital gain or loss

Useful Items

You may want to see:

Publication

• 334 Tax Guide for Small Business
• 532 Selling Your Home
• 544 Sales and Other Dispositions of Assets
• 550 Investment Income and Expenses
• 908 Bankruptcy Tax Guide

Form (and Instructions)

• Sch D (Form 1040) Capital Gains and Losses
• Sch F (Form 1040) Proﬁt or Loss From Farming
• 1099-A Acquisition or Abandonment of Secured Property
• 1099-C Cancellation of Debt
• 4797 Sales of Business Property

See chapter 17 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 determin-
ing whether any gain you have is taxable, and whether any loss you have is deductible. A sale is a transfer of property for money or a mortgage, note, or other promise to pay money. An exchange is a transfer of property for other property or services.

Determining Gain or Loss

You usually realize a gain or loss when you sell or exchange property. A gain is the amount you realize from a sale or exchange of property that is more than its adjusted basis. A loss is the adjusted basis of the property that is more than the amount you realize.

Adjusted basis. The adjusted basis of prop-
erty is original cost or other basis plus certain additions and minus certain deductions. See chapter 6 for more information about basis and adjusted basis.

Amount realized. The amount you realize from a sale or exchange is the total of all money you receive plus the fair market value (deﬁned in chapter 6) 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-
ple properties, see Treatment of liabilities under Multiple Property Exchanges in chapter 1 of Publication 544.

Amount recognized. Your gain or loss real-
ized from a sale or exchange of property is us-
ually a recognized gain or loss for tax pur-
poses. A recognized gain is a gain you must include in gross income and report on your in-
come tax return. A recognized loss is a loss you deduct from gross income. For example, if your recognized gain from the sale of your tractor is $5,300, you include that amount in gross income on Form 1040. However, your gain or loss real-
ized from the exchange of property may not be recognized for tax purposes. See Like-Kind Ex-
changes, next. Also, a loss from the disposition of property held for personal use is not deducti-
ble.
Like-Kind Exchanges

Certain exchanges of property are not taxable. This means any gain from the exchange is not recognized, and any loss cannot be deducted. Your gain or loss will not be recognized until you sell or otherwise dispose of the property you receive.

The exchange of property for the same kind of property is the most common type of nontaxable exchange. To be a like-kind exchange, the property traded and the property received must be both of the following:

- Qualifying property.
- Like-kind property.

These two requirements are discussed later.

Multiple-party transactions. The like-kind exchange rules also apply to property exchanges that involve three- and four-party transactions. Any part of these multiple-party transactions can qualify as a like-kind exchange if it meets all the requirements described in this section.

Example of title from third party. If you receive property in a like-kind exchange and the other party who transfers the property to you does not give you the title, but a third party does, you can still treat this transaction as a like-kind exchange if it meets all the requirements.

Basis of property received. If you receive property in a like-kind exchange, the basis of the property will be the same as the basis of the property you gave up. See chapter 6 for more information.

Example. Bill Smith trades an old tractor with an adjusted basis of $1,500 for a new one. The new tractor costs $22,000. He is allowed $8,000 for the old tractor and pays $14,000 cash. He has no recognized gain or loss on the transaction regardless of the adjusted basis of his old tractor. If Bill sold the old tractor to a third party for $8,000 and bought a new one, he would have a recognized gain or loss on the sale of his old tractor equal to the difference between the amount realized and the adjusted basis of the old tractor.

Reporting the exchange. Report the exchange of like-kind property, even though no gain or loss is recognized, on Form 8824, Like-Kind Exchanges. The instructions for the form explain how to report the details of the exchange.

If you have any recognized gain because you received money or unlike property, report it on Schedule D (Form 1040) or Form 4797, whichever applies. You may also have to report the recognized gain as ordinary income because of depreciation recapture on Form 4797. See chapter 9 for more information.

Qualifying property. In a like-kind exchange, both the property you give up and the property you receive must be held by you for investment or for productive use in your trade or business. Machinery, buildings, land, trucks, breeding livestock, and rental houses are examples of property that may qualify.

The rules for like-kind exchanges do not apply to exchanges of the following property:

- Property you use for personal purposes, such as your home and your family car.
- Stock in trade or other property held primarily for sale, such as crops and produce.
- Stocks, bonds, notes, or other securities or evidences of indebtedness, such as accounts receivable.
- Partnership interests.

However, you may have a nontaxable exchange under other rules. See Other Nontaxable Exchanges in chapter 1 of Publication 544.

Like-kind property. To qualify as a nontaxable exchange, the properties exchanged must be of like kind as defined in the income tax regulations. Generally, real property exchanged for real property qualifies as an exchange of like-kind property.

Personal property. Depreciable tangible personal property can be either like kind or like class to qualify for nontaxable exchange treatment. Like-class properties are depreciable tangible personal properties within the same General Asset Class or Product Class. Property classified in any General Asset Class may not be classified within a Product Class. 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 computers (asset class 00.13).
4. Airplanes (airframes and engines), except planes used in commercial or contract carrying of passengers or freight, and all helicopters (airframes and engines) (asset class 00.21).
5. Automobiles and taxis (asset class 00.22).
6. Buses (asset class 00.23).
7. Light general purpose trucks (asset class 00.241).
8. Heavy general purpose trucks (asset class 00.242).
9. Railroad cars and locomotives, except those owned by railroad transportation companies (asset class 00.25).
10. Tractor units for use over-the-road (asset class 00.26).
11. Trailers and trailer-mounted containers (asset class 00.27).

12. Vessels, barges, tugs, and similar water-transportation equipment, except those used in marine construction (asset class 00.28).

13. Industrial steam and electric generation and/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, 2007 (NAICS Manual). It can be accessed at http://www.census.gov/naics. Copies of the hard cover manual may be obtained from the National Technical Information Service (NTIS) at http://www.ntis.gov or by calling 1-800-553-NTIS (1-800-553-6847) or (703) 605-6000. The cost of the hard cover manual is $59 (plus handling) and the order number is PB2007100002 (which must be typed into the NTIS website search box). A CD-ROM version with search and retrieval software is also available from NTIS. The CD-ROM disc comes in three versions: 1) single concurrent network license; 2) up to 5 users; and, 3) unlimited concurrent users. The cost of the CD-ROM is respectively $79, $179, and $358 (plus handling) and the order number is PB2007000023 (which must be typed into the NTIS website search box).

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 cash, you received a tractor with a fair market value of $10,000. Your recognized gain is still limited to $10,000, the value of the tractor (the unlike property).

Example 3. Assume in Example 1 that the fair market value of the land you received was only $15,000. Your $5,000 loss is not recognized.
Unlike property given up. If, in addition to like-kind property, you give up unlike property, you must recognize gain or loss on the unlike property you give up. The gain or loss is the difference between the fair market value of the unlike property and the adjusted basis of the unlike property.

Like-kind exchanges between related persons. Special rules apply to like-kind exchanges between related persons. These rules affect both direct and indirect exchanges. Under these rules, if either person disposes of the property within 2 years after the exchange, the exchange is disqualified from nonrecognition treatment. The gain or loss on the property exchanged must be recognized as of the date of the disposition. The 2-year holding period begins on the date of the last transfer of property that was part of the like-kind exchange.

Related persons. Under these rules, related persons include, for example, you and a member of your family (spouse, brother, sister, parent, child, etc.). You and a corporation in which you have more than 50% ownership, you and a partnership in which you directly or indirectly own more than a 50% interest of the capital or profits, and two partnerships in which you directly or indirectly own more than 50% of the capital interests or profits.

For the complete list of related persons, see 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 2006, 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 $7,000 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 gave up, or $6,800 minus $200). You also realized a gain of $1,000 (the $7,000 FMV of the grey pickup truck you owned plus the $200 you paid, minus the $1,000 adjusted basis of the red pickup truck you 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 $6,200 (the $6,000 adjusted basis of the pickup truck you exchanged with her plus the $200 you paid). Your sister’s basis in the grey pickup truck is $7,200 (the $7,000 adjusted basis of the red pickup truck she exchanged with you minus the $200 received, plus the $200 gain recognized).

In 2007, 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 2007, you must report your $1,000 gain on the 2006 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 2007 the $6,000 balance of her gain on the 2006 exchange. Her adjusted basis in the pickup truck she acquired from you is increased to $7,000 (its $1,000 basis plus the $6,000 gain recognized).

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

- Dispositions due to the death of either related person.
- Involuntary conversions.
- Dispositions where it is established to the satisfaction of the IRS that neither the exchange nor the disposition has, as a main purpose, the avoidance of federal income tax.

Multiple property exchanges. Under the like-kind exchange rules, you must generally make a property-by-property comparison to figure your recognized gain and the basis of the property you receive in the exchange. However, for exchanges of multiple properties, you do not make a property-by-property comparison if you meet the following conditions.

- 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 your 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 the property that the taxpayer foremerly 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 trust’s adjusted basis.

Any transfer of property to a spouse or former spouse on which gain or loss is not recognized is not considered a sale or exchange. The recipient’s basis in the property will be the same as the adjusted basis of the giver immediately before the transfer. This carryover basis rule applies whether the adjusted basis of the transferred property is less than, equal to, or greater than either its fair market value at the time of transfer or any consideration paid by the recipient. This rule applies for determining loss as well as gain. Any gain recognized on a transfer in trust increases the basis.

For more information on transfers of property incident to divorce, see Property Settlements in Publication 504, 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 and losses as short-term or long-term). You must do this to figure your net capital gain or loss. You must do this to figure your net capital gain or loss.

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

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

Section 1231 transactions. Section 1231 transactions are sales and exchanges of property held longer than 1 year and either used in a trade or business or held for the production of rents or royalties. They also include certain involuntary conversions of business or investment
property, including capital assets. See Section 1231 Gains and Losses in chapter 9 for more information.

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

The following items are examples of capital assets:

- A home owned and occupied by you and your family.
- Household furnishings.
- A car used for pleasure. If your car is used both for pleasure and for farm business, it is partly a capital asset and partly a non-capital asset, defined later.
- Stocks and bonds. However, there are special rules for gains and losses on qualified small business stock. For more information on this subject, see Losses on Section 1244 (Small Business) Stock in chapter 4 of Publication 550.

Personal-use property. Property held for personal use is a capital asset. Gain from a sale or exchange of that property is not deductible. You can deduct a loss relating to personal-use property only if it results from a casualty or theft. For information about casualties and thefts, see chapter 11.

Long and Short Term
Where you report a capital gain or loss depends on how long you own the asset before you sell or exchange it. The time you own an asset before disposing of it is the holding period.

If you hold a capital asset 1 year or less, the gain or loss resulting from its disposition is short-term. Report it in Part I, Schedule D (Form 1040). If you hold a capital asset longer than 1 year, the gain or loss resulting from its disposition is long-term. Report it in Part II, Schedule D (Form 1040).

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

Example. If you bought an asset on June 19, 2006, you should start counting on June 20, 2006. If you sold the asset on June 19, 2007, your holding period is not longer than 1 year, but if you sold it on June 20, 2007, 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 holding period is figured using the donor’s basis, the holding period includes the donor’s holding period.

Real property. To figure how long you held real property, start counting on the day after you received title to it, or if earlier, on the day after you took possession of it and assumed the burdens and privileges of ownership.

However, taking possession of real property under an option agreement is not enough to start the holding period. The holding period cannot start until there is an actual contract of sale. The holding period of the seller cannot end before that time.

Figuring Net Gain or Loss
The totals for short-term capital gains and losses and the totals for long-term capital gains and losses must be figured separately.

Net short-term capital gain or loss. Combine your short-term capital gains and losses. Do this by adding all your short-term capital gains. Then add all your short-term capital losses. Subtract the lesser total from the other. The result is your net short-term capital gain or loss.

Net long-term capital gain or loss. Follow the same steps to combine your long-term capital gains and losses. The result is your net long-term capital gain or loss.

Net gain. If the total of your capital gains is more than the total of your capital losses, the difference is taxable. However, part of your gain (but not more than your net capital gain) may be taxed at a lower rate than the rate of tax on your ordinary income. See Capital Gains Tax Rates, later.

Net loss. If the total of your capital losses is more than the total of your capital gains, the difference is deductible. But there are limits on how much loss you can deduct and when you can deduct it. See Treatment of Capital Losses, next.

Treatment of Capital Losses
If your capital losses are more than your capital gains, you must claim the difference even if you do not have ordinary income to offset it. For taxpayers other than corporations, the yearly limit on the capital loss you can deduct is $3,000 ($1,500 if you are married and file a separate return). If your other income is low, you may not be able to use the full $3,000. The part of the $3,000 you cannot use becomes part of your capital loss carryover.

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 2007, see Capital Losses under Reporting Capital Gains and Losses in chapter 9 for more information. To figure the amount you can carry over to 2008.

To figure your capital loss carryover from 2007 to 2008, you will need a copy of your 2007 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.
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 options contracts, see Commodity Futures and Section 1256 Contracts Marked to Market in Publication 550.

Accounting methods for hedging transactions. The accounting method you use for a hedging transaction must clearly reflect income. This means that your accounting method must reasonably match the timing of income, deduction, gain, or loss from a hedging transaction with the timing of income, deduction, gain, or loss from the item or items being hedged. There are requirements and limits on the method you can use for certain hedging transactions. See 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.

If, as a farmer-producer, to protect yourself from the risk of unfavorable price fluctuations, you enter into commodity forward contracts, future 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.
Livestock used in farm business. If live-
stock is held solely for draft, breeding, dairy, or sporting purposes, it is used in your farm business. The purpose for which an animal is held ordinarily is determined by a farmer's actual use of the animal, not by an intended use. The animal is not held for draft, breeding, dairy, or sporting purposes merely because it is suitable for that purpose, or because it is sold. A breed-
ing or sporting purpose may be present if an animal is disposed of within a reasonable time after it is prevented from its intended use or made undesirable as a result of an accident, disease, drought, or unfitness of the animal.

Example 1. You discover an animal that you intend to use for breeding purposes is sterile. You dispose of it within a reasonable time. This animal was held for breeding purposes.

Example 2. You retire and sell your entire herd, including young animals that you would have used for breeding or dairy purposes had you remained in business. These young animals were held for breeding or dairy purposes. If so, 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 rais-
ing hogs for sale. You sell the brood sows after obtaining the litter. Even though you hold these brood sows for ultimate sale to cus-
tomers in the ordinary course of your business, they are considered to be held for breeding purposes.

Example 4. You are in the business of rais-
ing hogs for sale. You sell the brood sows after obtaining the litter. Even though you hold these brood sows for ultimate sale to cus-
tomers in the ordinary course of your business, they are considered to be held for breeding purposes.

Example 5. You are in the business of rais-
ing hogs for sale. You sell the brood sows after obtaining the litter. Even though you hold these brood sows for ultimate sale to cus-
tomers in the ordinary course of your business, they are considered to be held for breeding purposes.

Example 6. You breed, raise, and train hor-
es for racing purposes. Every year you cull horses from your racing stable. In 2007, you decided to prevent your racing stable from getting too large to be effectively operated, you must cull six horses that had been raced at public tracks in 2006. These horses are all con-
sidered held for sporting purposes.

Figuring gain or loss on the cash method. Farmers or ranchers who use the cash method of accounting figure their gain or loss on the sale of livestock used in their farming business as follows.

Raised livestock. Gain on the sale of raised livestock is generally the gross sales price minus your adjusted basis and any ex-

Purchased livestock. The gross sales price minus your adjusted basis and any ex-

Example. A farmer sold a breeding cow on January 8, 2007, for $1,250. Expenses of the sale were $125. The cow was bought July 2, 2004, for $1,300. Depreciation (not less than the amount allowable) was $759.

Converting and Highly Erodible Cropland

Special rules apply to dispositions of land con-
verted to farming use after March 1, 1986. Any gain realized on the disposition of converted woodland or highly erodible cropland is treated as ordinary income. Any loss on the disposition of such property is treated as a long-term capital loss.

Converting and Highly Erodible Cropland

This is generally land that was drained or filled to make the production of agricultural commodities possible. It includes converted woodland held by the person who origi-
nally converted it or held by any other person who used the converted woodland at any time after conversion for farming.

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

• It is mostly soil that, in its undrained condi-
tion, is saturated, flooded, or ponded long enough during a growing season to de-
velop an oxygen-deficient state that sup-
ports the growth and regeneration of plants growing in water.

• It is saturated by surface or groundwater at a frequency and duration sufficient to support mostly plants that are adapted for life in saturated soil.

• It supports, under normal circumstances, mostly plants that grow in saturated soil.

Highly erodible cropland. This is cropland subject to erosion that you used at any time for farming purposes other than grazing animals.

Generally, highly erodible cropland is land cur-
rently classified by the Department of Agricul-
ture as Class IV, VI, VII, or VIII under its classification system. Highly erodible cropland also includes land that would have an excessive average annual erosion rate in relation to the soil loss tolerance level, as determined by the De-
partment of Agriculture.

Successor. Converted woodland or highly erodible cropland is also land held by any per-
son whose basis in the land is determined by refer-
ence to the adjusted basis of a person in whose hands the property was converted woodland or highly erodible cropland.

Timber

Standing timber you held as investment property is a capital asset. Gain or loss from its sale is capital gain or loss reported on Schedule D (Form 1040). If you held the timber primarily for sale to customers, it is not a capital asset. Gain or loss on its sale is ordinary business income or loss. It is reported on Schedule F, line 1 (pur-
chased 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 busi-
nesses. Amounts realized from these minor sales, and the expenses incurred in cutting, hauling, etc., are ordinary farm income and ex-
penses reported on Schedule F.

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

Timber considered cut. Timber is considered cut on the date when, in the ordinary course of business, the quantity of felled timber is first definitely determined. This is true whether the timber is cut under contract or whether you cut it yourself.

Christmas trees. Evergreen trees, such as Christmas trees, that are more than 6 years old when severed from their roots and sold for orna-
tmental purposes are included in the term timber. They qualify for both rules discussed below.

Election to treat cutting as a sale or ex-
change. Under the general rule, the cutting of timber results in no gain or loss. It is not until a sale or exchange occurs that gain or loss is realized. But if you own or have a contractual right to cut timber, you can elect to treat the cutting of timber as a section 1231 transaction in the year it is cut. Even though the cut timber is not actually sold or exchanged, you report your gain or loss on the cutting for the year the timber is cut. Any later sale results in ordinary business income or loss.

To elect this treatment, you must:

1. Own or hold a contractual right to cut the timber for a period of more than 1 year before it is cut, and
2. Cut the timber for sale or use in your trade or business.

Making the election. You make the elec-
tion 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 subsequent year. The 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 previously elected for any tax year ending before October 23, 2004, to treat the cutting of timber as a sale or exchange under section 631(a), you may revoke this election within 180 days after the date you file your return for the tax year ending after October 22, 2004. The prior election (and revocation) is disregarded for purposes of making a subsequent election. See Form T (Timber) 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 used for the cut timber, and should be figured in the same manner as shown in Internal Revenue Code section 611 and Regulations section 1.611-3.

Depletion of timber is discussed in chapter 7.

**Example.** In April 2007, you owned 4,000 MBF (1,000 board feet) of standing timber longer than 1 year. It had an adjusted basis for depletion of $40 per MBF. You are a calendar year taxpayer. On January 1, 2007, the timber had a fair market value (FMV) of $350 per MBF. It was cut in April for sale. On your 2007 tax return, you elect to treat the cutting of the timber as a sale or exchange. You report the difference between the FMV and your adjusted basis for depletion on your return. The election is made on amended 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, 2007 ... $1,400,000 Minus: Adjusted basis 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.

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

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

- You are the owner of the timber.
- You held the timber longer than 1 year before its disposal.
- You kept an economic interest in the timber.

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

The difference between the amount realized from the disposal of the timber and its adjusted basis for depletion is treated as gain or loss on its sale. Include this amount on Form 4797 along with your other section 1231 gains or losses to figure whether it is treated as capital or ordinary gain or loss.

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

This election applies only to figure the holding period of the timber. It has no effect on the time for reporting gain or loss (generally when the timber is sold or exchanged).

To make this election, attach a statement to the tax return filed by the due date (including extensions) for the year payment is received. The statement must identify the advance payments subject to the election and the contract under which they were made. If you timely filed your return for the year you received payment without making the election, you can still make the election by filing an amended return within 6 months after the due date for that year’s return (excluding extensions). Attach the statement to the amended return and write “Filed pursuant to section 301.9101-2” 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.

**Tree stumps.** Tree stumps are a capital asset if they are on land held by an investor who is not in the timber or stump business as a buyer, seller, or processor. Gain from the sale of stumps sold in one lot by such a holder is taxed as a capital gain. However, tree stumps held by timber operators after the saleable standing timber was cut and removed from the land are considered by-products. Gain from the sale of stumps in lots or tonnage by such operators is taxed as ordinary income.

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

**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 elect not to use the installment method of reporting the gain. See chapter 10 for information about installment sales.

When you sell your farm, the gain or loss on each asset is figured separately. The tax treatment of gain or loss on the sale of each asset is determined by the classification of the asset. Each of the assets sold must be classified as one of the following.

- Capital asset held 1 year or less.
- Capital asset held longer than 1 year.
- Property (including real estate) used in your business and held 1 year or less (including draft, breeding, 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, and sporting animals held for the holding periods discussed earlier).
- Property held primarily for sale or which is of the kind that would be included in inventory if on hand at the end of your tax year.

**Allocation of consideration paid for a farm.** The sale of a farm for a lump sum is considered a sale of each individual asset rather than a single asset. The residual method is required only if the group of assets sold constitutes a trade or business. This method determines gain or loss from the transfer of each asset. It also determines the buyer’s basis in the business assets.

**Consideration.** The buyer’s consideration is the cost of the assets acquired. The seller’s consideration is the amount realized (money plus the fair market value of property received) from the sale of assets.

**Residual method.** The residual method must be used for any transfer of a group of assets that constitutes a trade or business and for which the buyer’s basis is determined only by the amount paid for the assets. This applies to both direct and indirect transfers, such as the sale of a business or the sale of a partnership interest in which the basis of the buyer’s share of the partnership assets is adjusted for the amount paid under 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 either of the following applies.

- Goodwill or going concern value could, under any circumstances, attach to them.
- The use of the assets would constitute an active trade or business under 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)(3)(ii) for exceptions that apply to debt instruments issued by persons related to a target corporation, contingent debt instruments, and debt instruments convertible into stock or other property.

3. Property of a kind that would properly be included in inventory if on hand at the end of the tax year or property held by the taxpayer primarily for sale to customers in the ordinary course of business.

4. All other assets except section 197 intangibles.

5. Section 197 intangibles (other than goodwill and going concern value).

6. Goodwill and going concern value (whether or not the goodwill or going concern value qualifies as a section 197 intangible).

If an asset described in (1) through (6) is includable in more than one category, include it in the lower numbered category. For example, if an asset is described in both (4) and (6), include it in (4).

Property used in farm operation. The rules for excluding the gain on the sale of your home, described later under Sale of your home, do not apply to the property used for your farming business. Recognized gains and losses on business property must be reported on your return for the year of the sale. If the property was held longer than 1 year, it may qualify for section 1231 treatment (see chapter 9).

