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 livestock, dairy, poultry, fish, fruit, and truck farms. It also includes plantations, ranches, ranges, and orchards.

This publication explains how the federal tax laws apply to farming. Use this publication as a guide to figure your taxes and complete your farm tax return. If you need more information on a subject, get the specific IRS tax publication covering that subject. We refer to many of these free publications throughout this publication. See chapter 16 for information on ordering these publications.

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

The IRS Mission. Provide America’s taxpay-
ers top quality service by helping them under-
stand 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.

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Washington, DC 20224

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Therefore, it would be helpful if you would in-
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You can email us at taxforms@irs.gov. (The
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ject line. Although we cannot respond individu-
ally to each email, we do appreciate your
feedback and will consider your comments as
we revise our tax products.

Ordering forms and publications. Visit www.irs.gov/formspubs to download forms and
publications, call 1-800-829-3676, or write to the
address below and receive a response within 10
days after your request is received.

Internal Revenue Service
1201 N. Mitsubishi Motorway
Bloomington, IL 61705-6613

Tax questions. If you have a tax question,
check the information available at 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@sba.gov,
or
• Download the appraisal form at
www.sba.gov/ombudsman.

Treasury Inspector General for Tax Adminis-
tration. If you want to confidentially report mis-
conduct, 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. Contact your county
extension office for more information.

What’s New for 2009

The following items highlight a number of admin-
istrative and tax law changes for 2009. They are
discussed in more detail throughout the publica-
tion. More information on these and other changes can be found on the IRS website at
www.irs.gov/formspubs and click on What’s Hot
in forms and publications.

Exclusion extended on qualified principal
residence debt. You can exclude from in-
come a canceled debt that is qualified principal
residence debt. The exclusion has been ex-
tended through 2012. The amount excluded from
income is applied to reduce (but not below
zero) the basis of your principal residence. See
chapter 3.

Exclude from income payments under Fed-
eral Health Protection Program (FHPP).
Payments received under the FHPP are ex-
ccluded from income. These are payments re-
ceived from the Department of Agriculture for an
integrated pest management strategy to protect
forest, trees, and woods. See chapter 3.

Election to defer income from debt cancella-
tion. You can elect to defer income from the
cancellation of certain business debt. See
chapter 3.

Standard mileage rate. The standard mile-
age rate for the cost of operating your car, van,
pickup, or panel truck in 2009 is 55 cents per
mile for all business miles driven. See chapter 4.

Endangered species recovery expenses.
Beginning in 2009, you can choose to deduct
endangered species recovery expenses. See
chapter 5.

New recovery period for race horses.
Any race horse (without regard to the age of
the horse) placed in service after 2008 is treated as
5-year property for General Depreciation Sys-
tem (GDS) recovery purposes. See chapter 7.

Increased section 179 expense deduction
dollar limits. The maximum amount you can
elect to deduct for most section 179 property you
placed in service in 2009 is $250,000. This limit
is reduced by the amount by which the cost of
the property placed in service during the tax year
exceeds $800,000. See chapter 7.

Extension of special depreciation allowance
for certain qualified property acquired after
2008. You may be able to take a special de-
preciation allowance for certain qualified prop-
erty acquired after 2007 and placed in service
before 2010. See chapter 7.

New recovery period for certain machinery
and equipment. Certain machinery or equip-
ment placed in service after 2008 and before
2010 will be treated as 5-year property for GDS
purposes (10-year property for Alternative De-
preciation System (ADS) purposes). See
chapter 7.

Increase in personal casualty and theft loss
limit. Generally, a personal casualty or theft loss
must exceed $100 to be allowed for 2009. T h i s
is in addition to the 10%-of-adjusted-gross-income
limit that gener-
ally applies to the net loss. See chapter 11.

New Schedule L (Form 1040A or 1040).
If you claim a net disaster loss as part of your
standard deduction, you must complete Sched-
ule L (Form 1040A or 1040) and attach it to Form
1040. See chapter 11.

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 $116,800 for
2009. There is no maximum limit on earnings
subject to the Medicare part (2.9%). See
chapter 12.

New employment tax adjustment process in
2009. If you discover an error on a previously
filed Form 943, Employer’s Annual Federal Tax
Return for Agricultural Employees, after 2008,
make the correction using Form 943-X, Adjusted
Employer’s Annual Federal Tax Return for Agri-
cultural Employees or Claim for Refund. Previ-
ously, taxpayers made corrections to Form 943
using Form 941c, Supporting Statement To Cor-
rect Information, that is filed once a year with
Form 943. Form 943-X is a stand-alone form,
meaning taxpayers can file Form 943-X when an
error is discovered, rather than waiting until the
end of the year to file Form 941c with Form 943.
Current year adjustments will continue to be
made on line 8 of Form 943. See chapter 13.

What’s New for 2010

Expiration of increased section 179 deduc-
tion and special allowance for qualified dis-
aster assistance property. The higher maximum
179 expense deduction and special
depreciation allowance will not apply to qualified
disaster assistance property placed in service in
federally declared disaster areas where the dis-
aster occurred after 2009. See chapter 7.

Expiration of the 5-year recovery period for
certain machinery and equipment. Certain
machinery or equipment used in a farming busi-
ness and placed in service after 2009 will no
longer be treated as 5-year property under
MACRS (or 10-year property under ADS).
See chapter 7.

Marginal production of oil and gas. The
temporary suspension of the taxable income
limit on percentage depletion from the marginal
production of oil and natural gas will no longer
be available for tax years beginning after 2009.
See chapter 7.

Decrease in personal casualty and theft loss
limit. A personal casualty or theft loss must
exceed $100 to be allowed for 2010 and later
years. This is in addition to the
10%-of-adjusted-gross-income limit that gener-
ally applies to the net loss. See chapter 11.
Disaster losses. The special rules that were in effect in 2008 and 2009 for losses of personal use property attributable to federally declared disasters do not apply to losses occurring in 2010 and later years. Instead, these losses will be subject to the 10%-of-AGI limit and will be deductible only if you itemize deductions. These losses will continue to be subject to the $100-per-loss limit. See chapter 11.

Maximum net earnings. The maximum net self-employment earnings subject to the social security part of the self-employment tax is $106,000 for 2010. There is no maximum limit on earnings subject to the Medicare part. See chapter 12.

Reminders

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

IRS e-file (Electronic Filing)

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

- Use an authorized IRS e-file provider.
- Use a personal computer.
- Visit a Volunteer Income Tax Assistance (VITA) or Tax Counseling for the Elderly (TCE) site.

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

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

Publication on employer identification numbers (EIN). Publication 1365, Understanding Your EIN, provides general information on employer identification numbers. Topics include how to apply for an EIN and how to complete Form SS-4.

Change of address. If you change your home address or business address, you should use Form 8822, Change of Address, to notify the IRS. Be sure to include your suite, room, or other unit number.

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

Form W-4 for 2010. You should make new Forms W-4 available to your employees and encourage them to check their income tax withholding for 2009. Those employees who owed a large amount of tax or received a large refund for 2009 may need to file a new Form W-4. See Publication 919, How Do I Adjust My Tax Withholding.

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

Electronic deposits of taxes. You must use the Electronic Federal Tax Payment System (EFTPS) to make electronic deposits of all domestic tax liabilities you incur in 2010 and thereafter if you deposited more than $200,000 in federal domestic taxes in 2008 or you had to use EFTPS in 2009 or a prior year. See chapter 13.

Photographs of missing children. The Internal Revenue Service is a proud partner with the National Center for Missing and Exploited Children for financial reporting and analysis. For information on recordkeeping, you may download Financial Guidelines for Agricultural Producers at www.ffsc.org. For more information, contact the Farm Financial Standards Council 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 16 for information about getting publications.

Benefits of Recordkeeping

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

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

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

Identify source of receipts. You will receive money or property from many sources. Your records can identify the source of your receipts.

Chapter 1 Importance of Records Page 3
You need this information to separate farm from nonfarm receipts and taxable from nontaxable income.

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

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

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

**Kinds of Records To Keep**

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

You should set up your recordkeeping system using an accounting method that clearly shows your income for your tax year. See chapter 2. If you are in more than one business, you should keep a complete and separate set of records for each business. A corporation should keep minutes of board of directors’ meetings.

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

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

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

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

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

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

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

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

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

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

**IF payment is THEN the statement must show the...**

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

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

<table>
<thead>
<tr>
<th>Credit card</th>
<th>• Amount charged.</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Payee’s name.</td>
<td></td>
</tr>
<tr>
<td>• Transaction date.</td>
<td></td>
</tr>
</tbody>
</table>

**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. Keep records that support an item of income or a deduction appearing on a return until the period of limitations for the return runs out. A period of limitations is the period of time after which no legal action can be brought. Generally, that means 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. You may need to keep records relating to the basis of property longer than the period of limitation. Keep those records as long as they are important in figuring the basis of the original or replacement property. Generally, this means as long as you own the property and, after you dispose of it, for the period of limitations that applies to you. For example, if you received property in a nontaxable exchange, you must keep the records for the old property, as well as for the new property, until the period of limitations expires for the year in which you dispose of the new property in a taxable disposition. For more information on basis, see chapter 6.

**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 each tax year. An accounting method is discussed later under Special Methods of Accounting.

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. Generally, a taxpayer engaged in the trade or business of farming is allowed to use the cash method for its farming business. However, certain farm corporations and partnerships, if all tax shelters, must use an accrual method of accounting. See Accrual Method, later.

Business and personal items. You can account for business and personal items using different accounting methods. For example, you can use a different accounting method for each.

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.

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

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 do not need to 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. If you do not constructively receive an amount in income; and in a later year you have received or made available to you without restriction, you must include it in income.

Direct payments and counter-cyclical payments. If you received direct payments or counter-cyclical payments under Subtitle A 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 you receive possession of it. See chapter 11 of Publication 535, Business Expenses.

Expenses
Under the cash method, generally you deduct expenses as the taxes are paid. You may be required to capitalize certain costs, as explained under Uniform Capitalization Rules in chapter 4.

Example.

On November 1, 2009, you sold grain in December 2009 under a bona fide arm’s-length contract that calls for payment in 2010. You include the sale proceeds in your 2010 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 2009 income, regardless of when you actually receive payment.

Example.

You are a farmer who uses the cash method and a calendar tax year. You sell grain in December 2009 under a bona fide arm’s-length contract that calls for payment in 2010. You include the sale proceeds in your 2010 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 2009 income, regardless of when you actually receive payment.

Repayment of income. If you include an amount in income; and in a later year you have to repay all or part of it, then you can usually 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 535, Business Expenses.

Example.

On November 1, 2009, you sold grain in December 2009 under a bona fide arm’s-length contract that calls for payment in 2010. You include the sale proceeds in your 2010 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 2009 income, regardless of when you actually receive payment.

Accounting Methods

An accounting method is a set of rules used to determine when and how income and expenses are reported on your tax return. Your accounting method includes not only your overall method of accounting, but also the accounting treatment you use for any material item. You generally choose an accounting method for your farm business when you file your first income tax return that includes a Schedule F (Form 1040), Profit or Loss From Farming. If you later want to change your accounting method, you generally must get IRS approval. How to obtain IRS approval to change an accounting method is discussed later under Change in Accounting Method.
insurance contract for equipment. In 2009, you are allowed to deduct only $200 (2/36 x $3,600) of the cost of the policy that is attributable to 2009. In 2010, you’ll be able to deduct $1,200 (12/36 x $3,600); in 2011, you’ll be able to deduct $1,200 (12/36 x $3,600); and in 2012 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. Certain businesses engaged in farming must use an accrual method of accounting for its farm business and for sales and purchases of inventory items. See **Accrual Method Required** and **Farm Inventory**, later.

**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 that you have a liability, and
   b. The amount of 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 others, economic performance occurs as you provide the property or services.

**Example.** Jane, who is a farmer, uses a calendar tax year and an accrual method of accounting. She enters into a contract with ABC Farm Consulting in 2009. The contract states that Jane must pay ABC Farm Consulting $2,000 in December 2009. It further stipulates that ABC Farm Consulting will develop a plan for integrating her farm with a larger farm operation based in a neighboring state by January 1, 2010.

She pays ABC Farm Consulting $2,000 in December 2009. Integration of operations according to the plan begins in May 2010 and they complete the integration in December 2010.

Economic performance for Jane’s liability in the contract occurs as the property and services are provided. Jane incurs the $2,000 cost in 2010.

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.

**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**.

**Accrual Method Required**

The following businesses, if engaged in farming, must use an accrual method of accounting.

1. A corporation (other than a family corporation) that has 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) above 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 stock 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.

**Farm Inventory**

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

**Hatchery business.** If you are in the hatchery business, and use an 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** below. If you are in the business of breeding and raising chinchillas, mink, foxes, or other fur-bearing animals, these animals are livestock for inventory purposes.

**Growing crops.** Generally, growing crops are not required to be included in inventory. However, if the crop has a preproductive period of more than 2 years, you may have to capitalize (or include in inventory) costs associated with the crop. See **Uniform Capitalization Rules** below. Also see **Uniform Capitalization Rules** in chapter 6.
Items to include in inventory. Your inventory should include all items held for sale, for or use as feed, seed, etc., whether raised or pur chased, that are unsold at the end of the year.

Uniform capitalization rules. 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 then 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 producing livestock. IRS approval is not required for these adjustments. Any other changes in unit prices or classifications do require IRS approval.

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

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

You must include in inventory all livestock purchased primarily for sale. You may also include in inventory any increase in the cost of any animal 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 2009 but you are not paid until January 2010. You must both include the sale proceeds in income for 2010, they are held for sale or for draft, breeding, stock purchased for draft, breeding, sport or dairy purposes. This method accounts also includes the expenses 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 9.
- 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 an accrual method for reporting your expenses, you must use an accrual method for figuring your income.

Change in Accounting Method

Generally, once you have set up your accounting method, 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).


Chapter 2 Accounting Methods
3. Farm Income

Farm Income

What’s New

Exclusion extended on qualified principal residence debt. You can exclude from income a canceled debt that is qualified principal residence debt. The exclusion has been extended through 2012. The amount excluded from income is applied to reduce (but not below zero) the basis of your principal residence. See Qualified Principal Residence Debt, later.

Exclude from income payments under Federal Health Protection Program (FHPP). Payments received under the FHPP are excluded from income. These are payments received from the Department of Agriculture for an integrated pest management strategy to protect forest, trees, and woods.

Election to defer income from debt cancellation. You can elect to defer income from the cancellation of certain business debt. See Cancellation of Debt for more information.

Introduction

You may receive income from many sources. You must report the income from all the different sources on your tax return, unless it is excluded by law. Where you report the income on your tax return 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 in the year you receive it. See Cash Method in chapter 5.

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

**Form (and Instructions)**
- Sch E (Form 1040) Supplemental Income and Loss
- Sch F (Form 1040) Profit or Loss From Farming
- Sch J (Form 1040) Income Averaging for Farmers and Fishermen
- 982 Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)
- 1099-G Certain Government Payments
- 1099-PATR Taxable Distributions Received From Cooperatives
- 4797 Sales of Business Property
- 4835 Farm Rental Income and Expenses

See chapter 16 for information about getting publications and forms.

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 from the sale 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 selling price (money plus the fair market value of any property) and your basis in the item (usually the cost). 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 2008, you bought 20 feeder calves for $6,000 for resale. You sold them in 2009 for $11,000. You report the $11,000 sales price, subtract your $6,000 basis, and report the resulting $5,000 profit on your 2009 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.

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

<table>
<thead>
<tr>
<th>Item Sold</th>
<th>Schedule F</th>
<th>Form 4797</th>
</tr>
</thead>
<tbody>
<tr>
<td>Farm products raised for sale</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Farm products bought for resale</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Farm products not held primarily for sale, such as livestock held for draft, breeding, sport, or dairy purposes (bought or raised)</td>
<td></td>
<td>X</td>
</tr>
</tbody>
</table>
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 17.

Usual business practice. You must determine the number of animals you would have sold had you followed your usual business practice in the absence of the weather-related condition. Do this by considering all the facts and circumstances, but do not take into account your sales in any earlier year for which you postponed the gain. If you have not yet established a usual business practice, rely on the usual business practices of similarly situated farmers in your general region.

Connection with affected area. The livestock does not have to be raised or sold in an area affected by a weather-related condition for the postponement to apply. However, the sale must occur solely because of a weather-related condition that affected the water, grazing, or other requirements of the livestock. This requirement generally will not be met if the costs of food, water, or other requirements of the livestock affected by the weather-related condition are not substantial in relation to the total costs of holding the livestock.

Classes of livestock. You must figure the amount to be postponed separately for each generic class of animals—for example, hogs, sheep, and cattle. Do not separate animals into classes based on age, sex, or breed.

Amount to be postponed. Follow these steps to figure the amount 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 livestock sold.
   For this purpose, do not treat any postponed gain from the previous year as income received from the sale of livestock.
2. Multiply the result in (1) by the excess number of such livestock sold solely because of weather-related conditions.

Example. If you sell or exchange livestock under your usual business practices, you would not have sold or exchanged 135 head of beef cattle because of a drought, you sold 135 head during 2009. You realized $70,200 from the sale. On August 9, 2009, as a result of drought, the affected area was declared a disaster area eligible for federal assistance. The income you can postpone until 2010 is $18,200 [$70,200 – 135 x $35].

How to postpone gain. To postpone gain, attach a statement to your tax return for the year when you sell your livestock. The statement must include your name and address and give the following information:

- 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 usual business practice in the absence 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 rental income on Schedule E (Form 1040), Part I.

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

Crop Shares

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

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

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

Report the rental income on Schedule F. If you do not materially participate in operating the farm, report this income on Form 4835 and carry the net income or loss to Schedule E (Form 1040). The income is not included in self-employment income.

Crop shares you use to feed livestock. Crop shares you receive as a landlord and fed to your livestock are considered converted to money when fed to the livestock. You must include the fair market value of the crop shares in income at that time. You are entitled to a business expense deduction for the livestock feed in the same amount and at the same time you include the fair market value of the crop share as rental income. Although these two transactions cancel each other for figuring adjusted gross income on Form 1040, they may be necessary to figure your self-employment tax. See chapter 12.

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

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

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

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

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 in which you receive the loan amount, you must report any deposits of loan proceeds as income 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 and Revenue Procedure 2008-52 as modified by Announcement 2008-84. Revenue Procedure 2008-52, 2008-36 I.R.B. 587, is available at www.irs.gov/irb/2008-36_IRB/ar08.html. Announcement 2008-84, 2008-38 I.R.B. 748, is available at www.irs.gov/irb/2008-38_IRB/ar14.html.

You can request income tax withhold- ing from CCC loan payments you re- ceive. Use Form W-4V, Voluntary Withholding Request. See chapter 16 for infor- mation about ordering the form.

To elect to report a CCC loan as income, include the loan proceeds as income on Sched- ule F, line 1, the year in which you receive it. Attach a statement to your return showing the details of the loan.

You must file the statement and the return by the due date of the return, including extensions. If you timely filed your return for the year without making the election, you can still make the elec- tion by filing an amended return within 6 months of the due date of the return (excluding exten- sions). Attach the statement to the amended return and write “Filed pursuant to section 301.9100-2” at the top of the return. File the amended return at the same address you filed the original return.

When you make this election, the amount you report as income becomes your basis in the commodity. See chapter 6 for information on the basis of assets. If you later repay the loan, re- deem the pledged commodity, and sell it, you report as income at the time of sale the sale proceeds minus your basis in the commodity. If the sale proceeds are less than your basis in the commodity, you can report the difference as a loss on Schedule F.

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

Form 1099-A. If you forfeited pledged crops to the CCC in full payment of a loan, you may receive a Form 1099-A, Acquisition or Abandon- ment 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 assis- tance loan program, your repayment amount for a loan secured by your pledge of an eligible commodity is generally based on the lower of the loan rate or the prevailing world market price for the commodity on the date of repayment. If you repay the loan when the world price is lower, the difference between that repayment amount and the original loan amount is market gain. Whether you use cash or CCC certificates to repay the loan, you will receive a Form CCC-1099-G showing the market gain you real- ized. 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. How- ever, 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 2008, Mike pledged 1,000 pounds of cotton as collateral for a CCC loan of $500 (a loan rate of $.50 per pound). In 2009, he repaid the loan and redeemed the cotton for $420 when the world price was $.42 per pound (lower than the loan amount). Later in 2009, he sold the cotton for $600.

The market gain on the redemption was $08 ($500 - $420) per pound. Mike realized total market gain of $80 ($08 x 1,000 pounds). How he reports this market gain and figures his gain or loss from the sale of the cotton depends on whether he included CCC loans in income in 2008.

Included CCC loan. Mike reported the $500 CCC loan as income for 2008, 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 2009 as an agricultural program payment on Schedule F, line 6a, but does not include it as a taxable amount on line 6b.

Mike’s basis in the cotton after he redeemed it was $420, which is the redemption (repar- tition) price paid for the cotton. His gain from the sale is $180 ($600 - $420). He reports the $180 gain as income for 2009 on Schedule F, line 4.

Excluded CCC loan. Mike has income of $80 from market gain in 2009. He reports it on Schedule F, line 6a and line 6b. His basis in the cotton is zero, so his gain from its sale is $600. He reports the $600 gain as income for 2009 on Schedule F, line 4.

Example 2. The facts are the same as in Example 1 except that, instead of selling the crop 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 2009, 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 2008.

Included CCC loan. As in Example 1, Mike is treated as though he sold the cotton for $500 when he pledged it and repurchased the cotton for $420 when Tom redeemed it for him. The $80 market gain is not recognized on the re- demption. Mike reports it for 2009 as an Agricultu- ral 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 2009. He reports it on Schedule F, line 6a and line 6b. His basis in the cotton is zero, so his gain from its sale is $420. He reports the $420 gain as in- come for 2009 on Schedule F, line 4.
Conservation Reserve Program (CRP)

Under the Conservation Reserve Program (CRP), if you own or operate highly erodible or other specified cropland, you may enter into a 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 [Improvements], later.) CRP payments are reported to you on Form CCC-1099-G.

Certain Conservation Reserve Program payments may be excluded from self-employment tax. For more information, see chapter 12.