Example. You sell your farm, including your main home, which you have owned since December 1999. You realize gain on the sale as follows.

<table>
<thead>
<tr>
<th>Farm</th>
<th>Home</th>
<th>Only</th>
<th>Farm</th>
</tr>
</thead>
<tbody>
<tr>
<td>Selling price</td>
<td>$120,000</td>
<td>$54,000</td>
<td>$124,000</td>
</tr>
<tr>
<td>Cost (or other basis)</td>
<td>40,000</td>
<td>10,000</td>
<td>30,000</td>
</tr>
<tr>
<td>Gain</td>
<td>$10,000</td>
<td>$44,000</td>
<td>$94,000</td>
</tr>
</tbody>
</table>

You must report the $94,000 gain from the sale of the property used in your farming 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. This gain is discussed in section 1231.

The $48,000 gain from the sale of your home is not taxable as long as you meet the requirements explained later under Gain on sale of your main home.

Partial sale. If you sell only part of your farm, you must report any recognized gain or loss on the sale of that part on your tax return for the year of the sale. You cannot wait until you have sold enough of the farm to recover its entire cost before reporting gain or loss.

Adjusted basis of the part sold. This is the 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 $60,000 (10% of $600,000), plus any unrecovered cost (cost not depreciated) of the fence on the 60 acres at the time of sale. Use this amount to determine your gain or loss on the sale of the 60 acres.

Assessed values for local property taxes. If you paid a flat sum for the entire farm and no other facts are available for properly allocating your original cost or other basis between the land and the buildings, you can use the assessed values for local property taxes for the year of purchase to allocate the costs.

Example. Assume that in the preceding example there was no breakdown of the $700,000 purchase price between land and buildings. However, in the year of purchase, local taxes on the entire property were based on assessed valuations of $420,000 for land and $140,000 for improvements, or a total of $560,000. The assessed valuation of the land is 75% (75%) of the total assessed valuation. Multiply the $700,000 total purchase price by 75% to figure basis of $252,000 for the 600 acres of land. The unadjusted basis of the 60 acres sold would then be $52,500 (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.

If you use part of your home for business, you must make an appropriate adjustment to the basis for depreciation allowed or allowable. For more information on basis, see chapter 6.

Gain on sale of your main home. If you sell your main home at a gain, you may qualify to exclude from income all or part of the gain. To qualify, you must meet the ownership and use tests.

You can claim the exclusion if, during the 5-year period ending on the date of the sale, you meet both the following requirements.

- You owned the home for at least 2 years (the ownership test).
- You lived in the home as your main home for at least 2 years (the use test).

You can exclude the entire gain on the sale of your main home up to:

1. $250,000, or
2. $500,000, if all the following are true.
   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. This is true even if you voluntarily return the property to the lender. You may also realize ordinary income from cancellation of debt if the loan balance is more than the fair market value of the property.

Buyer’s (borrower’s) gain or loss. You figure and report gain or loss from a foreclosure or repossession in the same way as gain or loss from a sale or exchange. The gain or loss is the difference between your adjusted basis in the transferred property and the amount realized.

See Determining Gain or Loss, earlier.
**Worksheet for Foreclosures and Repossessions**

**Keep for Your Records**

**Part 1. Figure your income from cancellation of debt.** (Note: If you are personally liable for the debt, you must report entire income from cancellation of debt. Skip Part 1 and go to Part 2.)

1. Enter the amount of debt canceled by the transfer of property.
2. Enter the fair market value of the transferred property.
3. Income from cancellation of debt.* Subtract line 2 from line 1. If less than zero, enter zero.

**Part 2. Figure your gain or loss from foreclosure or repossession.**

1. 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.)
2. Enter the adjusted basis of the transferred property.
3. Gain or loss from foreclosure or repossession. Subtract line 5 from line 4.

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

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**Amount realized on a nonrecourse debt.** If you are not personally liable for repaying the debt (nonrecourse debt) secured by the transferred property, the amount you realize includes the full amount of the debt canceled by the transfer. The 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 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.

**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.

**Seller's (lender's) gain or loss on repossession.** If you finance a buyer's purchase of property and later acquire an interest in it through foreclosure or repossession, you may have a gain or loss on the acquisition. For more information, see Repossession in Publication 537, Installment Sales.

**Cancellation of debt.** If property that is repossessed or foreclosed upon secures a debt for which you are personally liable (recourse debt), you generally must report as ordinary income the amount by which the canceled debt is more than the fair market value of the property. This income is separate from any gain or loss realized from the foreclosure or repossession. Report the income from cancellation of a nonbusiness debt as miscellaneous income on Form 1040, line 21.

**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).
- You are insolvent or bankrupt (see chapter 3).

**Abandonment**

The abandonment of property is a disposition of property. You abandon property when you voluntarily and permanently give up possession and use of the property with the intention of ending your ownership, but without passing it on to anyone else.

**Business or investment property.** Loss from abandonment of business or investment property is deductible as an ordinary loss even if the property is a capital asset. The loss is the property's adjusted basis when abandoned. This rule also applies to leasehold improvements the lessor made for the lessee that were abandoned. However, if the property is later foreclosed on or repossessed, gain or loss is figured as discussed, earlier, under Foreclosure or Repossession.

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

**Example.** Abena lost her contract with the local poultry processor and abandoned poultry facilities that she built for $100,000. At the time she abandoned the facilities, her mortgage balance was $85,000. She has a deductible loss of $66,554 (her adjusted basis). If the bank later forecloses on the loan or repossesses the facilities, she will have to figure her gain or loss as discussed, earlier, under Foreclosure or Repossession.

**Personal-use property.** You cannot deduct any loss from abandonment of your home or other property held for personal use.

**Canceled debt.** If the abandoned property secures a debt for which you are personally liable and the debt is canceled, you will realize ordinary income equal to the canceled debt. This income is separate from any loss realized from abandonment of the property. Report income from cancellation of a debt related to a business or rental activity as business or rental income. Report income from cancellation of a nonbusiness debt as miscellaneous income on Form 1040, line 21.

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

**Forms 1099-A and 1099-C.** A lender who acquires an interest in property through a foreclosure, repossession, or abandonment should send you Form 1099-A showing the information you need to figure your loss from the forecloiture, 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
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 24 months or longer.
- **Sale or exchange of other livestock.** This livestock must be held for draft, breeding, dairy, or sporting purposes and held for 12 months or longer. Other livestock includes hogs, mules, sheep, 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

<table>
<thead>
<tr>
<th>Table 9-1. Where to First Report Certain Items on Form 4797</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Type of property</strong></td>
</tr>
</tbody>
</table>
| 1 Depreciable trade or business property:  
  a. Sold or exchanged at a gain  | Part II | Part II | Part III (1245, 1250) | Part I |
  b. Sold or exchanged at a loss | Part II | Part II | Part III (1245, 1250) | Part I |
| 2 Farmland held less than 10 years for which soil, water, or land clearing expenses were deducted:  
  a. Sold at a gain  | Part II | Part II | Part III (1252) | Part I |
  b. Sold at a loss  | Part II | Part II | Part III (1252) | Part I |
| 3 All other farmland | Part II | Part II | Part III (1255) | Part I |
| 4 Disposition of cost-sharing payment property described in section 126 | Part II | Part II | Part III (1245) | Part I |
| 5 Cattle and horses used in a trade or business for draft, breeding, dairy, or sporting purposes:  
  a. Sold at a gain  | Part II | Part II | Part III (1245) | Part I |
  b. Sold at a loss  | Part II | Part II | Part III (1245) | Part I |
  c. Raised cattle and horses sold at a gain  | Part II | Part II | Part III (1245) | Part I |
| 6 Livestock other than cattle and horses used in a trade or business for draft, breeding, dairy, or sporting purposes:  
  a. Sold at a gain  | Part II | Part II | Part III (1245) | Part I |
  b. Sold at a loss  | Part II | Part II | Part III (1245) | Part I |
  c. Raised livestock sold at a gain  | Part II | Part II | Part III (1245) | Part I |

Introduction

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

When you dispose of depreciable property (section 1245 property or section 1250 property) at a gain, you may have to recognize all or part of the gain as ordinary income under the depreciation recapture rules. Any gain remaining after applying the depreciation recapture rules is a section 1231 gain, which may be taxed as a capital gain.

Gains and losses from property used in farming are reported on Form 4797, Sales of Business Property. Table 9-1 contains examples of items reported on Form 4797 and refers to the part of that form on which they first should be reported. Chapter 16, Sample Return, contains a sample filled-in Form 4797.

Topics

This chapter discusses:

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

Useful Items

You may want to see:

- Publication
  - 544 Sales and Other Dispositions of Assets
  - 4797 Sales of Business Property
- Form (and Instructions)

See chapter 17 for information about getting publications and forms.
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 had the property for more than one 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.

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

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 loss, it is an ordinary loss.
- If you have a net section 1231 gain, it is ordinary income up to your nonrecaptured section 1231 losses from previous years, explained next. The rest, if any, is long-term capital gain.

Nonrecaptured section 1231 losses. Your nonrecaptured section 1231 losses are your net section 1231 losses for the previous 5 years that have not been applied against a net section 1231 gain by treating the gain as ordinary income. To determine your net section 1231 gain beginning with the earliest loss in the 5-year period.

Example. In 2007, 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 2002 through 2006 he had the following section 1231 gains and losses.

<table>
<thead>
<tr>
<th>Year</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002</td>
<td>$0</td>
</tr>
<tr>
<td>2003</td>
<td>$0</td>
</tr>
<tr>
<td>2004</td>
<td>($2,500)</td>
</tr>
<tr>
<td>2005</td>
<td>$0</td>
</tr>
<tr>
<td>2006</td>
<td>$1,800</td>
</tr>
</tbody>
</table>

Ben uses this information to figure how to report his net section 1231 gain for 2007 as shown below.

1) Net section 1231 gain (2007) .................. $2,000
2) Net section 1231 loss (2004) .................. ($2,500)
3) Net section 1231 gain (2006) .................. $1,800
4) Remaining net section 1231 loss from prior 5 years ............... ($700)
5) Gain treated as ordinary income .................. $700
6) Gain treated as long-term capital gain .................. $1,100

His remaining net section 1231 loss from 2004 is completely recaptured in 2007.

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 non-taxable) as ordinary income.

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

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.

Defined. Section 1245 property includes any property that is or has been subject to an allowance for depreciation or amortization and that is any of the following types of property:

1. Personal property (either tangible or intangible).
2. Other tangible property (except buildings and their structural components) used as any of the following. See Buildings and structural components below.
   a. An integral part of manufacturing, production, or extraction, or of furnishing transportation, communications, electricity, gas, water, or sewage disposal services.
   b. A research facility in any of the activities in (a).
   c. A facility in any of the activities in (a) for the bulk storage of fungible commodities (discussed below).
3. That part of real property (not included in (2)) with an adjusted basis reduced by (but not limited to) the following.
   a. Amortization of certified pollution control facilities.
   b. The section 179 expense deduction.

- d. Certain expenditures for child care facilities. (Repealed by Public Law 101-58, Omnibus Budget Reconciliation Act of 1990, section 11801(a)(13) except with regards to deductions made prior to November 5, 1990.)
- e. Expenditures to remove architectural and transportation barriers to the handicapped and elderly.
- f. Certain reforestation expenditures.
- 4. Single purpose agricultural (livestock) or horticultural structures.
- 5. Storage facilities (except buildings and their structural components) used in distributing petroleum or any primary product of petroleum.

See Chapter 3 of Publication 544 for more details.

Buildings and structural components. Section 1245 property does not include build-1. Personal property (either tangible or intangible).
2. Other tangible property (except buildings and their structural components) used as
   a. An integral part of manufacturing, production, or extraction, or of furnishing transportation, communications, electricity, gas, water, or sewage disposal services.
   b. A research facility in any of the activities in (a).
   c. A facility in any of the activities in (a) for the bulk storage of fungible commodities (discussed below).
3. That part of real property (not included in (2)) with an adjusted basis reduced by (but not limited to) the following.
   a. Amortization of certified pollution control facilities.
   b. The section 179 expense deduction.
- d. Certain expenditures for child care facilities. (Repealed by Public Law 101-58, Omnibus Budget Reconciliation Act of 1990, section 11801(a)(13) except with regards to deductions made prior to November 5, 1990.)
- e. Expenditures to remove architectural and transportation barriers to the handi- capped and elderly.
- f. Certain reforestation expenditures.
- 4. Single purpose agricultural (livestock) or horticultural structures.
- 5. Storage facilities (except buildings and their structural components) used in dis- tributing petroleum or any primary product of petroleum.

See Chapter 3 of Publication 544 for more details.

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   a. An integral part of manufacturing, production, or extraction, or of furnishing transportation, communications, electricity, gas, water, or sewage disposal services.
   b. A research facility in any of the activities in (a).
   c. A facility in any of the activities in (a) for the bulk storage of fungible commodities (discussed below).
3. That part of real property (not included in (2)) with an adjusted basis reduced by (but not limited to) the following.
   a. Amortization of certified pollution control facilities.
   b. The section 179 expense deduction.
- d. Certain expenditures for child care facilities. (Repealed by Public Law 101-58, Omnibus Budget Reconciliation Act of 1990, section 11801(a)(13) except with regards to deductions made prior to November 5, 1990.)
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- 4. Single purpose agricultural (livestock) or horticultural structures.
- 5. Storage facilities (except buildings and their structural components) used in dis- tributing petroleum or any primary product of petroleum.

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   b. A research facility in any of the activities in (a).
   c. A facility in any of the activities in (a) for the bulk storage of fungible commodities (discussed below).
3. That part of real property (not included in (2)) with an adjusted basis reduced by (but not limited to) the following.
   a. Amortization of certified pollution control facilities.
   b. The section 179 expense deduction.
- d. Certain expenditures for child care facilities. (Repealed by Public Law 101-58, Omnibus Budget Reconciliation Act of 1990, section 11801(a)(13) except with regards to deductions made prior to November 5, 1990.)
- e. Expenditures to remove architectural and transportation barriers to the handi- capped and elderly.
- f. Certain reforestation expenditures.
- 4. Single purpose agricultural (livestock) or horticultural structures.
- 5. Storage facilities (except buildings and their structural components) used in dis- tributing petroleum or any primary product of petroleum.
2. The gain realized on the disposition (the amount realized from the disposition minus the adjusted basis of the property).

For any other disposition of section 1245 property, ordinary income is the lesser of (1) above or the amount by which its fair market value is more than its adjusted basis. For details, see chapter 3 of Publication 544.

Use Part III of Form 4797 to figure the ordinary income part of the gain.

Depreciation claimed on other property or claimed by other taxpayers. Depreciation and amortization include the amounts you claimed on the section 1245 property as well as the following depreciation and amortization amounts:

- Amounts you claimed on property you exchanged for, or converted to, your section 1245 property in a like-kind exchange or involuntary conversion. For details on exchanges of property that are not taxable, see Like-Kind Exchanges in chapter 8.
- Amounts a previous owner of the section 1245 property claimed if your basis is determined with reference to that person's adjusted basis (for example, the donor’s depreciation deductions on property you received as a gift).

**Example.** Jeff Free paid $120,000 for a tractor in 2005. On February 23, 2007, he traded it for a chopper and paid an additional $30,000. To figure his depreciation deduction for the current year, Jeff continues to use the basis of the tractor as he would have before the trade to depreciate the chopper. Jeff can also depreciate the additional $30,000 basis on the chopper.

Depreciation and amortization. Depreciation and amortization deductions that must be recaptured as ordinary income include:

1. Ordinary depreciation deductions.
2. Section 179 deduction (see chapter 7).
3. Any special depreciation allowance.
4. Amortization deductions for all the following costs:
   a. Acquiring a lease.
   b. Lessee improvements.
   c. Pollution control facilities.
   d. Reforestation expenses.
   e. Section 197 intangibles.
   g. Franchises, trademarks, and trade names acquired before August 11, 1993.
5. Deductions for all the following costs:
   a. Removing barriers to the disabled and the elderly.
   b. Tertiary injectant expenses.
   c. Depreciable clean-fuel vehicles and re-fueling property (minus any recaptured deduction).

- Any basis reduction for the investment credit (minus any basis increase for a credit recapture).
- Any basis reduction for the qualified electric vehicle credit (minus any basis increase for a credit recapture).

**Example.** You file your returns on a calendar-year basis. In February 2005, you bought and placed in service for 100% use in your farming business a light-duty truck (5-year property) that cost $10,000. You used the half-year convention and your MACRS deductions for the truck were $1,500 in 2005 and $2,550 in 2006. For the gain on the section 179 expen-

dition deduction for the truck. You sold it in May 2007 for $7,000. The MACRS deduction in 2007, the year of sale, is $893 (1/5 of $1,785). Figure the gain treated as ordinary income as follows:

1) Amount realized: $7,000
2) Cost (February 2005): $10,000
3) Depreciation allowed or allowable (MACRS deductions: $1,500 + $2,550 + $893): 4,943
4) Adjusted basis (subtract line 3 from line 2): $5,057
5) Gain realized (subtract line 4 from line 1): 1,943
6) Gain treated as ordinary income (lesser of line 3 or line 5): $1,943

Depreciation allowed or allowable. You generally use the greater of the depreciation allowed or allowable when figuring the part of the gain to report as ordinary income. If, in prior years, you have consistently taken proper deductions under one method, the amount allowed for your prior years will not be increased even though a greater amount would have been al-
lowed under another proper method. If you did not take any deduction at all for depreciation, your adjustments to basis for depreciation allowable are figured by using the straight line method.

The treatment applies only when figuring what part of the gain is treated as ordinary in-
come under the rules for section 1245 deprecia-
tion recapture.

Disposition of plants and animals. If you elect not to use the uniform capitalization rules (see chapter 6), you must treat any plant you produce as section 1245 property. If you have a gain on the property’s disposition, you must re-
capture the preproductive expenses you would have capitalized if you had not made the choice by treating the gain, up to the amount of these expenses, as ordinary income. For section 1231 transactions, show these expenses as deprecia-
tion 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 be-
cause 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 2007 for $80,000. Her adjusted basis at the time of sale was $60,000. She bought the orchard in 2000, but the trees did not produce a crop until 2003. 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 an allowance for depreciation that is not and never has been section 1245 property. It includes a leasehold of land or section 1250 property subject to an allowance for deprecia-
tion. A fee simple interest in land is not section 1250 property because, like land, it is not depre-
ciable.

Gain on the disposition of section 1250 prop-
erty 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 dis-
pensed 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 prop-
erty in service after 1986 (or after July 31, 1986, if the choice to use MACRS was made) and you held it longer than 1 year. These properties are depreciated us-

**Installment Sale**

If you report the sale of property under the install-
ment method, any depreciation recapture under section 1245 or 1250 is taxable as ordi-

nary 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 pur-
pose, include the recapture income in your in-
stallment 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 recap-
ture 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 deprecia-
ble property:

- By gift.
- At death.
that are fully deductible in 2007. The applicable percentage is based on the length of time you hold the 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 expenditures for the land, as discussed in chapter 5, you must treat part of the gain as ordinary income and treat the balance as section 1231 gain.

**Exceptions.** Do not treat gain on the following transactions as gain on section 1252 property:

- Disposition of farmland by gift.
- Transfer of farm property at death (except for income in respect of a decedent). For more information, see 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 tax treatment of the gain or loss on the sale of each class of assets is determined by its classification as a capital asset, as property used in the business, or as property held for sale in the business.) Separate computations must be made to figure the ordinary income part of a gain from the sale, exchange, or involuntary conversion of section 1252 property and section 1255 property.

**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 acquire it, the applicable percentage is reduced by 20% 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, 2000. On October 3, 2007, you sold the land at a $30,000 gain. Between January 1 and October 3, 2007, you make soil and water conservation expenditures of $15,000 for the land that are fully deductible in 2007. 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 chose not to exclude these payments, you will not have to recognize ordinary income under this provision.

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

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

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

**Publication 535** Accounting Periods and Methods

**Publication 538** Accounting Periods and Methods

**Publication 544** Accounting Periods and Methods

**Publication 6252** Installment Sale Income

**Publication 4797** Sales of Business Property

**Publication 523** Selling Your Home

**Publication 535** Business Expenses

This chapter discusses:

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

**Useful Items**

- You may want to see:
  - **Publication**
  - **Form (and Instructions)**
  - **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 property for which you must maintain an 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, as property used in the business, or as property held for sale and by the length of time the asset was 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 installment method, any depreciation recapture under section 1245 or 1250 of the Internal Revenue Code is generally taxable as ordinary income in the year of sale. See Depreciation recapture, later. This applies even if no payments are received in that year.

**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.
If inventory items are included in an installment sale, the gain must be reported under the installment method unless you elect out of using the installment method. See Electing out of the installment method later, for information on recognizing the entire gain in the year of sale.

Sale at a loss. If your sale results in a loss, you cannot use the installment method. If the loss is on an installment sale of business assets, you can elect it only in the tax year of the 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 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. However, any payments received by the seller within 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.

More information. For more information on the disposition of an installment obligation, see Publication 537.

Inventory. If you are not required to maintain an inventory, you may be able to use the installment method to report the sale of property you use or produce in your farming business. For examples of farm inventory, see Farm Inventory in chapter 2.

The sale of farm inventory items cannot be reported on the installment method. All gain or loss on their sale must be reported in the year of sale, even if you receive payment in later years.

If 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 6
7. Enter the contract price for the property
8. Divide line 6 by line 7

Figuring Installment Sale Income

Each payment on an installment sale usually consists of the following three parts:

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

In each year you receive a payment, you must include 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 unreported 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 still have to figure your basis. See Adjusting for the installment method, later.

Adjusted basis. Basis is the amount of your investment in the property for installment sale purposes. The way you figure basis depends on how you acquire the property. The basis of property you buy is generally its cost. The basis of

yield on the sale needs to be figured as interest.

For more information on

Converting non-interest-bearing notes. If you receive non-interest-bearing notes in a sale, you must report the gain on the sale as interest income. If the non-interest-bearing note is assigned to a third party, the buyer must report it as interest income. See Electing out of the installment method, later, for more information.

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 return payments received, or considered received because of related party resales, in later years.

Attach it to your tax return for each year.

Keep for Your Records

Figuring Installment Sale Income

Each payment on an installment sale usually consists of the following three parts:

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

In each year you receive a payment, you must include 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 unreported 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 still have to figure your basis. See Adjusting for the installment method, later.

Adjusted basis. Basis is the amount of your investment in the property for installment sale purposes. The way you figure basis depends on how you acquire the property. The basis of property you buy is generally its cost. The basis of...
property you inherit, receive as a gift, build your-
self, or receive in a tax-free exchange is figured differ-
entially.

While you own property, various events may change
your original basis. Some events, such as adding rooms
or making permanent improve-
ments, increase basis. Others, such as deducti-
ble casualty losses or depreciation previously
allowed or allowable, decrease basis. The result
is adjusted basis.

**Selling expenses.** Selling expenses are
any expenses that relate to the sale of the prop-
erty. They include commissions, attorney fees,
and any other expenses paid on the sale. Selling
expenses are added to the basis of the sold
property.

**Depreciation recapture.** If the property you
sold was depreciable property, you may need to
recapture part of the gain on the sale as ordinary
income. See Depreciation Recapture Income in
Publication 537.