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 16 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 2009, report the amount you received on Schedule F, line 8a, but do not include it as a taxable amount on line 8b. Check the box on line 8a and attach a statement to your return. The statement must include your name and address and contain the following information.

• A statement that you are making an election under section 451(d) of the Internal Revenue Code and Regulations section 1.451-6.

• The specific crop or crops destroyed or damaged.

• A statement that under your normal business practice you would have included income from the destroyed or damaged crops in gross income for a tax year following the year the crops were destroyed or damaged.

• The cause of the destruction or damage and the date or dates it occurred.

• The total payments you received from insurance carriers, itemized for each specific crop, and the date you received each payment.

• The name of each insurance carrier from whom you received payments.

One 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

Feed Assistance and Payments

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

Include in income:

• The market value of donated feed.

• The difference between the market value and the price you paid for feed you buy at below market prices, and

• Any cost reimbursement you receive.

You must include these benefits in income in the year you receive them. You cannot postpone reporting them under the rules explained earlier for weather-related sales of livestock or crop insurance proceeds. Report the benefits on Schedule F, Part I, as agricultural program payments. You can usually take a current deduction for the same amount as a feed expense.

Cost-Sharing Exclusion (Improvements)

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

1. It was for a capital expense. You cannot exclude any part of a payment for an expense you can deduct in the year you pay or incur it. You must include the payment for a deductible expense in income, and you can take any offsetting deduction. (See chapter 5 for information on deducting soil and water conservation expenses.)

2. It does not substantially increase your annual income from the property for which it is made. An increase in annual income is substantial if it is more than the greater of the following amounts.

a. 10% of the average annual income derived from the affected property before receiving the improvement.

b. $2.50 times the number of affected acres.

4. The Secretary of Agriculture certified that the payment was primarily made for conserving soil and water resources, protecting or restoring the environment, improving forests, or providing a habitat for wildlife.

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

• The rural clean water program authorized by the Federal Water Pollution Control Act.

• The rural abandoned mine program authorized by the Surface Mining Control and Reclamation Act of 1977.

• The water bank program authorized by the Water Bank Act.

• The emergency conservation measures program authorized by title IV of the Agricultural Credit Act of 1978.

• The agricultural conservation program authorized by the Soil Conservation and Domestic Allotment Act.

• The great plains conservation program authorized by the Soil Conservation and Domestic Policy Act.

• The resource conservation and development program authorized by the Bankhead-Jones Farm Tenant Act and by the Soil Conservation and Domestic Allotment Act.

• Certain small watershed programs, listed later.

• Any program of a state, possession of the United States, a political subdivision of any of these, or of the District of Columbia.
under which payments are made to individuals primarily for conserving soil, protecting or restoring the environment, improving forests, or providing a habitat for wildlife. Several state programs have been approved. For information about the status of those programs, contact the state offices of the Farm Service Agency (FSA) and the Natural Resources and Conservation Service (NRCS).

Small watershed programs. If the three tests listed earlier are met, you can exclude payments you receive under the following 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.
- Certain programs under the Colorado River Basin Salinity Control Act.
- 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 Forest Land Enhancement Program authorized under the Farm Security and Rural Investment Act of 2002.
- The Forest Health Protection Program (FHP) authorized by the Cooperative Forestry Assistance Act of 1978.

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 excluded portion and your share of the cost of the improvement (if any).

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

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

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

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

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

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

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

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

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

Value of cost-sharing improvement . . . $15,000
Minus: Your share . . . . $10,000
Excludable portion 1,550 11,550
Amount included in income . . . . . $3,450

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

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

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

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

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

Recapture. If you dispose of the property within 20 years after you received the excluded payments, you must treat as ordinary income part or all of the cost-sharing payments you excluded. You must report the recapture on Form 1097. See Section 1255 property under Other Gains in chapter 9.

E Electing 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 quotas 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 below), over your adjusted basis. The gain or loss is capital or ordinary depending on how you used
the quota. See Capital or ordinary gain or loss, later.

Report the entire gain on your income tax return for the tax year that includes the date you entered into the contract if you elect not to use the installment method.

Adjusted basis. The adjusted basis of your quota is determined differently depending on how you obtained the quota.
- The basis of a quota derived from an original grant by the federal government is zero.
- The basis of a purchased quota is the purchase price.
- The basis of a quota received as a gift is generally the same as the donor’s basis. However, under certain circumstances, the basis is increased by the amount of gift taxes paid. If the basis is greater than the fair market value of the quota at the time of the gift, the basis for determining loss is the fair market value.
- The basis of an inherited quota is generally the fair market value of the quota at the time of the decedent’s death.

Reduction of basis. You are required to reduce the basis of your tobacco quota by the following amounts:
- Deductions you took for amortization, depletion, or depreciation.
- Amounts you previously deducted as a loss resulting from the quota payments does not apply.
- Deductions you took for amortization, depletion, or depreciation.
- Amounts to reflect a reduction in the number of pounds of tobacco allowable under the quota.
- The entire cost of a purchased quota you deducted in an earlier year (which reduces your basis to zero).

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 tobacco quota buyout program payment before you calculate your gain or loss. For more information, see Notice 2005-57, 2005-32 I.R.B. 267, available at www.irs.gov/irb/2005-32_IRB/ar13.html.

Installment method. You may use the installment method to report a gain if you receive at least one payment after the close of your tax year. Under the installment method, a portion of the gain is taken into account in each year in which a payment is received. See chapter 12 for more information.

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

Quota used in the trade or business of farming. If you used the quota in the trade or business of farming and you held it for more than one year, you report the transaction as a section 1231 transaction on Form 4797. See Section 1237 transactions in 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 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-NT for the year in which the payment is made.

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

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

Tobacco Growers

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

Taxation of payments to tobacco growers. Payments to growers replace ordinary income that would have been earned had the tobacco marketing quota and price support programs continued. Individuals will generally report the payments as an Agricultural program payment on Schedule F. If you are a landowner who does not materially participate in the operation or management of the farm and are receiving the grower payment because your farm rental income is based on the tobacco grown by a tenant, the grower payment should be reported on Form 4835, Farm Rental Income and Expenses.

Self-employment income. Payments to growers generally represent self-employment income. If the grower is an individual carrying on a trade or business and deriving income (other than farm rental income properly reported on Form 4835) from that trade or business, the payments are net earnings from self-employment.

Income averaging for farmers. Payments to growers who are individuals qualify for farm income averaging.

Form 1099-G. If the amount received in a taxable year is $600 or more, the amount will generally be reported by the USDA on a Form 1099-G.

Other Payments

You must include most other government program payments in income.

Fertilizer and Lime

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

Improvements

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

National Tobacco Growers’ Settlement Trust Fund Payments

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

If you produce a tobacco crop, report the payments as income from farming on your Schedule F. If you are a landowner and 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
Income From Cooperatives

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

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

**Patronage Dividends**

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

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

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

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

**Qualified written notice of allocation.** If you receive a qualified written notice of allocation as part of a patronage dividend, you must generally include its stated dollar value in your income in the year you receive it. A written notice of allocation is qualified if at least 25% of the patronage dividend is paid in money or by qualified check and either of the following conditions is met.

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

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

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

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

**Nonqualified notice of allocation.** Do not include the stated dollar value of any nonqualified notice of allocation in income when you receive it. Your basis in the notice is zero. You must include in income for the tax year of disposition any amount you receive from its sale, redemption, or other disposition. Report that amount, up to the stated dollar value of the notice, on Schedule F, lines 5a and 5b. However, do not include that amount in your income if the notice resulted from buying or selling capital assets or depreciable property or from buying personal items, as explained in the following discussions. If the amount you receive is more than the stated dollar value of the notice, report the excess as the type of income it represents. For example, if it represents interest income, report it on your return as interest.

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

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

**Example.** On July 1, 2008, 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 2008, he claimed a depreciation deduction of $311, using the 10.71% depreciation rate from the 150% declining balance, half-year convention table (shown in Table A-14 in Appendix A of Publication 946). On July 2, 2009, the cooperative association paid Mr. Brown a $300 cash patronage dividend for buying the machine. Mr. Brown adjusts the basis of the machine and figures his depreciation deduction for 2009 (and later years) as follows:

- Cost of machine on July 1, 2008: $2,900
- Minus: 2008 depreciation: $311
- 2009 cash dividend: 300
- $611

**Adjusted basis for depreciation for 2009:** $2,289

Depreciation rate: 1% – 6% (remaining recovery period as of 1/1/08) = 15.38% × 1.5 = 23.07%

**Depreciation deduction for 2009** ($2,289 × 23.07%) = $528

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

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

If the dividends are for selling capital assets or depreciable property during the year you received the dividends, you 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 by you, regardless of whether you received a specified dollar amount or a percentage. Per-unit retain allocations issued by cooperatives generally receive the same tax treatment as patronage dividends, discussed earlier.

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

Nonqualified certificates. Do not include the stated dollar value of a nonqualified per-unit retain certificate in income when you receive it. Your basis in the certificate is zero. You must include in income the 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. For more information on canceled debt, see Publication 4681, Canceled Debts, Foreclosures, Repossessions, and Abandonments.

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. Discharge of qualified farm indebtedness is the only exception. The calculation and treatment of the discharge is explained below. It is one of the exceptions to the general rule. It is excluded from taxable income (see Exclusions below). Report the canceled amount on Schedule F, line 10, if you incurred the debt in your farming business. If the debt is a nonbusiness debt, report the canceled amount as other income on Form 1040, line 21.

Electio n to defer income from discharge of indebtedness. You can elect to defer income from a discharge of business indebtedness that occurred after 2008 and before 2010. Generally, if the election is made, the deferred income is included in gross income ratably over a 5-year period beginning in 2014 (for calendar-year taxpayers) and the elections listed below do not apply. See section 108(i) and Publication 4681 for details.

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

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

Price reduced after purchase. If your purchase of property was financed by the seller and the seller reduces the amount of the debt at a time when you are not insolvent and the reduction does not occur in a chapter 11 bankruptcy case, the amount of the debt reduction will be treated as a reduction in the purchase price of the property. Reduce your basis in the property by the amount of the reduction in the debt. The rules that apply to bankruptcy and insolvency are explained below under Exclusions.

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

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

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

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

Exclusions
Do not include canceled debt in income in the following situations:

1. The cancellation takes place in a bankrupcty 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 debt (in the case of a taxpayer other than a C corporation). See chapter 5 in Publication 334.
5. The canceled debt is qualified principal residence indebtedness which is discharged after 2006 and before 2013.
6. The discharge of certain indebtedness of a qualified individual because of Midwestern disasters. See Publication 4459-B, Information for Affected Taxpayers in the Midwestern Disaster Areas.

The exclusions do not apply in the following situations:

• If a canceled debt is excluded from income because it takes place in a bankruptcy case, the exclusions in situations (2), (3), (4), (5), and (6) do not apply.
• If a canceled debt is excluded from income because it takes place when you are insolvent, the exclusions in situations (2), (3), and (4) do not apply to the extent you are insolvent.
• If a canceled debt is excluded from income because it takes place in a chapter 11 bankruptcy case, the exclusions for qualified principal residence indebtedness do not apply.

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 attributes, explained below under Reduction of tax attributes.

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

You can exclude canceled debt from gross income up to the amount by which your liabilities exceeded your assets. If the canceled debt is more than this amount and the debt qualifies, you can apply the rules for qualified farm debt or qualified real property debt to the difference. Otherwise, you include the difference in gross income. Use the amount excluded because of insolvency to reduce any tax attributes, as explained below under Reduction of tax attributes. You must reduce the tax attributes under the insolvency rules before applying the rules for qualified farm debt or for qualified real property debt.

Example. You had a $15,000 debt canceled outside of bankruptcy. Immediately before the cancellation, your liabilities totaled $80,000 and your assets totaled $75,000. Since your liabilities were more than your assets, you were insolvent to the extent of $5,000 ($80,000 − $75,000). You can exclude this amount from income. The remaining canceled debt ($10,000) may be subject to the qualified farm debt or qualified real property debt rules. If not, you must include it in income.

Reduction of tax attributes. If you exclude canceled debt from income in a bankruptcy case
or during insolvency, you must use the excluded debt to reduce certain tax attributes.  

**Order of reduction.** You must use the excluded canceled debt to reduce the following tax attributes 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 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.
   e. Other property.

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

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

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

7. **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 attribute reductions.** Always make the required reductions in tax attributes in the order listed unless you elect to reduce the basis of depreciable property first, as explained later. In making the reductions in (1) and (4) earlier, 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) earlier, 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 theFull text removal instructions are not covered in this response. Please see the original document for the full text.  

**Qualified Principal Residence Debt**

You can exclude from income a canceled debt that is qualified principal residence debt. The amount excluded from income is applied to reduce (but not below zero) the basis of your principal residence. 

**Qualified principal residence.** This is property you own and lived in at least 2 out of the 5 year period ending on the date the canceled debt occurred.

**Qualified principal residence debt.** This is acquisition debt that is incurred in acquiring, constructing, or substantially improving your qualified principal residence and is secured by that residence. This also includes any debt secured by the residence resulting from the refinancing of the acquisition debt but only to the extent the amount of the debt resulting from the refinancing does not exceed the amount of the refinanced debt. Qualified principal residence debt is limited to acquisition debt of $2 million ($1 million if you are married and filing a separate return) with respect to the principal residence of the taxpayer.

The exclusion from gross income for cancellation of qualified principal residence debt does not apply if the canceled debt is on account of services performed for the lender or any other factor not directly related to a decline in the value of the residence or to your financial condition.

If any loan is canceled, in whole or in part, and only a portion of the loan is qualified principal residence debt, the exclusion from gross income for cancellation of qualified principal residence debt will apply only to the amount of the loan (as determined immediately before the canceled debt) that is qualified principal residence debt.

**Qualified Farm Debt**

You can exclude from income a canceled debt that is qualified farm debt owed to a qualified person. This exclusion applies only if you were solvent when the debt was canceled or, if you were insolvent, only to the extent the canceled debt is more than the amount by which you were insolvent. This exclusion does not apply to a canceled debt excluded from income because it relates to your principal residence or it takes place in a bankruptcy case.

Your debt is qualified farm debt if both the following requirements are met:

- You incurred it directly in operating a farming business.
- At least 50% of your total gross receipts for the 3 tax years preceding the year of debt cancellation were from your farming business.

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

- A person related to you.
- A person from whom you acquired 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 attributes 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 attributes because of the exclusion of canceled debt from gross income during insolvency.

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

Adjusted tax attributes. Adjusted tax attributes means the sum of the following items:

1. Any net operating loss (NOL) for the tax year of the debt cancellation and any NOL carryover to that year.
2. Any general business credit carryover to or from the year of the debt cancellation, multiplied by 3.
3. Any maximum 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 attributes. If you exclude canceled debt from income under the qualified farm debt rules, you must use the excluded debt to reduce tax attributes. (If you also excluded canceled debt under the insolvency rules, you reduce the amount of the tax attributes remaining after reduction for the exclusion allowed under the insolvency rules.) You generally must follow the reduction rules previously explained under Bankruptcy and Insolvency. However, do not follow the rules in item (5). Basis. Instead, follow the special rules explained next.

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

1. Depreciable qualified property. You may 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 attributes 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 attributes. 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 8.

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

Commodity futures and options. See Hedging (Commodity Futures) in chapter 8 for information on gains and losses from commodity futures and options transactions.

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

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

Example. You granted a right-of-way for a gas pipeline through your property for $250. Only a specific part of your farmland was affected. You reserved the right to continue farming the surface land after the pipe was laid. Treat the payment for the right-of-way in one of the following ways.

1. If the payment is less than the basis properly allocated to the part of your land affected by the right-of-way, reduce the basis by $10,000.
2. If the payment is equal to or more than the basis of the affected part of your land, reduce the basis to zero and the rest, if any, is gain from a sale. The gain is reported on Form 4797 and is treated as section 1231 gain if you held the land for more than 1 year. See chapter 9.

Tip. Easement contracts usually describe the affected land using square feet. Your basis may be figured per acre.

One acre equals 43,560 square feet.

If construction of the line damaged growing crops and you later receive a settlement of what you receive. The same rule applies if you deduct the cost of the fuel as an expense that reduced your income tax. See chapter 14 for more information about fuel tax credits and refunds.

Illegal federal irrigation subsidy. The federal government, operating through the Bureau of Reclamation, has made irrigation water from certain reclamation and irrigation projects available for agricultural purposes. The excess of the amount required to be paid for water from these projects over the amount you actually paid is an illegal subsidy. For example, if the amount required to be paid is full cost and you paid less than full cost, the difference is an illegal subsidy and you must include it in income. Report this on Schedule F, line 10. You cannot take a deduction for the amount you must include in income.

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

Prizes. Report prizes you win on farm livestock or products at contests, exhibitions, fairs, etc., on Schedule F as Other income. If you receive a prize in cash, include the full amount in...
income. If you receive a prize in produce or other property, include the fair market value of the property in income. If you receive a Form 1099-MISC, Miscellaneous Income, see chapter 12 for information about prizes related to 4-H Club or FFA projects. See Publication 525 for information about other prizes.

Property sold, destroyed, stolen, or condemned. You may have an ordinary or capital gain if property you own is sold or exchanged, stolen, destroyed by fire, flood, or other casualty, or condemned by a public authority. In some situations, you can postpone the tax on the gain to a later year. See chapters 8 through 11.

Recapture of certain depreciation. If you took a section 179 deduction for property used in your farming business and at any time during the property’s recovery period you do not use it more than 50% in your business, you must include part of the deduction in income. See chapter 7 for information on the section 179 deduction and when to recapture that deduction.

In addition, if the percentage of business use of listed property (see chapter 7) fails to 50% or less in any tax year during the recovery period, you must include in income any excess depreciation you took on the property.

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

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

Example. A tenant farmer purchased fertilizer for $1,000 in April 2008. He deducted $1,000 on his 2008 Schedule F and the entire deduction reduced his tax. The landowner reimbursed him $500 of the cost of the fertilizer in February 2009. The tenant farmer must include $500 in income on his 2009 tax return because the entire deduction decreased his 2008 tax.

Sale of soil and other natural deposits. If you remove and sell topsoil, loam, fill dirt, sand, gravel, or other natural deposits from your property, the proceeds are ordinary income. A reasonableness test may apply to the depletion of the natural deposit sold may be claimed as a deduction. See Depletion in chapter 7.

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

Granting the right to remove deposits. If you enter into a legal relationship granting someone else the right to excavate and remove natural deposits from your property, you must determine whether the transaction is a sale or another type of transaction (for example, a lease). If you receive a specified sum or an amount fixed without regard to the quantity produced and sold from the deposit and you retain no economic interest in the deposit, your transaction is a sale. You are considered to retain an economic interest if, under the terms of the legal relationship, you depend on the income derived from extraction of the deposit for a return of your capital investment in the deposit.

Your income from the deposit is capital gain if the transaction is a sale. Otherwise, it is ordinary income. See chapter 7 for information on depletion and chapter 8 for the tax treatment of capital gain or loss from the sale or other disposition of deposit property.

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

Income Averaging for Farmers

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

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

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

Elected Farm Income (EFI)

EFI is the amount of income from your farming business that you elect to have taxed at base year rates. You can designate as EFI any type of income attributable to your farming business. However, your EFI cannot be more than your total farm 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 or loss from the sale or other disposition of land, or from the sale of development rights, grazing rights, and other similar rights.

Gains or losses from the sale or other disposition of farm property. Gains or losses 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 or losses on property sold within a reasonable time after operations stop can be designated as EFI. A period of 1 year after stopping operations is a reasonable time. After that, what is a reasonable time depends on the facts and circumstances.

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

How To Figure the Tax

If you average your farm income, you will figure your tax on Schedule J (Form 1040). Negative taxable income for base year. If your taxable income for any base year was zero because your deductions were more than your income, your tax liability for that year is zero. You can use income averaging for that year to combine with your EFI on Schedule J.

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

Effect on Other Tax Determinations

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

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

Tax for Certain Children Who Have Investment Income of More Than $1,900

If your child was under age 19 (or 24 if a full-time student) at the end of 2009 and had investment income of more than $1,900, part of that income may be taxed at your tax rate instead of your child’s tax rate. For more information, see the Instructions for Form 8615.

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

**Alternative Minimum Tax (AMT)**

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

**Credit for prior year minimum tax.** You may be able to claim a tax credit if you owed AMT in a prior year. See the Instructions for Form 8801, Credit for Prior Year Minimum Tax—Individuals, Estates, and Trusts.

**Schedule J**

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

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**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 2009 is 55 cents per mile for all business miles driven. See **Truck and Car Expenses**, later.

**Introduction**

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

**Topics**

This chapter discusses:

- Deductible expenses
- Domestic production activities deduction
- Capital expenses
- Nondeductible expenses
- Losses from operating a farm
- Not-for-profit farming
- Personal and business expenses.
- 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 part personal and part 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 your business and personal parts. Generally, the personal part of these expenses is not deductible. The business portion of the expenses would be deductible on Schedule F.
- Example. You paid $1,500 for electricity during the tax year. You used 1/3 of the electricity for personal purposes and 2/3 for farming. Under these circumstances, you could deduct $1,000 (2/3 of $1,500) of your electricity expense as a farm business expense.

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

**Prepaid Farm Supplies**

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

- Feed, seed, fertilizer, and similar farm supplies not used or consumed during the year. However, do not include amounts paid for farm supplies that you would have consumed if not for a fire, storm, flood, other casualty, disease, or drought.
- Poultry (including egg-laying hens and baby chicks) bought for use (or both use and resale) in your farm business. However, include only the amount that would be deductible in the following year if you had capitalized the cost and deducted it ratably over the lesser of 12 months or the useful life of the poultry.
- Poultry bought for resale and not resold during the year.

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

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

**Example.** During 2009, you bought fertilizer ($4,000), feed ($1,000), and seed ($500) for use on your farm in the following year. Your total prepaid farm supplies expense for 2009 is $5,500. Your other deductible farm expenses totaled $10,000 for 2009. Therefore, your deduction for prepaid farm supplies cannot be more than $5,000 (50% of $10,000) for 2009. The excess prepaid farm supplies expense of $500 ($5,500 – $5,000) is deductible in a later tax year when you use or consume the supplies.

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

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

You are a farm-related taxpayer if any of the following tests apply.
1. Your main home is on a farm.
2. Your principal business is farming.
3. A member of your family meets (1) or (2).

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

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

Prepaid Livestock Feed

If you report your income and expenses under the cash method of accounting, you cannot deduct in the year paid the cost of feed your livestock will consume in a later year unless you meet all the following tests.
1. The payment is for the purchase of feed rather than a deposit.
2. The prepayment has a business purpose and is not merely for tax avoidance.
3. Deducing the prepayment does not result in a material distortion of your income.

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

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

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

Payment for the purchase of feed. Whether a payment is for the purchase of feed or a deposit depends on the facts and circumstances in each case. It is for the purchase of feed if you can show you made it under a binding commitment to accept delivery of a specific quantity of feed at a fixed price and you are not entitled by contract or business custom, to a refund or repayment.

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

• The absence of specific quantity terms.
• The right to a refund of any unpaid payment credit at the end of the contract.
• The seller's treatment of the payment as a deposit.
• The right to substitute other goods or products for those specified in the contract.

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

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

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

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

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

• Your customary business practice in deducting your livestock operations.
• The expense in relation to past purchases.
• The time of year you made the purchase.
• The expense in relation to your income for the year.

Labor Hired

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

If you must withhold social security, Medicare, and other taxes from your employees' wages, you can still deduct the full amount of wages subject to these taxes.

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

• The absence of specific quantity terms.
• The right to a refund of any unpaid payment credit at the end of the contract.
• The seller's treatment of the payment as a deposit.
• The right to substitute other goods or products for those specified in the contract.

A provision permitting substitution of ingredients to vary the particular feed mix to meet your livestock's current diet requirements will not
Empowerment zone and renewal community employment credit (Form 8844).

Indian employment credit (Form 8845).

Work opportunity credit (Form 5884).

For more information, see the forms and their instructions.

**Repairs and Maintenance**

You can deduct most expenses for the repair and maintenance of your farm property. Common items of repair and maintenance are re-painting, replacing shingles and supports on farm buildings, and periodic or routine maintenance of trucks, tractors, and other farm machinery. However, repairs to, or overhauls of, depreciable property that substantially prolong the life of the property, increase its value, or adapt it to a different use are capital expenses. For example, if you repair the barn roof, the cost is deductible. But if you replace the roof, it is a capital expense. For more information, see Capital Expenses, later.

**Interest**

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

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

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

- **Accrual method.** If you use an accrual method of accounting, you can deduct only interest that has accrued during the tax year. However, you cannot deduct interest owed to a related person who uses the cash method until payment is made and the interest is includible in the gross income of that person. For more information, see Accrual Method in chapter 2.

**Allocation of interest.** If you use the proceeds of a loan for more than one purpose, you may limit your deduction for these materials. If the property that secures the loan is your home, you generally do not allocate the loan proceeds to the related interest. The interest is usually deductible as qualified home mortgage interest, regardless of how the loan proceeds are used. However, you can choose to treat the loan as not secured by your home. For more information, see Publication 936.

- **Allocation period.** The period for which a loan is allocated to a particular use begins on the date the proceeds are used and ends on the earlier of the following dates:
  - The date the loan is repaid.
  - The date the loan is reallocated to another use.

**More information.** For more information on interest, see chapter 4 in Publication 535.

**Breeding Fees**

You can deduct breeding fees as a farm business expense. However, if you use an accrual method of accounting, you must capitalize breeding fees and allocate them to the cost basis of the calf, foal, etc. For more information on who must use an accrual method of accounting, see Accrual Method Required under Accounting Methods in chapter 2.

**Fertilizer and Lime**

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

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

Farmland, for these purposes, is land used for producing crops, fruits, or other agricultural products or for sustaining livestock. It does not include land you have never used previously for producing crops or sustaining livestock. You cannot deduct initial land preparation costs. (See Capital Expenses, later.)

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

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

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

- **Allocation of taxes.** If the benefits of a loan last a year or less. You can deduct as a farm business expense the cost of applying these materials to the cost before the year it is due. Interest paid in advance may be deducted only in the tax year in which it is due.

**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). You may be able to take a deduction for nonbusiness real estate taxes paid even if you do not itemize deductions on your income tax return. See the Instructions for Form 1040 for additional information. 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 nondeductible farm business expenses 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 farming 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 tractor truck 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.
Rent and Leasing
If you lease property for use in your farm busi-
ness, 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 pay-
ments 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 pay-
ments for the purchase of the property. Do not deduct these payments as rent, but capitalize the cost of the property and recover this cost through depreciation.

Example. You lease new farm equipment from a dealer who both sells and leases. The agreement includes an option to purchase the equipment for a specified price. The lease pay-
ments and the specified option price equal the sales price of the equipment plus interest. Under the agreement, you are responsible for mainte-
nance, repairs, and the risk of loss. For federal income tax purposes, the agreement is a condi-
tional 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 de-
pends 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 is con-
sidered a conditional sales contract rather than a lease if any of the following is true.

• The agreement applies part of each pay-
ment 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 prop-
erty 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 total amount you have to pay under the agree-
ment.
• The agreement designates part of the pay-
ments as interest, or part of the payments can be easily recognized as interest.

Motor vehicle leases. Special rules apply to lease agreements that have a terminal rental adjustment clause. In general, this is a clause that provides for a rental price adjustment based on the amount the lessor is able to sell the vehicle for at the end of the lease. If your rental agreement contains a terminal rental adjust-
ment 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 infor-
mation, see chapter 3 of Publication 535 and the following revenue procedures.


Depreciation
If property you acquire to use in your farm busi-
ness 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, or
• In connection with your trade or business, if you are using a separate structure that is not attached to your home.

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

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

Workers’ compensation insurance set by state law that covers any claims for job-related bodily injuries or diseases suf-
f ered by employees on your farm, regard-
less of fault.

Business interruption insurance.

State unemployment insurance on your farm employees (deductible as taxes if they are considered taxes under state law).

Insurance to secure a loan. If you take out a policy on your life or on the life of another person with a financial interest in your farm business to get or protect a business loan, you cannot de-
duct 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 pay-
ments of insurance premiums only in the year to which they apply, regardless of your accounting method.

Example. On June 28, 2009, 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, 2009. Only the cost for the 6 months in 2009 is deductible as an insurance expense on your 2009 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 2010 and 2011, deduct $1,000 (1/3 of $3,000). Deduct the remaining $500 in 2012. Had the policy been effective on January 1, 2009, the deductible expense would have been $1,000 for each of the years 2009, 2010, and 2011, based on one-third of the premium used each year.

Business interruption insurance. Use and occu-
pancy and business interruption insurance premiums are deductible as a business ex-
 pense. 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 figur-
ing your adjusted gross income on your Form 1040. Generally, this deduction cannot be more than the net profit from the business under which the plan was established.

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

Generally, use the Self-Employed Health In-
surance 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 Premi-
ums in chapter 6 of Publication 535.


Depreciation
If property you acquire to use in your farm busi-
ness 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, or
• In connection with your trade or business, if you are using a separate structure that is not attached to your home.

Your home office will qualify as your principal place of business for deducting expenses for its use if you meet both of the following 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 expenses (including expenses for the business use of your home), you can deduct all your farm expenses. But if your gross income from farming is less than your total farm expenses, your deduction for certain expenses for the use of your home in your farming business is limited.

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

- The business part of expenses you could deduct even if you did not use your home for business (such as deductible mortgage interest, real estate taxes, and casualty and theft losses).
- Farm expenses other than expenses that relate to the use of your home. If you are self-employed, do not include your deduction for half of your self-employment tax.

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

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

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

Truck and Car Expenses

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

Standard mileage rate. Instead of using actual costs, under certain conditions you can use the standard mileage rate. For 2009, the standard mileage rate for each mile of business use is 55 cents per mile. You can use the standard mileage rate for a car or a light truck, such as a van, pickup, or panel truck, you own or lease. You cannot use the standard mileage rate if you operate five or more cars or light trucks at the same time if you alternate using the vehicles (you use them at different times) for business.

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

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

- Cultivating land.
- Raising or harvesting any agricultural or horticultural commodity.
- Raising, shearing, feeding, caring for, training, and managing animals.
- Driving to the feed or supply store.
- Traveling to or from the location of your farm business.

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

More information. For more information on deductible truck and car expenses, see chapter 2 of Publication 463. If you pay your employees for the use of their truck or car in your farm business, see Reimbursements to employees under Travel Expenses, next.

Travel Expenses

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

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

If you meet these requirements and can prove the time, place, and business purpose of your travel, you can deduct your ordinary and necessary travel expenses.

The following are some types of deductible travel expenses:

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

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

The expense of a meal includes amounts you spend for your food, beverages, taxes, and tips relating to the meal. You can deduct either 50% of the actual cost or 50% of a standard meal allowance that covers your daily meal and incidental expenses.

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

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

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

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

Reimbursements to employees. You generally can deduct reimbursements you pay to your employees for travel and transportation expenses they incur in the conduct of your business. Employees may be reimbursed under an accountable or nonaccountable plan. Under an accountable plan, the employee must provide evidence of expenses. Under a nonaccountable plan, no evidence of expenses is required. If you reimburse expenses under an accountable plan, deduct them as travel and transportation expenses. If you reimburse expenses under a nonaccountable plan, you must report the reimbursements as wages on Form W-2 and deduct them as wages. For more information, see chapter 11 of Publication 535.

Marketing Quota Penalties

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

Tenant House Expenses

You can deduct the costs of maintaining houses and their furnishings for tenants or hired help as farm business expenses. These costs include repairs, utilities, insurance, and depreciation.
The value of a dwelling you furnish to a tenant under the usual tenant-farmer arrangement is not taxable income to the tenant.

**Items Purchased for Resale**

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

**Example.** You use the cash method of accounting. In 2009, you buy 50 steers you will sell in 2010. You cannot deduct the cost of the steers on your 2009 tax return. You deduct their cost in Part I of your 2010 Schedule F.

Chickens, seeds, and young plants. If you are a cash method farmer, you can deduct the cost of hens and baby chicks bought for commercial egg production, or for raising and resale, as an expense in Part II of Schedule F in the year paid if you do it consistently and it does not distort income. You also can deduct the cost of seeds and young plants bought for further development and cultivation before sale as an expense in Part II of Schedule F when paid if you do this consistently and you do not figure your income on the crop method. However, see Prepaid Farm Supplies, earlier, for a rule that may limit your deduction for these items.

If you deduct the cost of chickens, seeds, and young plants as an expense, report their entire selling price as income. You cannot also deduct the cost from the selling price. You cannot deduct the cost of seeds and young plants for Christmas trees and timber as an expense. Deduct the cost of these seeds and plants through depletion allowances. For more information, see Depletion in chapter 7.

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

Capitalize the cost of plants with a preproductive period of more than 2 years, unless you can elect out of the uniform capitalization rules. These rules are discussed in chapter 6.

**Example.** You use the cash method of accounting. In 2009, you buy 500 baby chicks to raise for resale in 2010. You also buy 50 bushels of winter wheat seed in 2009 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 2009.

**Election to use crop method.** If you use the crop method, you can delay deducting the cost of seeds and young plants until you sell them. You must get IRS approval to use the crop method. If you follow this method, deduct the cost from the selling price to determine your profit in Part I of Schedule F. For more information, see Crop method under Special Methods of Accounting in chapter 6.

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

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

**Other Expenses**

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

- Accounting fees.
- Advertising.
- Business travel and meals.
- Commissions.
- Consultant fees.
- Crop scouting expenses.
- Dues to cooperatives.
- Educational expenses (to maintain and improve farming skills).
- Farm-related attorney fees.
- Farm magazines.
- Ginning.
- Insect sprays and dusts.
- Litter and bedding.
- Livestock fees.
- Marketing fees.
- Milk assessment.
- Recordkeeping expenses.
- Service charges.
- Small tools expected to last one year or less.
- Stamps and stationery.
- Subscriptions to professional, technical, and trade journals that deal with farming.
- Tying material and containers.

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

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

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

**Domestic Production Activities Deduction**

You are allowed a deduction for income attributable to domestic production activities. You can deduct 6% of the lesser of your qualified production activities income or your taxable income (adjusted gross income for individuals) for the tax year. Your deduction is limited to 50% of the Form W-2 wages you paid for the tax year that are properly allocable to domestic production gross receipts.

For this purpose, Form W-2 wages do not include noncash wages paid for agricultural labor, such as compensation paid as commodities. Also, excluded from Form W-2 wages are wages paid to your children under age 18 and nontaxable fringe benefits. 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.

**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 and organizational costs, below.)
- 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 equipping costs.
9. Land preparation costs, such as:
   b. Leveling and conditioning land.
   c. Purchasing and planting trees.
   d. Building irrigation canals and ditches.
   e. Laying irrigation pipes.
   f. Installing drain tile.
   g. Modifying channels or streams.
   h. Constructing earthen, masonry, or concrete tanks, reservoirs, or dams.
   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 you previously deducted or amortized. Any remaining costs must be amortized. See chapter 7.

You elect to deduct start-up or organizational costs by claiming the deduction on the income tax return filed by the due date (including extensions) for the tax year in which the active trade or business begins. However, if you timely filed your return for the year without making the election, you can still make the election by filing an amended return within 6 months of the due date of the return (excluding extensions). Clearly indicate the election on your amended return and write “Filed pursuant to section 301.9100-2” at the top of the amended return. File the amended return at the same address you filed the original return. The election applies when figuring taxable income for the current tax year and all subsequent years.

You can choose to forgo the election by clearly electing to capitalize your start-up or organizational costs on a income tax return filed by the due date (including extensions) for the tax year in which the active trade or business begins. For more information about start-up and organizational costs, see chapter 7.

**Crop production expenses.** The uniform capitalization rules generally require you to capitalize expenses incurred in producing plants. However, if you elect to deduct certain start-up or organizational costs, you can use an accrual method of accounting, the capitalization rules do not apply to plants with a depreciable useful life of 20 years or less.

For more information, see Uniform Capitalization Rules in chapter 6.

**Timber.** Capitalize the cost of acquiring timber. Do not include the cost of land in the cost of the timber. You must generally capitalize direct costs incurred in reforestation. However, you can elect to deduct some reforestation costs. You elect to deduct start-up or organizational costs by claiming the deduction on the income tax return filed by the due date (including extensions) for the tax year in which the expenses were paid or incurred. If you are filing Form T (Timber), Forest Activities Schedule, also complete Form T (Timber), Part IV. If you are not filing Form T (Timber), 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 costs that are 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 “Filed pursuant to section 301.9100-2” at the top of the amended return. File the amended return at the same address you filed the original return.

For more information about 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, thinning, and noncommercial thinning are also deductible as business expenses.

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

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

Personal, Living, and Family Expenses

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

Other Nondeductible Items

You cannot deduct the following items on your tax return.

Loss of growing plants, produce, and crops. Losses of plants, produce, and crops raised for sale are generally not deductible. However, you may have a deductible loss on plants with a preproductive period of more than 2 years. See chapter 11 for more information.

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

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

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

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

Cost of raising unharvested crops. You cannot deduct the cost of raising unharvested crops sold with land owned more than one year if you sell both at the same time and to the same person. Add these costs to the basis of the land to determine the gain or loss on the sale. For more information, see Section 1231 Gains and Losses in chapter 5.

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

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

Club dues and membership fees. Generally, you cannot deduct amounts you pay or incur for membership in any club organized for business, pleasure, recreation, or any other social purpose. This includes country clubs, golf and athletic clubs, hotel clubs, sporting clubs, airline clubs, and clubs operated to provide meals under circumstances generally considered to be conducive to business discussions.

Exception. The following organizations will not be treated as a club organized for business, pleasure, recreation, or other social purposes. One of its main purposes is to conduct the 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.

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 losses for the investors also comes under this limit.

The limit on not-for-profit losses applies to individuals, partnerships, estates, trusts, and S corporations. It does not apply to corporations other than S corporations.

In determining whether you are carrying on your farming activity for profit, all the facts are taken into account. No one factor alone is decisive. Among the factors to consider are whether:
You operate your farm in a businesslike manner;
The time and effort you spend on farming indicate you intend to make it profitable;
You depend on income from farming for your livelihood;
Your losses are due to circumstances beyond your control or are normal in the start-up phase of farming;
You change your methods of operation in an attempt to improve profitability;
You, or your advisors, have the knowledge needed to carry on the farming activity as a successful business;
You were successful in making a profit in similar activities in the past;
You make a profit from farming in some years and the amount of profit you make; and
You can expect to make a future profit from the appreciation of the assets used in the farming activity.

Presumption of profit. Your farming or other activity is presumed carried on for profit if it produced a profit in at least 3 of the last 5 tax years, including the current year. Activities that consist primarily of breeding, training, showing, or racing horses are presumed carried on for profit if they produced a profit in at least 2 of the last 7 tax years, including the current year. The activity must be substantially the same for each year within this period. You have a profit when the gross income from an activity is more than the deductions for it.

If a taxpayer dies before the end of the 5-year (or 7-year) period, the period ends on the date of the taxpayer’s death.

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

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

Using the presumption later. If you are starting out in farming and do not have 3 (or 2) years showing a profit, you may want to take advantage of this presumption later, after you have had the 6 (or 7) years of experience allowed by the text.

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

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

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

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

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

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

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

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

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

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

5. Soil and Water Conservation Expenses

What’s New

Endangered species recovery expenses. Beginning in 2009, you can choose to deduct endangered species recovery expenses. See Endangered species recovery expenses, under Conservation Expenses, for more information.

Introduction

If you are in the business of farming, you can choose to deduct certain expenses for:

• Soil or water conservation,
• Prevention of erosion of land used in farming, or
• Endangered species recovery expenses.

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 for conservation expenses cannot be more than 25% of your gross income from farming. See 25% Limit on Deduction later.

Certain 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 of this chapter.

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

Topics

This chapter discusses:

• Business of farming
• Plan certification
• Conservation expenses
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 an owner or a tenant. You are not in the business of farming if you cultivate or operate a farm for recreation or pleasure, rather than for profit. You are not farming if you are engaged only in forestry or the growing of timber.

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

Farm rental. If you own a farm and receive farm rental payments based on farm production, either in cash or crop shares, you are in the business of farming. If you receive a fixed rental payment that is not based on farm production, you are in the business of farming only if you materially participate in operating or managing the farm. See Landlord Participation in Farming in chapter 12.

If you get cash rental for a farm you own that is not used in farm production, you cannot deduct soil and water conservation expenses for that farm.

Example. You own a farm in Iowa and live in California. You rent the farm for $125 in cash per acre and do not materially participate in producing or managing production of the crops grown on the farm. You cannot deduct your soil conservation expenses for this farm. You must capitalize the expenses and add them to the basis of the land.

Plan Certification

You can deduct soil and water conservation expenses only if they are consistent with a soil conservation plan developed by NRCS. If no such plan exists, you must use another method to allocate these expenses if you can clearly show that your method is more reasonable.

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, the following:

1. The treatment or movement of water, such as:
   a. Diversion channels,
   b. Drainage ditches,
   c. Irrigation ditches,
   d. Earthen dams, and
   e. Watercourses, outlets, and ponds.

2. The construction, control, and protection of:
   a. Contour furrowing, and
   b. Restoration of soil fertility.

3. The eradication of brush.

4. The planting of windbreaks.

New farm or farmland. If you acquire a new farm or new farmland from someone who was using it in farming immediately before you acquired the land, soil and water conservation expenses you incur on it will be treated as made on land 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 between the two types of land. For example, if the expenses benefit 200 acres of your land, but only 120 acres of this land are used for farming, then you can deduct 60% (120 ÷ 200) of the expenses. You can use another method to allocate these expenses if you can clearly show that your method is more reasonable.

Depreciable conservation assets. You generally cannot deduct 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 performs against your farm. See Assessment for Depreciable Property in chapter 12.

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 machinery, 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 12.

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 for a low supply of water for a reason so that all economic benefits from the well are terminated constitutes an abandonment.

Endangered species recovery expenses. Beginning in 2009, if you are in the business of farming and meet other specific requirements, you can choose to deduct the conservation expenses discussed earlier as endangered species recovery expenses. Otherwise, these are capital expenses that must be added to the basis of the land.
The expenses must be paid or incurred for the purpose of achieving site-specific management actions recommended in a recovery plan approved under section 4(f) of the Endangered Species Act of 1973. See Internal Revenue Code section 175 for more information.

Assessment by Conservation District

In some localities, a soil or water conservation or drainage district incurs expenses for soil or water conservation and levies an assessment against the farmers who benefit from the expenses. You can deduct as a conservation expense amounts you pay or incur for the part of an assessment that:
- Covers expenses you could deduct if you had paid them directly, or
- Covers expenses for depreciable property used in the district's business.

Assessment for Depreciable Property

You generally can deduct as a conservation expense amounts you pay or incur for the part of a conservation or drainage district assessment that covers expenses for depreciable property. This includes items such as pumps, locks, concrete structures (including dams and weir gates), draglines, and similar equipment. The depreciable property must be used in the district's soil and water conservation activities. However, the following limits apply to these assessments:
- The total assessment limit.
- The yearly assessment limit.

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

Total assessment limit. You cannot deduct more than 10% of the total amount assessed to all members of the conservation or drainage district for the depreciable property. This applies whether you pay the assessment in one payment or in installments. If your assessment is more than 10% of the total amount assessed, both the following rules apply:
- The amount over 10% is a capital expense and is added to the basis of your land.
- If the assessment is paid in installments, each payment must be prorated between the conservation expense and the capital expense.

Yearly assessment limit. The maximum amount you can deduct in any one year is the total of 10% of your deductible share of the cost as explained earlier, plus $500. If the amount you pay or incur is equal to or less than the maximum amount, you can deduct it in the year it is paid or incurred. If the amount you pay or incur is more, you can deduct in that year only 10% of your deductible share of the cost. You can deduct the remainder in equal amounts over the next 9 tax years. Your total conservation expense deduction for each year is also subject to the 25% of gross income from farming limit on the deduction, discussed later.