**Gross profit.** Gross profit is the total gain
you report on the installment method.

To figure your gross profit, subtract your ad-
justed 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, plus
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 per-
centage of each payment (after subtracting in-
stallment sale income) is reported as installment sale income. This percentage is called the gross profit per-
centage and is figured by dividing your gross profit from the sale by the contract price.

The gross profit percentage generally re-
mains 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 and your gross profit is $1,500.
Your gross profit percentage is 25% ($1,500 ÷ $6,000). After subtracting interest, you report 25% of each payment, including the down pay-
ment, 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 Re-
ceived or Considered Received, later.

### Sale of depreciable property

You gener-
ally cannot report gain from the sale of deprecia-
ble property to a related person on the installment method. See Sale to a Related Per-
son in Publication 537.

You cannot use the installment method to report any recapture income up to the gain on the sale. However, report any gain greater than the recapture income on the install-
ment 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

TIP

If you sell depreciable business prop-
erty, prepare Form 4797 first in order to
figure the amount to enter on line 12 of Part I, Form 6252. See the Form 6252 instruc-
tions for details.

For more information on the section 179 de-
duction, see Section 179 Deduction in chapter 7.

**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 pay-
ments. Refigure your gross profit using Work-
sheet B, New Gross Profit Percentage — Selling Price Reduced. You will spread any re-
mainin gain over future installments.

### Worksheet B. New Gross Profit Percentage — Selling Price Reduced

<table>
<thead>
<tr>
<th>Step</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Enter the reduced selling price for the property.</td>
</tr>
<tr>
<td>2.</td>
<td>Enter your adjusted basis for the property.</td>
</tr>
<tr>
<td>3.</td>
<td>Enter your selling expenses.</td>
</tr>
<tr>
<td>4.</td>
<td>Enter any depreciation recapture.</td>
</tr>
<tr>
<td>5.</td>
<td>Add lines 2, 3, and 4.</td>
</tr>
<tr>
<td>6.</td>
<td>Subtract line 5 from line 1.</td>
</tr>
<tr>
<td>7.</td>
<td>Enter any installment sale income reported in prior year(s).</td>
</tr>
<tr>
<td>8.</td>
<td>Subtract line 7 from line 6.</td>
</tr>
<tr>
<td>9.</td>
<td>Enter future installments.</td>
</tr>
<tr>
<td>10.</td>
<td>Divide line 8 by line 9.</td>
</tr>
</tbody>
</table>

This is your new gross profit percentage.

### Example

In 2005, you sold land with a ba-
sis 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 2005 and 2006.

In 2007, you and the buyer agreed to reduce the purchase price to $85,000 and payments during 2007, 2008, and 2009 are reduced to
$15,000 for each year.

The new gross profit percentage, 46.67%, is figured in Worksheet B.

You will report a gain of $7,000 (46.67% of
$15,000) on each of the $15,000 installments due in 2007, 2008, and 2009.

### Example

<table>
<thead>
<tr>
<th>Step</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Enter the reduced selling price for the property.</td>
</tr>
<tr>
<td>2.</td>
<td>Enter your adjusted basis for the property.</td>
</tr>
<tr>
<td>3.</td>
<td>Enter your selling expenses.</td>
</tr>
<tr>
<td>4.</td>
<td>Enter any depreciation recapture.</td>
</tr>
<tr>
<td>5.</td>
<td>Add lines 2, 3, and 4.</td>
</tr>
<tr>
<td>6.</td>
<td>Subtract line 5 from line 1.</td>
</tr>
<tr>
<td>7.</td>
<td>Enter any installment sale income reported in prior year(s).</td>
</tr>
<tr>
<td>8.</td>
<td>Subtract line 7 from line 6.</td>
</tr>
<tr>
<td>9.</td>
<td>Enter future installments.</td>
</tr>
<tr>
<td>10.</td>
<td>Divide line 8 by line 9.</td>
</tr>
</tbody>
</table>

This is your new gross profit percentage.

### TIP

Apply this percentage to all future payments to determine how much of each of those payments is installment sale income.
Payments Received or Considered Received

You must figure your gain each year on the payments you receive, or are treated as receiv-
ing, 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 situa-
tions 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 as-
sumption 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, you are treated as having received a payment to you in the year of sale. Include these expenses in the selling and contract prices when figuring the gross profit percentage.

Buyer assumes mortgage. If the buyer as-
sumes or pays off your mortgage, or otherwise takes the property subject to the mortgage, the following rules apply.

Mortgage less than basis. If the buyer assumes a mortgage that is not more than your installment sale basis in the property, it is not considered a payment to you. It is considered a recovery of your basis. The contract price is the selling price minus the mortgage.

Example. You sell property with an ad-
justed basis of $19,000. You have selling ex-
penses of $1,000. The buyer assumes your existing mortgage of $15,000 and agrees to pay
you $10,000 (a cash down payment of $2,000 and $2,000 (plus 12% interest) in each of the next 4 years).
The selling price is $25,000 ($15,000 + $10,000). Your gross profit is $5,000 ($25,000 - $20,000 installment sale basis). The contract price is $10,000 ($25,000 - $15,000 mortgage). Your gross profit percentage is 50% ($5,000 / $10,000). You report half of each $2,000 pay-
ment received as gain from the sale. You also report all interest you receive as ordinary in-
come.

Mortgage more than basis. If the buyer assumes a mortgage that is more than your installment sale basis in the property, you re-
cover your entire basis. The part of the mortgage greater than your basis is treated as a payment received in the year of sale.

To figure the contract price, subtract the mortgage from the selling price. This is the total amount you will receive directly from the buyer. Add to this amount the payment you are consid-
idered to have received (the difference between the mortgage and your installment sale basis). The contract price is the same as your gross profit from the sale.

If the mortgage the buyer assumes is equal to or more than your installment sale basis, the gross profit percentage always will be 100%.

Example. The selling price for your property is $25,000. The buyer will pay you $1,000 annu-
ally (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 install-
ment sale basis of $5,000. The part of the mort-
gage 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 con-
tract price is $4,000:

Selling price ............... $9,000
 Minus: Mortgage ............... (6,000)
 Amount actually received ........... $3,000
 Add difference:
 Mortgage ............... $6,000
 Minus: Installment sale basis ............... (5,000)
 Contract price ............... $4,000

Your gross profit on the sale is also $4,000: Seling price ............... $9,000
 Minus: Installment sale basis ............... (5,000)
 Gross profit ............... $4,000

Your gross profit percentage is 100%. Re-
port 100% of each payment (less interest) as gain from the sale. Treat the $1,000 difference between the mortgage and your installment sale basis as a payment and report 100% of it as gain in the year of sale.

Buyer assumes other debts. If the buyer as-
sumes any other debts, such as a loan or back taxes, it may be considered a payment to you in the year of sale.

If the buyer assumes the debt instead of paying it off, only part of it may have to be treated as a payment. Compare the debt to your installment sale basis in the property being sold. If the debt is less than your installment sale basis, none of it is treated as a payment. If it is more, only the difference is treated as a pay-
ment. If the buyer assumes more than one debt, any part of the total that is more than your installment sale basis is treated as a payment. These rules are the same as the rules discussed earlier under Buyer assumes mortgage. How-
you apply them to the following types of debt the buyer assumes:

- Those acquired from ownership of the property you are selling, such as a mort-
gage, lien, overdue interest, or back taxes.
- Those acquired in the ordinary course of your business, such as a balance due for inventory you purchased.

If the buyer assumes any other type of debt, such as a personal loan or your legal fees relat-
ing to the sale, it is treated as if the buyer had paid off the debt at the time of the sale. The value of the assumed debt is then considered a payment to you in the year of sale.

Property used as a payment. If you receive property rather than money from the buyer, it is still considered a payment in the year received. However, see Trading property for like-kind property, earlier. Generally, the amount of the payment is the property’s FMV on the date you receive it.

Exception. If the property the buyer gives you is payable on demand or readily tradable, the amount you should consider as payment in the year received is:

- The FMV of the property on the date you receive it if you use the cash receipts and disbursements method of accounting.
- The face amount of the obligation on the date you receive it if you use the accrual method of accounting, or
- The stated redemption price at maturity less any original issue discount (OID) or, if there is no OID, the price at maturity appropriately discounted to reflect total unstated interest. See Un-
stated interest, later.

Debt not payable on demand. Any evi-
cence 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 or a financial institution.

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. Exclude this 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, the bond has interest coupons attached or can be readily traded in an established securities mar-
et, 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-
tact may provide that each deferred payment on 
the sale will include interest or that there will 
be an interest payment in addition to the prin-
cipal 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-
pplies to the contract, this interest is called or-
iginal issue discount (OID).

In general, an installment sale contract pro-
vides for adequate stated interest if the stated 
interest rate (based on an appropriate com-
pounding period) is at least equal to the ap-
picable 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 

Generally, if a buyer gives a debt in consider-
ation for personal use property, the unstated 
interest rules do not apply. Therefore, the buyer 
cannot deduct the unstated interest. The seller 
must report the unstated interest as income. 
Personal-use property is any property in which 
substantially all of its use by the buyer is not in 
connection with a trade or business or an invest-
ment activity.

If the debt is subject to the IRC section 483 
rules and is also subject to the below-market 
loan rules, such as a gift loan, compensa-
tion-related loan or corporation-shareholder 
loan, then both parties are subject to the be-
low-market loan rules rather than the unstated 
interest rules.

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, 2007, 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 2007. Your selling 
expenses were $15,000.

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

<table>
<thead>
<tr>
<th>Asset</th>
<th>Depreciation Claimed</th>
<th>Adjusted Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Home</td>
<td>$0</td>
<td>$30,000</td>
</tr>
<tr>
<td>Buildings</td>
<td>$31,500</td>
<td>28,500</td>
</tr>
<tr>
<td>Truck</td>
<td>3,001</td>
<td>1,499</td>
</tr>
<tr>
<td>Equipment</td>
<td>15,811</td>
<td>9,189</td>
</tr>
<tr>
<td>Tractor</td>
<td>15,811</td>
<td>9,189</td>
</tr>
<tr>
<td>Cattle*</td>
<td>1,977</td>
<td>2,023</td>
</tr>
<tr>
<td>Cattle**</td>
<td>19,167</td>
<td>833</td>
</tr>
</tbody>
</table>

* Owned and used as main home for at least 2 
of the 5 years prior to the sale
** Held less than 2 years or more

Gain on each asset. The following schedule 
does not show the assets included in the sale, each 
asset’s selling price based on its respective 
value, the selling expense allocated to each asset, 
the adjusted basis of each asset, and the gain on each asset. The selling expense for each asset is 5% of the selling price ($15,000 selling expense - $300,000 selling price). The livestock and produce held for sale were sold in 2006 in anticipation of selling the farm. The section 179 deduction was not claimed on any asset.

<table>
<thead>
<tr>
<th>Selling Price</th>
<th>Selling Adjusted Price</th>
<th>Basis</th>
<th>Gain</th>
</tr>
</thead>
<tbody>
<tr>
<td>Home*</td>
<td>$50,000</td>
<td>$2,500</td>
<td>$30,000</td>
</tr>
<tr>
<td>Land</td>
<td>125,000</td>
<td>6,250</td>
<td>61,250</td>
</tr>
<tr>
<td>Buildings</td>
<td>55,000</td>
<td>2,750</td>
<td>28,500</td>
</tr>
<tr>
<td>Truck</td>
<td>5,000</td>
<td>250</td>
<td>1,499</td>
</tr>
<tr>
<td>Equip.</td>
<td>17,000</td>
<td>850</td>
<td>9,189</td>
</tr>
<tr>
<td>Tractor</td>
<td>23,000</td>
<td>1,150</td>
<td>9,189</td>
</tr>
<tr>
<td>Cattle*</td>
<td>5,000</td>
<td>250</td>
<td>2,023</td>
</tr>
<tr>
<td>Cattle**</td>
<td>20,000</td>
<td>1,000</td>
<td>833</td>
</tr>
</tbody>
</table>

* Owned and used as main home for at least 2 of the 5 years prior to the sale
** Held less than 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 
methods.

Special rules may apply when you sell sec-
tion 1250 assets depreciated under the 
straight line method. See the Unrecaptured Section 
1250 Gain Worksheet in the instructions for 
Schedule D (Form 1040).

The truck used for hauling is section 1245 
property. The entire depreciation of $3,001 is 
recapture income because it is less than the 
gain on the truck. The remaining gain of $250 is 
reported on the installment method.

The equipment and tractor are section 1245 
property. The entire gain on each ($6,961 and 
$12,661, respectively) is depreciation recapture income.

The cattle used for breeding and held for less 
than 2 years are section 1245 property. The 
entire depreciation of $1,977 is recapture income 
because it is less than the gain. The re-
mainingly 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 depre-
ciation claimed ($19,167), the total gain is de-
preciation recapture income.

The total depreciation recapture income fig-
ured in Part III of Form 4797 is $42,767. (This is 
the sum of: $3,001 + $6,961 + $12,661 + $1,977 
+ $18,167.) Depreciation recapture income is 
reported as ordinary income in the year of sale 
even if no payments were received.

The part of the gain reported as depreciation 
recapture income on the truck and the cattle 
held less than 2 years ($3,001 and $1,977) is 
added to the adjusted basis of each property 
when making the installment sale computations.

Assets not reported on the installment 
method. In the year of sale, the gain on the 
cattle held 2 years or more, the equipment, 
and the tractor is reported in full. Because the entire 
gain on the home can be excluded from income, 
the installment method does not apply to the 
sale of the home. See Sale of your home in 
chapter 8. The selling price of these assets 
($110,000) is subtracted from the total selling 
price ($300,000). The selling price for the assets 
included in the installment sale is $190,000.

Installment sale basis and gross profit. 
The following table shows each asset reported on 
the installment method, its selling price, install-
ment sale basis, and gross profit.

<table>
<thead>
<tr>
<th>Selling Price</th>
<th>Sale Basis</th>
<th>Gross Profit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Farm land</td>
<td>$125,000</td>
<td>$67,500</td>
</tr>
<tr>
<td>Buildings</td>
<td>55,000</td>
<td>31,250</td>
</tr>
<tr>
<td>Truck</td>
<td>5,000</td>
<td>4,750</td>
</tr>
<tr>
<td>Cattle*</td>
<td>5,000</td>
<td>4,250</td>
</tr>
</tbody>
</table>

$190,000 $107,750 $82,250

* Held less than 2 years

Section 1231 gains. The ordinary income 
part of the gain on the truck is reported in the 
year of sale, so the remaining gain ($250) and 
the gain on the land and buildings are reported 
as section 1231 gains. The cattle held for less 
than 2 years do not qualify for section 1231 
treatment. The $750 gain on their sale is re-
ported as ordinary gain in Part II of Form 4797 
as payments are received. See Section 1231 
Gains and Losses in chapter 9.

Contract price and gross profit percentage. 
The contract price is $140,000 for the part of 
the sale reported on the installment method. This 
is the selling price ($300,000) minus the mortgage 
assumed ($50,000) minus the selling price of 
the assets with gains fully reported in the year of 
sale or excluded from income ($110,000).

The gross profit percentage for the sale is 
58.75% ($82,250 gross profit / $140,000 con-
tact price). The gross profit percentage for each 
asset is figured as follows:

<table>
<thead>
<tr>
<th>Asset</th>
<th>Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Farm land ($57,500 + $140,000)</td>
<td>41.0714</td>
</tr>
<tr>
<td>Buildings ($23,750 + $140,000)</td>
<td>16.9643</td>
</tr>
<tr>
<td>Truck ($250 + $140,000)</td>
<td>0.1786</td>
</tr>
<tr>
<td>Cattle* ($750 + $140,000)</td>
<td>0.5357</td>
</tr>
<tr>
<td>Total</td>
<td>58.75</td>
</tr>
</tbody>
</table>

* Held less than 2 years

Chapter 10

Installment Sales

Page 63
Figuring the gain to report on the installment method. Only 56% of each payment is reported on the installment method ($140,000 contract price = $250,000 to be received on the sale ($300,000 selling price – $50,000 mortgage assumed)). The total amount received on the installment sale in 2007 is $75,000 ($50,000 down payment + $25,000 payment on July 1). The installment sale part of the total payments received in 2007 is $42,000 ($75,000 × 58.75%). Figure the gain to report for each asset by multiplying its gross profit percentage times $42,000.

**Summary.** The installment income (rounded to the nearest dollar) from the sale of the farm is reported as follows:

<table>
<thead>
<tr>
<th>Gain reported in 2007 (year of sale)</th>
<th>$24,675</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gain reported in 2008:</td>
<td>$16,450</td>
</tr>
<tr>
<td>Gain reported in 2009:</td>
<td>$16,450</td>
</tr>
<tr>
<td>Gain reported in 2010:</td>
<td>$16,450</td>
</tr>
<tr>
<td>Gain reported in 2011:</td>
<td>$16,450</td>
</tr>
<tr>
<td>Total gain reported</td>
<td>$82,250</td>
</tr>
</tbody>
</table>

* Held less than 2 years

**Reporting the sale.** Report the installment sale on Form 6252. Then report the amount on Form 6252 on Form 4797 and Schedule D (Form 1040). Attach a separate page to Form 6252 that shows the computations in the example.

**If you sell depreciable business property, prepare Form 4797 first in order to figure the amount to enter on line 12 of Part I, Form 6252.**

### Section 1231 gains

The gains on the land, buildings, and truck are section 1231 gains. They may be reported as either capital or ordinary gain depending on the net balance when combined with other section 1231 losses. The gain on cattle is capital gain and a net 1231 loss is an ordinary loss.

**Depreciation recapture and gain on cattle.** The depreciation recapture income on Form 4797. The $225 gain on the cattle held less than 2 years is ordinary income reported in Part II of Form 4797. See Table 9-1 in chapter 9.

**Instalment income for years after 2007.** You figure instalment income for the years after 2007 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 ($56,000 × 50%). You realize income as follows:

| Gain reported in 2008:              | $16,450|
| Gain reported in 2009:              | $16,450|
| Gain reported in 2010:              | $16,450|
| Gain reported in 2011:              | $16,450|
| Total gain reported                  | $82,250|

* 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 continue 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.

**Casualties, Thefts, and Condemnations**

**Introduction**

This chapter explains the tax treatment of casualties, thefts, and condemnations. A casualty occurs when property is damaged, destroyed, or lost due to a sudden, unexpected, or unusual event. A theft occurs when property is stolen. A condemnation occurs when private property is legally taken for public use without the owner's consent. A casualty, theft, or condemnation may result in a deductible loss or taxable gain on your federal income tax return. You may have a deductible loss or a taxable gain even if only a portion of your property was affected by a casualty, theft, or condemnation.

**An involuntary conversion occurs when you receive money or other property as reimbursement for a casualty, theft, condemnation, disposition of property under threat of condemnation, or certain other events discussed in this chapter.** If an involuntary conversion results in a gain 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 may have a taxable gain.

**Casualty.** A casualty is the damage, destruction, or loss of property resulting from an identifiable event that is sudden, unexpected, or unusual.

**Deductible losses.** Deductible casualty losses can result from a number of different causes, including the following:

- **Airplane crashes.**
- **Car, 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.**
Nondeductible losses. A casualty loss is not deductible if the damage or destruction is caused by the following:

- Storms, including hurricanes and tornadoes.
- 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 striped 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 disease may cause another type of involuntary conversion. See Other Involuntary Conversions, later.

Theft. A theft is the taking and removing of money or property with the intent to deprive the owner of it. The taking of property must be illegal under the law of the state where it occurred and it must have been done with criminal intent. Theft includes the taking of money or property by the following means:

- Blackmail.
- Burglary.
- Embezzlement.
- Extortion.
- Kidnapping for ransom.
- Larceny.
- Robbery.
- Threats.

The taking of money or property through fraud or misrepresentation is theft if it is illegal under state or local law.

Decline in market value of stock. You cannot deduct as a theft loss the decline in market value of stock acquired on the open market for investment if the decline is caused by disclosure of accounting fraud or other illegal misconduct by the officers or directors of the corporation that issued the stock. However, you can deduct as a capital loss the loss you sustain when you sell or exchange the stock or the stock becomes completely worthless. You report a capital loss on Schedule D (Form 1040). For more information about stock sales, worthless stock, and capital losses, see chapter 4 of Publication 550.

Mislated or lost property. The simple disappearance of money or property is not a theft. However, an accidental loss or disappearance of property can qualify as a casualty if it results from an identifiable event that is sudden, unexpected, or unusual.

Example. A car door is accidentally slammed on your hand, breaking the setting of your diamond ring. The diamond falls from the ring and is never found. The loss of the diamond is a casualty.

Farming Losses
You can deduct certain casualty or theft losses that occur in the business of farming. The following is a discussion of some losses you can deduct and some you cannot deduct.

Livestock or produce bought for resale. Casualty 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 2 years or more, 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 destroyed your barn, or you lost 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:

- You use inventories to determine your income and you included the animals in your inventory.
- You capitalized the expenses associated with the animals under the uniform capitalization rules and therefore have a tax basis in the animals subject to a casualty or theft.

When you include livestock in inventory, its last inventory value is its basis. When you lose an inventoried animal held for draft, breeding, dairy, or sport by casualty or theft during the year, decrease ending inventory by the amount you included in inventory for the animal. You cannot take a separate deduction.

How To Figure a Loss
How you figure a deductible casualty or theft loss depends on whether the loss was to farm or personal-use property and whether the property was stolen or partly or completely destroyed.

Farm property. Farm property is the property you use in your farming business. If your farm property was completely destroyed or stolen, your loss is figured as follows:

- Your adjusted basis in the property: MINUS
- Any salvage value: MINUS
- Any insurance or other reimbursement you receive or expect to receive

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 in the personal-use property section, 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.
## Casualties, Thefts, and Condemnations

**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.

Adj usted basis is your basis (usually cost) increased or decreased by various events, such as improvements and casualty losses. For more information about adjusted basis, see chapter 6.

### Decrease in fair market value (FMV).

The decrease in FMV is the difference between the property’s value immediately before the casualty or theft and its value immediately afterward. FMV is defined in chapter 10 under Payments Received or Considered Received.

#### Appraisal.

To figure the decrease in FMV because of a casualty or theft, you generally need a competent appraisal. But other measures, such as the cost of cleaning up or making repairs (discussed next) can be used to establish decreases in FMV.

An appraisal to determine the difference between the FMV of the property immediately before a casualty or theft and immediately afterward should be made by a competent appraiser. The appraiser must recognize the effects of any general market decline that may occur along with the casualty. This information is needed to limit any deduction to the actual loss resulting from damage to the property.

### Cost of cleaning up or making repairs.

The cost of cleaning up after a casualty is not part of a casualty loss. Neither is the cost of repairing damaged property after a casualty. But you can use the cost of cleaning up or making repairs after a casualty as a measure of the decrease in FMV if you meet all the following conditions.

- The repairs are actually made.
- The repairs are necessary to bring the property back to its condition before the casualty.
- The amount spent for repairs is not excessive.
- The repairs fix the damage only.
- The value of the property after the repairs is not, due to the repairs, more than the value of the property before the casualty.