Example 1. This year, the soil conservation district levies and you pay an assessment of $2,400 against your farm. Of the assessment, $1,500 is for digging drainage ditches. You can deduct this part as a soil or conservation expense as if you had paid it directly. The remaining $900 is for depreciable equipment to be used in the district's irrigation activities. The total amount assessed by the district against all its members for the depreciable equipment is $7,000.

The total amount you can deduct for the depreciable equipment is limited to 10% of the total amount assessed by the district against all its members for depreciable equipment, or $700. The $200 excess ($900 – $700) is a capital expense you must add to the basis of your farm.

Example 2. Assume the same facts as 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 $5,550. The total amount you can deduct for the depreciable equipment is limited to 10% of this amount, or $550.

The maximum amount you can deduct this year for the depreciable equipment is $555 (10% of your deductible share of the total assessment, $55, plus $500). Since your deductible share is less than the maximum amount deductible in one year, you can deduct the entire $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 below.

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.

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. The total is then subject to the 25% of gross income from farming limit in that year.</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></td>
</tr>
</tbody>
</table>
25% Limit on Deduction

The total deduction for conservation expenses in any tax year is limited to 25% of your gross income from farming for the year.

Gross income from farming. Gross income from farming is the income you derive in the business of farming from the production of crops, fish, fruits, other agricultural products, or livestock. Gains from sales of draft, breeding, or dairy livestock are included. Gains from sales of assets such as farm machinery, or from the disposition of land, are not included.

Carryover of deduction. If your deductible conservation expenses in any year are more than 25% of your gross income from farming for that year, you can carry the unused deduction over to later years. However, the deduction in any later year is limited to 25% of the gross income from farming for that year as well.

Example. In 2009, 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 2010 and added to deductible soil and water conservation expenses made in that year. The total of the 2009 carryover plus 2010 expenses is deductible in 2010, subject to the limit of 25% of your gross income from farming in 2010. Any expenses over the limit in that year are carried to 2011 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 for the treatment of soil and water conservation expenses, or you want to treat the expenses for a particular project or a single farm in a different manner, you must get the approval of the IRS. To get this approval, submit a written request by the due date of your return for the first tax year you want the new method to apply. You or your authorized representative must sign the request.

The request must include the following information:

- Your name and address.

- The first tax year the method or change of method is to apply.
- Whether the method or change of method applies to all your soil and water conservation expenses or only to those for a particular project or farm. If the method or change of method does not apply to all your expenses, identify the project or farm to which the expenses apply.
- The total expenses you paid or incurred in the first tax year the method or change of method is to apply.
- A statement that you will account separately in your books for the expenses to which this method or change of method relates.

Send your request to the following address.

Department of the Treasury
Internal Revenue Service Center
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 on keeping records, see chapter 1.

Topics

This chapter discusses:
- Cost basis
- Adjusted basis
- Basis other than cost

Useful Items

You may want to see:

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

See chapter 16 for information about getting publications and forms.

Cost Basis

The basis of property you buy is usually its cost. Cost is the amount you pay in cash, debt obligations, other property, or services. Your cost includes amounts you pay for sales tax, freight, installation, and testing. The basis of real estate and business assets will include other items. Basis generally does not include interest payments. However, see Carrying charges 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 basis 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 a right based on its FMV 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 buyer for the taxes the seller paid for you, you generally can deduct that amount as a tax expense. Whether or not you reimburse the buyer, 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 Publication 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 in later disposition of any of these assets. You and the seller may agree in the sales contract to a specific allocation of the purchase price among the assets. If this allocation is based on the value of each asset and you and the seller have adverse tax interests, the allocation generally will be accepted.

- Farming business acquired. If you buy a group of assets that makes up a farming business, there are special rules you must use to allocate the purchase price among the assets. Generally, reduce the purchase price by any cash received. Allocate the remaining purchase price to the other business assets received in proportion to (but not more than) their FMV and in a certain order. See Trade or Business Acquired under Allocating the Basis in Publication 551 for more information.

- Transplanted embryo. If you buy a cow that is pregnant with a transplanted embryo, allocate to the basis of the cow the part of the purchase price equal to the FMV of the cow without the implant. Allocate the rest of the purchase price to the basis of the calf. Neither the cost allocated to the cow nor the cost allocated to the calf is deductible as a current business expense.

- Quotas and allotments. Certain areas of the country have quotas or allotments for commodities such as milk, tobacco, and peanuts. The cost of the quota or allotment is its basis. If you acquire a right to a quota with the purchase of land or a herd of dairy cows, allocate part of the purchase price to that right based on its FMV and the FMV of the land or herd.

**Uniform Capitalization Rules**

Under the uniform capitalization rules, you must include certain direct and indirect costs in the basis of property you produce or in your 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 annual gross receipts for the 3-tax-year period ending with the year preceding the current tax year are $10 million or less.

You produce property if you construct, build, install, manufacture, develop, improve, or create the property.

- You are not 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 and preproductive period costs. Preparatory costs include the acquisition costs of the seed, seedling, plant, or animal. For plants, preproductive period costs include the costs of items such as irrigation, pruning, frost protection, spraying, and harvesting. For animals, preproductive period costs include the costs of items such as feed, maintaining pasture or pen areas, breeding, veterinary services, and bedding.

**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, or
- 3. Any costs of replanting certain plants lost or damaged due to casualty.

Exceptions (1) and (2) do not apply to a farm, corporation, partnership, or tax shelter required to use an accrual method of accounting. See Accrual Method Required under Accounting Methods in chapter 2.
In addition, you can elect not to use the uniform capitalization rules for plants with a preproductive period of more than 2 years. If you make this election, special rules apply. This election cannot be made by a corporation, partnership, or tax shelter required to use an accrual method of accounting. This election also does not apply to any costs incurred for the planting, cultivation, maintenance, or development of any citrus, coffee, peach, or apricot tree, or for 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 these deductions, see Form 5695. 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 first determine certain adjustments (increases and decreases) to the cost of the property. The result is the adjusted basis of the property.

### Increases to Basis

Increase the basis of any property by all items properly added to a capital account. These include the cost of any improvements having a useful life of more than 1 year.

The following costs increase the basis of property.

- The cost of extending utility service lines to property.
- Legal fees, such as the cost of defending and perfecting title.
- Legal fees for seeking a decrease in an assessment levied against property to pay for local improvements.
- Assessments for items such as paving roads and building ditches that increase the value of the property assessed. Do not deduct these expenses as taxes. However, you can deduct as taxes amounts assessed for maintenance or repairs, or for meeting interest charges related to the improvements.
- If you make additions or improvements to business property, depreciate the basis of each addition or improvement as separate depreciable property using the rules that would apply to the original property if you had placed it in service at the same time you placed the addition or improvement in service. See chapter 7.

### 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 efficient property 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 next. 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 (allowed or allowable depreciation), under the method of depreciation you chose. If you took less depreciation than you could have or did not take a depreciation deduction, reduce the basis by the full amount of depreciation you could have taken. If you deducted more depreciation than you should have, decrease your basis by the amount you should have deducted plus the part of the excess depreciation you deducted that actually reduced your tax liability for any year.

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

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 reimbursements. 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.

### Plants With a Preproductive Period of More Than 2 Years

<table>
<thead>
<tr>
<th>Plants producing the following crops or yields have a nationwide weighted average preproductive period of more than 2 years.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Almonds</td>
</tr>
<tr>
<td>Apples</td>
</tr>
<tr>
<td>Apricots</td>
</tr>
<tr>
<td>Avocados</td>
</tr>
<tr>
<td>Blackberries</td>
</tr>
<tr>
<td>Blueberries</td>
</tr>
<tr>
<td>Cherries</td>
</tr>
<tr>
<td>Chestnuts</td>
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<tr>
<td>Coffee beans</td>
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<tr>
<td>Pecans</td>
</tr>
<tr>
<td>Plums</td>
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<tr>
<td>Raspberries</td>
</tr>
<tr>
<td>Tangos</td>
</tr>
</tbody>
</table>
To make this determination, compare the re-paired property to the property before the casu-
ality.

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. You are neither increased nor decreased 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 recog- nized gain. See Easements and rights-of-way in chapter 3.

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

Canceled debt excluded from income. If a debt you owe is canceled or forgiven, other than as a gift or bequest, you generally must include the canceled amount in your gross income for tax purposes. A debt includes any indebtedness for which you are liable or which attaches to property you hold.

You can exclude your canceled debt from income if the debt is any of the following.

1. Debt canceled in a bankruptcy case or when you are insolvent.
2. Qualified farm debt.
3. Qualified real property business debt (pro-
vided you are not a C corporation).
4. Qualified principal residence indebtedness.
5. Discharge of certain indebtedness of a qualified individual because of Midwestern disas-
ters.

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

For more information about canceled debt in a bankruptcy case, see Publication 908, Bank-
ruptcy Tax Guide. For more information about insolvent and canceled debt that is qualified farm debt or qualified principal residence indebtedness, see chapter 3.

For more information about qualified real property business debt, see Publication 534, Tax Guide for Small Business.

For more information about canceled debt in Midwestern disaster areas, see Publication 4429-B, Information for Affected Taxpayers in the Midwestern Disaster Areas.

Basis Other Than Cost

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

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

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

The basis for depreciation is the lesser of:

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

Property received for services. If you re-
ceive property for services, include the prop-
ty’s FMV in income. The amount you include in income becomes your basis. You determine your basis by the FMVs of the property when the services were performed for a price agreed on before-
hand, it will be accepted as the FMV of the property if there is no evidence to the contrary.

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

Taxable Exchanges

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

If you receive property in exchange for other property in a taxable exchange, the basis of the property you receive is usually its FMV at the time of the exchange.

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

Involuntary Conversions

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

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

1. Decrease the basis by the following amounts.

   a. Any loss you recognize on the involun-
tary conversion.
   b. Any money you receive that you do not spend on similar property.

2. Increase the basis by the following amounts.

   a. Any gain you recognize on the involun-
tary conversion.
   b. Any cost of acquiring the replacement property.

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

Allocating the basis. If you buy more than one replacement property, allocate the basis among the properties based on their re-
pective costs.

Basis for depreciation. Special rules apply in determining and depreciating the basis of MACRS property acquired in an involuntary con-
version. For more information, see Figuring the De-
puction for Property Acquired in a Nontaxable Exchange under Figuring Depreciation Under MACRS in chapter 6.

For more information about involuntary con-
versions, see chapter 11.

Nontaxable Exchanges

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

Like-Kind Exchanges

The exchange of property for the same kind of property is the most common type of nontaxable exchange.

For an exchange to qualify as a like-kind exchange, you must hold for business or invest-
ment purposes both the property you transfer and the property you receive. There must also be an exchange of like-kind property. For more information, see Like-Kind Exchanges in chapter 6.

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

Example 1. You traded a truck you used in your farming business for a new smaller truck to use in farming. The adjusted basis of the old truck was $10,000. The FMV of the new truck is $14,000. Because this is a nontaxable ex-
change, you do not recognize any gain, and your basis in the new truck is $10,000, the same as the adjusted basis of the truck you traded.
Example 2. 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 6.

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.

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

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

<table>
<thead>
<tr>
<th>Basis of truck received</th>
<th>$22,750</th>
</tr>
</thead>
<tbody>
<tr>
<td>Minus: Cash received (adjustment 1(a))</td>
<td>$10,000</td>
</tr>
<tr>
<td>Plus: Gain recognized (adjustment 2(b))</td>
<td>$7,250</td>
</tr>
<tr>
<td>Total basis of truck received</td>
<td>$10,000</td>
</tr>
</tbody>
</table>

Allocate the total basis of $15,000 first to the amount of the gift for gift tax purposes was $1,000. Any gain you recognize on the exchange is treated as described in chapter 7.

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 she 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, you are 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 your income tax return, you must figure the adjusted basis of the like-kind property and allocate your basis (the donor’s adjusted basis) by any required adjustments to basis while you held the property. See Adjusted Basis earlier.

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

Net increase in value of the gift

Amount of the gift

The net increase in value of the gift is the FMV of the gift minus the donor’s adjusted basis.

The amount of the gift is its value for gift tax purposes after reduction by any annual exclusion and marital or charitable deduction that applies to the gift. For information on the gift tax, see Publication 950, Introduction to Estate and Gift Taxes.

Example. In 2009, you received a gift of property from your mother that had an FMV of $50,000. Her adjusted basis was $20,000. The amount of the gift for gift tax purposes was $37,000 ($50,000 minus the $13,000 annual exclusion). She paid a gift tax of $7,540. Your basis, $26,107, is figured as follows.
The type and rule above prints on all proofs including departmental reproduction proofs. MUST be removed before printing.

Fair market value .......................... $50,000
Minus: Adjusted basis ........................ -20,000
Net increase in value ........................ 30,000
Gift tax paid .................................. $7,500
Multiplied by ($30,000 - $37,000) ........................... > 81
Gift tax due to net increase in value ........................ $6,107
Adjusted basis of property to your mother .................. +20,000
Your basis in the property .......................... $28,107

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

FMV less than donor’s adjusted basis. If the FMV of the property at the time of the gift is less than the donor’s adjusted basis, your basis depends on whether you have a gain or a loss when you dispose of the property. Your basis for figuring gain is the donor’s adjusted basis plus or minus any required adjustments to basis while you held the property. Your basis for figuring loss is its FMV when you received the gift plus or minus any required adjustments to basis while you held the property. (See Adjusted Basis, earlier.)

If you use the donor’s adjusted basis for figuring a gain and get a loss, and then use the FMV for figuring a loss and get a gain, you have neither gain nor loss on the sale or other disposition of the property.

Example. You received farmland as a gift from your parents when they retired from farming. At the time of the gift, the land had an FMV of $80,000. Your parents’ adjusted basis was $100,000. After you received the land, no events occurred that would increase or decrease your basis.

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

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

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

Property Transferred From a Spouse

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

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

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

Inherited Property

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

• The FMV of the property at the date of the decedent’s death. If a federal estate return is filed, you can use its appraised value.

• The FMV on the alternate valuation date, if the personal representative for the estate elects to use alternate valuation. For information on the alternate valuation, see the Instructions for Form 706.

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, use the FMV included in the estate distribution as your basis.

Special-use valuation method. Under certain conditions, when a person dies, the executor or personal representative of that person’s estate may elect to value qualified real property at other than its FMV. If so, the executor or personal representative values the qualified real property based on its use as a farm or other closely held business. If the executor or personal representative elects this method of valuation for estate tax purposes, this value is the basis of the property for the qualified heirs. The qualified heirs should be able to get the necessary value from the executor or personal representative of the estate.

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

You may be liable for an additional estate tax if, within 10 years after the death of the decedent, you transfer the property or the property stops being used as a farm. This tax does not apply if you dispose of the property in a like-kind exchange or in an involuntary conversion in which all of the proceeds are reinvested in qualified replacement property. The tax also does not apply if you transfer the property to a member of your family and certain requirements are met.

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 Transfers) 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 to the partner with respect to the partner’s interest in the partnership and from a corporation to the shareholder with respect to the shareholder’s ownership of stock in the corporation.

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

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

What's New for 2009

New recovery period for race horses. Any race horse (without regard to the age of the horse) placed in service after 2008 is treated as 3-year property for General Depreciation System (GDS) recovery purposes.

Increased section 179 expense deduction dollar limits. The maximum amount you can elect to deduct for most section 179 property placed in service in 2009 is $250,000. This limit is reduced by the amount by which the cost of the property placed in service during the tax year exceeds $800,000. See Dollar Limits under Section 179 Expense Deduction later.

Extension of special depreciation allowance for certain qualified property acquired after 2007. You may be able to take a special depreciation allowance for certain qualified property acquired after 2007 and placed in service before 2010. See Claiming the Special Depreciation Allowance later.

New recovery period for certain machinery and equipment. Certain machinery or equipment placed in service after 2008 and before 2010 will be treated as 5-year property for GDS purposes (10-year property for Alternative Depreciation System (ADS) purposes).

What's New for 2010

Expiration of increased section 179 deduction and special allowance for qualified disaster assistance property. The higher maximum 179 expense deduction and special depreciation allowance will not apply to qualified disaster assistance property placed in service in federally declared disaster areas where the disaster occurred after 2009.

Expiration of the 5-year recovery period for certain machinery and equipment. Certain machinery or equipment used in a farming business and placed in service after 2009 will no longer be treated as 5-year property under MACRS (or 10-year property under ADS).

Marginal production of oil and gas. The temporary suspension of the taxable income limitation on percentage depletion from the marginal production of oil and natural gas will no longer be available for tax years beginning after 2009.

Introduction

If you buy or make improvements to 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.

Topics

This chapter discusses:

- Overview of depreciation.
- Section 179 expense deduction.
- Special depreciation allowance.
- Modified Accelerated Cost Recovery System (MACRS).
- Listed property.
- Amortization.
- 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 (Timber), Forest Activities Schedule
  - 3115 Application for Change in Accounting Method
  - 4562 Depreciation and Amortization
  - 4797 Sales of Business Property

See chapter 4 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.
- 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 in-come-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
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.

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 2009 after harvest was over. You begin to depreciate the planter for 2009 because it was ready and available for its specific use in 2009, even though it will not be used until the spring of 2010.

If your planter comes unassembled in December 2009 and is put together in February 2010, it is not placed in service until 2010. You begin to depreciate it in 2010.

If your planter was delivered and assembled in February 2010 but not used until April 2010, it is placed in service in February 2010, because this is when the planter was ready for its specified use. You begin to depreciate it in 2010.

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

Irrigation systems and water wells. Irrigation systems and wells used in a trade or business can be depreciated if their useful life can be determined. You can depreciate irrigation systems and wells composed of 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. Depreciation begins when the livestock reach the age of maturity. If you acquire immature livestock for breeding, or dairy purposes, you can depreciate them based on their percentage of use in farming. See Inventory, below.

Livestock. Livestock purchased for draft, breeding, or dairy purposes can be depreciated only if they are not kept in an inventory account. If you use livestock primarily for sale to customers in the ordinary course of your business, you may be able to deduct depreciation on that part based on its business use. For more information, see Business Use of Your Home in chapter 4, Inventory.

You can never depreciate inventory because it is not held for use in your business. Inventory is any property you hold primarily for sale to customers in the ordinary course of your business.

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.

What Property Cannot Be Depreciated?
Certain property cannot be depreciated, even if the requirements explained earlier are met. This includes the following:

- Land.
- Intangible property such as section 197 computer software.
- Certain term interests in property.
- Fruit or nut trees and vines.
- Equipment used to build capital improvements.
- Immature livestock.
- Investment property as a life tenant.
- Computer software.

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

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 expense 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, Amortization.
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).

How Do You Correct Depreciation Deductions?

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 are claiming any of the following:

- A section 179 expense 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 placed in service by you in tax years ending after December 29, 2003.
- You claimed the incorrect amount on property placed in service by you in tax years ending before December 30, 2003.

Note. You have adopted a method of accounting if you used the same incorrect method of depreciation for two or more consecutively filed returns.

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 Expense 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 expense deduction. You can elect the section 179 expense deduction instead of recovering the cost by taking depreciation deductions.

This part of the chapter explains the rules for the section 179 expense 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 expense 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 expense 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 or furnished
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 expense deduction if it is used in connection with any of the activities listed earlier in item (2)(a). Bulk storage means the storage of a commodity in a large mass before it is used.

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

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

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

- To house, raise, and feed a particular type of livestock and its produce.
- To house the equipment, including any replacements, needed to house, raise, or feed the livestock.

For this purpose, livestock includes poultry.

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

Horticultural structure. A single purpose horticultural structure is either of the following.

- A greenhouse specifically designed, constructed, and used for the commercial production of plants.
- A structure specifically designed, constructed, and used for the commercial production of mushrooms.

Use of structure. A structure must be used only for the purpose that qualified it. For example, a hog barn will not be qualifying property if you use it to house poultry. Similarly, using part of your greenhouse to sell plants will make the greenhouse nonqualifying property.

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

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

Property Acquired by Purchase

To qualify for the section 179 expense deduction, your property must have been 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 expense 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.

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

- Certain property you lease to others (if you are a noncorporate lessor).
- Certain property used predominantly to furnish lodging or in connection with the furnishing of lodging.
- 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 expense 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 under Partnerships and S Corporations, later.

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

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

Partial business use. When you use property for business and nonbusiness purposes, you can elect the section 179 expense 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 expense 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 expense 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 expense 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 expense deduction. J-Bar's business costs that qualify for the section 179 expense 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 2009 is $250,000. If you acquire and place in
service more than one item of qualifying prop-
erty during the year, you can allocate the section 179 expense deduction among the items in any
way, as long as the total deduction is not more than $250,000. You do not have to claim the full $250,000.

Example. This year, you bought and placed in service a corn combine for $305,000 and a mower for $7,800 for use in your farming busi-
ness. You elect to deduct the entire $7,800 for the mower and $242,200 for the corn combine, a total of $250,000. This is the most you can
deduct. Your $7,800 deduction for the mower completely recovered its cost. Your basis for deprec-
ation is zero. The basis of your corn combine for depreciation is $62,800. You figure this by subtracting the amount of your section 179 expense deduction, $242,200, from the cost of the corn combine, $305,000.

Reduced dollar limit for cost exceeding $800,000. If the cost of your qualifying section 179 property placed in service in 2009 is over $800,000, you must reduce the dollar limit for the section 179 expense deduction (not below zero) by the amount of cost over $800,000. If the cost of your section 179 prop-
erty placed in service during 2009 is $1,050,000 or more, you cannot take a section 179 expense
deduction and you cannot carry over the cost that is more than $1,050,000.

Example. This year, James Smith placed in service machinery costing $850,000. Because this cost is $50,000 more than $800,000, he must reduce his dollar limit to $200,000 ($250,000 − $50,000).

You may be able to take an increased section 179 expense deduction for qualified section 179 disaster assis-
tance property placed in service in federally de-
clared disaster areas where the disaster occurred before 2010. A list of the federally declared disaster areas is available at the Fed-
eral Emergency Management Agency (FEMA) web site at www.fema.gov. For more informa-
tion, including the definition of qualified section 179 disaster assistance property and the eligible disaster areas, see chapter 2 of Publication 946.

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 2009 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 Publi-
cation 946.