### Related expenses.

The incidental expenses due to a casualty or theft, such as expenses for the treatment of personal injuries, temporary housing, or a rental car, are not part of your casualty or theft loss. However, they may be deductible as farm business expenses if the damaged or stolen property is farm property.

### Separate computations for more than one item of property.

Generally, if a single casualty or theft involves more than one item of property, you must figure your loss separately for each item of property. Then combine the losses to determine your total loss.

### 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 $14,000 just before the fire and $10,000 immediately afterward. The barn had an adjusted basis of $28,000. Its FMV was $55,000 just before the fire and $25,000 immediately afterward. You received insurance reimbursements of $2,100 on the tractor and $26,000 on the barn. Figure your deductible casualty loss separately for the two items of property.

<table>
<thead>
<tr>
<th>Tractor</th>
<th>Barn</th>
</tr>
</thead>
<tbody>
<tr>
<td>1) Adjusted basis</td>
<td>$3,300</td>
</tr>
<tr>
<td>2) FMV before fire</td>
<td>$14,000</td>
</tr>
<tr>
<td>3) FMV after fire</td>
<td>$10,000</td>
</tr>
<tr>
<td>4) Decrease in FMV (line 2 – line 3)</td>
<td>$18,000</td>
</tr>
<tr>
<td>5) Loss (lesser of line 1 or line 4)</td>
<td>$3,300</td>
</tr>
<tr>
<td>6) Minus: Insurance</td>
<td>2,100</td>
</tr>
<tr>
<td>7) Deductible casualty loss</td>
<td>$1,200</td>
</tr>
<tr>
<td>8) Total deductible casualty loss</td>
<td>$3,200</td>
</tr>
</tbody>
</table>

### 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 2007, 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) Loss before storm | $130,000 |
| 3) FMV after 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 | 0 |
| 7) Amount of loss | $4,000 |

### 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 in the same tax year.

**Do not subtract from your loss any insurance payments you receive for living expenses if you lose the use of your main home or are denied access to it because of a casualty. You may have to include a portion of these payments in your income.** See Publication 547 for details.

#### Disaster relief.

Food, medical supplies, and other forms of assistance you receive do not reduce your casualty loss. See Table 1 for information on how to calculate the disaster relief you receive and its effect on your income tax return. In some cases, disaster relief payments may not be taxable income. See 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 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 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.

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**TIP**

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.

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**Related expenses.**

The incidental expenses due to a casualty or theft, such as expenses for the treatment of personal injuries, temporary housing, or a rental car, are not part of your casualty or theft loss. However, they may be deductible as farm business expenses if the damaged or stolen property is farm property.
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 on repairs to restore your property to its pre-casualty condition increase your adjusted basis. See Adjusted Basis in chapter 6 for more information.

Deduction Limits on Losses of Personal-Use Property

Casualty and theft losses of property held for personal use may be deductible if you itemize deductions on Schedule A (Form 1040).

There are two limits on the deduction for casualty or theft loss of personal-use property. You figure these limits on Form 4684.

$100 rule. You must reduce each casualty or theft loss on personal-use property by $100. This rule applies after you have subtracted any reimbursement.

10% rule. You must further reduce the total of all your casualty or theft losses on personal-use property by 10% of your adjusted gross income. Apply this rule after you reduce each loss by $100. Adjusted gross income is on line 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:

1. Loss after insurance .................. $2,000
2. Subtract $100 ...................... 100
3. Loss after $100 rule ................ $1,900
4. Subtract 10% x $57,000 AGI ...... $5,700
5. Theft loss deduction ............... 1,900

You do not have a theft loss deduction because your loss ($1,900) is less than 10% of your adjusted gross income ($5,700).

If you have a casualty or theft gain in addition to a loss, you will have to make a special computation before you figure your 10% limit. See 10% Rule in Publication 547.

When Loss Is Deductible

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 discovered your property was stolen. However, losses in Presidential 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 can deduct a loss on the property in the year your liability for the loss is fixed. This is true even if the loss occurred or the liability was paid in a different year. You are not entitled to a deduction until your liability under the lease can be determined with reasonable accuracy. Your liability can be determined when a claim for recovery is settled, adjudicated, or abandoned.

Example. Robert leased a tractor from First Implement, Inc., for use in his farm business. The tractor was destroyed by a tornado in June 2007. 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 2008, 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 2008. He can claim the $20,000 as a loss on his 2008 tax return.

Net operating loss (NOL). If your deductions, including casualty or theft loss deductions, are more than your income for the year, you may have an NOL. An NOL can be carried back or carried forward and deducted from income in other years. See Publication 536 for more information on NOLs.

Proof of Loss

To deduct a casualty or theft loss, you must be able to prove that there was a casualty or theft. You must have records to support the amount you claim for the loss.

Casualty loss proof. For a casualty loss, your records should show all the following information:

• The type of casualty (car accident, fire, storm, etc.) and when it occurred.
• That the loss was a direct result of the casualty.
• That you were the owner of the property or, if you leased the property from someone else, that you were contractually liable to the owner for the damage.
• Whether a claim for reimbursement exists for which there is a reasonable expectation of recovery.

Thief 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 that was used to pay off a mortgage or other lien on the damaged, destroyed, or stolen property.

Example. A tornado severely damaged your barn. The adjusted basis of the barn was $25,000. Your insurance company reimbursed you $40,000 for the damaged barn. However, you had legal expenses of $2,000 to collect that insurance. Your insurance minus your expenses to collect the insurance is more than your adjusted basis in the barn, so you have a gain.

1) Insurance reimbursement ............. $40,000
2) Legal expenses .......................... 2,000
3) Amount received (line 1 – line 2) ........ $38,000
4) Adjusted basis ..................... 25,000
5) Gain on casualty (line 3 – line 4) $13,000

Other Involuntary Conversions

In addition to casualties and thefts, other events cause involuntary conversions of property. Some of these are discussed in the following paragraphs.

Gain or loss from an involuntary conversion of your property is usually recognized for tax purposes. You report the gain or deduct the loss on your tax return for the year you realize it. However, depending on the type of property you receive, you may not have to report your gain on the involuntary conversion. See Postponing Gain, later.

Condemnation

Condemnation is the process by which private property is legally taken for public use without the owner’s consent. The property may be taken by the federal government, a state government, a political subdivision, or a private organization that has the power to legally take property. The owner receives a condemnation award (money or property) in exchange for the property taken. A condemnation is a forced sale, the owner being the seller and the condemning authority being the buyer.

Threat of condemnation. Treat the sale of your property under threat of condemnation as a condemnation, provided you have reasonable grounds to believe that your property will be condemned.

Main home condemned. If you have a gain because your main home is condemned, you generally can exclude the gain from your income.
as if you had sold or exchanged your home. For information on this exclusion, see Publication 523. If your gain is more than the amount you can exclude, but you buy replacement property, you may be able to postpone reporting the excess gain. See Postponing Gain, later. (You cannot deduct a loss from the condemnation of your main home.)

More information. For information on how to figure the gain or loss on condemned property, see chapter 1 in Publication 544. Also see Postponing Gain, later, to find out if you can postpone reporting the gain.

Irrigation Project

The sale or other disposition of property located within an irrigation project to conform to the acreage limits of federal reclamation laws is an involuntary conversion.

Livestock Losses

Diseased livestock. If your livestock die from disease, or are destroyed, sold, or exchanged because of disease, even though the disease is not of epidemic proportions, treat these occurrences as involuntary conversions. If the livestock was raised or purchased for resale, follow the rules for livestock discussed earlier under Farming Losses. Otherwise, figure the gain or loss from these conversions using the rules discussed under Determining Gain or Loss in chapter 8. If you replace the livestock, you may be able to postpone reporting the gain. See Postponing Gain, later.

Reporting dispositions of diseased live-
tock. If you choose to postpone reporting gain on the disposition of diseased livestock, you must attach a statement to your return explaining that the livestock was disposed of because of disease. You must also include other information on this statement. See How To Post-
poning Gain, later, under Postponing Gain.

Weather-related sales of livestock. If you sell or exchange livestock (other than poultry) held for draft, breeding, or dairy purposes solely because of drought, flood, or other weather-related conditions, treat the sale or exchange as an involuntary conversion. Only livestock sold in excess of the number you normally would sell under usual business practice, in the absence of weather-related conditions, are considered involuntary conversions. Figure the gain or loss using the rules discussed under Determining Gain or Loss in chapter 8. If you replace the livestock, you may be able to postpone reporting the gain. See Postponing Gain, later.

Example. It is usual business practice to sell five of your dairy animals during the year. This year you sold 20 dairy animals because of drought. The sale of 15 animals is treated as an involuntary conversion.

If you do not replace the livestock, you may be able to report the gain in the following year’s income. This rule also applies to other livestock (including poultry). See Sales Caused by Weather-Related Conditions in chapter 3.

Tree Seedlings

If, because of an abnormal drought, the failure of planted tree seedlings is greater than normally anticipated, you may have a deductible loss. Treat the loss as a loss from an involuntary conversion. The loss is figured in the same way as a loss from any other capi-
talized reforestation costs you had to duplicate on replanting. You deduct the loss on the return for the year the seedlings died. If you took the investment credit for any of these costs, you may have to recapture all or part of the credit.

Form 4255, Recapture of Investment Credit.

Postponing Gain

Do not report a gain if you receive reimburse-
ment in the form of property similar or related in service or use to the destroyed, stolen, or other involuntarily converted property. Your basis in the new property is generally the same as your adjusted basis in the property it replaces.

You must ordinarily report the gain on your stolen, destroyed, or other involuntarily con-
verted property if you receive money or unlike property as reimbursement. However, you can choose to postpone reporting the gain if you purchase replacement property similar or related in service or use to your destroyed, stolen, or other involuntarily converted property within a specific replacement period. If you have a gain on damaged property, you can postpone reporting the gain if you spend the reimbursement to restore the property.

Postpone reporting all the gain, the cost of your replacement property must be at least as much as the reimbursement you receive. If the cost of the replacement property is less than the reimbursement, you must include the gain in your income up to the amount of the unspent reimbursement.

Example. In 1970, you bought a cottage in the mountains for your personal use at a cost of $18,000. You made no further improvements or additions to it. When a storm destroyed the cot-
tage this January, the cottage was worth $250,000. You received $146,000 from the in-
surance company in March. You had a gain of $128,000 ($146,000 – $18,000).

You spent $144,000 to rebuild the cottage. Since this is less than the insurance proceeds received, you must include $2,000 ($146,000 – $144,000) in your income.

Buying replacement property from a related person. You cannot postpone reporting a gain from a casualty, theft, or other involuntary con-
version if you buy the replacement property from a related person (discussed later). This rule ap-
pplies 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), the gain must be reported for the year 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 share-
holder.

Exception. This rule does not apply if the related person acquired the property from an unrelated person within the period of time al-
lowed for replacing the involuntarily converted property.

Related persons. Under this rule, related persons include, for example, a parent and child, a brother and sister, a corporation and an individual who owns more than 50% of its out-
standing stock, and two partnerships in which the same C corporations own more than 50% of the common stock in each of which more than 50% of the capital or profits interest is owned by C corporations.

Replacement Property

You must buy replacement property for the spe-
cific purpose of replacing your property. Your replacement property must be similar or related in service or use to the property it replaces. You do not have to use the same funds you receive as reimbursement to acquire the replacement property. If you spend the money you receive for other purposes, and bor-
tow money to buy replacement property, you can still choose to postpone reporting the gain if you meet the other requirements. Property you acquire by gift or inheritance does not qualify as replacement property.

Owner-user. If you are an owner-user, similar or related in service or use means that replace-
ment property must function in the same way as the property it replaces. Examples of property that functions in the same way as the property it replaces are a home that replaces another home, a dairy cow that replaces another dairy cow, and farm land that replaces other farm land. A passenger automobile that replaces a tractor does not qualify. Neither does a breeding or draft animal that replaces a dairy cow.

Soil or other environmental contamination. If, because of soil or other environmental con-
tamination, 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 (in-
cluding real property) used for farming pur-
poses, as property similar or related in service or use to the destroyed livestock.
Weather-related sales of livestock. If you sell or exchange livestock because of weather-related conditions (discussed earlier under Livestock Losses) and it is not practical for you to reinvest the sales proceeds in property similar or related in service or use to the livestock, you can treat other property (excluding real property) used for farming purposes, as property similar or related in service or use to the livestock you sold.

Standing crop destroyed by casualty. If a storm or other casualty destroyed your standing crop and you used the insurance money to acquire either another standing crop or a harvested crop, this purchase qualifies as replacement property. The costs of planting and raising a new crop qualify as replacement costs for the destroyed crop only if you use the crop method of accounting (discussed in chapter 2). In that case, the costs of bringing the new crop to the same level of maturity as the destroyed crop qualify as replacement costs to the extent they are incurred during the replacement period.

Timber loss. Standing timber you bought with the proceeds from the sale of timber downed as a result of a casualty, such as high winds, earthquakes, or volcanic eruptions, qualifies as replacement property. If you bought the standing timber within the replacement period, you can postpone reporting the gain.

Business or income-producing property located in a Presidentially declared disaster area. If your destroyed business or income-producing property was located in a Presidentially declared disaster area, any tangible replacement property you acquire for use in any business is treated as similar or related in service or use to the destroyed property. For more information, see Disaster Area Losses in Publication 547.

Substituting replacement property. Once you have acquired qualified replacement property that you designate as replacement property in a statement attached to your tax return, you cannot substitute other qualified replacement property. This is true even if you acquire the other property within the replacement period. However, if you discover that the original replacement property was not qualified replacement property, you can, within the replacement period, substitute the new qualified replacement property.

Basis of replacement property. You must reduce the basis of your replacement property (its cost) by the amount of postponed gain. In this way, tax on the gain is postponed until you dispose of the replacement property.

Replacement Period
To postpone reporting your gain, you must buy replacement property within a specified period of time. This is the replacement period.

The replacement period begins on the date your property was damaged, destroyed, stolen, sold, or exchanged. The replacement period generally ends 2 years after the close of the first tax year in which you realize any part of your gain from the involuntary conversion.

**Example.** You are a calendar year tax payer. 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, 2006. Your insurance company investigated the theft and did not settle your claim until January 3, 2007, when they paid you $3,000. You first realized a gain from the reimbursement for the theft during 2007, so you have until December 31, 2009, 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 in Publication 547.

Property in the Hurricane Katrina disaster area. For property located in the Hurricane Katrina disaster area that was destroyed, damaged, 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.

For information on extensions of the replacement period because of persistent drought, see Notice 2006–82, available at www.irs.gov/irb/2006–29_IRBard01.html. For a list of counties for which exceptional, extreme, or severe drought was reported during the preceding 12 months, see Notice 2007–80, available at www.irs.gov.

**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 can apply for an extension of the replacement period. Send your written application to the Internal Revenue Service Center where you file your tax return. See your tax return instructions for the address. Include all the details about your need for an extension. Make your application before the end of the replacement period. However, you can file an application within a reasonable time after the replacement period ends if you can show a good reason for the delay. You will get an extension of the replacement period if you can show reasonable cause for not making the replacement within the regular period.

**How To Postpone Gain**
You postpone reporting your gain by reporting your choice on your tax return for the year you have the gain. You have the gain in the year you receive insurance proceeds or other reimbursements that result in a gain.

**Required statement.** You must 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 re turn filed.** If you acquire replacement property before you file your return for the year you gave the gain, your statement should also include detailed information about all the following items.

- The replacement property.
- The postponed gain.
- The basis adjustment that reflects the postponed gain.
- Any gain you are reporting as income.

**Replacement property acquired after return filed.** If you intend to buy replacement property after you file your return for the year in which you gave the gain, your statement should also say that you are choosing to replace the property within the required replacement period. You should then attach another statement to your return for the year in which you buy the replacement property. This statement should contain detailed information on the replacement property. If you acquire part of your replacement property in one year and part in another year, you must attach a statement to each year’s return. Include in the statement detailed information on the replacement property bought in that year.

**Reporting weather-related sales of live stock.** 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 part 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.
You must choose this to take your casu-
ally 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 re-
turn for the preceding tax year.

Federal disaster relief grants. Do not include post-disaster relief grants received under the Robert T. Stafford Disaster Relief and Emer-
gency 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 spe-
cifically reimbursed by these disaster relief grants. If the casualty loss was specifically reim-
bursed by the grant and you received the grant after the year in which you deducted the casu-
ality loss, see Reimbursement received after de-
ducing loss earlier. Unemployment assistance payments under the Act are taxable unemploy-
ment compensation.

Qualified disaster relief payments. Qualified disaster relief payments are not included in the income of individuals to the extent any expenses compensated by these payments are not other-
wise compensated for by insurance or other reimbursement. These payments are not sub-
ject to income tax, self-employment tax, or em-
ployment 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, fam-
ily, living, or funeral expenses incurred as a result of a Presidentially declared disas-
ter.
• Reasonable and necessary expenses in-
curred 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 in-
curred 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 gov-
ernment in connection with a Presidentially de-
clarated 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 in-
come, 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 not included in income. These are payments you,
as a property owner, receive to reduce the risk of future damage to your property. You can-
not increase your basis in property, or take a deduction or credit, for expenditures made with
respect to those payments.

Sale of property under hazard mitigation pro-
gram. 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 other-
wise transfer property to the Federal Govern-
ment, a state or local government, or an Indian tribal government in a covered disaster area
under a Presidentially declared disaster, you can choose to postpone reporting the gain if you buy qualifying replacement property:

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 in-
come, excise, and employment taxes, and mak-
ing contributions to a traditional IRA or Roth IRA.

If any tax deadline is postponed, the IRS will
publish a notice of postponement in your area.

Postponing Gain earlier for the rules that apply.

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taxpayers who are affected by a Presidentially declared disaster. The tax deadlines the IRS
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may postpone include those for filing income, excise, and employment tax returns, paying in-
come, excise, and employment taxes, and mak-
ing contributions to a traditional IRA or Roth IRA.

If any tax deadline is postponed, the IRS will
publish a notice of postponement in your area.
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.

Reporting Gains and Losses

You will have to file one or more of the following forms to report your gains or losses from involuntary conversions:

- **Form 4684.** Use this form to report your gains and losses from casualties and thefts.
- **Form 4797.** Use this form to report involuntary conversions (other than from casualty or theft) of property used in your trade or business and capital assets held in connection with a trade or business or a transaction entered into for profit. Also use this form if you have a gain from a casualty or theft on trade, business or income-producing property held for more than 1 year and you have to recapture some or all of your gain as ordinary income.
- **Schedule A (Form 1040).** Use this form to deduct your losses from casualties and thefts of personal-use property that you reported on Form 4684.
- **Schedule D (Form 1040).** Use this form to report gain from an involuntary conversion of property other than from casualty or theft of personal-use property. Also, carry over the following gains to Schedule D.
  - Net gain shown on Form 4797 from an involuntary conversion of business property held for more than 1 year.
  - Net gain shown on Form 4684 from the casualty or theft of personal-use property.
- **Schedule F (Form 1040).** Use this form to deduct your gains or losses from casualty or theft of livestock or produce bought for sale under other expenses in Part II, line 34, if you use the cash method of accounting and have not otherwise deducted these losses.

12. Self-Employment Tax

What's New for 2007

Husband-wife farm. Beginning in 2007, you and your spouse, if you are filing married filing jointly, may be able to make a joint election to be taxed as a qualified joint venture instead of a partnership. See Husband and wife partners under Who Must Pay Self-Employment Tax.

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 $97,500 for 2007. There is no maximum limit on earnings subject to the Medicare part (2.9%).

What's New for 2008

Maximum net earnings. The maximum net self-employment earnings subject to the social security part (12.4%) of the self-employment tax will increase to $102,000 for 2008. There is no maximum limit on earnings subject to the Medicare part.

Introduction

Self-employment tax (SE tax) is a social security and Medicare tax primarily for individuals who work for themselves. It is similar to the social security and Medicare taxes withheld from the pay of most wage earners.

You usually have to pay SE tax if you are self-employed. You are usually self-employed if you operate your own farm on land you own or rent. You have to figure SE tax on Schedule SE (Form 1040).

Farmers who have employees may have to pay the employer's share of social security 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

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

Why Pay Self-Employment Tax?

Social security benefits are available to self-employed persons just as they are to wage earners. Your payments of SE tax contribute to your coverage under the social security system. Social security coverage provides you with retirement benefits, disability benefits, survivor benefits, and hospital insurance (Medicare) benefits.

How to become insured under social security. You must be insured under the social security system before you begin receiving social security benefits. You are insured if you have the required number of credits (also called quarters of coverage).

Earning credits in 2007. You can earn a maximum of four credits per year. For 2007, you earn one credit for each $1,000 of combined wages and self-employment earnings subject to social security tax. You need $4,000 ($1,000 × 4) of combined wages and self-employment earnings subject to social security tax to earn four credits in 2007. It does not matter whether the income is earned in 1 quarter or is spread over 2 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.socialsecurity.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 earnings. 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 the SSA time limit for posting self-employment earnings, 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 after the SSA time limit listed above.

How To Pay Self-Employment Tax

To pay SE tax, you must have a social security number (SSN) or an individual taxpayer identification number (ITIN). This section explains how to:

Chapter 12 Self-Employment Tax Page 71
2. Your share of the crop or livestock, or the proceeds from their sale, depends on the amount produced.

Your net farm profit or loss from the income-sharing arrangement is reported on Schedule F (Form 1040) and included in your self-employment earnings.

If you produce a crop or livestock on land belonging to another person and are to receive a specified rate of pay, a fixed sum of money, or a fixed quantity of the crop or livestock, and not a share of the crop or livestock or their proceeds, you may be either self-employed or an employee of the landowner. This will depend on whether the landowner has the right to direct or control your performance of service.

Example. A share farmer produces a crop on land owned by another person on a 60-40 standing. The share farmer decides how much of the land 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 on Schedule F (Form 1040) and included in self-employment earnings.

Contract farming. Under typical contract farming arrangements, the grower receives a fixed payment per unit of crops or finished live-stock delivered to the processor or packing company. Since the grower typically furnishes labor and bears some production risk, the payments are reported on Schedule F and are therefore subject to self-employment tax.

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 local 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 in box 14 of your Schedule K-1 (Form 1065).

Husband and wife partners. If you and your spouse jointly own and operate a farm and share the profits and losses, you are partners in a partnership whether or not you ever had an SSN. Your partnership agreement and must file Form 1065 instead of Schedule F. However, if you and your spouse jointly own and operate a farm and file a joint tax return, you can make a joint election to be taxed as a qualified joint venture instead of a partnership. For an explanation of “material participation,” see the instructions for Schedule C, line G, and the instructions for Schedule F, line E. You must divide all items of income, gain, loss, deduction, and credit between you and your spouse in accordance with your respective interests in the venture. Each of you must file a separate Schedule F. 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 carried on by the partnership 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. If your self-employment earnings in box 14, code A, of your Schedule K-1 (Form 1065), Box 14 of Schedule K-1 may also provide amounts for gross farming or fishing income (code B) and gross nonfarm income (code C). Use these amounts if you use the farm or nonfarm optional method to figure net earnings from self-employment (see Methods for Figuring Net Earnings, later).

If you are a general partner, you may need to reduce these reported earnings by amounts you claim as a section 179 deduction, unreimbursed...
partnership expenses, or depletion on oil and gas properties. If the amount reported is a loss, include only the deductible amount when you figure your total self-employment earnings.

For more information, see the Partner's Instructions for Schedule K-1 (Form 1065).

For general information on partnerships, see Publication 541.

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 (discussed later) 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 farm business (even though it is temporarily inactive). A connection exists if it is clear the payment would not have been made but for your conduct of your farm business.

Gain or loss. A gain or loss from the disposition of property that is neither stock in trade nor held primarily for sale to customers 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 1 year.
- Timber, coal, or iron ore held for more than 1 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 Timber in chapter 8.

Wages and salaries. Wages and salaries received for services performed as an employee and covered by social security or railroad retirement are not included in 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 during the year.
- The retired partner is owed only the retirement payments.
- The retired partner’s share (if any) of the partnership capital was fully paid to the retired partner.
- The payments to the retired partner are lifelong periodic payments.

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>Are your net farm profits less than $1,733?</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 farm optional method.</td>
</tr>
<tr>
<td>Yes</td>
<td>You cannot use the nonfarm optional method.* See Publication 334.</td>
</tr>
<tr>
<td>No</td>
<td></td>
</tr>
</tbody>
</table>

*If you use both optional methods, see Using Both Optional Methods for limit on the amount to report.
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. However, income and deductions from farm rentals, including government commodity program payments received by a landlord who rents land, are included if the rental arrangement provides that the landowner will, and does, materially participate in the production or management of production of the farm products on the land.

Crop shares. Rent paid in the form of crop shares is included in self-employment earnings for the year you sell, exchange, give away, or use the crop shares if you meet one of the four material participation tests (discussed next) at the time the crop shares are produced. Feeding such crop shares to livestock is considered using them. Your gross income for figuring your self-employment earnings includes the fair market value of the crop shares when they are used as feed.

Material participation for landlords. You materially participate if you have an arrangement with your tenant for your participation and you meet one of the following tests.

1. You do any three of the following.
   a. Pay, using cash or credit, at least half the direct costs of producing the crop or livestock.
   b. Furnish at least half the tools, equipment, and livestock used in the production activities.
   c. Advise or consult with your tenant.
   d. Inspect the production activities periodically.

2. You regularly and frequently make, or take an important part in making, management decisions substantially contributing to or affecting the success of the enterprise.

3. You work 100 hours or more spread over a period of 5 weeks or more in activities connected with agricultural production.

4. You do things that, considered in their totality, show you are materially and significantly involved in the production of the farm commodities.

These tests may be used as general guides for determining whether you are a material participant.

Example. Drew Houston agrees to produce a crop on J. Clarke's cotton farm with each receiving half the proceeds. Clarke advises Houston when to plant, spray, and pick the cotton. During the growing season, Clarke inspects the crop every few days to determine whether Houston is properly taking care of the crop. Houston furnishes all labor needed to grow and harvest the crop.

The management decisions made by J. Clarke in connection with the care of the cotton crop and his regular inspection of the crop establish that he participates to a material degree in the cotton production operations. The income Clarke receives from his cotton farm is included in his self-employment earnings.

Methods for Figuring Net Earnings

There are three ways to figure your net earnings from self-employment.

1. The regular method.
2. The farm optional method.
3. The nonfarm optional method.

You must use the regular method unless you are eligible to use one or both of the optional methods. See Figure 12-1, shown later.

Why use an optional method? You may want to use the optional methods (discussed later) when you have a loss or a small net profit and any one of the following applies.

- You want to receive credit for social security benefit coverage.
- You incurred child or dependent care expenses for which you could claim a credit. (An optional method may increase your earned income, which could increase your credit.)
- You are entitled to the earned income credit. (An optional method may increase your earned income, which could increase your credit.)
- You are entitled to the additional child tax credit. (An optional method may increase your earned income, which could increase your credit.)

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

If you use either or both optional methods, you must figure and pay the SE tax due under these methods even if you would have had a smaller SE tax or no SE tax using the regular method.

The optional methods may be used only to figure your SE tax. To figure your income tax, include your actual self-employment earnings in gross income, regardless of which method you use to determine SE tax.

Regular Method

Multiply your total self-employment earnings by 92.35% (.9235) to get your net earnings under the regular method. See Short Schedule SE, line 4, or Long Schedule SE, line 4a.

Net earnings figured using the regular method are also called “actual net earnings.”

Net earnings figured using the regular method can reduce or eliminate SE tax. If your gross farm income is $2,400 or less and your farm net earnings figured under the regular method are less than your actual net earnings, you may need to adjust the amount reported on Schedule K-1 if you are a general partner or if it is a loss. For more information, see Partnership income or loss, earlier.

Figuring farm net earnings. If you meet either of the two tests explained earlier, use Table 12-1, Figuring Farm Net Earnings, to figure your net earnings from self-employment under the farm optional method.

Table 12-1. Figuring Farm Net Earnings

<table>
<thead>
<tr>
<th>IF your gross farm income is ...</th>
<th>THEN your net earnings are equal to ...</th>
</tr>
</thead>
<tbody>
<tr>
<td>$2,400 or less</td>
<td>Two-thirds of your gross farm income.</td>
</tr>
<tr>
<td>More than $2,400</td>
<td>$1,600</td>
</tr>
</tbody>
</table>

Optional method can reduce or eliminate SE tax. If your gross farm income is $2,400 or less and your farm net earnings figured under the farm optional method are less than your actual net earnings, you can use the farm optional method to reduce or eliminate your SE tax. Your actual net earnings are your net earnings figured using the regular method, explained earlier.

Example. Your gross farm income is $540 and your net farm profit is $460. Consequently, your net earnings figured under the farm optional method are $280 ($540 - $260). However, your actual net earnings are $240 ($460 - $220), so you owe no SE tax if you use the optional method because your net earnings under the farm optional method are less than $400.

Nonfarm Optional Method

This is an optional method available for determining net earnings from nonfarm...
self-employment, much like the farm optional method. If you are also engaged in a nonfarm business, you may be able to use this method to figure your nonfarm net earnings. You can use this method even if you do not use the farm optional method for determining your farm net earnings and even if you have a net loss from your nonfarm business. For more information 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 each method to arrive at your total net earnings from self-employment. You cannot use the farm 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 6, 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, earlier, under Who Must Pay Self-Employment Tax.

13. Employment Taxes

What’s New for 2008

Federal unemployment (FUTA) tax rate. Beginning in 2008, the FUTA tax rate is scheduled to decrease from 6.2% to 6.0%. As this publication was prepared for printing, legislation had been introduced that would postpone the decrease. See Publication 553, Highlights of 2007 Tax Changes.

Substitute Forms W-4. After October 10, 2007, you cannot accept substitute Forms W-4 developed by employees. However, continue to honor any valid employee-developed Forms W-4 you accepted before October 11, 2007.

Wage limit for social security tax. The limit on wages subject to the social security tax will increase to $102,000 for 2008. There is no limit on wages subject to the Medicare tax.

Reminder

Electronic deposits of taxes. You must use the Electronic Federal Tax Payment System (EFTPS) to make electronic deposits of all deposit tax liabilities you incur in 2008 and thereafter if you deposited more than $200,000 in federal deposit taxes in 2008 or you had to use EFTPS in 2007. See Electronic Federal Tax Payment System (EFTPS) under Reporting and Paying Social Security, Medicare, and Withheld Federal Income Taxes.

Important Dates

You should take the action indicated on or before the dates listed. See By February 15 and On February 16 for Form W-4 information. 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 Calendars for 2008.

Note. If any date shown below for filing a return, furnishing a form, or depositing taxes, falls on a Saturday, Sunday, or legal holiday, the due date is the next business day. A statewide legal holiday delays a filing due date only if the IRS office where you are required to file is located in that state. For any due date, you will meet the “file” or “furnish” date requirement if the form is properly addressed and mailed First-Class or sent by an IRS-designated delivery service by the due date. See Private delivery services in Publication 51 (Circular A).

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 employee 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 Form W-4S 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 previ-ously given to you claiming exemption is now expired.

By February 28

• File Forms 1099 and 1096. File 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 February 29

• File Forms W-2 and W-3. File Copy A of all Forms W-2 with Form W-3, Transmittal of Wage and Tax Statements with the Social Security Administration (SSA). 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 W-2 Filing Instructions and Information webpage at www.socialsecurity.gov/employer for more information about filing Forms W-2 and W-2c electronically.
Useful Items Exemptions for your spouse.

Introduction
You are generally required to withhold federal income tax from the wages of your employees. You may also be subject to social security and Medicare taxes under the Federal Insurance Contributions Act (FICA) and federal unemployment tax under the Federal Unemployment Tax Act (FUTA). This chapter includes information about these taxes.

You must also pay self-employment tax on the net earnings from farming. See chapter 12 employment taxes. However, certain exemptions about these taxes. left by a hurricane (also known as hurricane clearing land of brush and other debris, income tax from the wages of your employees. You are generally required to withhold federal cultural products on a farm.

You are required to report any new employee to a designated state income tax withholding are also not subject to social security or Medicare taxes. However, see

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. However, see Nonexempt services of a child or spouse. 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 in other than a trade or business, whether or not in your trade or business, are not subject to FUTA tax. 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. 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 tax.

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.

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.
- Services performed in salvaging timber, or clearing land of brush and other debris, left by a hurricane (also known as 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.

If you employ a family of workers, each worker subject to your control (not just the head of the family) is an employee.

Special rules apply to crew leaders. See Crew Leaders, later.

Employer identification number (EIN). If you have employees, you must have an EIN. If you do not have an EIN, you may apply for one online. Go to the IRS website at www.irs.gov/businesses/small and click on the "Employer ID Numbers (EINs)" link. You may also apply for an EIN by calling 1-800-829-4933 (hours of operation are Monday - Friday, 7:00 a.m. to 10:00 p.m. local time), or you can fax or mail Form SS-4 to the IRS.

Employee’s social security number (SSN). An employee who does not have an SSN should submit Form SS-5, Application for a Social Security Card, to the Social Security Administration (SSA). Form SS-5 is available from any SSA office or by calling 1-800-772-1213. It is also available from the SSA’s website at www.socialsecurity.gov.

The employee must furnish evidence of age, identity, and U.S. citizenship or lawful 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 the Employer Services (USCIS) offices or by calling the Bureau of Citizenship and Immigration Services Forms Request Line at 1-800-870-3676. Form I-9 is also available from the USCIS website at www.uscis.gov. You can also contact the USCIS at 1-800-375-5283 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 Federal Office of Child Support Enforcement at 202-401-9267 or visit their Employer Services webpage at www.acf.hhs.gov/programs/cse/newhire/employer/home.htm 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. However, see Nonexempt services of a child or spouse. Payments for the services of your child under age 21 employed by you in other than a trade or business, whether or not in your trade or business, are not subject to FUTA tax. 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. 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 tax.

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.
Family Employees, (boxes 3 and 5 on Form W-2) or as wages for a permanent home to the farm, and 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.

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 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 employment,
- Commutes daily from his or her permanent home to the farm, and
- Worked in agriculture less than 13 weeks in the preceding calendar year.

See Family Employees, earlier, for certain exceptions from social security and Medicare taxes that apply to your child, spouse, and parent.

Religious exemption. An exemption from social security and Medicare taxes is available only if both the employee and the employer are members of the sect.

For more information, see Publication 17, Social Security and Other Information for Members 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 employees for social security benefit purposes. Payments not subject to these taxes, such as commodity wages, do not contribute to your employees’ social security coverage. For information about social security benefits, contact the SSA at 1-800-772-1213 or online at www.socialsecurity.gov.

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 noncash wages in box 3, Social security wages, or in box 5, Medicare wages and tips (unless the substance of the transaction is a cash payment).

Tax rates and social security wage limit. For 2008, the employer and the employee will each pay both the following taxes.

- 6.2% of cash wages for social security tax (old-age, survivors, and disability insurance).
- 1.45% of cash wages for Medicare tax (hospital insurance).

Wage limit. The limit on 2008 wages subject to the social security tax will increase to $102,000 for 2008. There is no limit on wages subject to the Medicare All covered wages are subject to the Medicare tax.

Paying employee’s share. If you would rather pay the employee’s share of social security and Medicare taxes without deducting it from his or her wages, you may do so. It is additional income to the employee. You must include it on the employee’s Form W-2 in box 1, but do not count it as social security and Medicare wages (boxes 3 and 5 on Form W-2) or as wages for federal unemployment (FUTA) tax purposes.

Example. Jane operates a small family fruit farm. She employs day laborers in the picking season to enable her to timely get her crop to market. She does not deduct the employees’ share of social security and Medicare taxes from their pay; instead, she pays it on their behalf.

When her accountant, Susan, prepares the employees’ Forms W-2, she adds each employee’s share of social security and Medicare taxes paid by Jane to the employee’s wage income (box 1 of Form W-2), but does not include it in box 3 (social security wages) or box 5 (Medicare wages and tips).

Jane paid Mary $1,000 during the year. Susan enters $1,078.50 in box 1 of Mary’s Form W-2 ($1,000 wages plus $76.50 social security and Medicare taxes paid for Mary). She enters $1,000 in boxes 3 and 5.
Federal Income Tax Withholding

If the cash wages you pay to farmworkers are subject to social security and Medicare taxes, they are also subject to federal income tax withholding. Although noncash wages are subject to federal income tax, withhold income tax only if you and the employee agree to do so. The amount to withhold is figured on gross wages without taking out social security and Medicare taxes, union dues, insurance, etc.

Form W-4. Generally, the amount of federal income tax you withhold is based on the employee’s marital status and withholding allowances claimed on the employee’s Form W-4. In general, an employee can claim withholding allowances on Form W-4 equal to the number of exemptions the employee will be entitled to claim on his or her tax return. An employee may also be able to claim a special withholding allowance and allowances for estimated deductions and credits.

Do not withhold federal income tax from the wages of an employee who, by filing Form W-4, certifies that he or she had no federal income tax liability last year and anticipates no liability for the current year.

You should give each new employee a Form W-4 as soon as you hire the employee. For Spanish-speaking employees, you may use Formulario 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 2008. You should make the 2006 Form W-4 available to your employees and encourage them to update their federal withholding for 2008. Those employees who owed a large amount of tax or received a large refund for 2007 may want to file a new Form W-4.

After October 10, 2007, you cannot accept substitute Forms W-4 developed by employees. However, continue to honor any valid employee-developed Forms W-4 you accepted before October 11, 2007.

How to figure withholding. You can use one of several methods to determine the amount to withhold. The methods are described in Publication 51 (Circular A), which contains tables showing the correct amount of federal income tax you should withhold. Publication 51 (Circular A) also contains additional information about federal income tax withholding.

Nonemployee compensation. Generally, you are not required to withhold federal income tax on payments for services to individuals who are not your employees. However, you may be required to report these payments on Form 1099-MISC, Miscellaneous Income, and to withhold under the backup withholding rules. For more information, see the Instructions for Form 1099-MISC.

Advance Payment of Earned Income Credit

An employee who is eligible for the earned income credit (EIC) and who has a qualifying child is entitled to receive EIC payments with his or her pay during the year. To get these payments, the employer must give you a properly completed Form W-5, earned income credit advance payment certificate. You are usually required to make advance EIC payments to employees who give you a properly completed Form W-5, but you are not required to make these payments to 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 must compute the employee’s liability for federal income tax withholding, social security tax, and Medicare tax by the total advance EIC payments made. For more information, see Publication 51 (Circular A).

Notification. You must provide notification about the EIC to each employee who worked for you at any time during the year and from whom you withheld 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 giving each employee any of the following:

- Form W-2, which contains the EIC notification on the back of Copy B.
- A substitute Form W-2 with the exact wording shown on the back of copy B of Form W-2.
- Notice 797, Possible Federal Tax Refund Due to the Earned Income Credit (EIC).
- Your own written statement with the exact wording of Notice 797.

For more information about notification requirements and claiming the EIC, see Notice 1015, Have You Told Your Employees About the Earned Income Credit (EIC).

Reporting and Paying Social Security, Medicare, and Withheld Federal Income Taxes

You must withhold federal income, social security, and Medicare taxes from the wages of all employees, and withhold on nonwage payments. For more information, see the Instructions for Form 1099-MISC.

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, unemployment, excise, and corporate income taxes) you incur in 2008 if you deposited more than $50,000 in federal depository taxes in 2007. If you first meet the $200,000 threshold in 2007, you must begin depositing using EFTPS in 2009. 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 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 or to enroll in EFTPS, visit www.eftps.gov or see Publication 966, The Secure Way to Pay Your Federal Taxes, or call 1-800-555-4477.

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, for example, 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 willful failure must be shown.

Consequences of treating an employee as an independent contractor. If you classify an employee as an independent contractor and you have no reasonable basis for doing so, you may be held liable for employment taxes for that employee.

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worker. See Publication 15-A for more information.

**FUTA Tax**

You must pay FUTA tax if you meet either of the following tests:

- You paid cash wages of $20,000 or more to 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 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-2A 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 the wages you paid to determine whether you meet either test above.

**Commodity wages.**

Payments in kind for farm labor are not cash wages. Do not count the wages you paid to determine whether you meet either test above.

**Tax rate and credit.**

The gross FUTA tax is 6.2% of the first $7,000 cash 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.

Beginning in 2008, the FUTA tax rate is scheduled to decrease from 6.2% to 6.0%. As this publication was prepared for printing, legislation had been introduced that would postpone the decrease. See Publication 553, Highlights of 2007 Tax Changes.

**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 2007 form is due January 31, 2008 (or February 11, 2008, if you timely deposited the full amount of your 2007 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, 2008, 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.

**Excise Taxes**

**Excise Taxes**

**What's New for 2007**

Kerosene for use in aviation. The ultimate purchaser of kerosene for use in aviation on a farm for farming purposes can claim a credit or refund if they have not waived their right to make the claim.

**Reminders**

**Publication 378, Fuel Tax Credits and Refunds, eliminated.** Publication 378 is no longer available as a separate product. Publication 510, Excise Taxes for 2007, 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 income tax return for how to claim your credit.

**Introduction**

You may be eligible to claim a credit on your income tax return for the federal excise tax on certain fuels. You may also be eligible to claim a quarterly refund of the fuel taxes during the year, instead of waiting to claim a credit on your income tax return.

Whether you can claim a credit or refund depends on whether the fuel was taxed and the purpose (nontaxable use) for which you used the fuel. The nontaxable uses of fuel for which a farmer may claim a credit or refund are generally the following:

- Use on a farm for farming purposes.
- Off-highway business use.
- Uses other than as a fuel in a propulsion engine, such as home use.

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**Table 14-1. Fuel Tax Credits and Refunds at a Glance**

Use this table to see if you can take a credit or refund for a nontaxable use of the fuel listed.

<table>
<thead>
<tr>
<th>Fuel Used</th>
<th>On a Farm for Farming Purposes</th>
<th>Off-Highway Business Use</th>
<th>Household Use or Use Other Than as a Fuel</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gasoline</td>
<td>Credit only</td>
<td>Credit or refund</td>
<td>None</td>
</tr>
<tr>
<td>Aviation gasoline</td>
<td>Credit only</td>
<td>None</td>
<td>None</td>
</tr>
<tr>
<td>Undyed diesel fuel</td>
<td>Credit or refund by the farmer only</td>
<td>Credit or refund&lt;sup&gt;2&lt;/sup&gt;</td>
<td>Credit or refund&lt;sup&gt;2&lt;/sup&gt;</td>
</tr>
<tr>
<td>Undyed kerosene</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Kerosene for use in aviation</td>
<td>Credit or refund</td>
<td>None</td>
<td>None</td>
</tr>
<tr>
<td>Dyed diesel fuel and dyed kerosene</td>
<td>None</td>
<td>None</td>
<td>None</td>
</tr>
<tr>
<td>Other Fuels (including alternative fuels)&lt;sup&gt;3&lt;/sup&gt;</td>
<td>Credit or refund by the farmer only</td>
<td>Credit or refund</td>
<td>None</td>
</tr>
</tbody>
</table>

<sup>1</sup> 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.

<sup>2</sup> Other Fuels means any liquid except gas oil, fuel oil, or any product taxable under Internal Revenue Code section 4081. It includes the alternative fuels: liquefied petroleum gas (LPG), "P Series" fuels, compressed natural gas (CNG), liquefied hydrogen, any liquid fuel derived from coal (including peat) through the Fischer-Tropsch process, liquid hydrocarbons derived from biomass, and liquefied natural gas (LNG).

<sup>3</sup> For a use other than as fuel in a propulsion engine.
Table 14-1 presents an overview of credits and refunds that may be claimed for fuels used for the nontaxable uses listed above. See Publication 510 for information about credits and refunds for fuels used for nontaxable uses not discussed in this chapter.

### Topics
This chapter discusses:

- Fuels used in farming,
- Dyed diesel fuel and dyed kerosene,
- Fuels used in off-highway business use,
- Fuels used for household use or other than as a fuel,
- How to claim a credit or refund, and
- Including the credit or refund in income.

### Useful Items
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

See chapter 17 for information about getting publications and forms.

### Fuels Used in Farming
You may be eligible to claim a credit or refund of excise taxes on fuel used on a farm for farming purposes. This applies if you are the owner, tenant, or operator of a farm. See Table 14-1 for a list of available fuel tax credits and refunds. Fuel is used on a farm for farming purposes only if used in carrying on a trade or business of farming, on a farm in the United States, and for farming purposes.

**Farm.** A farm includes livestock, dairy, fish, poultry, fruit, fur-bearing animals, and truck farms, orchards, plantations, ranches, nurseries, ranges, and feed yards for fattening 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 preserve (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 who used the fuel 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 purposes not included in list items (1) or (2), no one can claim the credit or refund for fuel used on your farm for those other services.

**Example.** Farm owner Haleigh Blue hired custom operator Tyler Steele to cultivate the soil on her farm. Tyler used 200 gallons of 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 dyed 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 used on the farm, each can claim a credit for the tax on half the fuel used.

**Undyed diesel fuel, undyed kerosene, and Other Fuels (including alternative fuels).** The farmer is the only person who can make a claim for credit or refund for the tax on undyed diesel fuel, undyed kerosene, or Other Fuels (including alternative fuels) used for farming purposes. Also see Dyed Diesel Fuel and Dyed Kerosene, later.

**Custom application of fertilizer and pesticide.** Fuel used on a farm for farming purposes includes fuel used in the application of fertilizer, pesticides, or other substances, including aerial applications. Generally, the applicator is treated as having used the fuel on a farm for farming purposes. For aviation gasoline, the aerial applicator makes the claim as the ultimate purchaser. For kerosene used in aviation, the ultimate purchaser may make the claim or waive the right to make the claim to the registered ultimate vendor. A sample waiver is included as Model Waiver L in the appendix of Pub. 510.