Limits for passenger automobiles. For a passenger automobile that is placed in service in 2009, the total section 179 and depreciation
deduction is limited. See Do the Passenger Au-
tomobile Limits Apply, later.

Married individuals. If you are married, how you figure your section 179 expense deduction depends on whether you file jointly or sepa-
rate. If you file a joint return, you and your spouse are treated as one taxpayer in determin-
ing any reduction to the dollar limit, regardless of which of you purchased the property or placed it in service. If you and your spouse file separate
returns, you are treated as one taxpayer for the dollar limit, including the reduction for costs over $800,000. You must allocate the dollar limit (af-
er any reduction) equally between you, unless you both elect a different allocation. If the per-
centages elected by each of you do not total 100%, 50% will be allocated to each of you.

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

• The dollar limit (after reduction for any cost of section 179 property over $800,000).

• The total cost of section 179 property you and your spouse elected to expense on your separate returns.

Business Income Limit

The total cost you can deduct each year for ap-
ply the dollar limit is limited to the taxable income from the active conduct of any trade or business during the year. Generally, you are considered to actively conduct a trade or busi-
ness if you meaningfully participate in the man-
agement or operations of the trade or business.

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

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

• Section 1231 gains (or losses) as dis-
cussed in chapter 9.

• Interest from working capital of your trade or business.

• Wages, salaries, tips, or other pay earned by you (or your spouse if you file a joint return) as an employee of any employer.

In addition, figure taxable income without re-
gard to any of the following.

• The section 179 expense deduction.

• The self-employment tax deduction.

• Any net operating loss carryback or car-
ryforward.

• Any unreimbursed employee business ex-
penses.

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

Step 1. Taxable income figured without ei-
ther deduction is $270,000.

Step 2. Using $270,000 as taxable income, XYZ’s hypothetical section 179 expense de-
duction is $250,000.

Step 3. Subtract the hypothetical section 179 expense deduction figured in Step 2 from the taxable income figured in Step 1.

Step 4. Figure a hypothetical amount for the other deduction using the amount figured in Step 3 as taxable income.

Step 5. Subtract the hypothetical other deduction figured in Step 4 from the taxable income figured in Step 1.

Step 6. Figure your actual section 179 expense deduction using the taxable income figured in Step 5.

Step 7. Subtract your actual section 179 expense deduction figured in Step 6 from the taxable income figured in Step 1.

Step 8. Figure your actual other deduction using the taxable income figured in Step 7.

Example. On February 1, 2009, the XYZ farm corporation purchased and placed in serv-
lice qualifying section 179 property that cost $250,000. It elects to expense the entire $250,000 cost under section 179. In June, the corporation gave a charitable contribution of $10,000. A corporation’s limit on charitable con-
tributions is figured after subtracting any section 179 expense deduction. The business income limit for the section 179 expense deduction is figured after subtracting any allowable charita-
table contributions. XYZ’s taxable income without the section 179 expense deduction or the deduction for charitable contributions is $270,000. XYZ figures its section 179 expense deduction and its deduction for charitable contributions as follows.

Step 1. Taxable income figured without ei-
ther deduction is $270,000.

Step 2. Using $270,000 as taxable income, XYZ’s hypothetical section 179 expense de-
duction is $250,000.

Step 3. Subtract the hypothetical section 179 expense deduction figured in Step 2 from the taxable income figured in Step 1.

Step 4. Using $20,000 (from Step 3) as taxable income, XYZ’s hypothetical charita-
table contribution (limited to 10% of taxable income) is $2,000.

Step 5. Subtract $268,000 ($270,000 − $2,000).

Step 6. Using $268,000 (from Step 5) as taxable income, XYZ figures the actual sec-
tion 179 expense deduction. Because the taxable income is at least $250,000, XYZ can take a $250,000 section 179 expense deduction.

Step 7. Subtract $20,000 ($270,000 − $250,000).

Step 8. Using $20,000 (from Step 7) as taxable income, XYZ’s actual charitable
contribution (limited to 10% of taxable in-
come) 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 deter-
mining the section 179 expense deduction allocable to the next year. However, it is subject to the limits in that year. If you place more than one property in service in a year, you can select the properties for which all or a part of the cost will be carried forward. Your selections must be shown in your books and records.

Example. Last year, Joyce Jones placed in service a machine that cost $8,000 and elected to deduct all $8,000 under section 179. The taxable income from her business (determined without regard to both a section 179 expense deduction for the cost of the machine and the self-employment tax deduction) was $6,000. Her section 179 expense deduction was limited to $6,000. The $2,000 cost that was not allowed as a section 179 expense 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 expense deduction for the cost of the machine and the self-employment tax deduction) was $5,000. 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 bal-
ance of $1,000 to next year.

Partnerships and S Corporations

The section 179 expense 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 expense deduction subject to the limits. It then allocates the deduction among its partners or shareholders.

If you are a partner in a partnership or share-
holder of an S corporation, you add the amount allocated from the partnership or S corporation to any section 179 costs related to the part-
nership or S corporation and then apply the dollar limit to this total. To determine any reduc-
tion in the dollar limit for costs over $800,000, 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 re-
mainder section 179 costs. For more informa-
tion, see chapter 2 of Publication 946.

Example. In 2009, Partnership P placed in service section 179 property with a total cost of $960,000. P must reduce its dollar limit by $160,000 ($960,000 − $800,000). Its maximum

of the elected section 179 expense deduction you in service in a year, you can select the properties claimed. ... will be carried the property in service and include the forture amount as follows.

How Must You Recapture the Deduction?

You may have to recapture the section 179 expense 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 in-
come. You also increase the basis of the prop-
erty by the recapture amount. Recovery periods for property are discussed 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 chapter 9 under Section 1245 Property.

Claiming the Special Depreciation Allowance

For qualified property (defined below) placed in service in 2009, you can take an additional 50% special depreciation allowance. The allowance is an additional deduction you can take after any section 179 expense deduction and before you

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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 specified GO Zone extension property, certain qualified property acquired after 2007 and placed in service before 2010, and qualified disaster assistance property.

Specified GO Zone extension property. Farmers may be able to take a special depreciation allowance for specified GO Zone extension property (as defined in section 1400N(d)(6)(B) of the Internal Revenue Code) that is placed in service in specified portions of the GO Zone (as described in section 1400N(d)(6)(C) of the Internal Revenue Code). This is depreciable property that also meets the following requirements:

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


Certain qualified property acquired after 2007 and placed in service before 2010. Certain qualified property (defined below) acquired after 2007 and before 2010 is eligible for a 50% special depreciation allowance.

Qualified property includes the following:

• Tangible property depreciated under the modified accelerated cost recovery system (MACRS) with a recovery period of 20 years or less.
• Water utility property.
• Off-the-shelf computer software.
• Qualified leasehold improvement property.

Qualified property must also meet all of the following tests:

• You must have acquired qualified property by purchase after 2007 and before 2010. If a binding contract to acquire the property existed before 2008, the property does not qualify.
• Qualified property must be placed in service after 2007 and placed in service before 2010 (before 2011 for certain property with a long production period and for certain aircraft).
• The original use of the property must begin with you after 2007.

You may be able to take a special depreciation allowance for qualified disaster assistance property placed in service in a federally declared disaster area where the disaster occurred before 2010. A list of the federally declared disaster areas is available at the Federal Emergency Management Agency (FEMA) web site at www.fema.gov. For more information, including the definition of qualified disaster assistance property and the eligible disaster areas, 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 depreciation 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 depreciation 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 (included 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.

Figuring Depreciation Under MACRS

The Modified Accelerated Cost Recovery System (MACRS) is used to recover the basis of most business and investment property placed in service after 1986. MACRS consists of two depreciation systems, the General Depreciation System (GDS) and the Alternative Depreciation System (ADS). Generally, these systems provide different methods and recovery periods to use in figuring depreciation deductions.

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

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

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

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

Which Depreciation System (GDS or ADS) Applies?

Your use of either the General Depreciation System (GDS) or the Alternative Depreciation System (ADS) to depreciate property under MACRS determines what depreciation method and recovery period you use. You generally must 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 you placed in service during the tax 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 either in a trade or business or for the production of income. The placed-in-service date for your property is the date the property is ready and available for a specific use. It is therefore not necessarily the date it is first used. If you converted property held for personal use to use in a trade or business or for the production of income, treat the property as being placed in service on the conversion date. See Placed in Service under When Does Depreciation Begin and Ends, 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.

Which Recovery Period Applies?

The recovery period of property is the number of years over which you recover its cost or other basis. It is determined based on the depreciation system (GDS or ADS) used. See Table 7-1 for recovery periods under both GDS and ADS for some commonly used assets. For a complete list of recovery periods, see the Table of Class Lives and Recovery Periods in Appendix B of Publication 946.

House trailers for farm laborers. To depreciate a house trailer you supply as housing for those who work on your farm, use one of the following recovery periods if the house trailer is mobile (it has wheels and a history of movement).

- A 7-year recovery period under GDS.
- A 10-year recovery period under ADS.

However, if the house trailer is not mobile (its wheels have been removed and permanent utilies and pipes attached to it), use one of the following recovery periods.

- A 20-year recovery period under GDS.
- A 25-year recovery period under ADS.

Water wells. Water wells used to provide water for raising poultry and livestock are land improvements. If they are depreciable, use one of the following recovery periods.

- A 15-year recovery period under GDS.
- A 20-year recovery period under ADS.

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

Which Convention Applies?

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

- The half-year convention.
- The mid-month convention.
- The mid-quarter convention.

Table 7-1. Farm Property Recovery Periods

<table>
<thead>
<tr>
<th>Assets</th>
<th>Recovery Period in Years</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agricultural structures (single purpose)</td>
<td>10 15</td>
</tr>
<tr>
<td>Automobiles</td>
<td>5 5</td>
</tr>
<tr>
<td>Calculators and copiers</td>
<td>5 6</td>
</tr>
<tr>
<td>Cattle (dairy or breeding)</td>
<td>5 7</td>
</tr>
<tr>
<td>Communication equipment 1</td>
<td>7 10</td>
</tr>
<tr>
<td>Computer and peripheral equipment</td>
<td>5 5</td>
</tr>
<tr>
<td>Drainage facilities</td>
<td>15 20</td>
</tr>
<tr>
<td>Farm buildings 2</td>
<td>20 25</td>
</tr>
<tr>
<td>Farm machinery and equipment 1</td>
<td>5 10</td>
</tr>
<tr>
<td>Fences (agricultural)</td>
<td>7 10</td>
</tr>
<tr>
<td>Goats and sheep (breeding)</td>
<td>5 5</td>
</tr>
<tr>
<td>Grain bin</td>
<td>7 10</td>
</tr>
<tr>
<td>Hogs (breeding)</td>
<td>3 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 10</td>
</tr>
<tr>
<td>Breeding and working (more than 12 years)</td>
<td>3 10</td>
</tr>
<tr>
<td>Racing horses</td>
<td>3 12</td>
</tr>
<tr>
<td>Horticultural structures (single purpose)</td>
<td>10 15</td>
</tr>
<tr>
<td>Logging machinery and equipment 1</td>
<td>5 6</td>
</tr>
<tr>
<td>Nonresidential real property</td>
<td>39 40</td>
</tr>
<tr>
<td>Office furniture, fixtures, and equipment (not calculators, copiers, or typewriters)</td>
<td>7 10</td>
</tr>
<tr>
<td>Paved lots</td>
<td>15 20</td>
</tr>
<tr>
<td>Residential rental property</td>
<td>27.5 40</td>
</tr>
<tr>
<td>Tractor units (over-the-road)</td>
<td>3 4</td>
</tr>
<tr>
<td>Trees or vines bearing fruit or nuts</td>
<td>10 20</td>
</tr>
<tr>
<td>Truck (heavy duty, unloaded weight 13,000 lbs. or more)</td>
<td>5 6</td>
</tr>
<tr>
<td>Truck (actual weight less than 13,000 lbs)</td>
<td>5 5</td>
</tr>
<tr>
<td>Water wells</td>
<td>15 20</td>
</tr>
</tbody>
</table>

1. Not including communication equipment listed in other classes.
2. Not including single purpose agricultural or horticultural structures.
3. Any machinery or equipment (other than grain bins, cotton ginning assets, fences, or other land improvements) used in a farming business where the original use begins with you after 2008 and it was placed in service before 2010.
4. Used by logging and sawmill operators for cutting of timber.
5. For property placed in service before May 12, 1993; for property placed in service before May 13, 1993, the recovery period is 31.5 years.
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>All 15- and 20-year property</td>
</tr>
<tr>
<td></td>
<td>Nonfarm 3-, 5-, 7-, and 10-year property1</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 property1</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 property1</td>
</tr>
<tr>
<td></td>
<td>Any property for which you elect to use this method1</td>
</tr>
<tr>
<td>GDS using 200% DB</td>
<td>Nonfarm 3-, 5-, 7-, and 10-year property</td>
</tr>
</tbody>
</table>

1Elective method
2See 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% declining balance method over a GDS recovery period or you can elect one of the following methods.

- The straight line method over a GDS recovery period.
- The straight line method over an ADS recovery period.

For property placed in service before 1999, you can have elected to use the 150% declining balance 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 Figure?, you do not need to determine in which year your deduction is greater using the straight line method. The tables have the switch to the straight line method built into their rates.

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

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

ELECTING A DIFFERENT METHOD. As shown in the Depreciation Table, you can elect a different method for depreciation for certain types of property. You must make the election by 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 §105-2." 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 and nonresidential real property.

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

ADS election. As explained earlier under Which Depreciation System (GDS or ADS) Applies?, you can elect to use ADS even though your property may come under GDS. ADS uses the straight line method of depreciation over the ADS recovery periods, which are generally longer than the GDS recovery periods. The ADS recovery periods for many assets used in the business of farming are listed in Table 7-1. Additional ADS recovery periods for other classes of property may be found in the Table of Class Lives and Recovery Periods in Appendix B of Publication 946.

How Is the Depreciation Deduction Figured?

To figure your depreciation deduction under MACRS, you first determine the depreciation system, property class, placed-in-service date, basis amount, recovery period, convention, and depreciation method that applies to your property. Then you are ready to figure your depreciation deduction. You can figure it in one of two ways.

- You can use the percentage tables provided by the IRS.
- You can figure your own deduction without using the tables.

Figuring your own MACRS deduction will generally result in a slightly different amount than using the tables.

Using the MACRS Percentage Tables

To help you figure your deduction under MACRS, the IRS has established percentage tables that incorporate the applicable 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 basis amount you would use to figure gain on a sale but figured without reducing your original basis by any MACRS depreciation taken in earlier years.
2. You cannot use the percentage tables for a short tax year. See chapter 4 of Publication 946 for information on how to figure the deduction for a short tax year.
3. You generally must continue to use them for the entire recovery period of the property.
4. You must stop using the tables if you adjust the basis of the property for any reason other than—
   a. Depreciation allowed or allowable, or
   b. An addition or improvement to the property, which is depreciated as a separate property.

Basis adjustment due to casualty loss. If you reduce the basis of your property because of a casualty, you cannot continue to use the percentage tables. For the year of the adjustment and the remaining recovery period, you...
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 percent-ages 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 expense 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 depreciation.

Since this is 7-year property, you multiply $10,000 by 10.71% to get this year’s depreciation of $1,071. For next year, your depreciation will be $1,913 ($10,000 × 19.13%).

**Example 2.** You had a barn constructed on your farm at a cost of $20,000. You placed the barn in service this year. You elect not to claim the special depreciation allowance. The barn is 20-year property and you use the table percentages to figure your depreciation. You figure this year’s depreciation by multiplying $20,000 (unadjusted basis) by 3.75% to get $750. For next year, your depreciation will be $1,443.80 ($20,000 × 7.219%).

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

<table>
<thead>
<tr>
<th>Year</th>
<th>3-Year</th>
<th>5-Year</th>
<th>7-Year</th>
<th>20-Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>25.0%</td>
<td>15.00%</td>
<td>10.71%</td>
<td>3.750%</td>
</tr>
<tr>
<td>2</td>
<td>37.5%</td>
<td>23.50%</td>
<td>19.13%</td>
<td>7.219%</td>
</tr>
<tr>
<td>3</td>
<td>25.0%</td>
<td>17.85%</td>
<td>15.03%</td>
<td>6.677%</td>
</tr>
<tr>
<td>4</td>
<td>12.5%</td>
<td>16.66%</td>
<td>12.25%</td>
<td>6.177%</td>
</tr>
<tr>
<td>5</td>
<td>16.66%</td>
<td>12.25%</td>
<td>5.713%</td>
<td></td>
</tr>
<tr>
<td>6</td>
<td>8.33%</td>
<td>12.25%</td>
<td>5.285%</td>
<td></td>
</tr>
<tr>
<td>7</td>
<td>12.25%</td>
<td>4.888%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>8</td>
<td>6.13%</td>
<td>4.522%</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**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.

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

<table>
<thead>
<tr>
<th>Year</th>
<th>3-Year</th>
<th>5-Year</th>
<th>7-Year</th>
<th>20-Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>16.67%</td>
<td>10%</td>
<td>7.14%</td>
<td>2.5%</td>
</tr>
<tr>
<td>2</td>
<td>33.33%</td>
<td>20</td>
<td>14.29%</td>
<td>5.0</td>
</tr>
<tr>
<td>3</td>
<td>33.33%</td>
<td>20</td>
<td>14.29%</td>
<td>5.0</td>
</tr>
<tr>
<td>4</td>
<td>16.67%</td>
<td>20</td>
<td>14.28%</td>
<td>5.0</td>
</tr>
<tr>
<td>5</td>
<td>20</td>
<td>14.29%</td>
<td>5.0</td>
<td></td>
</tr>
<tr>
<td>6</td>
<td>10</td>
<td>14.28%</td>
<td>5.0</td>
<td></td>
</tr>
<tr>
<td>7</td>
<td>10</td>
<td>14.28%</td>
<td>5.0</td>
<td></td>
</tr>
<tr>
<td>8</td>
<td>7.14%</td>
<td>5.0</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The following shows how to figure depreciation under MACRS using the straight line percentages in Table 7-3.

**Example.** If in Example 2, earlier, you had elected the straight line method, you figure this year’s depreciation by multiplying $20,000 (unadjusted basis) by 2.5% to get $500. For next year, your depreciation will be $1,000 ($20,000 × 5%).

**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 class (if any), recovery period, depreciation method, and convention of the property’s 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.

**When Do You Recapture MACRS Depreciation?**

When you dispose of property you depreciated using MACRS, any gain on the disposition is generally recaptured (included in income) as ordinary income up to the amount of the depreciation previously allowed or allowable for the property. For more information on depreciation recapture, see chapter 5. 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 telecommunication equipment).
- A truck or van that is a qualified nonpersonal use vehicle, where that vehicle is used only at a regular business establishment and owned or leased by the person operating the establishment.
- Special purpose farm vehicles. A special purpose farm vehicle is any 4-wheeled vehicle made primarily for use on public streets, roads, and highways and rated at 4,000 pounds or less of gross vehicle weight (4,000 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.

Other property used for transportation.

This includes trucks, buses, boats, airplanes, motorcycles, and other vehicles used for transporting persons or goods.

- Exempt vehicles. Other property used for transportation does not include the following vehicles.
  - Tractors and other special purpose farm vehicles.
  - Bucket trucks (cherry pickers), dump trucks, flatbed trucks, and refrigerated trucks.
  - Combines, cranes and derricks, and forklifts.

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 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.

Depletion

Depletion is the using up of natural resources by the person operating the establishment. The cash method for depletion allows an owner or operator to account for the reduction of a product’s reserves.

Who Can Claim Depletion?

If you have an economic interest in mineral property or standing timber (defined below), you can take a deduction for depletion. More than one person can have an economic interest in the same mineral deposit or timber.

You have an economic interest if both the following apply.

- You have acquired by investment any interest in mineral deposits or standing timber.
- You have a legal right to income from the extraction of the mineral or the cutting of the timber, to which you must look for a return of your capital investment.

A contractual relationship that allows you an economic or monetary advantage from products of the mineral deposit or standing timber is not, in itself, an economic interest. A production payment carved out of, or retained on the sale of, mineral property is not an economic interest.

Mineral property is each separate interest you own in each mineral deposit in each separate tract or parcel of land. You can treat two or more separate interests as one interest if the separate interests are not apart in the mineral deposit or standing timber.

Figuring Depletion

There are two ways of figuring depletion.

- Cost depletion.
- Percentage depletion.

For mineral property, you generally must use the method that gives you the larger deduction. For standing timber, you must use cost depletion.

Cost Depletion

To figure cost depletion you must first determine the following.

- The property’s basis for depletion.
- The total recoverable units of mineral in the property’s natural deposit.
- The number of units of mineral sold during the tax year.

You must estimate or determine recoverable units (tons, barrels, board feet, thousands of cubic feet, or other measure) using the current industry method and the most accurate and reliable information you can obtain.

Basis for depletion and total recoverable units are explained in chapter 9 of Publication 535.

Number of units sold. You determine the number of units sold during the tax year based on your method of accounting. Use the following table to make this determination.

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

The number of units sold during the tax year does not include any units for which depletion deductions were not 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 Ogallala Formation. Farmers who extract ground water from the Ogallala Formation for irrigation are allowed cost depletion. Cost depletion is allowed when it can be demonstrated the ground water is being depleted and the rate of recharge is so low that, once extracted, the water 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 4. Include allowable depletion for timber products not sold during the tax year the timber is cut, as a cost item in the closing inventory of timber products for the year. The inventory is your basis for determining gain or loss in the tax year you sell the timber products.

Form T (Timber). Complete and attach Form T (Timber) to your income tax return if you are claiming a deduction for timber depletion, electing to treat the cutting of timber as a sale or exchange, or making an outright sale of timber. See the Instructions for Form T (Timber).

Example. Sam Brown bought a farm that included standing timber. This year Sam determined that the standing timber could produce 300,000 units when cut. At that time, the adjusted basis of the standing timber was $24,000. Sam then cut and sold 27,000 units. (Sam did not elect to treat the cutting of the timber as a sale or exchange.) Sam’s depletion for each unit for the year is $0.08 ($24,000 ÷ 300,000). His deduction for depletion is $2,160 (27,000 × $0.08). If Sam had cut 27,000 units but sold only 20,000 units during the year, his depletion for each unit would have remained at $0.08. However, his depletion deduction would have been $1,600 (20,000 × $0.08) for this year and he would have included the balance of $560 ($2,160 – $1,600) in the closing inventory for the year.

Percentage Depletion

You can use percentage depletion on certain mines, wells, and natural gas. You cannot use the percentage method to figure depletion for standing timber, soil, sod, dirt, or turf.

To figure your depletion deduction, multiply a certain percentage, specified for each mineral, by your gross income from the property during the year. See Mines and other natural deposits in chapter 9 of Publication 535 for a list of the percentages. You can find a complete list in section 613(b) of the Internal Revenue Code.

TIP

For tax years beginning after 2008 and before 2010, the 100 percent taxable income limit does not apply to percentage depletion on the marginal production of oil and natural gas. For information on marginal production, see section 615A(c)(6) of the Internal Revenue Code.

The following rules apply when figuring your taxable income from the property for purposes of the taxable income limit.

• Do not deduct any net operating loss deduction from the gross income from the property.
• Corporations do not deduct charitable contributions from the gross income from the property.
• If, during the year, you disposed of an item of section 1245 property used in connection with the mineral property, reduce any allowable depletion for mining expenses by the part of any gain you must report as ordinary income that is allocable to the mineral property. See Regulations section 1.613-5(b)(1) for information on how to figure the ordinary gain allocable to the property.

For more information on depletion, see chapter 9 in Publication 535.

Amortization

Amortization is a method of recovering (deducting) certain capital costs over a fixed period of time. It is similar to the straight line method of depreciation. The amortizable costs discussed in this section include the start-up costs of going 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 expenditures 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 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 expenses 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.
costs of planting or seeding for forestation or reforestation.

**Qualifying costs.** Qualifying costs include only those costs you must otherwise capitalize and include in the adjusted basis of the property. They include costs for the following items:

- Site preparation.
- Seeds or seedlings.
- Labor.
- Tools.
- Depreciation on equipment used in planting and seeding.

If the government reimburses you for reforestation costs under a cost-sharing program, you can amortize these costs only if you include the reimbursement in your income.

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

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

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

**Amortization period.** The 84-month amortization period starts on the first day of the first month of the second half of the tax year you incur the costs (July 1 for a calendar year taxpayer), regardless of the month you actually incur the costs. You can claim amortization deductions for no more than 6 months of the first 84-month period, beginning either the month the facility is completed or acquired.

You can elect to amortize the costs 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 depreciation allowance you claim.

**Certified pollution control facility.** A certified pollution control facility is a new identifiable treatment facility used in connection with a plant or other property generally in operation before 1976 to reduce or control water or atmospheric pollution or contamination. The facility must do so by removing, changing, disposing, storing, or preventing the creation or emission of pollutants, contaminants, wastes, or heat. The facility must also be certified by the state and federal certifying authorities. Examples of such a facility include septic tanks and manure control facilities.

The federal certifying authority will not certify your property to the extent it appears you will recover (over the property’s useful life) all or part of its cost from the profit based on its operation (such as through sales of recovered wastes). The federal certifying authority will describe the nature of the potential cost recovery. You must then reduce the amortizable basis of the facility by this potential recovery.

**Example.** This year, you purchase a new $75,000 manure control facility for use in connection with a dairy plant on your farm. The farm has been in operation since you bought it in 1976 and all of the dairy plant was in operation before that date. You have no intention of recovering the cost of the facility through sale of the waste and a federal certifying authority has so certified.

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

**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.

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**Section 197 Intangibles**

You must generally amortize over 15 years the capitalized costs of section 197 intangibles you acquired after August 10, 1993. You must amortize these costs if you hold the section 197 intangible in connection with your farming business or in an activity engaged in for the production of income. Your amortization deduction each year is the applicable part of the intangible's adjusted basis (for purposes of determining gain), figured by amortizing it ratably over 15 years (180 months). You are not allowed any other depreciation or amortization deduction for an amortizable section 197 intangible.

**Section 197 intangibles include the following assets:**

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

See chapter 8 in Publication 535 for more information, including a complete list of assets that are section 197 intangibles and special rules.

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**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, foreclosures, repossessions, canceled debts, hedging transactions, and elections to treat cutting of timber as a sale or exchange.

**Topics**

- Sales and exchanges
- Ordinary or capital gain or loss
Sales and Exchanges

If you sell, exchange, or otherwise dispose of your property, you usually have a gain or a loss. This section explains certain rules for determining whether any gain you have is taxable, and whether any loss you have is deductible.

A sale is a transfer of property for money or a mortgage, note, or other promise to pay money. An exchange is a transfer of property for other property or services.

Determining Gain or Loss

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

Basis and adjusted basis. The basis of property you buy is usually its cost. The adjusted basis of property is 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 (FMV) (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 multiple properties, see Treatment of liabilities under Multiple Property Exchanges in chapter 1 of Publication 544.

Amount recognized. Your gain or loss realized from a sale or exchange of property is usually a recognized gain or loss for tax purposes. A recognized gain is a gain you must include in gross income and report on your income tax return. A recognized loss is a loss you deduct from gross income. For example, if your recognized gain from the sale of your tractor is $5,500, you include that amount in gross income on Form 1040. However, your gain or loss realized from the exchange of property may not be recognized for tax purposes. See Like-Kind Exchanges, next. Also, a loss from the disposition of property held for personal use is not deductible.

Like-Kind Exchanges

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

Example. Your old tractor is the property you gave up. The new one is the property received. See chapter 6 for more information.

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

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

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.

Money paid. If, in addition to giving up like-kind property, you pay money in a like-kind exchange, you still have no recognized gain or loss. The basis of the property received is the basis of the property given up, increased by the money paid.

Example. You traded an old tractor with an adjusted basis of $1,500 for a new one. The new tractor costs $30,000. You were allowed $8,000 for the old tractor and paid $22,000 cash. You have no recognized gain or loss on the transaction regardless of the adjusted basis of your old tractor and the basis of the new tractor is $23,500, the adjusted basis of the old tractor plus the cash paid.

If you had sold the old tractor to a third party for $8,000 and bought a new one, you would have a recognized gain or loss on the sale of your old tractor equal to the difference between the amount realized and the adjusted basis of the old tractor. In this case, the taxable gain would be $6,500 ($8,000 - $1,500).

Reporting the exchange. Report the exchange of like-kind property, even though no gain or loss is recognized. See 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, Miscellaneous Income. You may have to report the recognized gain as ordinary income because of depreciation recapture on Form 4797. See chapter 6 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, rental houses, and certain mutual ditch, reservoir, or irrigation company stock are examples of property that may qualify.

Nonqualifying property. 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 family car.

• Stock in trade or other property held primarily for sale, such as crops and produce.

• Stocks, bonds, or notes. However, see Qualifying property above.

• 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. For example, an exchange of city property for farm property or improved property for unimproved property is a like-kind exchange.

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. The exchange of livestock of one sex for livestock of the other sex is not a like-kind exchange. 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.

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

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, but are not limited to, the following property.

1. Office furniture, fixtures, and equipment (asset class 00.11).
2. Information systems, such as computers and peripheral equipment (asset class 00.24). Example 3. Assume in Example 1 that the FMV of the land you received was only $15,000. Your $5,000 loss is not recognized.

3. Data handling equipment except computers (asset class 00.13).
4. Automobiles and taxis (asset class 00.12).
5. Light general purpose trucks (asset class 00.241).
6. Heavy general purpose trucks (asset class 00.242).
7. Tractor units for use over-the-road (asset class 00.26).
8. Trailers and trailer-mounted containers (asset class 00.27).
9. 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, 2008 (NAICS Manual). It can be accessed at www.census.gov/geo/www/naics/. Copies of the hard cover manual may be purchased from the National Technical Information Service (NTIS) at www.ntis.gov/products/naics.aspx or by calling 703-305-6123 or 703-305-9477 or 703-605-6600. A CD-ROM version with search option is also available from NTIS.

**Example 2.** Assume the same facts as in Example 1, except that, instead of money, you received a tractor with a FMV of $10,000. Your recognized gain is still limited to $10,000, the value of the tractor (the unlike property).

Any transfer of property to a spouse (or in trust for the benefit of) a spouse, or a former spouse if incident to divorce. This rule applies whether the adjusted basis of the transferred property is less than, equal to, or greater than either its FMV at the time of transfer or any consideration paid by the recipient. This rule applies for determining loss as well as gain. Any gain recognized on a transfer in trust increases the basis.

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

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

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

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

For more information, see Deferred Exchanges 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 applies whether the adjusted basis of the transferred property is less than, equal to, or greater than either its FMV at the time of transfer or any consideration paid by the recipient. This rule applies for determining loss as well as gain. Any gain recognized on a transfer in trust increases the basis.

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Ordinary or Capital Gain or Loss

Generally, you will have a capital gain or loss if you sell or exchange a capital asset (defined below). You may also have a capital gain if your section 1231 transactions result in a net gain. See Section 1231 Gains and Losses in chapter 2.

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

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

Capital Assets

Almost everything you own and use for personal purposes 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 on qualified small business stock. For more information on this subject, see Gains on Qualified Small Business Stock and Losses on Section 1244 (Small Business) Stock in chapter 4 of Publication 550.

Personal-use property.

Gain from a sale or exchange of personal-use property is a capital gain and is taxable. Loss from the sale or exchange of personal-use property is not deductible. You can deduct a loss relating to personal-use property only if it results from a casualty or theft. For information on casualties and thefts, see chapter 11.

Long and Short Term

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

If you hold a capital asset 1 year or less, the gain or loss resulting from its disposition is short term. Report it in Part I, 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, 2008, you should start counting on June 20, 2008. If you sold the asset on June 19, 2009, your holding period is not longer than 1 year, but if you sold it on June 20, 2009, 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 live- stock used in a farm business. See Holding period under Livestock, later.

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

Nontaxable exchange. If you acquire an asset in exchange for another asset and your basis for the new asset is figured, in whole or in part, by using your basis in the old property, the holding period of the new property includes the holding period of the old property. That is, it begins on the same day as your holding period for the old property.

Gift. If you receive a gift of property and your basis in it is figured using the donor’s basis, your holding period includes the donor’s holding period.

Real property. To figure how long you held real property, start counting on the day after you received title to it or, 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 totalling all of your short-term capital gains. Then total all of your short-term capital losses. Subtract the lesser total from the greater. The difference is your net short-term capital gain or loss, whichever is greater.

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 deductible. However, part of your gain (but not more than your net capital gain) may be taxed at a lower rate than the rate of tax on your ordinary income. See Capital Gains Tax Rates, later.

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

Treatment of Capital Losses

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

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

- Your net loss on Schedule D (Form 1040), 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 2009, see Capital Losses under Reporting Capital Gains and Losses in chapter 4 of Publication 550 to figure the amount you can carry over to 2010.

To figure your capital loss carryover from 2009 to 2010, you will need a copy of your 2009 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 the Instructions for Schedule D (Form 1040).

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 Instructions for Schedule D (Form 1040).

Property held for sale in the ordinary course of your farm business. Property you hold mainly for sale to customers, such as livestock, poultry, livestock products, and crops, is a non-capital asset. Gain or loss from sales or other dispositions of this property is reported on Schedule F (Form 1040) (not on Schedule D (Form 1040) or Form 4797). The treatment of this property is discussed in chapter 3.

Land and depreciable properties. Land and depreciable property you use in farming are not...
If you have numerous transactions in the commodity futures market during the year, you must be able to show which transactions are hedging transactions. Clearly identify a hedging transaction on your books and records before the end of the day you entered into the transaction. It may be helpful to have separate brokerage accounts for your hedging and speculation transactions.

The identification must not only be on, and retained as part of, your books and records but must specify both the hedging transaction and the item(s) or aggregate risk that is being hedged. Although the identification of the hedging transaction must be made before the end of the day it was entered into, you have 35 days after entering into the transaction to identify the hedged item(s) or risk.

For more information on the tax treatment of futures and options contracts, see Commodity Transactions under section 1231 of the Internal Revenue Code. See also Regulations section 1.475-4(e) for those requirements and limits.

Hedging (Commodity Futures)

Hedging transactions are transactions that you enter into in the normal course of business primarily to manage the risk of interest rate or price changes, or currency fluctuations, with respect to borrowings, ordinary property, or ordinary obligations. Ordinary property or obligations are those that cannot produce capital gain or loss if sold or exchanged.

A commodity futures contract is a standardized, exchange-traded contract for the sale or purchase of a fixed amount of a commodity at a future date for a fixed price. The holder of an option on a futures contract has the right (but not the obligation) for a specified period of time to enter into a futures contract to buy or sell at a particular price. A forward contract is generally similar to a futures contract except that the terms are not standardized and the contract is not exchange traded.

Businesses may enter into commodity futures contracts or forward contracts and may acquire options on commodity futures contracts as either of the following.

• Hedging transactions.
• Transactions that are not hedging transactions.

Futures transactions with exchange-traded commodity futures contracts that are not hedging transactions, generally, result in capital gain or loss and are, generally, subject to the mark-to-market rules discussed in Publication 550. There is a limit on the amount of capital losses you can deduct each year. Hedging transactions are not subject to the mark-to-market rules.

If, as a farmer-producer, to protect yourself from the risk of unfavorable price fluctuations, you enter into commodity forward contracts, futures contracts, or options on futures contracts and the contracts cover an amount of the commodity within your range of production, the transactions are generally considered hedging transactions. They can take place at any time you have the commodity under production, have it on hand for sale, or reasonably expect to have it on hand.

The gain or loss on the termination of these hedges is generally ordinary gain or loss. Farmers who file their income tax returns on the cash method report any profit or loss on the hedging transaction on Schedule F, line 10.

Gain or loss on transactions that hedge supplies of a type regularly used or consumed in the ordinary course of its trade or business may be ordinary.
other mammals. Livestock does not include chickens, turkeys, pigeons, geese, emus, ostriches, theas, or other birds, fish, frogs, reptiles, etc.

Livestock used in farm business. If livestock is held primarily for draft, breeding, dairy, or sporting purposes, it is used in your farm business. The purpose for which an animal is held ordinarily is determined by a farmer’s actual use of the animal. An animal is not held for draft, breeding, dairy, or sporting purposes merely because it is suitable for that purpose, or because it is held for sale to other persons for use for them for that purpose. However, a draft, breeding, or sporting purpose may be present if an animal is disposed of within a reasonable time after it is prevented from its intended use or made undesirable as a result of an accident, disease, drought, or unfitness of the animal.

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

Example 2. You retire and sell your entire herd, including young animals that you would have used for breeding or dairy purposes had you remained in business. These young animals were held for breeding or dairy purposes. Also, if you sell young animals to reduce your breeding or dairy herd because of drought, these animals are treated as having been held for breeding or dairy purposes. See Sales Caused by Weather-Related Conditions in Chapter 3.

Example 3. You are in the business of raising registered cattle for sale to others for use as breeding cattle. The use of these registered cattle for sale to others for use as breeding cattle. The use of the young cattle for breeding purposes is ordinary and necessary for selling them as registered breeding cattle. Such use does not demonstrate that you are holding the cattle for breeding purposes. However, those cattle you held as additions or replacements to your own breeding herd to produce calves are considered to be held for breeding purposes, even though they may not actually have produced calves. The same applies to hog and sheep breeders.

Example 4. You are in the business of raising registered cattle for sale to others for use as breeding cattle. The young cattle used for breeding purposes is held for breeding purposes, and necessary for selling them as registered breeding cattle. Such use does not demonstrate that you are holding the cattle for breeding purposes. However, those cattle you held as additions or replacements to your own breeding herd to produce calves are considered to be held for breeding purposes, even though they may not actually have produced calves. The same applies to hog and sheep breeders.

Example 5. You breed, raise, and train horses for racing purposes. Every year you cull six horses that had been raced at public tracks in 2008. These horses are all considered held for sporting purposes.

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

Raised livestock. Gain on the sale of raised livestock is generally the gross sales price reduced by any expenses of the sale. Expenses of sale include sales commissions, freight or hauling from farm to commission company, and other similar expenses. The basis of the animal sold is zero if the costs of raising it were deducted during the years the animal was being raised. However, see Uniform Capitalization Rules in chapter 6.

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

Example. A farmer sold a breeding cow on January 8, 2009, for $1,250. Expenses of the sale were $125. The cow was bought July 2, 2005, for $1,300. Depreciation (not less than the amount allowable) was $867.

Gross sales price .......... $ 1,250
Cost (basis) ............... $ 1,300
Depreciation deduction 867
Unrecovered cost (adjusted basis) .......... $ 433
Expense of sale 125
Gain realized .......... $ 682

Converted Wetland and Highly Erodible Cropland

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

Converted wetland. This is generally land that was drained or filled to make the production of agricultural commodities possible. It includes converted wetland held by the person who originally converted it or held by any other person who used the converted wetland at any time after conversion for farming. A wetland (before conversion) is land that meets all the following conditions:

• It is mostly soil that, in its undrained condition, is saturated, flooded, or ponded long enough during a growing season to develop an oxygen-deficient state that supports the growth and regeneration of plants growing in water.

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

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

Highly erodible cropland. This is cropland subject to erosion that you used at any time for farming purposes other than grazing animals. Generally, highly erodible cropland is land currently classified by the Department of Agriculture as Class IV, V, VI, or VII under its classification system. Highly erodible cropland also includes land that would have an excessive average annual erosion rate in relation to the soil loss tolerance level, as determined by the Department of Agriculture.

Successor. Converted wetland or highly erodible cropland is also land held by any person whose basis in the land is figured by reference to the adjusted basis of a person in whose hands the property was converted wetland or highly erodible cropland.

Timber

Standing timber you held as investment property is a capital asset. Gain or loss from its sale is capital gain or loss reported on Schedule D (Form 1040). If you held the timber primarily for sale to customers, it is not a capital asset. Gain or loss on its sale is ordinary business income or loss. It is reported on Schedule F, line 1 (purchased timber) or line 4 (raised timber).

Farmers who cut timber on their land and sell it as logs, firewood, or pulpwood usually have no cost or other basis for that timber. Amounts realized from these sales, and the expenses incurred in cutting, hauling, etc., are ordinary farm income and expenses reported on Schedule F.

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

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

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

Election to treat cutting as a sale or exchange. Under the general rule, the cutting of timber results in no gain or loss. It is not until a sale or exchange occurs that gain or loss is realized. But if you owned or had a contractual right to cut timber, you can elect to treat the cutting of timber as a section 1231 transaction in the year it is cut. Even though the timber cut 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 election on your return for the year the cutting takes place by including in income the gain or loss on the cutting and including a computation of your gain or loss. You do not have to make the election in the first year you cut the timber. You can make it in any year to which the election would apply. If the timber is partnership property, the election is made on the partnership return. This election cannot be made on an amended return.
Once you have made the election, it remains in effect for all later years unless you revoke it.

**Election under section 631(a) may be revoked.** If you previously elected for any tax year ending before October 23, 2004, to treat the cutting of timber as a sale or exchange under section 631(a), you may revoke this election at the time you file your return for any tax year ending after October 22, 2004. For more information, see Publication 544, Selling Your Home.

You must treat the disposal in the farm operation and perhaps machinery costs (or other expenses) of standing timber under a cutting contract as a sale or exchange. See Form T (Timber), Forest Activities Schedule, for more information.

**Gain or loss.** Your gain or loss on the cutting of standing timber is figured in the same manner as shown in section 611 and Regulations section 1.611-1. Your adjusted basis for depletion is on the first day of your tax year in which it is cut. 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 at the time you file your return for any tax year ending after October 22, 2004. For more information, see Publication 544, Selling Your Home.

You are the owner of the timber.

You keep 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). 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 301.910-2” 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 disposals and the tax treatment 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) and the land. For more information, see Publication 523, Selling 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. Your taxable gain or loss on the sale of property used in your farm business is taxed under the rules for section 1231 transactions. See chapter 9. Losses from personal-use property, other than casualty or theft losses, are not deductible. If you receive payments for your farm in installments, 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, dairy, and sporting animals held less than the holding periods discussed earlier under Livestock).
- Property (including real estate) used in your business and held longer than 1 year (including only draft, breeding, dairy, and sporting animals held for the holding periods discussed earlier).
- Property held primarily for sale or which is of the kind that would be included in inventory if on hand at the end of your tax year.

**Allocation of consideration paid for a farm.** The sale of a farm for a lump sum is considered a sale of each individual asset rather than a single asset. The residual method is required only if the group of assets sold constitutes a trade or business. This method determines gain or loss from the transfer of each asset. It also determines the buyer’s basis in the business assets. For more information, see Sale of a Business in chapter 2 of Publication 544.

**Property used in farm operations.** 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. Gain or loss on the sale of property used in your farming business property to an unrelated person is deducted as an ordinary loss. Your taxable gain or loss on the sale of property used in your farm business is taxed under the rules for section 1231 transactions. See chapter 9. Losses from personal-use property, other than casualty or theft losses, are not deductible. If you receive payments for your farm in installments, 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.

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

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**Property used in farm operations.** 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. Gain or loss on the sale of property used in your farming business property to an unrelated person is deducted as an ordinary loss. Your taxable gain or loss on the sale of property used in your farm business is taxed under the rules for section 1231 transactions. See chapter 9. Losses from personal-use property, other than casualty or theft losses, are not deductible. If you receive payments for your farm in installments, 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, dairy, and sporting animals held less than the holding periods discussed earlier under Livestock).
- Property (including real estate) used in your business and held longer than 1 year (including only draft, breeding, dairy, and sporting animals held for the holding periods discussed earlier).
- Property held primarily for sale or which is of the kind that would be included in inventory if on hand at the end of your tax year.

**Allocation of consideration paid for a farm.** The sale of a farm for a lump sum is considered a sale of each individual asset rather than a single asset. The residual method is required only if the group of assets sold constitutes a trade or business. This method determines gain or loss from the transfer of each asset. It also determines the buyer’s basis in the business assets. For more information, see Sale of a Business in chapter 2 of Publication 544.