A registered ultimate vendor is the person who sells undyed diesel fuel, undyed kerosene, or kerosene for use in aviation to the user (ultimate purchaser) of the fuel for use on a farm for farming purposes. To claim a credit or refund of tax, the ultimate vendor must be registered with the Internal Revenue Service at the time the claim is made. However, registered ultimate vendors cannot make claims for undyed diesel fuel and undyed kerosene sold for use on a farm for farming purposes. Fuel not used for farming. You do not use fuel on a farm for farming purposes when you use it in 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 tax. 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 $.001 leaking underground storage tank (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. The penalty is the greater of $1,000 or $10 per gallon of the dyed diesel fuel or dyed kerosene involved. After the first violation, the $1,000 portion of the penalty increases.
Fuels Used in Off-Highway Business Use

You may be eligible to claim a credit or refund for the excise tax on fuel used in an off-highway business use.

Off-highway business use. This is any use of fuel in a trade or business or in an income-producing activity. The use must not be in a highway vehicle registered or required to be registered for use on public highways. Off-highway business use generally does not include any use in a motorboat.

Examples. Off-highway business use includes the use of fuels in any of the following ways:

- In stationary machines such as generators, compressors, power saws, and similar equipment.
- For cleaning purposes.
- In forklift trucks, bulldozers, and earthmovers.

Generally, it does not include nonbusiness, off-highway use of fuel, such as use by minibikes, snowmobiles, power lawn mowers, chain saws, and other yard equipment. For more information, see Publication 510.

Fuels Used for Household Use or Other Than as a Fuel

You may be eligible to claim a credit or refund for the excise tax on undyed kerosene used for home use or used other than as a fuel. This applies to undyed kerosene you purchased and used in your home for heating, lighting, and cooking. Home use is considered a use other than as a fuel in a propulsion engine. It is not considered an off-highway business use.

Claiming a Credit or Refund of Excise Taxes

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

<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>Type of form</td>
<td>Annual</td>
</tr>
<tr>
<td>When to file</td>
<td>With your income tax return</td>
</tr>
<tr>
<td>Amount of tax</td>
<td>Any amount</td>
</tr>
</tbody>
</table>

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

depending on the number of violations. For more information on this penalty, see Publication 510.

How To Claim a Credit or Refund

You may be able to claim a credit or refund of the excise tax on fuels you use for nontaxable uses. The basic rules for claiming credits and refunds are listed in Table 14-2.

Keep at your principal place of business all records needed to enable the IRS to verify that you are the person entitled to claim a credit or refund and the amount you claimed. You do not have to use any special form, but the records should establish the following information:

- The total number of gallons bought and used during the period covered by your claim.
- The dates of the purchases.
- The names and addresses of suppliers and amounts bought from each during the period covered by your claim.
- The nontaxable use for which you used the fuel.
- The number of gallons used for each nontaxable use.

It is important that your records separately show the number of gallons used for each nontaxable use that qualifies as a claim. For more information about recordkeeping, see Publication 583, Starting a Business and Keeping Records.

Credit or refund. A credit is an amount that reduces the tax on your income tax return when you file it at the end of the year. If you meet certain requirements, you may claim a refund during the year instead of waiting until you file your tax return.

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

- Tax on gasoline and aviation gasoline you used on a farm for farming purposes.
- Tax on fuels (including undyed diesel fuel or undyed kerosene) you used for nontaxable uses if the total for the tax year is less than $750.
- Tax on fuel you did not include in any claim for refund previously filed for any quarter of the tax year.

Claiming a Credit

You make a claim for a fuel tax credit on Form 4136 and attach it to your income tax return. Do not claim a credit for any excise tax for which you have filed a refund claim.

How to claim a credit. How you claim a credit depends on whether you are an individual, partnership, corporation, S corporation, trust, or farmers’ cooperative association.

Individuals. You claim the credit on the “Payments from” line of your Form 1040. Check box b. If you would not otherwise have to file an income tax return, you must do so to get a fuel tax credit.

Partnership. Partnerships (other than electing large partnerships) claim the credit by including a statement on Schedule K-1 (Form 1065), Partner’s Share of Income, Deductions, Credits, etc., showing each partner’s share of the number of gallons of each fuel sold or used for a nontaxable use, the type of use, and the applicable credit per gallon. Each partner claims the credit on his or her income tax return for the partner’s share of the fuel used by the partnership.

An electing large partnership can claim the credit on the “Other payments” line of Form 1065-B, U.S. Return of Income for Electing Large Partnerships.

Other entities. Corporations, S corporations, farmers’ cooperative associations, and trusts make the claim on the appropriate line of their income tax return.

When to claim a credit. You can claim a fuel tax credit on your income tax return for the year you used the fuel.

You may be able to make a fuel tax credit on an amended income tax return for the year you used the fuel. Generally, you must file an amended return by the later of 3 years from the date you filed your original return or within 2 years from the date you paid the income tax.

Claiming a Refund

You make a claim for refund of the excise tax on fuel on Form 8849. Do not claim a refund on Form 8849 for any excise tax for which you have filed or will file a claim on Schedule C (Form 720) or Form 4136.

You may file a claim for refund for any quarter of your tax year for which you can claim $750 or more. This amount is the excise tax on all fuels used for a nontaxable use during that quarter or any prior quarter (for which no other claim has been filed) during the tax year.

If you cannot claim at least $750 at the end of a quarter, you carry the amount over to the next quarter of your tax year to determine if you can claim at least $750 for that quarter. If you cannot...
claim at least $750 at the end of the fourth quarter of your tax year, you must claim a credit on your income tax return using Form 4136. Only one claim can be filed for a quarter.

You cannot claim a refund for excise tax on gasoline and aviation gasoline used on a farm for farming purposes. You must claim a credit on your income tax return for the tax.

How to file a quarterly claim. File the claim for refund by filling out Schedule 1 (Form 8849) and attaching it to Form 8849. Send it to the address shown in the instructions. If you file Form 720, you can use the Schedule C portion of Form 720 for your refund claims. See the Form 720 instructions. When to file a quarterly claim. You must file a claim by the last day of the first quarter following the last quarter included in the claim. If you do not file a timely refund claim for the fourth quarter of your tax year, you will have to claim a credit for that amount on your income tax return, as discussed earlier.

Including the Credit or Refund in Income

Include any credit or refund of excise taxes on fuels in your gross income if you claimed the total cost of the fuel (including the excise taxes) as an expense deduction that reduced your income tax liability.

Which year you include a credit or refund in gross income depends on whether you use the cash or an accrual method of accounting.

Cash method. If you use the cash method and file a claim for refund, include the refund amount in gross income for the tax year in which you receive the refund. If you claim a credit on your income tax return, include the credit amount in gross income for the tax year in which you receive the credit.

Example. Sharon Brown, a cash basis farmer, filed her 2007 Form 1040 on March 3, 2008. 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 2008 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 2007 Form 1040 on April 15, 2008. On Schedule F, she deducts the total cost of gasoline (including $155 of excise taxes) she used on the farm for farming purposes during 2007. On Form 4136, Patty claims the $155 as a credit. She reports the $155 as other income on line 10 of her 2007 Schedule F.

15. 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 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

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 2007 if at least two-thirds of his or her gross income from all sources for 2006 or 2007 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 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 in- come to your gross income. To decide whether two-thirds of your gross income for 2007 was from farming, use as your gross income the total of the following income (not loss) amounts from your tax return.

- Wages, salaries, tips, etc. 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 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 Invest- ment Conduit reported on Schedule P (Form 1040), line 39.
- Gross farm rental income from Form 4835, line 19.
- 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 is not the same as total income shown on line 22 of Form 1040.
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 2007, 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.

Farm 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 machines 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 2007.

<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>41,500</td>
<td></td>
</tr>
<tr>
<td>Farm income (Sch F)</td>
<td>75,000</td>
<td>$75,000</td>
</tr>
<tr>
<td>Gain (Form 4797)</td>
<td>5,000</td>
<td>5,000</td>
</tr>
<tr>
<td>Total</td>
<td>$125,000</td>
<td>$80,000</td>
</tr>
</tbody>
</table>

Determine the farm income from Schedule D showed gain from the sale of dairy cows carried over from Form 4797 ($5,000) in addition to a loss from the sale of corporate stock ($2,000). However, that loss is not netted against the gain to figure Ms. Smith's total gross income or her gross farm income.

Gross farm income is 64% of her total gross income ($80,000 = $125,000 = 0.64). Therefore, based on her 2007 income, she does not qualify to use the special estimated tax rules for qualified farmers, discussed next. However, she does qualify if at least two-thirds of her 2006 gross income was from farming.

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 2007.

- You do not have to pay estimated tax if you file your 2007 tax return and pay all the tax due by March 3, 2008.
- You do not have to pay estimated tax if you expect your 2007 income tax withholding (including any amount applied to your 2007 estimated tax from your 2006 return) to be at least 66 2/3% (.6667) of the total tax to be shown on your 2007 tax return or 100% of the total tax shown on your 2006 return.
- If you must pay estimated tax, you are required to make only one estimated tax payment (your required annual payment) by January 15, 2008, using special rules to figure the amount of the payment. See Required Annual Payment, next, for details.

Figure 15-1 presents an overview of the special estimated tax rules that apply to qualified farmers.

Required Annual Payment

If you are a qualified farmer and must pay estimated tax for 2007, 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.

- On line 14a, multiply line 13c by 66 2/3% (.6667).
- On line 14b, enter 100% of the tax shown on your 2006 tax return regardless of the amount of your adjusted gross income.

For this purpose, the "tax shown on your 2006 tax return" is the amount on line 62 of your 2006 return modified by certain adjustments. For more information, see Total tax for 2006 under Required Annual Payment in chapter 2 of Publication 505.
Estimated Tax Penalty for 2007

If you do not pay all your required estimated tax for 2007 by January 15, 2008, or file your 2007 return and pay the tax by March 3, 2008, 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 15, 2008, 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 met the gross-income-from-farming requirement. If you receive a penalty notice for underpaying estimated tax and you think it is in error, write to the address on the notice and explain why you think the notice is in error. Include a computation similar to the one in Example 1 (earlier), showing that you met the gross income from farming requirement.

16. Sample Return

This sample return uses actual forms to show you how to prepare your income tax return.

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).

If two or more amounts must be added to figure the amount to enter on a line, include cents when adding the amounts and round off only the total.

Losses from operating a farm. The sample return shows a profit from the operation of the farm. However, if your deductible farm expenses are more than your farm income for the year, you have a loss from the operation of your farm. If your loss is more than your other income for the year, you may have a net operating loss (NOL). You may also have an NOL if you had a personal or business-related casualty or theft loss that was more than your income.

If you have an NOL this year, you may be able to reduce your income (and tax) in other years by carrying the NOL to those years and deducting it from income.

To determine if you have an NOL, complete your tax return for the year. You may have an NOL if a negative figure appears on Form 1040, 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 8, 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 2007, 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, $6,073, 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 2007 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, $283,018, includes sales of all of the following.

Milk ........................................... $233,874
Steers and calves he raised ........... 2,914

Vegetables he grew ........................ 1,457
Corn ($7.286), hay ($8.944), and wheat ($8.543) he raised ........ 24,773

Total reported on line 4 ............ $263,018

- Raised other than for draft, breeding, sport, or dairy purposes.

Lines 5a and 5b. He reports the $1,145 he received from cooperatives on line 5a. Since this is the dollar amount of a qualified written notice of allocation paid as part of a patronage dividend, he enters $1,145 as the taxable amount on line 5b.

Lines 6a and 6b. He received Farm Service Agency (FSA) cost-sharing payments of $6,781 on a soil conservation project (diversion channels) completed in 2007. He received the income as materials and services paid for by the government and reports it on both line 6a and line 6b. The Department of Agriculture (USDA) generally reports such payments to the recipient on Form 1099-G. The entire $6,781 has been included on Schedule F (1040), line 14, as a conservation expense. He did not receive any cost-sharing payments this year that he could exclude from his farm income.

Line 7a. He reports the $665 loan he received from the Commodity Credit Corporation (CCC) because he elected in a previous year to treat these loans as income in the year received. If he had elected not to report his CCC loan as income in the year received and forfeited the loan in a later year, he would report the loan as income on lines 7b and 7c in the year of forfeiture.

Line 9. He reports his $1,258 of income from custom harvesting.

Line 10. On his 2006 income tax return, he claimed a credit of $142 for excise taxes on gasoline used on his farm. He includes the entire $142 in his 2007 income on line 10 because he deducted the total cost of gasoline (including the $142 of excise taxes) as a farm business expense in 2006.

Schedule F (1040)- Part II (Expenses)

Mr. Brown records his farm expenses during the year for tax purposes and summarizes these expenses at the end of the year. (Farm business expenses are discussed in chapter 4.) This gives him his deductible expenses, which he enters in Part II of Schedule F (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 2007 was $1,090, which he enters on line 12. (Depreciation is reported on line 16.)

Line 13. The $8,055 on this line is the amount he paid for all chemicals purchased during the year.

Line 14. He deducts the $6,781 spent on diversion channels in 2007. 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...
Mr. Brown follows the instructions and lists the information called for in Parts I through IV. He also completes Part V on page 2 to provide information listed in Parts I through IV. He did not claim depreciation on any of his farm business buildings. He sent Copy A to the IRS with Form 1096. He gave ($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 on line 36, he skips line 37.

**Form 4562 Depreciation and Amortization**

Mr. Brown follows the instructions and lists the information called for in Parts I through IV. He also completes Part V on page 2 to provide information listed in Parts I through IV. He did not claim depreciation on any of his farm business buildings. He sent Copy A to the IRS with Form 1096. He gave ($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 on line 36, he skips line 37.

**Depreciation record.** He records information on his depreciable property in a book that he can use to figure his depreciation allowance for sever- al years. He uses the Depreciation Worksheet in his book from the Form 4562 instructions to figure his 2007 deduction.

**Basis for depreciation.** He bought his farm on January 8, 1978. Timber on the farm was immature and had no fair market value (FMV). He immediately allocated the total purchase price of the farm among the land, house, barn, and fences (no other capital improvements were included in the price of the farm). He made the allocation on the purchase date in proportion to (but not in excess of) the FMVs of the assets and in the required asset order. See Trade or Business Acquired in Publication 551 for more information.

He entered in his depreciation record the part of the purchase price for the depreciable barn and fences, giving him the basis for figuring his depreciation allowance. The fences were fully depreciated in 1987. Because he cannot depreciate the house (no office claimed) and land, he keeps a separate record showing their bases.

**Methods of depreciation.** He chose the alternate Accelerated Cost Recovery System (ACRS) method for his method 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.

- **2003 - straight line Alternative Deprecia- tion.**
- **2004, 2005, and 2007 - 150% declining balance General Depreciation System (GDS).**

**Depreciable property.** One of his purchased dairy cows (#42) was killed by lightning in July 2007. Two other purchased cows (#52 and #60) were sold in 2007. The cows were depreciated using MACRS (ADS), using a half-year convention. Therefore, he can claim a half-year’s de- preciation for each cow in 2007.

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 pur-

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**Chapter 16 Sample Return**


The type and rule above prints on all proofs including departmental reproduction proofs. MUST be removed before printing.
The Depreciation Worksheet contains an itemized list of Mr. Brown's assets for which he is deducting depreciation in 2007. 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 2007.

1. In January, he completed and placed in service a dairy facility designed specifically for the production of milk and to house, feed, and care for dairy cattle (single purpose livestock structure). The construction of the dairy facility began in 2006. 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 property 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 referring 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 2007. He enters $100,250 because he is using the simplified overall method. See the instructions for Form 4562 for more information.

On line 1, Mr. Brown enters $301,763, his total gross receipts from his farming business in 2007. He enters $301,763 on line 1 and enters the result, $77,499, on lines 6 through 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. Therefore, line 16 is the same as line 14.

Line 17. He enters $2,593. This is the MACRS depreciation for assets placed in service from 2003 through 2005.

Line 19. All property placed in service in 2007 in each class is combined and entered in Part III. The abbreviation HY used in column (e) stands for the half-year convention. The 150 DB in column (f) stands for the 150% declining balance method under MACRS.

Line 21. He enters his depreciation deduction for listed property, $1,179, on line 21. This is the total shown on line 29 of the form. He has one depreciable asset (the pickup truck purchased in 2004) that is listed property. The other truck, which he sold this year, was fully depreciated.

Line 22. He enters the total depreciation on line 22 and carries the total, $33,837, to Schedule F (1040), line 16.

Other items. He completes Sections A and B of Part V of an Information required for listed property. He does not complete Section C because he does not provide vehicles for his employees' use. He follows the practice of writing down the odometer readings on his vehicles at the end of each year and when he places the vehicles in service and disposes of them. 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 prepared using the small business simplified overall method. See the instructions for Form 8903 for more information.

The domestic production activities deduction (DPAD) is generally 6% 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 that are properly allocable to domestic production gross receipts.

Entries. Mr. Brown prints his name, his wife's name, and his identification 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 + 707) 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 cost or other basis of other items sold, $1,316 ($325 + (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 7. 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 11. He figures adjusted gross income within the domestic production activities deduction by completing lines 1 through 38 (skipping line 35) of Form 1040 and enters $63,315 on line 11.

Line 12. He enters $63,315, the smallest of line 10 or line 11.

Line 13. He enters $3,799 (6% of $63,315). Lines 14 through 16. He enters $26,368, his total Form W-2 wages from Schedule F (1040), line 24. He skips line 15 because he is not a shareholder, partner, or beneficiary of an entity which passed wages through to him. Therefore, line 16 is the same as line 14.

Line 19. On line 19, he enters $13,184, one-half of the wages shown on line 18.

Lines 20 through 23. On line 20, he enters $3,799, the smaller of line 13 or line 19. He skips lines 21 and 22 because he did not have a cooperative pass the deduction through to him, nor did he have an expanded affiliated group allocation. Thus, line 23 is also $3,799 and represents his domestic production activities deduction to be entered on Form 1040, line 35.

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 items. He figures his self-employment tax on the following lines:

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 $8,994 on line 5. This is his self-employment tax for 2007. He also enters $8,994 on line 13 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 this event on Form 4684. Only page 2 is shown, because page 1 is for nonbusiness casualties.

He prints his name, his wife’s name, and his identifying number at the top of page 2.

**Part I.** He prints the kind of property, “Dairy cow #42,” its location, and the date acquired on line 19. He enters his adjusted basis in the cow, $257, on line 20 and the $109 insurance payment he received for the cow on line 21. Line 20 is more than line 21, so he skips line 22. On lines 23 and 24, he enters the FMV’s before and after the casualty ($250 and $0, respectively), and he shows the difference, $500, on line 25. He enters the amount from line 20 on line 26, subtracts line 21 from line 26, and enters $148 on lines 27 and 28.

**Part II.** He owned the cow for more than 1 year, so he identifies the casualty on line 34 and enters $148 on lines 34(b)(i), 35(b)(i), 37, and 58a, 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 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 2007 at a gain. They consisted of a truck, a mower, and a purchased dairy cow, #60. He capital assets. He prints his name, his wife’s name, and his self-employment tax, $4,497, which he figures on line 19A through 19C and relates the corresponding property columns to the properties on those lines. He completes lines 20 through 25(b) for each disposition.

**Gains 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 total amount of the gain is the appropriate property column on line 25(b).

**Summary of Part III gains.** On line 30, he enters $852, the total of property columns A through C, line 24. On line 31, he enters $852, the total of property columns A through C, line 25(b). This amount is the gain that is ordinary income. He also enters this amount on Part II, line 13.

He subtracts line 31 from line 30 and enters $0 on line 32. He has no long-term capital gain on the dispositions. All his gains are ordinary income.

**Part I.** All the animals in Part I met the required holding period.

Mr. Brown sold at a gain several cows he had raised and used for dairy purposes. His selling expense was $325 for these cows, which he shows on line 2(f). He enters the gain from the sale on line 2(g). He also enters on line 2(g) the loss from the sale of purchased dairy cow #52. Because he sold purchased dairy cow #52 at a loss, he entered it in Part I instead of Part II. See Table 9-1 in chapter 9 for how to report items on Form 4797.

He combines the gains and losses 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(f).

**Part II.** Mr. Brown enters on line 10 the $250 gain from the sale of a raised dairy heifer held less than 24 months for breeding purposes. He had previously entered the $852 gain from Part III, line 31, on line 13 and the $148 loss from Form 4684 on line 14. He totals lines 10 through 16 and enters $954 on line 17. He carries the gain from line 17 line 18b and shows it as ordinary income on Form 4040, 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 total capital loss on 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 filling 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 2007. He enters on line 7 her total wages, $10,908, 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 ($595). It was credited to his account so that he could have withdrawn it in 2007. Therefore, he constructively received it and correctly included it in his income for 2007.

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 7 through 21 and enters the total, $74,854.

**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 2007 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.
Mr. Brown fills in the following lines on page 2 of Form 1040.

Line 40. He enters $15,000 from his Sched- ule A (1040), which is not shown, because the total of his itemized deductions is larger than the $10,700 standard deduction for his filing status (married filing jointly).

Lines 41, 42, and 43. He subtracts the maximum for claiming the earned income credit of $3,516 on line 38 and enters the result, $44,516, on line 41. He enters $6,800 (2 x $3,400) on line 42 and sub- tracts this amount from the amount on line 41 to get a taxable income of $37,716 on line 43.

Line 44. He enters $3,772 from Schedule J (1040), line 22. For information on how he fig- gured his tax using income averaging, see Schedule J (Form 1040), Income Averaging for Farmers and Fishermen, later.

Lines 46 through 56. Mr. Brown deter- mined 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 56.

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 $12,766, which is the total tax for 2007.

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 2006 or 2007. In accordance with the special estimated tax rules for farmers, Mr. Brown did not have to make a 2007 estimated tax payment (which would have been due on January 15, 2008) because they intend to file their tax return and pay the tax in full by March 3, 2008. See chapter 15 for more information on special estimated tax rules for qualified farmers.

Line 66a. The Browns are not entitled to claim the earned income credit on line 66a be- cause their adjusted gross income exceeds the maximum income limit for claiming the credit.

Line 70. Mr. Brown enters his credit for $350 of federal excise tax on gasoline used in 2007. 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 2008 because his deduction for the total cost of gaso- line (including the $350 of excise taxes) was as a farm business expense on Schedule F (1040) reduced his 2007 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 and enters the balance, $10,981, on line 76.

Schedule J (Form 1040) Income Averaging for Farmers and Fishermen

In 2007, Mr. Brown’s taxable income, $37,716, is substantially higher than in each of the 3 previous years. His taxable income amounts were only $1,112, $697, and $3,968, for 2004, 2005, and 2006, respectively. He elects to use income averaging by completing Schedule J to get this year’s tax.

He prints his name, his wife’s name, and his identifying number at the top of Schedule J (1040).

Item 1. He enters $37,716, his taxable in- come from line 43 of Form 1040.

Item 2. He enters the part of his farm income he is electing to average, $27,189. He elects to treat this earned farm income as all coming out of ordinary farm income. His ordinary farm in- come is $60,114 ($63,657 of ordinary income from Schedule F (Form 1040), plus $954 of net ordinary gain from Form 4797, minus the $4,497 deduction for one-half of self-employment tax). Elected farm income is limited to the smaller of the ordinary farm income of $60,114 or total taxable income of $37,716. See the Schedule J (1040) instructions for more information on elected farm income.

Item 3. He subtracts the amount on line 2 from the amount on line 1 and enters $10,527 on line 3.

Item 4. He uses the 2007 tax rates to figure the tax on the amount on line 3 and enters $1,053.