**Property used in farm operations.** 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. Gain or loss on the sale of property used in your farming business property to an unrelated person is deducted as an ordinary loss. Your taxable gain or loss on the sale of property used in your farm business is taxed under the rules for section 1231 transactions. See chapter 9. Losses from personal-use property, other than casualty or theft losses, are not deductible. If you receive payments for your farm in installments, 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, dairy, and sporting animals held less than the holding periods discussed earlier under Livestock).
- Property (including real estate) used in your business and held longer than 1 year (including only draft, breeding, dairy, and sporting animals held for the holding periods discussed earlier).
- Property held primarily for sale or which is of the kind that would be included in inventory if on hand at the end of your tax year.
The $48,000 gain from the sale of your home is not taxable as long as you meet the require-
ments explained later under Sale of your home.

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

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, de-
preciation, 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 below 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. 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 ass-
essed valuation of the land is $60,000 (1/10 of $600,000), plus any unrecov-
ered 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 as-
essed values for local property taxes for the year of purchase to allocate the costs.

Example. Assume that in the preceding ex-
ample 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 as-
essed valuation of the land is $60,000 (1/10 of $600,000), plus any unrecov-
ered 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.

Sale of your home. Your home is a capital asset and not property used in the trade or business of farming. If you sell a farm that in-
cludes a house you and your family occupy, you must determine the full cost of the selling price and the part of the cost or other basis allocable to your home. Your home includes the immediate surroundings and outbuildings relating to it that are not used for business purposes.

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

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

Gain from condemnation. If you have a gain from a condemnation or sale under threat of condemnation, you may use the preceding rules as if for excluding the gain, rather than the rules dis-
cussed under Postponing Gain in chapter 11. However, any gain that cannot be excluded (be-
cause it is more than the limit) may be post-
poned under the rules discussed under Postponing Gain in chapter 11.

Foreclosure or Repossession

If you do not make payments you owe on a loan secured by property, the lender may foreclose on the loan or repossess the property. The fore-
closure or repossession is treated as a sale or exchange from which you may realize gain or loss. This is true even if you voluntarily return the property to the lender. You may also realize ordinary income from cancellation of debt if the loan balance is more than the FMV of the prop-
erty.

Buyer’s (borrower’s) gain or loss. You fig-
ure and report gain or loss from a foreclosure or repossession in the same way as gain or loss from a sale or exchange. The gain or loss is the difference between your adjusted basis in the transferred property and the amount realized. See Determining Gain or Loss, earlier.

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

Amount realized on a nonrecourse debt. If you are not personally liable for repaying the debt (nonrecourse debt) secured by the trans-
ferred 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 FMV 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 FMV of the land was $170,000. The amount Ann realized on the foreclosure was $180,000, the debt canceled by the foreclosure. She figures her gain or loss on Form 4797, Part I, by comparing the amount realized ($180,000) with her adjusted basis ($200,000). She has a $20,000 deductible loss.

Example 2. Assume the same facts as in Example 1 except the FMV of the land was $210,000. The result is the same. The amount Ann realized on the foreclosure is $180,000, the debt canceled by the foreclosure. Because her adjusted basis is $200,000, she has a deducti-
ble loss of $20,000, which she reports on Form 4797, Part I.

Amount realized on a recourse debt. If you are personally liable for repaying the debt (recourse debt), the amount realized on the fore-
closure or repossession does not include the canceled debt that is income from cancellation of debt. However, if the FMV of the transferred property is less than the canceled debt, the amount realized includes the canceled debt up to the FMV of the property. You are treated as receiving ordinary income from the canceled debt for the part of the debt that is more than the FMV. See Cancellation of debt, later.

Example 3. Assume the same facts as in Example 1 above 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 FMV of the land ($170,000). Ann figures her gain or loss on the foreclosure by comparing the amount real-
ized ($170,000) with her adjusted basis ($200,000). She has a $30,000 deductible loss, which she figures on Form 4797, Part I. She is also treated as receiving ordinary income from cancellation of debt. That income is $10,000 ($180,000 − $170,000). This is the part of the canceled debt not included in the amount real-
ized. She reports this income on Schedule F, line 10.

Seller’s (lender’s) gain or loss on reposses-
see. 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 repos-
essed 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 FMV of the property. This income is separate from any gain or loss realized from the foreclosure or repossession. Report the income from cancellation of a business debt on Sched-
ule F, line 10. Report the income from cancella-
tion of a nonbusiness debt as miscellaneous income on Form 1040, line 21.

Abandonment

The abandonment of property is a disposition of property. You abandon property when you vol-
untarily 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 prop-
erty is deductible as an ordinary loss, even if the property is a capital asset. The loss is the prop-
erty’s adjusted basis when abandoned. This rule

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also applies to leasehold improvements the lessee made for the lessor. 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.

### Dispositions of Property Used in Farming

**9. Dispositions of Property Used in Farming**

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.

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

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

*The income may not be taxable. See Cancellation of debt.*
Section 1231
Gains and Losses

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

If you have a gain from a section 1231 transaction, first determine whether any of the gain is ordinary income under the depreciation recapture rules (explained later). Do not take that gain into account in the section 1231 computation. Any gain or loss is ordinary income relating to the property except as provided in the following.

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 leasehold on the land, even if sold to the same person in a single transaction, are not excluded.

Distribution of 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 1) must be held longer than 1 year. It must be business property or a capital asset held in connection with a trade or business or a transaction entered into for profit, such as investment property. It cannot be property held for personal use.

Casualty or theft. The casualty or theft must have affected business property, property held for the production of rents or royalties, or investment property (such as notes and bonds). You must have held the property longer than 1 year. However, if your casualty or theft losses are more than your gains on such property, that part of the casualty or theft losses must be reported as ordinary income.

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

Example. In 2009, 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 $1,200 net section 1231 gains and losses from the previous 5-year period. From 2004 through 2008 he had the following section 1231 gains and losses:

<table>
<thead>
<tr>
<th>Year</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>2004</td>
<td>$0</td>
</tr>
<tr>
<td>2005</td>
<td>$-</td>
</tr>
<tr>
<td>2006</td>
<td>($2,500)</td>
</tr>
<tr>
<td>2007</td>
<td>$0</td>
</tr>
<tr>
<td>2008</td>
<td>$1,800</td>
</tr>
</tbody>
</table>

Ben uses this information to figure how to report his net section 1231 gain for 2009 as shown below.

Distributive share of partnership gains and losses. 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 in the section 1231 computation. Any gain or loss is ordinary income relating to the property except as provided in the following.

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 of your section 1231 gains and losses for the year.

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

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

Depreciation Recapture

If you dispose of depreciable or amortizable property at a gain, you may have to treat all or part of the gain (even if it is otherwise nontaxable) as ordinary income.

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.

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 Other Tangible Property... and structural components below.
   a. An integral part of manufacturing, pro-
      duction, or extraction, or of furnishing
      transportation, communications, elec-
      tricity, gas, water, or sewage disposal
      services.
   b. A research facility in any of the activi-
      ties in (a).
   c. A facility in any of the activities in (a) for
      the bulk storage of fungible commodi-
      ties (discussed later).
   d. Pollution control facilities.
   e. Certain reforestation expenditures.
   f. Single purpose agricultural (livestock) or
      horticultural structures.

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.
   c. Deduction for clean-fuel vehicles and
      certain refueling property placed in
      service before 2006.
   d. Certain expenditures for child care facil-
      ities. (Repealed by Public Law 101-58,
      Omnibus Budget Reconciliation Act of
      1990, section 11801(a)(13) except with
      regards to deductions made prior to No-
      vember 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.

Buildings and structural components. Sec-
   tion 1245 property does not include buildings and
   structural components. The term building includes
   a house, barn, warehouse, or garage. The term
   structural component includes walls, floors, windows,
   doors, central air conditioning systems, light fixtures, etc.

Do not treat a structure that is essentially
   machinery or equipment as a building or struc-
   tural component. Also, do not treat a structure
   that houses property used as an integral part of
   an activity as a building or structural component
   if the structure’s use is so closely related to the
   property’s use that the structure can be ex-
   pected to be replaced when the property it ini-
   tially houses is replaced.

The fact that the structure is specially de-
   signed to withstand the stress and other de-
   mands of the property and cannot be used
   economically for other purposes indicates it is
   closely related to the use of the property it
   houses. Structures such as oil and gas storage
   tanks, grain storage bins, and silos are not
treated as buildings, but as section 1245 prop-
erty.

Facility for bulk storage of fungible commodi-
ties. This facility is used mainly for the bulk
storage of fungible commodities. Bulk storage
means storage of a commodity in a large mass
before it is used. For example, if a facility is used
 to store oranges that have been sorted and
boxed, it is not used for bulk storage. To be
fungible, a commodity must be such that one
part may be used in place of another.

Gain Treated as Ordinary Income
The gain treated as ordinary income on the sale,
exchange, or involuntary conversion of section
1245 property, including a sale and leaseback transac-
tion, is the lesser of the following amounts.

1. The depreciation (which includes any sec-
   tion 179 deduction claimed) and amor-
   titization allowed or allowable on the property.
2. The gain realized on the disposition (the
   amount realized from the disposition minus
   the adjusted basis of the property).

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

Use Part III of Form 4797 to figure the ordi-
 nary 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 claimed on property you ex-
   changed for, or converted to, your section
   1245 property in a like-kind exchange or
   involuntary conversion. For details on ex-
   changes 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 de-
   termined 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
it for a chopper and paid an additional $30,000.
To figure his depreciation deduction for the cur-
rent 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. Deprecia-
tion and amortization deductions that must be
recaptured as ordinary income include (but are
not limited to) the following items.

1. Ordinary depreciation deductions.
2. Section 179 deduction (see chapter 7).
3. Any special depreciation allowance.
4. Amortization deductions for all the follow-
ing costs.
   a. Acquiring a lease.
   b. Lessee improvements.
   c. Pollution control facilities.
   d. Reforestation expenses.
   e. Section 197 intangibles.
   f. Childcare facility expenses incurred before
      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).

6. Any basis reduction for the investment
credit (minus any basis increase for a
credit recapture).

7. Any basis reduction for the qualified
plug-in electric or qualified electric vehicle
credit (minus any basis increase for a
credit recapture).

Example. You file your returns on a calen-

The gains treated as ordinary income as follows.

1) Amount realized ................... $7,000
2) Cost (February 2007) ........... $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 depre-
ciation allowed or allowable when figuring the part
of gain to report as ordinary income. If, in prior
years, you have consistently taken proper de-
ductions 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 allow-
able are figured by using the straight line
method. This treatment applies only when figur-
ing what part of the gain is treated as ordinary income 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

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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 election by treating the gain, up to the amount of these expenses, as ordinary income. For section 1231 transactions, show these expenses as depreciation
on Form 4797, Part III, line 22. For plant
sales that are reported on Schedule F (1040), Profit or Loss From Farming, this recapture rule does not change the reporting of income because the gain is already ordinary income. You can use the straight-line method or the unit-
livestock-price method discussed in chapter 2 to figure these expenses.

Example. Janet Maple sold her apple orchard in 2009 for $80,000. Her adjusted basis at the time of sale was $60,000. She bought the orchard in 2002, but the trees did not produce a crop until 2005. Her pre-productive expenses were $6,000. She elected not to use 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:

• 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 placed in service after 1986 (or after July 31, 1986, if the choice to use MACRS was made) and you held it longer than 1 year. These properties are depreciated us-
ing the straight line method.

Installment Sale
If you report the sale of property under the in-
stallment 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-
tion property.

• By gift.
• At death.
• In like-kind exchanges.
• In involuntary conversions.

Publication 544 also explains how to handle a single transaction involving multiple properties.

Other Gains
This section discusses gain on the disposition of farmland for which you were allowed either of the following.

• Deductions for soil and water conservation expenditures (section 1252 property).
• Exclusions from income for certain cost sharing payments (section 1255 property).

Section 1252 property. If you disposed of farmland you held more than 1 year and less than 10 years at a gain and you were allowed deductions for soil and water conservation ex-
penses for the land, as discussed in chapter 5, you must treat part of the gain as ordinary in-
come and treat the balance as section 1231 gain.

Exceptions. Do not treat gain on the follow-
ing transactions as gain on section 1252 prop-
erty.
• 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 con-
version, or the FMV for all other disposi-
tions).

• The total deductions allowed for soil and water conservation expenses multiplied by the applicable percentage, discussed next.

Applicable percentage. The applicable percentage is based on the length of time you held the land. If you dispose of your farmland within 5 years after the date you acquired it, the percentage is 100%. If you dispose of the land within the 6th through 9th year after you ac-
quired it, the applicable percentage is reduced by 20% a year for each year or part of a year you hold the land after the 5th year. If you dispose of the land 10 or more years after you acquired it, the percentage is 0%, and the entire gain is a section 1231 gain.

Example. You acquired farmland on Janu-
ary 1, 2001. On October 3, 2009, you sold the land at a $30,000 gain. Between January 1 and October 3, 2009, you incur soil and water con-
servation expenditures of $15,000 for the land that are fully deductible in 2009. 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 ex-
clude those payments from income (as dis-
cussed 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 ex-
cluded cost-sharing payments.

• The gain on the disposition of the prop-
erty.

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. However, you do report as ordinary income under this rule a gain or a part of a gain regardless of any contrary provi-
sions (including nonrecognition provisions) under any other section.

Applicable percentage. The applicable percentage of the excluded cost-sharing pay-
ments to be reported as ordinary income is based on the length of time you hold the prop-
erty after receiving the payments. If the property is held less than 10 years after you receive the payments, the percentage is 100%. After 10 years, the percentage is reduced by 10% a year, or part of a year, until the rate is 0%.

Form 4797, Part III. Use Form 4797, Part III, to figure the ordinary income part of a gain from the sale, exchange, or involuntary conversion of section 1252 property and section 1255 prop-
erty.

The total deductions allowed for soil and water conservation expenses multiplied by the applicable percentage, discussed next.
10. Installment Sales

Introduction
An installment sale is a sale of property where you receive at least one payment after the tax year of the sale. If you realize a gain on an installment sale, you may be able to report part of your gain when you receive each payment. This method of reporting gain is called the installment method. You cannot use the installment method to report a loss. You can choose to report all of your gain in the year of sale.

Installment obligation. The buyer's obligation to make future payments to you can be in the form of a deed of trust, note, land contract, mortgage, or other evidence of the buyer's debt to you.

Topics
This chapter discusses:
- The general rules that apply to using the installment method
- Installment sale of a farm

Useful Items
You may want to see:
- Publications
  - Selling Your Home
  - Business Expenses
  - Installment Sales
  - Accounting Periods and Methods
  - Sales and Other Dispositions of Assets

Form (and Instructions)
- 4797 Sales of Business Property
- 6252 Installment Sale Income

See chapter 16 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 6 for a discussion of capital assets and chapter 7 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. 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 Income in Publication 537. This applies even if no payments are received in that year.

Installment Method
An installment sale is a sale of property where you receive at least one payment after the tax year of the sale. A farmer who is not required to maintain an inventory can use the installment method to report gain from the sale of property used or produced in farming. See Inventory, later, for information on the sale of farm property where inventory items are included in the assets sold.

If a sale qualifies as an installment sale, the gain must be reported under the installment method unless you elect out of using the installment method. See Electing out of the installment method, later, for information on recognizing the entire gain in the year of sale.

Sale at a loss. If your sale results in a loss, you cannot use the installment method. If the loss is on an installment sale of business assets, you can deduct it only in the tax year of sale.

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 unstated interest or original issue discount. See Unstated interest, later.

You must continue to report the interest income on payments you receive in subsequent years as interest income.

Adjusted basis and installment sale income (gain on sale). After you have determined how much of each payment to treat as interest, you treat the rest of each payment as if it were made up of two parts:
- A tax-free return of your adjusted basis in the property, and
- Your gain (referred to as “installment sale income” on Form 6252).

Figuring adjusted basis for installment sale purposes. You can use Worksheet 10-1 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.

Selling price. The selling price is the total cost of the property to the buyer. It includes:
- Any money you are to receive,
- The fair market value (FMV) of any property you are to receive (FMV is discussed...
The gross profit percentage generally remains the same for each payment you receive. However, see the example under Selling price reduced, later, for a situation where the gross profit percentage changes.

Amount to report as installment sale income. Multiply the payments you receive each year (less interest) by the gross profit percentage. The result is your installment sales income for the tax year. In certain circumstances, you may be treated as having received a payment, even though you received nothing directly. A receipt of property or the assumption of a mortgage on the property sold may be treated as a payment. For a detailed discussion, see Payments Received or Considered Received, later.

Selling price reduced. If the selling price is reduced at a later date, the gross profit on the sale also will change. You then must refigure the gross profit percentage for the remaining payments. Refigure your gross profit using Worksheet 10-2. New Gross Profit Percentage—Selling Price Reduced. You will spread any remaining gain over future installments.

Example. In 2007, you sold land with a basis of $40,000 for $100,000. Your gross profit was $60,000. You received a $20,000 down payment and the buyer’s note for $80,000. The note provides for four annual payments of $20,000 each, plus 8% interest, beginning in 2008. Your gross profit percentage is 60%. You reported a gain of $12,000 on each payment received in 2007 and 2008.

In 2009, you and the buyer agreed to reduce the purchase price to $85,000 and payments during 2009, 2010, and 2011 are reduced to $15,000 each year. The new gross profit percentage, 46.67%, is figured in Example—Worksheet 10-2.

Worksheet 10-2. New Gross Profit Percentage—Selling Price Reduced

1. Enter the reduced selling price for the property............................................. 85,000
2. Enter your adjusted basis for the property....................................................... 40,000
3. Enter your selling expenses ........................................................................... 40,000
4. Enter any depreciation recapture .................................................................. 40,000
5. Add lines 2, 3, and 4. ....................................................................................... 40,000
6. Subtract line 5 from line 1. ............................................................................. 45,000
7. Enter any installment sale income reported in prior year(s) ......................... 24,000
8. Subtract line 7 from line 6. ............................................................................. 21,000
9. Future installments ......................................................................................... 45,000
10. Divide line 8 by line 9. ................................................................................. 46.67%

Example. You will report a gain of $7,000 (46.67% of $15,000) on each of the $15,000 installments due in 2009, 2010, and 2011.

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.

Worksheet 10-2. New Gross Profit Percentage—Selling Price Reduced

1. Enter the reduced selling price for the property ............................................. 85,000
2. Enter your adjusted basis for the property ....................................................... 40,000
3. Enter your selling expenses ........................................................................... 40,000
4. Enter any depreciation recapture .................................................................. 40,000
5. Add lines 2, 3, and 4. ....................................................................................... 40,000
6. Subtract line 5 from line 1. ............................................................................. 45,000
7. Enter any installment sale income reported in prior year(s) ......................... 24,000
8. Subtract line 7 from line 6. ............................................................................. 21,000
9. Future installments ......................................................................................... 45,000
10. Divide line 8 by line 9. ................................................................................. 46.67%

*Apply this percentage to all future payments to determine how much of each of those payments is installment sale income.
To make this election, do not report your sale on Form 6252. Instead, report it on Schedule D (Form 1040), Form 4797, or both.

When to elect out. Make this election by the due date, including extensions, for filing your tax return for the year the sale takes place.

However, if you timely file your tax return for the year the sale takes place without making the election, you still can make the election by filing an amended return within 6 months of the due date of the return (excluding extensions). Write “Filed pursuant to section 301.9100-2” at the top of the amended return and file it where the original return was filed.

Revoking the election. Once made, the election can be revoked only with IRS approval. A revocation is retroactive.


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.

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 inventory items are included in an installment sale, you may have an agreement stating which payments are for inventory and which are for the other assets being sold. If you do not, each payment must be allocated between the inventory and the other assets sold.

Disposition of installment obligation. If you are using the installment method and you dispose of the installment obligation, generally you will have a gain or loss to report. It is considered gain or loss on the sale of the property for which you received the installment obligation.

Cancellation. If an installment obligation is canceled or otherwise becomes unenforceable, it is treated as a disposition other than a sale or exchange. Your gain or loss is the difference between your basis in the obligation and its fair market value (FMV) at the time you cancel it. If the parties are related, the FMV of the obligation is considered to be no less than its full face value.

Transfer due to death. The transfer of an installment obligation (other than to a buyer) as a result of the death of the seller is not a disposition. Any unreported gain from the installment obligation is not treated as gross income to the decedent. No income is reported on the decedent’s return due to the transfer. Whoever receives the installment obligation as a result of the seller’s death is taxed on the installment payments the same as the seller would have if he had sold his property to receive the payments.

However, if the installment obligation is canceled, becomes unenforceable, or is transferred to the buyer because of the death of the holder of the obligation, it is a disposition. The estate must figure its gain or loss on the disposition. If the holder and the buyer were related, the FMV of the installment obligation is considered to be no less than its full face value.

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

Sale of depreciable property. You generally cannot report gain from the sale of depreciable property to a related person on the installment method. See Sale to a Related Person in Publication 537.

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

The recapture income reported in the year of sale is included in your installment sale basis to determine your gross profit on the installment sale.

Figure your depreciation recapture income (including the section 179 deduction and the section 179a deduction) in Part III of Form 4797. Report the depreciation recapture income in Part II of Form 4797 as ordinary income in the year of sale.

For more information on depreciation recapture, see Depreciation Recapture in chapter 9.

Payments Received or Considered Received

You must figure your gain each year on the payments you receive, or are treated as receiving, from an installment sale.

In certain situations, you are considered to have received a payment, even though the buyer does not pay you directly. These situations occur when the buyer assumes or pays any of your debts, such as a loan, or pays any of your expenses, such as a sales commission. However, as discussed later, the buyer’s assumption of your debt is treated as a recovery of basis, rather than as a payment, in many cases.

Buyer pays seller’s expenses. If the buyer pays any of your expenses related to the sale of your property, it is considered a payment to you. It is considered a disposition other than a sale or exchange. Your gross profit is the difference between your basis and this payment, if any, in the year of sale. Include these expenses in the selling and contract prices when figuring the gross profit percentage.

Buyer assumes mortgage. If the buyer assumes 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.

You sell property with an adjusted basis of $19,000. You have selling expenses of $1,000. The buyer assumes your existing mortgage of $15,000 and agrees to pay you $10,000 (a cash down payment of $2,000 and $2,000 plus 8% interest) in each of the next 4 years.