Items 5, 9, and 13. He enters his taxable income from 2004, 2005, and 2006 on lines 5, 9, and 13, respectively.

Items 6, 10, and 14. He divides the amount on line 2 by 3.0 and enters the result, $9,063, on lines 6, 10, and 14.

Items 7, 11, and 15. He figures his adjusted taxable income for the 3 previous years by ad- ding the amounts on lines 6, 10, and 14 to the amounts on lines 5, 9, and 13, respectively.

Items 8, 12, and 16. He figures the tax on the amounts on lines 7, 11, and 15 using the appropriate Tax Rate Schedules for the appro- priate year and enters the results on lines 8, 12, and 16, respectively. His income is taxed at no more than a 10% rate for each prior year.

Line 17. He adds the amounts on lines 4, 8, 12, and 16 and enters the total, $4,347, on line 17.

Lines 18, 19, and 20. He enters his tax from his 2004, 2005, and 2006 returns on lines 18, 19, and 20, respectively.

Line 21. He enters 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 $3,772 on line 22. The tax on this line is less than the $4,875 of tax he figured using the 2007 tax rate schedule. 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 sec- tion. He writes his and his wife’s social security numbers in the boxes next to 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 “2007 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®, or Visa® Card). For informa- tion 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 follow- ing 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)
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Filing Status

- 1 Single
- 2 Married filing jointly (even if only one had income)
- 3 Married filing separately. Enter spouse’s SSN above and full name here.
- 4 Head of household (with qualifying person). (See page 13.) If the qualifying person is a child but not your dependent, enter this child’s name here.
- 5 Qualifying widow(er) with dependent child (see page 14)
- 6 □ Box checked on 6a and 6b. No. of children on 6a whose
  □ did not live with you due to divorce or separation (see page 16)
  □ did not receive $3 (see page 12)
  □ not entered above
- 7 Dependents:
  □ Total number of dependents claimed
- 8 Add numbers on lines above □ 2
- 9 Income
  - 7 Wages, salaries, tips, etc. Attach Form(s) W-2
  - 8 Tax-exempt interest. Attach Schedule B if required
  - 9a Ordinary dividends, Attach Schedule B if required
  - 9b
- 10 Taxable interest. Attach Schedule B if required
- 11 Alimony received
- 12 Business income or loss. Attach Schedule C or C-EZ
- 13 Capital gain or loss. Attach Schedule D if required. If not required, check here □ 13 (1,260) –
- 14 Other gains or losses. Attach Form 4797
- 15a IRA distributions
  □ Taxable amount (see page 21)
  □ Taxable amount (see page 22)
  □ Taxable amount (see page 24)
- 16b Other income. List type and amount (see page 24)
- 17 Unemployment compensation
  □ Taxable amount (see page 24)
- 18 Social security benefits
  □ Taxable amount (see page 24)
- 19 □ Other income. List type and amount (see page 24)
- 20 □ Add the amounts in the far right column for lines 7 through 21. This is your total income □ 22
- 21 Adjusted Gross Income
  □ Subtract line 36 from line 22. This is your adjusted gross income □ 37

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see page 83.

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<table>
<thead>
<tr>
<th>Form 1040 (2007)</th>
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</thead>
</table>

**Tax and Credits**

<table>
<thead>
<tr>
<th>Line</th>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>38</td>
<td>Amount from line 37 (adjusted gross income)</td>
<td>$59,516</td>
</tr>
<tr>
<td>39a</td>
<td>Check: You were born before January 2, 1943, or Blind</td>
<td></td>
</tr>
<tr>
<td>b</td>
<td>If your spouse (if you have one) is or was born before January 2, 1943, or Blind</td>
<td></td>
</tr>
<tr>
<td>40</td>
<td>Total boxes checked</td>
<td></td>
</tr>
<tr>
<td>40a</td>
<td>If you have a separate return or a joint return, check here</td>
<td>$15,000</td>
</tr>
<tr>
<td>41</td>
<td>Subtract line 40 from line 38</td>
<td>$44,516</td>
</tr>
<tr>
<td>42</td>
<td>If line 38 is $117,300 or less, multiply $3,400 by the total number of exemptions claimed on line 6d. If line 38 is over $117,300, see the worksheet on page 33.</td>
<td>$6,800</td>
</tr>
<tr>
<td>43</td>
<td>Taxable income. Subtract line 42 from line 41. If line 42 is more than line 41, enter 0.</td>
<td>$37,716</td>
</tr>
<tr>
<td>44</td>
<td>Tax (see page 33). Check if any tax is from:</td>
<td>$3,772</td>
</tr>
<tr>
<td>44a</td>
<td>Power failure</td>
<td></td>
</tr>
<tr>
<td>44b</td>
<td>Form 8801</td>
<td></td>
</tr>
<tr>
<td>44c</td>
<td>Form 8859</td>
<td></td>
</tr>
<tr>
<td>44d</td>
<td>Form 8874</td>
<td></td>
</tr>
<tr>
<td>45</td>
<td>Alternative minimum tax (see page 36). Attach Form 6251.</td>
<td></td>
</tr>
<tr>
<td>46</td>
<td>Add lines 44 and 45.</td>
<td>$3,772</td>
</tr>
<tr>
<td>47</td>
<td>Credit for child and dependent care expenses. Attach Form 2441.</td>
<td></td>
</tr>
<tr>
<td>48</td>
<td>Credit for the elderly or the disabled. Attach Schedule R.</td>
<td></td>
</tr>
<tr>
<td>49</td>
<td>Education credits, Attach Form 8862.</td>
<td></td>
</tr>
<tr>
<td>50</td>
<td>Residential energy credits. Attach Form 5699.</td>
<td></td>
</tr>
<tr>
<td>51</td>
<td>Foreign tax credit. Attach Form 1116 if required.</td>
<td></td>
</tr>
<tr>
<td>52</td>
<td>Child tax credit (see page 39). Attach Form 8901 if required.</td>
<td></td>
</tr>
<tr>
<td>53</td>
<td>Retirement savings contributions credit. Attach Form 8880, Schedule A.</td>
<td></td>
</tr>
<tr>
<td>54</td>
<td>Credits:</td>
<td></td>
</tr>
<tr>
<td>55</td>
<td>Other credits:</td>
<td></td>
</tr>
<tr>
<td>56</td>
<td>Add lines 46 through 55. These are your total credits.</td>
<td>$3,772</td>
</tr>
<tr>
<td>57</td>
<td>Subtract line 56 from line 46. If line 55 is not more than line 46, enter 0.</td>
<td></td>
</tr>
</tbody>
</table>

**Other Taxes**

<table>
<thead>
<tr>
<th>Line</th>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>58</td>
<td>Self-employment tax, Attach Schedule SE.</td>
<td>$8,384</td>
</tr>
<tr>
<td>59</td>
<td>Unreported social security and Medicare tax from:</td>
<td></td>
</tr>
<tr>
<td>a</td>
<td>A Form 1099-S</td>
<td></td>
</tr>
<tr>
<td>b</td>
<td>Form 8919</td>
<td></td>
</tr>
<tr>
<td>60</td>
<td>Additional tax on IRA, other qualified retirement plans, etc., Attach Form 5329 if required.</td>
<td></td>
</tr>
<tr>
<td>61</td>
<td>Advance earned income credit payments from Forms W-2, box 9, and W-9, box 10.</td>
<td></td>
</tr>
<tr>
<td>62</td>
<td>Household employment taxes. Attach Schedule H.</td>
<td></td>
</tr>
<tr>
<td>63</td>
<td>Add lines 57 through 62. This is your total tax.</td>
<td>$12,766</td>
</tr>
<tr>
<td>64</td>
<td>Federal income tax withheld from Forms W-2 and 1099, 2007 estimated tax payments, and amount applied from 2006 return.</td>
<td></td>
</tr>
<tr>
<td>65</td>
<td>If you have a qualifying child, attach Schedule EIC.</td>
<td></td>
</tr>
<tr>
<td>66a</td>
<td>Earned income credit (EIC)</td>
<td></td>
</tr>
<tr>
<td>b</td>
<td>Nonrefundable tax credit</td>
<td></td>
</tr>
<tr>
<td>67</td>
<td>Excess social security tax (see page 39).</td>
<td></td>
</tr>
<tr>
<td>68</td>
<td>Additional child tax credit, Attach Form 8812</td>
<td></td>
</tr>
<tr>
<td>69</td>
<td>Amount paid with request for extension to file (see page 59).</td>
<td></td>
</tr>
<tr>
<td>70</td>
<td>Payments from:</td>
<td></td>
</tr>
<tr>
<td>a</td>
<td>A Form 2419, b Form 8863, c Form 8864</td>
<td></td>
</tr>
<tr>
<td>71</td>
<td>Refundable credit for prior year minimum tax from Form 8801, line 27.</td>
<td></td>
</tr>
<tr>
<td>72</td>
<td>Add lines 64, 65, 66a, and 67 through 71. These are your total payments.</td>
<td></td>
</tr>
<tr>
<td>73</td>
<td>If line 72 is more than line 63, subtract line 63 from line 72. This is the amount you overpaid</td>
<td>$1,795</td>
</tr>
<tr>
<td>74a</td>
<td>Amount of line 73 you want refunded to you, if Form 8888 is attached, check here</td>
<td></td>
</tr>
<tr>
<td>b</td>
<td>Routing number</td>
<td></td>
</tr>
<tr>
<td>c</td>
<td>Type</td>
<td></td>
</tr>
<tr>
<td>d</td>
<td>Checking</td>
<td></td>
</tr>
<tr>
<td>e</td>
<td>Savings</td>
<td></td>
</tr>
<tr>
<td>74b</td>
<td>You can also claim the credit in 2007 for 2006 tax.</td>
<td></td>
</tr>
<tr>
<td>75</td>
<td>Amount of line 73 you want applied to your 2008 estimated tax.</td>
<td></td>
</tr>
</tbody>
</table>

**Amount You Owe**

<table>
<thead>
<tr>
<th>Line</th>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>76</td>
<td>Amount you owe. Subtract line 72 from line 63. For details on how to pay, see page 63.</td>
<td>$10,081</td>
</tr>
</tbody>
</table>

**Third Party Designee**

<table>
<thead>
<tr>
<th>Name</th>
<th>Phone number</th>
<th>Personal identification number (if any)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Sign Here**

<table>
<thead>
<tr>
<th>Joint return?</th>
<th>Keep a copy for your records.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Date</th>
<th>Occupation</th>
<th>Daytime phone number</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Date</th>
<th>Occupation</th>
<th>Preparer’s occupation</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Date</th>
<th>Check if self-employed</th>
<th>Preparer’s SSN or PTIN</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
### SCHEDULE D  
**Capital Gains and Losses**

**Walter A. & Jane W. Brown**  
543 00 2111

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

<table>
<thead>
<tr>
<th>(a) Description of property (Example: 100 an. XYZ Co.)</th>
<th>(b) Date acquired (Mo., day, yr.)</th>
<th>(c) Date sold (Mo., day, yr.)</th>
<th>(d) Sales price (see page D-7 of the instructions)</th>
<th>(e) Cost or other basis (see page D-7 of the instructions)</th>
<th>(f) Gain or (loss)</th>
<th>Subtract (a) from (d)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>3</td>
<td></td>
</tr>
<tr>
<td>4</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>4</td>
<td></td>
</tr>
<tr>
<td>5</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>5</td>
<td></td>
</tr>
<tr>
<td>6</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>6</td>
<td></td>
</tr>
<tr>
<td>7</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>7</td>
<td></td>
</tr>
</tbody>
</table>

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

<table>
<thead>
<tr>
<th>(a) Description of property (Example: 100 an. XYZ Co.)</th>
<th>(b) Date acquired (Mo., day, yr.)</th>
<th>(c) Date sold (Mo., day, yr.)</th>
<th>(d) Sales price (see page D-7 of the instructions)</th>
<th>(e) Cost or other basis (see page D-7 of the instructions)</th>
<th>(f) Gain or (loss)</th>
<th>Subtract (a) from (d)</th>
</tr>
</thead>
<tbody>
<tr>
<td>8 140 Shares Circle Corp</td>
<td>10-16-85</td>
<td>6-5-07</td>
<td>1,000</td>
<td>15,000</td>
<td>(14,000)</td>
<td></td>
</tr>
<tr>
<td>9</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>10</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>10</td>
<td></td>
</tr>
</tbody>
</table>
| 11 Gain from Form 4797, Part I; long-term gain from Forms 2438 and 6252; and long-term gain or (loss) from Forms 4684, 6781, and 8824 | 12,740 | 12
| 12 Net long-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1 | 12,740 | 12
| 13 Capital gain distributions. See page D-2 of the instructions | 13
| 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 | 14 | ( )
| 15 Net long-term capital gain or (loss). Combine lines 8 through 14 in column (f). Then go to Part III on the back | 15 | (1,260) |
### Part III  Summary

#### 16  Combine lines 7 and 15 and enter the result.

| Line 16 | (1,260) | – |

If line 16 is:
- **A gain**, enter the amount from line 16 on Form 1040, line 13, or Form 1040NR, line 14. Then go to line 17 below.
- **A loss**, skip lines 17 through 20 below. Then go to line 21. Also be sure to complete line 22.
- **Zero**, skip lines 17 through 21 below and enter –0– on Form 1040, line 13, or Form 1040NR, line 14. Then go to line 22.

#### 17  Are lines 15 and 16 **both** gains?

- **Yes.** Go to line 18.
- **No.** Skip lines 18 through 21, and go to line 22.

| Line 18 | –0– |

#### 18  Enter the amount, if any, from line 7 of the 28% Rate Gain Worksheet on page D-8 of the instructions.

| Line 19 | –0– |

#### 19  Enter the amount, if any, from line 18 of the Unrecaptured Section 1250 Gain Worksheet on page D-9 of the instructions.

| Line 20 | –0– |

#### 20  Are lines 18 and 19 both zero or blank?

- **Yes.** Complete Form 1040 through line 43, or Form 1040NR through line 40. Then complete the Qualified Dividends and Capital Gain Tax Worksheet on page 35 of the Instructions for Form 1040 (or in the Instructions for Form 1040NR). **Do not** complete lines 21 and 22 below.
- **No.** 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.

#### 21  If line 16 is a **loss**, enter here and on Form 1040, line 13, or Form 1040NR, line 14, the smaller of:

- The loss on line 16 or
  - ($3,000), or if married filing separately, ($1,500)

**Note.** When figuring which amount is smaller, treat both amounts as positive numbers.

| Line 22 | (1,260) | – |

#### 22  Do you have qualified dividends on Form 1040, line 9b, or Form 1040NR, line 12b?

- **Yes.** Complete Form 1040 through line 43, or Form 1040NR through line 40. Then complete the Qualified Dividends and Capital Gain Tax Worksheet on page 35 of the Instructions for Form 1040 (or in the Instructions for Form 1040NR).
- **No.** Complete the rest of Form 1040 or Form 1040NR.
**Profit or Loss From Farming**

<table>
<thead>
<tr>
<th>Part I: Farm Income—Cash Method</th>
<th>Part II: Farm Expenses—Cash and Accrual Method</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>1. Sales of livestock and other items you bought for resale:</strong></td>
<td><strong>12. Car and truck expenses (see page F-4). Also attach Form 4922:</strong></td>
</tr>
<tr>
<td><strong>2. Cost or other basis of livestock and other items reported on line 1:</strong></td>
<td><strong>13. Chemicals</strong></td>
</tr>
<tr>
<td><strong>3. Subtract line 2 from line 1:</strong></td>
<td><strong>14. Conservation expenses (see page F-4):</strong></td>
</tr>
<tr>
<td><strong>4. Sales of livestock, produce, grains, and other products you raised:</strong></td>
<td><strong>15. Custom hire (machine work):</strong></td>
</tr>
<tr>
<td><strong>5a. Cooperative distributions (Form(s) 1099-PATR):</strong></td>
<td><strong>16. Depreciation and section 179 expense deduction not claimed elsewhere (see page F-9):</strong></td>
</tr>
<tr>
<td><strong>5b. Taxable amount:</strong></td>
<td><strong>17. Employee benefit programs other than on line 25:</strong></td>
</tr>
<tr>
<td><strong>6a. Agricultural program payments (see page F-5):</strong></td>
<td><strong>18. Feed:</strong></td>
</tr>
<tr>
<td><strong>6b. Taxable amount:</strong></td>
<td><strong>19. Fertilizers and lime:</strong></td>
</tr>
<tr>
<td><strong>7. Commodity Credit Corporation (CCC) loans (see page F-3):</strong></td>
<td><strong>20. Freight and trucking:</strong></td>
</tr>
<tr>
<td><strong>7a. CCC loans reported under election:</strong></td>
<td><strong>21. Gasoline, fuel, and oil:</strong></td>
</tr>
<tr>
<td><strong>7b. CCC loans forfeited:</strong></td>
<td><strong>22. Insurance (other than health):</strong></td>
</tr>
<tr>
<td><strong>7c. Taxable amount:</strong></td>
<td><strong>23. Interest:</strong></td>
</tr>
<tr>
<td><strong>8. Crop insurance proceeds and federal crop disaster payments (see page F-3):</strong></td>
<td><strong>23a. Mortgage (paid to banks, etc.)</strong></td>
</tr>
<tr>
<td><strong>8a. Amount received in 2007:</strong></td>
<td><strong>23b. Other</strong></td>
</tr>
<tr>
<td><strong>8b. Taxable amount:</strong></td>
<td><strong>24. Labor hired (less employment credits):</strong></td>
</tr>
<tr>
<td><strong>9. Custom hire (machine work) income:</strong></td>
<td><strong>25. Pension and profit-sharing plans:</strong></td>
</tr>
<tr>
<td><strong>10. Other income, including federal and state gasoline or fuel tax credit or refund (see page F-3):</strong></td>
<td><strong>26. Rent or lease (see page F-6):</strong></td>
</tr>
<tr>
<td><strong>11. Gross income. Add amounts in the right column for lines 3 through 10. If you use the accrual method, enter the amount from Part III (line 51):</strong></td>
<td><strong>26a. Vehcles, machinery, and equipment:</strong></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.

**35. Total expenses. Add lines 12 through 34. If line 34 is negative, see instructions.**

**36. Net farm profit or (loss). Subtract line 35 from line 11.**

- If you file Form 1040NR, enter the profit on Form 1040NR, line 19.
- If you have a loss, you must check the box that describes your investment in this activity (see page F-7).
- Some investment is not at risk.
- All investment is at risk.

**37. If you have a loss, you must check the box that describes your investment in this activity: (see page F-7).**

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

---

**SCHEDULE F**

<table>
<thead>
<tr>
<th>(Form 1040)</th>
<th>Profit or Loss From Farming</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Name of proprietor</strong></td>
<td><strong>WALTER A. BROWN</strong></td>
</tr>
<tr>
<td><strong>Accounting method:</strong></td>
<td><strong>(1) Cash</strong></td>
</tr>
<tr>
<td><strong>Internal Revenue Service</strong></td>
<td><strong>Department of the Treasury</strong></td>
</tr>
<tr>
<td><strong>Social security number (SSN):</strong></td>
<td><strong>543 : 00 : 211</strong></td>
</tr>
</tbody>
</table>

---

**Chapter 16 Sample Return Page 93**
The type and rule above prints on all proofs including departmental reproduction proofs. MUST be removed before printing.

**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-4).

**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.

<table>
<thead>
<tr>
<th>Step</th>
<th>Formula/Instructions</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Net farm profit or (loss) from Schedule F, line 36, and farm partnerships, Schedule K-1 (Form 1066), box 14, code A</td>
</tr>
<tr>
<td>2</td>
<td>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-3 for other income to report</td>
</tr>
<tr>
<td>3</td>
<td>Combine lines 1 and 2</td>
</tr>
<tr>
<td>4</td>
<td>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</td>
</tr>
<tr>
<td>5</td>
<td>Self-employment tax. If the amount on line 4 is: $97,500 or less, multiply line 4 by 15.3% (.153). Enter the result here and on Form 1040, line 58.</td>
</tr>
<tr>
<td>6</td>
<td>More than $97,500, multiply line 4 by 2.9% (.029). Then, add $12,090 to the result. Enter the total here and on Form 1040, line 58.</td>
</tr>
</tbody>
</table>

For Paperwork Reduction Act Notice, see Form 1040 instructions.
SCHEDULE J
(Form 1040)

Name(s) shown on return

WALTER A. & JANE W. BROWN

Social security number (SSN)

22

577

12

575

8

1,015

5

1,112

2

27,189

3

10,527

4

1,253

6

9,063

7

10,795

8

1,015

9

627

10

9,063

11

9,725

12

973

13

3,068

14

9,063

15

13,031

16

1,303

17

4,247

18

111

19

666

20

398

*Do not include any tax from Form 8814 or 4972 or from recapture of an education credit. Also, do not include alternative minimum tax from Form 1040A.

Add lines 1 through 20

21

575

22

3,772

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

Cat. No. 25513Y

Schedule J (Form 1040) 2007

2007

Attach to Form 1040 or Form 1040NR. See Instructions for Schedule J (Form 1040).

OMB No. 1545-0074

Attachment

Sequence No. 20

Department of the Treasury
Internal Revenue Service

SCHEDULE J
(For Paperwork Reduction Act Notice, see Form 1040 or Form 1040NR instructions.)

Chapter 16 Sample Return Page 95
#### SECTION B—Business and Income-Producing Property

**Part I**  
**Casualty or Theft Gain or Loss** *(Use a separate Part I for each casualty or theft.)*

19 Description of properties (show type, location, and date acquired for each property). Use a separate line for each property lost or damaged from the same casualty or theft.

<table>
<thead>
<tr>
<th>Property A</th>
<th>Property B</th>
<th>Property C</th>
<th>Property D</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>DAIRY COW #42</strong></td>
<td><strong>HOMETOWN, VA</strong></td>
<td><strong>6-22-03</strong></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Line</th>
<th>Description of properties (show type, location, and date acquired for each property). Use a separate line for each property lost or damaged from the same casualty or theft.</th>
</tr>
</thead>
<tbody>
<tr>
<td>20</td>
<td>Cost or adjusted basis of each property,</td>
</tr>
<tr>
<td>21</td>
<td>Insurance or other reimbursement (whether or not you filed a claim).</td>
</tr>
<tr>
<td></td>
<td>See the instructions for line 3.</td>
</tr>
<tr>
<td>22</td>
<td>Gain from casualty or theft. If line 21 is more than line 20, enter the difference here and on line 29 or line 34 and subtract line 24 from line 23.</td>
</tr>
<tr>
<td></td>
<td>Subtract line 24 from line 23.</td>
</tr>
<tr>
<td>23</td>
<td>Fair market value before casualty or theft.</td>
</tr>
<tr>
<td>24</td>
<td>Fair market value after casualty or theft.</td>
</tr>
<tr>
<td>25</td>
<td>Subtract line 24 from line 23.</td>
</tr>
<tr>
<td>26</td>
<td>Enter the smaller of line 20 or line 25.</td>
</tr>
<tr>
<td></td>
<td>See the instructions for line 3.</td>
</tr>
<tr>
<td>27</td>
<td>Subtract line 21 from line 26. If zero or less, enter 0.</td>
</tr>
</tbody>
</table>

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

<table>
<thead>
<tr>
<th>Line</th>
<th>Identification number</th>
<th>(a) Identify casualty or theft</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>(b) Trade, business, rental or royalty property</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Line</th>
<th>Summary of Gains and Losses (from separate Parts I)</th>
</tr>
</thead>
<tbody>
<tr>
<td>28</td>
<td></td>
</tr>
</tbody>
</table>

### Note:
- If the loss on line 37 is more than the gain on line 36:
- Combine lines 36 and 37 and enter here. Partnerships (except electing large partnerships) and S corporations, see the note below. Electing large partnerships, enter on Form 1065-B, Part II, line 11.
- If Form 4797 is not otherwise required, see instructions.
- Enter the amount from (line 35, column (b)(ii)) here. Individuals, enter the amount from income-producing property used as an employee on Schedule A (Form 1040), line 23, or Schedule A (Form 1040NR), line 11. Estates and trusts, partnerships, and S corporations, see instructions.
- The fair market value of the property was $148 for the month of October 2007.
<table>
<thead>
<tr>
<th>Part I</th>
<th>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)</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a) Description of property</td>
<td>(b) Date acquired (mo., day, yr.)</td>
</tr>
<tr>
<td>2</td>
<td>RAISED Cows</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Part II</th>
<th>Ordinary Gains and Losses (see instructions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a) Location</td>
<td>(b) Gain, if any, from line 3, 4, or 5</td>
</tr>
<tr>
<td>10 RAISED Dairy Heifer</td>
<td>2007</td>
</tr>
</tbody>
</table>

| (a) Location | (b) Gain or (loss) from Form 4684, lines 31 and 38a |
| 14 | 954 |

| (a) Location | (b) Gain or (loss) from like-kind exchanges from Form 8824 |
| 16 | 954 |

| (a) Location | (b) Gain, if any, from line 25 or 36 |
| 17 | 954 |

| (a) Location | (b) Loss, if any, from Form 4684, line 35, column (b)(ii), or Form 8824, line 38a |
| 18a | 954 |
### Form 4797 (2007)

#### Part III: Gain From Disposition of Property Under Sections 1245, 1250, 1252, 1254, and 1255

(see instructions)

<table>
<thead>
<tr>
<th>(a) Description of section 1245, 1250, 1252, 1254, or 1255 property:</th>
<th>(b) Date acquired (mo., day, yr.)</th>
<th>(c) Date sold (mo., day, yr.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Truck</td>
<td>6-22-97</td>
<td>7-9-07</td>
</tr>
<tr>
<td>Mower</td>
<td>4-21-98</td>
<td>8-12-07</td>
</tr>
<tr>
<td>Purchased Dairy Cow #60</td>
<td>2-21-04</td>
<td>10-28-07</td>
</tr>
</tbody>
</table>

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

<table>
<thead>
<tr>
<th>Property A</th>
<th>Property B</th>
<th>Property C</th>
<th>Property D</th>
</tr>
</thead>
<tbody>
<tr>
<td>700</td>
<td>70</td>
<td>670</td>
<td></td>
</tr>
<tr>
<td>4,390</td>
<td>1,200</td>
<td>1,200</td>
<td></td>
</tr>
<tr>
<td>2,200</td>
<td>670</td>
<td>1,200</td>
<td></td>
</tr>
<tr>
<td>23</td>
<td>0</td>
<td>0</td>
<td>558</td>
</tr>
</tbody>
</table>

24 Total gain. Subtract line 23 from line 20... 24 700 70 82

25 If section 1245 property:

a) Depreciation allowed or allowable from line 22...

b) Enter the smaller of line 24 or 25...

<table>
<thead>
<tr>
<th>Property A</th>
<th>Property B</th>
<th>Property C</th>
<th>Property D</th>
</tr>
</thead>
<tbody>
<tr>
<td>4,390</td>
<td>1,200</td>
<td>612</td>
<td></td>
</tr>
<tr>
<td>700</td>
<td>70</td>
<td>82</td>
<td></td>
</tr>
</tbody>
</table>

26 If section 1250 property:

i) Straight line depreciation was used, enter -0- on line 26g, except for a corporation subject to section 291.

ii) Applicable percentage multiplied by the smaller of line 24 or line 26a (see instructions).

<table>
<thead>
<tr>
<th>Property A</th>
<th>Property B</th>
<th>Property C</th>
<th>Property D</th>
</tr>
</thead>
<tbody>
<tr>
<td>26a</td>
<td>26b</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

27 If section 1252 property:

a) Soil, water, and land clearing expenses...

b) Line 27a multiplied by applicable percentage (see instructions)

c) Enter the smaller of line 24 or 27c...

<table>
<thead>
<tr>
<th>Property A</th>
<th>Property B</th>
<th>Property C</th>
<th>Property D</th>
</tr>
</thead>
<tbody>
<tr>
<td>27a</td>
<td>27b</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

28 If section 1255 property:

a) Applicable percentage of payments excluded from income...

b) Enter the smaller of line 24 or 29b (see instructions)

<table>
<thead>
<tr>
<th>Property A</th>
<th>Property B</th>
<th>Property C</th>
<th>Property D</th>
</tr>
</thead>
<tbody>
<tr>
<td>29a</td>
<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.

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

(see instructions)

<table>
<thead>
<tr>
<th>(a) Section 179</th>
<th>(b) Section 280F(b)(2)</th>
</tr>
</thead>
<tbody>
<tr>
<td>33</td>
<td>34</td>
</tr>
</tbody>
</table>

Section 179 expense deduction or depreciation allowable in prior years...
Recomputed depreciation (see instructions)
Recapture amount. Subtract line 34 from line 33. See the instructions for where to report...
Please note that the image contains a form with the following text:

**Form 4562**

**Depreciation and Amortization**

(Informing Information on Listed Property)

<table>
<thead>
<tr>
<th>Name(s) shown on return</th>
<th>WALTER A. &amp; JANE W. BROWN FARMING</th>
</tr>
</thead>
<tbody>
<tr>
<td>Business or activity to which this form relates</td>
<td>FARMING</td>
</tr>
</tbody>
</table>

**Part I**

**Election To Expense Certain Property Under Section 179**

1. Maximum amount. See the instructions for a higher limit for certain businesses.
   - **1** $125,000
   - **2** $100,250
   - **3** $500,000
   - **4** $0
   - **5** $125,000

2. Listed property. Enter amount from line 29.

3. Total elected cost of section 179 property placed in service (see instructions).

4. Threshold cost of section 179 property before reduction in limitation.

5. Dollar limitation for tax year. Subtract line 4 from line 2. If zero or less, enter -0-.

**Part II**

**Special Depreciation Allowance and Other Depreciation**

6. Elected cost of section 179 property. Add amounts in column (c), lines 6 and 7.

7. MACRS deductions for assets placed in service in tax years beginning before 2007.

8. Other depreciation (including ACRS).

9. Special allowance for qualified New York Liberty or Gulf Opportunity Zone property (other than listed property) and cellulosic biomass ethanol plant property placed in service during the tax year (see instructions).

10. Property subject to section 168(f)(1) election.

11. Section 179 expense deduction. Add lines 9 and 10, but do not enter more than line 11.

12. Carryover of disqualified deduction from line 13 of your 2006 Form 4562.

Note: Do not use Part II or Part III below for listed property. Instead, use Part V.

**Part III**

**MACRS Depreciation**


14. Carryover of disqualified deduction to 2008. Add lines 15 and 16, but do not enter more than line 17.

Note: Do not use Part III below for listed property.

**Section A**

**Section B—Assets Placed in Service During 2007 Tax Year Using the General Depreciation System**

<table>
<thead>
<tr>
<th>Classification of property</th>
<th>3-year property</th>
<th>Recovery period</th>
<th>Method</th>
<th>Depreciation deduction</th>
</tr>
</thead>
<tbody>
<tr>
<td>Basis for depreciation</td>
<td>30-month MACRS</td>
<td>HY</td>
<td>S/L</td>
<td>5,287</td>
</tr>
<tr>
<td>(b) Cost for depreciation</td>
<td>3-year property</td>
<td>100% S/L</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(c) Basis for depreciation</td>
<td>25% S/L</td>
<td>S/L</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(d) Recovery period</td>
<td>120% S/L</td>
<td>S/L</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(e) Convention</td>
<td>200% S/L</td>
<td>S/L</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(f) Method</td>
<td>300% S/L</td>
<td>S/L</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(g) Depreciation deduction</td>
<td>150% S/L</td>
<td>S/L</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Section C—Assets Placed in Service During 2007 Tax Year Using the Alternative Depreciation System**

<table>
<thead>
<tr>
<th>Class</th>
<th>12-year property</th>
<th>40-year property</th>
</tr>
</thead>
<tbody>
<tr>
<td>Basis for depreciation</td>
<td>30-month MACRS</td>
<td>HY</td>
</tr>
<tr>
<td>(b) Cost for depreciation</td>
<td>12-year property</td>
<td>S/L</td>
</tr>
<tr>
<td>(c) Basis for depreciation</td>
<td>40-year property</td>
<td>S/L</td>
</tr>
</tbody>
</table>

**Part IV**

**Summary (see instructions)**

<table>
<thead>
<tr>
<th>Listed property</th>
<th>Enter amount from line 28</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>Add amounts from line 12, lines 14 through 17, lines 19 and 20 in column (g), and line 21, then enter here and on the appropriate lines of your return.</td>
</tr>
</tbody>
</table>

For Paperwork Reduction Act Notice, see separate instructions.

Cat. No. 12906N

Form 4562 (2007)

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The type and rule above prints on all proofs including departmental reproduction proofs. MUST be removed before printing.
### Form 4562 (2007)

#### 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>(a) Type of property (list vehicles first)</th>
<th>(b) Date placed in service</th>
<th>(c) Cost or other basis</th>
<th>(d) Cost or other basis</th>
<th>(e) Basis for depreciation (business/ investment use only)</th>
<th>(f) Recovery period</th>
<th>(g) Method/ Convention</th>
<th>(h) Depreciation deduction</th>
</tr>
</thead>
<tbody>
<tr>
<td>PICKUP TRUCK</td>
<td>9-18-04</td>
<td>100 %</td>
<td>7,076.00</td>
<td>7,076.00</td>
<td>B</td>
<td>190DB/HYT</td>
<td>1,179.00</td>
</tr>
</tbody>
</table>

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

26 Property used more than 50% in a qualified business use:

<table>
<thead>
<tr>
<th>Type of property</th>
<th>Date placed in service</th>
<th>Cost</th>
<th>Basis for depreciation</th>
<th>Recovery period</th>
<th>Method/ Convention</th>
<th>Depreciation deduction</th>
</tr>
</thead>
<tbody>
<tr>
<td>PICKUP TRUCK</td>
<td>9-18-04</td>
<td>100</td>
<td>7,076.00</td>
<td>B</td>
<td>190DB/HYT</td>
<td>1,179.00</td>
</tr>
</tbody>
</table>

27 Property used 50% or less in a qualified business use:

<table>
<thead>
<tr>
<th>Type of property</th>
<th>Cost</th>
<th>Basis for depreciation</th>
<th>Recovery period</th>
<th>Method/ Convention</th>
<th>Depreciation deduction</th>
</tr>
</thead>
<tbody>
<tr>
<td>PICKUP TRUCK</td>
<td>100</td>
<td>7,076.00</td>
<td>B</td>
<td>190DB/HYT</td>
<td>1,179.00</td>
</tr>
</tbody>
</table>

28 Add amounts in column (h), lines 25 through 27. Enter here and on line 21, page 1.

29 Add amounts in column (i), line 26. Enter here and on line 7, page 1.

#### 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.

<table>
<thead>
<tr>
<th>(a) Type of property</th>
<th>(b) Date placed in service</th>
<th>(c) Cost or other basis</th>
<th>(d) Cost or other basis</th>
<th>(e) Basis for depreciation (business/ investment use only)</th>
<th>(f) Recovery period</th>
<th>(g) Method/ Convention</th>
<th>(h) Depreciation deduction</th>
</tr>
</thead>
<tbody>
<tr>
<td>PICKUP TRUCK</td>
<td>9-18-04</td>
<td>100 %</td>
<td>7,076.00</td>
<td>7,076.00</td>
<td>B</td>
<td>190DB/HYT</td>
<td>1,179.00</td>
</tr>
</tbody>
</table>

30 Total business/investment miles driven during the year (do not include commuting miles).

31 Total commuting miles driven during the year.

32 Total other personal (noncommuting) miles driven.

33 Total miles driven during the year. Add lines 30 through 32.

34 Was the vehicle available for personal use during off-duty hours?

35 Was the vehicle used primarily by a more than 5% owner or related person?

36 Is another vehicle available for personal use?

37 Do you maintain a written policy statement that prohibits all personal use of vehicles, including commuting, by your employees?

38 Do you maintain a written policy statement that prohibits personal use of vehicles, except commuting, by your employees?

39 Do you treat all use of vehicles by employees as personal use?

40 Do you provide more than five vehicles to your employees, obtain information from your employees about the use of the vehicles, and retain the information received?

41 Do you meet the requirements concerning qualified automobile demonstration use? (See instructions.)

<table>
<thead>
<tr>
<th>(a) Description of costs</th>
<th>(b) Date amortization begins</th>
<th>(c) Amortizable amount</th>
<th>(d) Code section</th>
<th>(e) Amortization period or percentage</th>
<th>(f) Amortization for this year</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

42 Amortization of costs that begins during your 2007 tax year (see instructions).

43 Amortization of costs that began before your 2007 tax year.

44 Total. Add amounts in column (f). See the instructions for where to report.

---

**Note:** The text provided is a transcription of the given page of the document. It includes necessary adjustments to ensure accessibility and readability. The context and meaning of the content remain consistent with the original document.
<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 ACRS</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>6,200</td>
<td>100%</td>
<td></td>
<td>6,200</td>
<td>– 0 –</td>
<td>SL</td>
<td>19</td>
<td></td>
<td>– 0 –</td>
</tr>
<tr>
<td>MACHS</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>6-22-03</td>
<td>600</td>
<td>&quot;</td>
<td></td>
<td>500</td>
<td>600</td>
<td>SL/HY</td>
<td>7</td>
<td>14.29</td>
<td>42.87</td>
</tr>
<tr>
<td>DAIRY COW #521 (old 2007)</td>
<td>7-16-04</td>
<td>900</td>
<td>&quot;</td>
<td></td>
<td>450</td>
<td>800</td>
<td>SL/HY</td>
<td>7</td>
<td>14.29</td>
<td>64.31</td>
</tr>
<tr>
<td>DAIRY COW #54</td>
<td>9-9-03</td>
<td>1,200</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 #60</td>
<td>2-21-04</td>
<td>1,200</td>
<td>100%</td>
<td></td>
<td>555</td>
<td>1,200</td>
<td>150DB/HY</td>
<td>7</td>
<td>12.25</td>
<td>73.50</td>
</tr>
<tr>
<td>PLOW</td>
<td>4-6-04</td>
<td>4,821</td>
<td>&quot;</td>
<td></td>
<td>1,599</td>
<td>4,821</td>
<td>150DB/HY</td>
<td>10</td>
<td>10.02</td>
<td>483.06</td>
</tr>
<tr>
<td>PICKUP TRUCK (listed property)</td>
<td>5-16-04</td>
<td>7,076</td>
<td>&quot;</td>
<td></td>
<td>4,129</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>9-1-04</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>10-12-04</td>
<td>13,483</td>
<td>&quot;</td>
<td></td>
<td>5,000</td>
<td>2,614</td>
<td>150DB/HY</td>
<td>10</td>
<td>10.02</td>
<td>649.99</td>
</tr>
<tr>
<td>MILK TANK</td>
<td>1-4-06</td>
<td>11,000</td>
<td>100%</td>
<td></td>
<td>10,200</td>
<td>446</td>
<td>150DB/HY</td>
<td>7</td>
<td>15.03</td>
<td>225.46</td>
</tr>
<tr>
<td>MANURE SPREADER</td>
<td>5-5-05</td>
<td>3,400</td>
<td>&quot;</td>
<td></td>
<td>1,650</td>
<td>3,400</td>
<td>150DB/HY</td>
<td>7</td>
<td>15.03</td>
<td>511.02</td>
</tr>
<tr>
<td>DAIRY FACILITY BUILDING</td>
<td>1-9-07</td>
<td>22,250</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>1-9-07</td>
<td>72,000</td>
<td>&quot;</td>
<td></td>
<td>– 0 –</td>
<td>– 0 –</td>
<td>150DB/HY</td>
<td>7</td>
<td>10.71</td>
<td>5,283.89</td>
</tr>
<tr>
<td>MACHINE SHED IMPROVEMENT</td>
<td>2-20-07</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>24.38</td>
</tr>
<tr>
<td>TOTAL</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>11,202.16</td>
</tr>
</tbody>
</table>

1 Depreciation limited to half-year
2 Adjusted basis
### Form 8903

**Domestic Production Activities Deduction**

- **Department of the Treasury**
- **Internal Revenue Service**

**Attach to your tax return.**

**See separate instructions.**

**Identification Number**: 543-00-2111

| Name(s) as shown on return |  |
|----------------------------|  |
| **WALTER A. AND JANE W. BROWN** |  |

#### Instructions:
- **Domestic production gross receipts (DPGR)**
- **Allocable cost of goods sold**
- **If you are using the section 861 method**
- **If you are using the small business simplified overall method**
- **Qualified production activities income**
- **Income limitation**
- **Form W-2 wages**
- **Estate and trusts, subtract line 17 from line 16**, all others, enter amount from line 16
- **Domestic production activities deduction**

#### Calculations:

1. **Domestic production gross receipts (DPGR)**
   - \(301,763\)

2. **Allocable cost of goods sold**
   - \(-0-\)

3. **If you are using the section 861 method**
   - \(-0-\)

4. **If you are using the small business simplified overall method**
   - \(224,264\)

5. **Add lines 2 through 4**
   - \(224,264\)

6. **Subtract line 5 from line 1**
   - \(77,499\)

7. **Qualified production activities income from estates, trusts, and certain partnerships and S corporations**
   - \(-0-\)

8. **Add lines 6 and 7**
   - \(77,499\)

9. **Amount allocated to beneficiaries of the estate or trust**
   - \(-0-\)

10. **If you are using the small business simplified overall method**
    - \(63,315\)

11. **Income limitation**
    - **Individuals, estates, and trusts**: Enter your adjusted gross income figured without the domestic production activities deduction
    - **All others**: Enter your taxable income figured without the domestic production activities deduction (tax-exempt organizations, see instructions)
    - \(63,315\)

12. **Enter the smaller of line 10 or line 11**
    - \(63,315\)

13. **Enter 6% of line 12**
    - \(3,799\)

14. **Form W-2 wages**
    - \(26,368\)

15. **Form W-2 wages from estates, trusts, and certain partnerships and S corporations**
    - \(-0-\)

16. **Add lines 14 and 15**
    - \(26,368\)

17. **Amount allocated to beneficiaries of the estate or trust**
    - \(-0-\)

18. **Enter the smaller of line 13 or line 17**
    - \(3,799\)

19. **Domestic production activities deduction from cooperatives**
    - \(3,799\)

20. **Expanded affiliated group allocation**
    - \(-0-\)

21. **Domestic production activities deduction**
    - \(3,799\)

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

**Cat. No. 37712F**

**Form 8903** (2007)
Chapter 17 How To Get Tax Help

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 (TAS) 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 TAS by calling the TAS toll-free case intake line at 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, Taxpayer Advocate Service – Your Voice at the IRS. You can file Form 911, Request for Taxpayer Advocate Service Assistance (And Application for Taxpayer Assistance Order), or ask an IRS employee to complete it on your behalf. For more information, go to www.irs.gov/advocate.

Taxpayer Advocacy Panel (TAP). The TAP listens to taxpayers, identifies taxpayer issues, and makes suggestions for improving IRS services and customer satisfaction. If you have suggestions for improvements, contact the TAP, toll free at 1-888-912-1227 or go to www.improveirs.org.

Low Income Taxpayer Clinics (LITC). 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.

Accessible versions of IRS published products are available on request in a variety of alternative formats for people with disabilities.

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 2007 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 2007 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 publications.
- Order IRS products online.
- Research your tax questions online.
- Search publications online by topic or keyword.
- View Internal Revenue Bulletins (IRBs) published in the last few years.
- Figure your withholding allowances using the withholding calculator online at www.irs.gov/individuals.
- Determine if Form 6251 must be filed using our Alternative Minimum Tax (AMT) Assistant.
- 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 publications. Call 1-800-829-3676 to order current-year forms, instructions, and publications, and prior-year forms and instructions. You should receive your order within 10 days.
- Asking tax questions. Call the IRS with your tax questions at 1-800-829-1040 (for individuals) or 1-800-829-4933 (for businesses).
- Solving problems. You can get face-to-face help solving tax problems every business day in IRS Taxpayer Assistance Centers. An employee can explain IRS letters, request adjustments to your account, or help you set up a payment plan. Call your local Taxpayer Assistance Center for an appointment. To find the number, go to www.irs.gov/localcontacts or look in the phone book under United States Government, Internal Revenue Service.
- TTY/TDD equipment. If you have access to TTY/TDD equipment, call 1-800-829-4059 to ask tax questions or to order forms and publications.
- TeleTax. Call 1-800-829-4477 to listen to pre-recorded messages covering various tax topics.

Refund information. To check the status of your 2007 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 2007 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.

Evaluating the quality of our telephone services. To ensure IRS representatives give accurate, courteous, and professional answers, we use several methods to evaluate the quality of our telephone services. One method is for a second IRS representative to listen in on or record random telephone calls. Another is to ask some callers to complete a short survey at the end of the call.

Walk-in. Many products and services are available on a walk-in basis.

- Products. You can walk in to many post offices, libraries, and IRS offices to pick up certain forms, instructions, and publications. Some IRS offices, libraries, grocery stores, copy centers, city and county government offices, credit unions, and office supply stores have a collection of products available to print from a CD 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 representative face-to-face. No appointment is necessary, and if you prefer, you can call your local Taxpayer Assistance Center where you can spread out your records and talk with an IRS representative face-to-face. No appointment is necessary.
- Mail. You can send your order for forms, instructions, and publications to the address below. You should receive a response within 10 days after your request is received.

For more information, go to www.irs.gov/advocate.
CD/DVD for tax products. You can order Publication 1796, IRS Tax Products CD/DVD, and obtain:

- Current-year forms, instructions, and publications.
- Prior-year forms, instructions, and publications.
- 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 response system.
- Fill-in, print, and save features for most tax forms.
- Internal Revenue Bulletins.
- Toll-free and email technical support.
- The CD which is released twice during the year.

- The first release will ship the beginning of January 2008.
- The final release will ship the beginning of March 2008.

Purchase the CD/DVD from National Technical Information Service (NTIS) at www.irs.gov/cdorders for $35 (no handling fee) or call 1-877-CDFORMS (1-877-233-6767) toll free to buy the CD/DVD for $35 (plus a $5 handling fee). Price is subject to change.

CD for small businesses. Publication 3207, The Small Business Resource Guide CD for 2007, 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 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 helps teens find a career path, develop work skills, and learn about 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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