The selling price is $25,000 ($15,000 + $10,000). Your gross profit is $5,000 ($25,000 – $20,000 installment sale basis). The contract price is $10,000 ($25,000 – $15,000 mortgage). Your gross profit percentage is 50% ($5,000 – $10,000). You report half of each $2,000 payment received as gain from the sale. You also report all interest you receive as ordinary income.

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

To figure the contract price, subtract the mortgage from the selling price. This is the total amount you will receive directly from the buyer. Add to this amount the payment you are considered to have received (the difference between the mortgage and your installment sale basis). The contract price will be 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 $9,000. The buyer will pay you $1,000 annually (plus 8% interest) over the next 3 years and assume an existing mortgage of $6,000. Your adjusted basis in the property is $4,400. You have selling expenses of $600, for a total installment sale basis of $5,000. The part of the mortgage that is more than your installment sale basis is $1,000 ($6,000 – $5,000). This amount is included in the contract price and treated as a payment received in the year of sale. The contract price is $4,000.

Your gross profit on the sale is also $4,000.

Example. You sell property for $9,000. The buyer will pay you $1,000 annually (plus 8% interest) over the next 3 years and assume an existing mortgage of $6,000. Your adjusted basis in the property is $4,400. You have selling expenses of $600, for a total installment sale basis of $5,000. The part of the mortgage that is more than your installment sale basis is $1,000 ($6,000 – $5,000). This amount is included in the contract price and treated as a payment received in the year of sale. The contract price is $4,000.

Your gross profit percentage is 100%. Report 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 assumes any other debts, such as a loan or back taxes, it may be considered a payment to you in the year of sale.
If the buyer assumes the debt instead of paying it off, only part of it may have to be treated as a payment. Compare the debt to your installment sale basis in the property being sold. If the debt is less than your installment sale basis, none of it is treated as a payment. If it is more, only the difference is treated as a payment. If the buyer assumes more than one debt, any part of the total that is more than your installment sale basis is considered a payment. These rules are the same as the rules discussed earlier under Buyer assumes mortgage. However, they apply only to the following types of debt the buyer assumes:

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

If the buyer assumes any other type of debt, such as a personal loan or your legal fees relating 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 debt assumed as a 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, later. 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 an accrual method of accounting, or
- The stated redemption price at maturity less any original issue discount (OID) or, if there is no OID, the stated redemption price at maturity appropriately discounted to reflect total unstated interest. See Unstated interest, later.

*Debt not payable on demand.* Any evidence 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 guaranteed by a third party, including a government agency.

**Fair market value (FMV).** This is the price at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having a reasonable knowledge of all the necessary facts.

**Third-party note.** If the property the buyer gives you is a third-party note (or other obligation of a third party), you are considered to have received a payment equal to the note’s FMV. Because the 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 Property used as a payment, earlier.

**Example.** You sold real estate in an installment sale. As part of the down payment, the buyer assigned to you a $50,000, 8% third-party note. The FMV of the third-party note at the time of the sale was $30,000. This amount, not $50,000, is a payment to you in the year of sale. The third-party note had an FMV equal to 60% of its face value ($30,000 ÷ $50,000), so 60% of each principal payment you receive on this note is a nontaxable return of capital. The remaining 40% is interest taxed as ordinary income.

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

If you receive a government or corporate bond for a sale before October 22, 2004, and the bond has interest coupons attached or can be readily traded in an established securities market, you are considered to have received payment 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 included when figuring the selling price and the contract price. Payments you receive on the note are used to figure your gain in the year received.

**Sale to a related person.** If you sell depreciable property to a related person and the sale is an installment sale, you may not be able to report the sale using the installment method. For information on these rules, see the Instructions for Form 6252 and Sale to a Related Person in Publication 537.

**Trading property for like-kind property.** If you trade business or investment property solely for the same kind of property to be held as business or investment property, you can postpone reporting the gain. See Like-Kind Exchanges in chapter 8 for a discussion of like-kind property.

If, in addition to like-kind property, you receive an installment obligation in the exchange, the following rules apply to determine installment sale income each year.

- The contract price is reduced by the FMV of the like-kind property received in the trade.
- The gross profit is reduced by any gain on the trade that can be postponed.
- Like-kind property received in the trade is not considered payment on the installment obligation.

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

If an installment sale contract does not provide for adequate stated interest, part of the installment that is stated interest 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 applies to the contract, this interest is called original issue discount (OID).

Generally, if a buyer gives a debt in consideration 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 investment activity.

If the debt is subject to the Internal Revenue Code section 483 rules, the unstated interest is called stated interest. This increases the seller’s interest income and the buyer’s interest expense.

In general, an installment sale contract provides for adequate stated interest if the stated interest rate (based on an appropriate compound period) is at least equal to the applicable federal rate (AFR).

The AFRs are published monthly in the Internal Revenue Bulletin (IRB). You can get this information by contacting an IRS office. IRBs are also available on the IRS website at www.irs.gov.

**More information.** For more information, see Unstated Interest and Original Issue Discount (OID) in Publication 537.

**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 payment, as installment sale income from the sale for the tax year you receive the payment. The remainder (balance) of each payment is the tax-free return of your adjusted basis.
### Table 9-1

<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>Farm land</td>
<td>125,000</td>
<td>62,500</td>
</tr>
<tr>
<td>Buildings</td>
<td>$31,500</td>
<td>28,500</td>
</tr>
<tr>
<td>Truck</td>
<td>$28,500</td>
<td>14,250</td>
</tr>
<tr>
<td>Equipment</td>
<td>17,000</td>
<td>850</td>
</tr>
<tr>
<td>Tractor</td>
<td>23,000</td>
<td>11,500</td>
</tr>
<tr>
<td>Cattle*</td>
<td>5,000</td>
<td>2,023</td>
</tr>
<tr>
<td>Cattle**</td>
<td>20,000</td>
<td>1,000</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
*** Held 2 years or more

### Depreciation recapture

The buildings are section 1245 property. There is no depreciation recapture income for them because they were depreciated using the straight line method. See chapter 9 for more information on depreciation recapture.

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

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

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

The cattle used for breeding and held for less than 2 years are section 1245 property. The entire depreciation of $1,977 is recapture income because it is less than the gain. The remaining gain of $750 is reported on the installment method.

The cattle used for breeding and held for 2 years or more are also section 1245 property.

Since the gain of $18,167 is less than the deprecia- tion claimed ($19,167), the total gain is de- preciation recapture income.

The total depreciation recapture income figured in Part III of Form 4797 is $42,767. (This is the sum of: $3,001 + $1,961 + $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 sale is $190,000.

### Installation sale basis and gross profit

The following table shows each asset reported on the installment method, its selling price, installment sale basis, and gross profit.

<table>
<thead>
<tr>
<th>Selling Price</th>
<th>Selling Adjusted Basis</th>
<th>Gain</th>
</tr>
</thead>
<tbody>
<tr>
<td>Home*</td>
<td>$50,000</td>
<td></td>
</tr>
<tr>
<td>Farm land</td>
<td>125,000</td>
<td>62,500</td>
</tr>
<tr>
<td>Buildings</td>
<td>55,000</td>
<td>28,500</td>
</tr>
<tr>
<td>Truck</td>
<td>5,000</td>
<td>2,023</td>
</tr>
<tr>
<td>Equipment</td>
<td>17,000</td>
<td>850</td>
</tr>
<tr>
<td>Tractor</td>
<td>23,000</td>
<td>11,500</td>
</tr>
<tr>
<td>Cattle*</td>
<td>5,000</td>
<td>2,023</td>
</tr>
<tr>
<td>Cattle**</td>
<td>20,000</td>
<td>1,000</td>
</tr>
</tbody>
</table>

** Held less than 2 years
*** Held 2 years or more

### 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 farm land and buildings are reported as section 1231 gains. The cattle held for less than 2 years do not qualify for section 1231 treatment. The $750 gain on their sale is reported as ordinary gain in Part II of Form 4797 as payments are received. See Section 1231 Gains and Losses in chapter 9.

### Contract price and gross profit percentage

The contract price is $140,000 for the part of the sale reported on the installment method. This is the selling price ($300,000) minus the mortgage assumed ($190,000). The gain on the home can be excluded from income ($110,000).

Gross profit percentage for the sale is 58.75% ($82,250 gross profit ÷ $140,000 contract price). The gross profit percentage for each asset is figured as follows:

<table>
<thead>
<tr>
<th>Percent</th>
<th>Farm land ($57,500 – $140,000)</th>
<th>41.0741%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Buildings ($23,750 – $140,000)</td>
<td>16.9643%</td>
<td></td>
</tr>
<tr>
<td>Truck ($250 – $140,000)</td>
<td>0.1786</td>
<td></td>
</tr>
<tr>
<td>Cattle* ($750 – $140,000)</td>
<td>0.0537%</td>
<td></td>
</tr>
</tbody>
</table>

** Held less than 2 years

Figuring the gain to report on the installment method.

Only 56% of each payment is reported on the installment method ($140,000 contract price ÷ $250,000 to be received on the sale ($300,000 selling price – $50,000 mortgage assumed). The total amount received on the sale in 2009 is $75,000 ($50,000 down payment + $25,000 payment on July 1). The installment sale part of the total payments received in 2009 is $42,000 ($75,000 × 56%). Installment sale income for each asset by multiplying its gross profit percentage times $42,000.

### Reporting the sale

Report the installment sale. Report the installment gain in Part II of Form 4797. You will complete 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 prop- erty, 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 farm land, buildings, and truck are section 1231 gains. They may be reported as either capital or ordi- nary gain depending on the net balance when combined with other section 1231 losses. A net 1231 gain is capital gain and a net 1231 loss is an ordinary loss.

### Depreciation recapture and gain on cattle

In the year of sale, you must report the total depreciation recapture income on Form 4797. The $225 gain on the cattle held less than 2 years is ordinary income reported in Part II of Form 4797. See Table 9-1 in chapter 8.

### Installment income for years after 2009

You figure installment income for the years after 2009 by applying the same gross profit per- centage to the payments you receive each year. If you receive $50,000 during the year, $28,000 is considered received as the percent of the installment sale basis ($140,000 × 56% = $75,000) required to be received on the contract price.

You figure installment income for the years after 2009 by applying the same gross profit percentage to the payments you receive each year. If you receive $50,000 during the year, $28,000 is considered received as the percent of the installment sale basis ($140,000 × 56% = $75,000) required to be received on the contract price.

### Income

<table>
<thead>
<tr>
<th>Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Farm land</td>
</tr>
<tr>
<td>Buildings</td>
</tr>
<tr>
<td>Truck</td>
</tr>
<tr>
<td>Cattle*</td>
</tr>
</tbody>
</table>

** Held less than 2 years

### Table 9-1

<table>
<thead>
<tr>
<th>Gain on cattle</th>
<th>Income</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Farm land</td>
</tr>
<tr>
<td></td>
<td>Buildings</td>
</tr>
<tr>
<td></td>
<td>Truck</td>
</tr>
<tr>
<td></td>
<td>Cattle*</td>
</tr>
</tbody>
</table>

Total installment income: $16,850

** 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 income. You may have 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 capital or ordinary gains.

The interest received with each payment will be included in full as ordinary income.
**Summary.** The installment income (rounded to the nearest dollar) from the sale of the farm is reported as follows:

<table>
<thead>
<tr>
<th>Selling price</th>
<th>$190,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Minus: Installment basis</td>
<td>($107,756)</td>
</tr>
<tr>
<td>Gross profit</td>
<td>$82,250</td>
</tr>
</tbody>
</table>

Gain reported in 2009 (year of sale) $24,675
Gain reported in 2010: $28,000 = $87,756 16,450
Gain reported in 2011: $28,000 = $87,756 16,450
Gain reported in 2012: $28,000 = $87,756 16,450
Gain reported in 2013: $14,000 = $87,756 8,225
Total gain reported $82,250

---

**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
- Sch A (Form 1040) Itemized Deductions
- Sch D (Form 1040) Capital Gains and Losses
- Sch F (Form 1040) Profit or Loss From Farming
- Sch L (Form 1040A or 1040) Standard Deduction for Certain Filers
- 4684 Casualties and Thefts
- 4797 Sales of Business Property

See chapter 16 for information about getting publications and forms.

---

**Casualties and Thefts**

If your property is destroyed, damaged, or stolen, you may have a deductible loss. If the insurance or other reimbursement is more than the adjusted basis of the destroyed, damaged, or stolen property, you may have a taxable gain.

**Casualty.** A casualty is the damage, destruction, or loss of property resulting from an identifiable event that is sudden, unexpected, or unusual.

**Deductible losses.** Deductible casualty losses can result from a number of different causes, including the following.
- Airplane crashes.
- Car, truck, or farm equipment accidents not resulting from your willful act or willful negligence.
- Earthquakes.
- Fires (but see Nondeductible losses, next, for exceptions).
- Floods.
- Freezing.
- Government-ordered demolition or relocation of a home that is unsafe to use because of a disaster as discussed under Disaster Area Losses, in Publication 547.
- Lightning.
- Storms, including hurricanes and tornadoes.

**Nondeductible losses.** A casualty loss is not deductible if the damage or destruction is caused by the following.
- Accidentally breaking articles such as glassware or china under normal conditions.
- A family pet (explained below).
- A fire if you willfully set it, or pay someone else to set it.
- A car, truck, or farm equipment accident if your willful negligence or willful act caused it. The same is true if the willful act or willful negligence of someone acting for you caused the accident.
- Progressive deterioration (explained below).

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

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

---

**Casualties, Thefts, and Condemnations**

**What’s New for 2009**

Increase in personal casualty and theft loss limit. Generally, a personal casualty or theft loss must exceed $500 to be allowed for 2009. This is in addition to the 10%-of-adjusted-gross-income limit that generally applies to the net loss.

New Schedule L (Form 1040A or 1040). If you claim a net disaster loss as part of your standard deduction, you must complete Schedule L (Form 1040A or 1040) and attach it to Form 1040. See Disaster Area Losses later.

**What’s New for 2010**

Decrease in personal casualty and theft loss limit. A personal casualty or theft loss must exceed $100 to be allowed for 2010 and later years. This is in addition to the 10%-of-adjusted-gross-income limit that generally applies to the net loss.

**Disaster losses.** The special rules that were in effect in 2008 and 2009 for losses of personal use property attributable to federally declared disasters do not apply to losses occurring in 2010 and later years. Instead, these losses will be subject to the 10%-of-AGI limit and will be deductible only if you itemize your deductions. These losses will continue to be subject to the $100-per-loss limit.

---

**Gain reported in 2011:** $28,000 (rounded to the nearest dollar) from the sale of the farm is reported as follows:

<table>
<thead>
<tr>
<th>Selling price</th>
<th>$190,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Minus: Installment basis</td>
<td>($107,756)</td>
</tr>
<tr>
<td>Gross profit</td>
<td>$82,250</td>
</tr>
</tbody>
</table>

Gain reported in 2010: $28,000 = $87,756 16,450
Gain reported in 2011: $28,000 = $87,756 16,450
Gain reported in 2012: $28,000 = $87,756 16,450
Gain reported in 2013: $14,000 = $87,756 8,225
Total gain reported $82,250

---

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

Thieves. 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. You do not need to show a conviction for theft.

Thieves includes the taking of money or property by the following means.
- Blackmail.
- Burglary.
- Embezzlement.
- Extortion.
- Kidnapping for ransom.
- Larceny.
- Robbery.
- Threats.

The taking of money or property through fraud or misrepresentation is theft if it is illegal under state or local law.

Decline in market value of stock. You cannot deduct as a theft loss the decline in market value of stock acquired on the open market for investment if the decline is caused by disclosure of accounting fraud or other illegal misconduct by the officers or directors of the corporation that issued the stock. However, you can deduct as a capital loss the loss you sustain when you sell or exchange the stock or the stock becomes completely worthless. You report a capital loss on Schedule D (Form 1040). For more information about stock sales, worthless stock, and capital losses, see chapter 4 of Publication 550.

Mislaid or lost property. The simple disappearance of money or property is not a theft. However, an accidental loss or disappearance of property can qualify as a casualty if it results from an identifiable event that is sudden, unexpected, or unusual.

Example. A car door is accidentally slammed on your hand, breaking the setting of your diamond ring. The diamond falls from the ring and is never found. The loss of the diamond is a casualty.

Farming Losses

You can deduct certain casualty or theft losses that occur in the business of farming. The following is a discussion of some losses you can deduct and some you cannot deduct.

Livestock or produce 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 more than 2 years, you may have a deductible loss if you have a tax basis in the plants. You usually have a tax basis if you capitalized the expenses associated with these plants under the uniform capitalization rules. The uniform capitalization rules are discussed in chapter 6.

If you report your income on an accrual method, casualty or theft losses are deductible only if you included the items in your inventory at the beginning of your tax year. You get the deduction by omitting the item from your inventory at the close of your tax year. You cannot take a separate casualty or theft deduction.

Income loss. A loss of future income is not deductible.

Example. A severe flood destroyed your crops. Because you are a cash method taxpayer and already deducted the cost of raising the crops as farm expenses, this loss is not deductible, as explained above under Livestock, plants, produce, and crops raised for sale. You estimate that the crop loss will reduce your farm income by $25,000. This loss of future income is also not deductible.

Loss of timber. If you sell timber downed as a result of a casualty, treat the proceeds from the sale as a reimbursement. If you use the proceeds to buy qualified replacement property, you can postpone reporting the gain. See Postponing Gain, later.

Property used in farming. Casualty and theft losses of property used in your farm business usually result in deductible losses. If a fire or storm destroyed your barn, or you lose by casualty or theft an animal you bought for draft, breeding, dairy, or sport, you may have a deductible loss. See How To Figure a Loss, later.

Raised draft, breeding, dairy, or sporting animals. Generally, losses of raised draft, breeding, dairy, or sporting animals do not result in deductible casualty or theft losses because you have no basis in the animals. However, you may have a basis in the animal and therefore may be able to claim a deduction if either of the following situations applies to you.
- You use inventories to determine your income and you included the animals in your inventory.
- You capitalized the expenses associated with the animals under the uniform capitalization rules and therefore have a tax basis in the animals subject to a casualty or theft.

When you include livestock in inventory, its last inventory value is its basis. When you lose an inventoried animal held for draft, breeding, dairy, or sport by casualty or theft during the year, decrease ending inventory by the amount you included in inventory for the animal. You cannot take a separate deduction.

How To Figure a Loss

How you figure a deductible casualty or theft loss depends on whether the loss was to farm or personal-use property and whether the property was stolen or partly or completely destroyed.

Farm property. Farm property is the property you use in your farming business. If your farm property was completely destroyed or stolen, your loss is figured as follows:

Your adjusted basis in the property MINUS Any salvage value MINUS Any insurance or other reimbursement you receive or expect to receive

You can use the schedules in Publication 584-B to list your stolen, damaged, or destroyed business property and to figure your loss.

If your farm property was partially damaged, use the steps shown under Personal-use property, next, to figure your casualty loss. However, the deduction limits, discussed later, do not apply.

Personal-use property. Personal-use property is property used by you or your family members for personal use. You figure the casualty or theft loss on this property by taking the following steps.

1. Determine your adjusted basis in the property before the casualty or theft.
2. Determine the decrease in fair market value of the property as a result of the casualty or theft.
3. From the smaller of the amounts you determined in (1) and (2), subtract any insurance or other reimbursement you receive or expect to receive.

You must apply the deduction limits, discussed later, to determine your deductible loss.

You can use Publication 584 to list your stolen or damaged personal-use property and figure your loss. It includes schedules to help you figure the loss on your home, its contents, and your motor vehicles.

Adjusted basis. Adjusted basis is your basis (usually cost) increased or decreased by various events, such as improvements and casualty losses. For more information about adjusted basis, see chapter 6.

Decrease in fair market value (FMV). The decrease in FMV is the difference between the property’s value immediately before the casualty or theft and its value immediately afterward. FMV is defined in chapter 10 under Payments Received or Considered Received.

Appraisal. To figure the decrease in FMV because of a casualty or theft, you generally need a competent appraisal. But other measures, such as the cost of cleaning up or making...
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 2009, a windstorm blew down three trees and three ornamental trees planted at a cost of $600 on the residential part. The adjusted basis of the residential part includes the $600. The fair market value (FMV) of the residential part immediately before the storm was $130,000, and $126,000 immediately after the storm. The trees were not covered by insurance.

1) Adjusted basis .......................... $16,000
2) FMV before the storm .......... $130,000
3) FMV after the storm ......... $126,000
4) Decrease in FMV (line 2 – line 3) ...... $4,000
5) Loss before insurance (lesser of line 1 or line 4) .......... $4,000
6) Minus: Insurance .......................... 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 until a later tax year.

Do not subtract from your loss any insurance payments you receive for living expenses if you lose the use of your personal residence for a year or more. You may have to include a portion of these payments in your income. See Publication 547 for details.

Disaster relief. Food, medical supplies, and other forms of assistance you receive do not reduce your casualty loss, unless they are replacements for lost or destroyed property. Excludable cash gifts you receive also do not reduce your casualty loss if there are no limits on how you can use the money.

Generally, disaster relief grants received under the Robert T. Stafford Disaster Relief and Emergency Assistance Act are not included in your income. See Federal disaster relief grants, Disaster Area Losses.

Qualified disaster relief payments for expenses you incurred as a result of a federally declared disaster are not taxable income to you. See Qualified disaster relief payments, later, under Disaster Area Losses.

Reimbursement received after deducting loss. If you figure your casualty or theft loss using your expected reimbursement, you may have to adjust your tax return for the tax year in which you get your actual reimbursement.

Actual reimbursement less than expected. If you later receive less reimbursement than you expected, include that difference as a loss with your other losses (if any) on your return for the year in which you can reasonably expect no more reimbursement.

Actual reimbursement more than expected. If you later receive more reimbursement than you expected after you have claimed a deduction for the loss, you may have to include the extra reimbursement in your income for the year you receive it. However, if any part of your original deduction did not reduce your tax for the tax year, do not allocat it to the reimbursement in your income. Do not refunge 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 what you expected, you do not have to include any of the reimbursement in your income and you cannot deduct any additional loss.

Lump-sum reimbursement. If you have a casualty or theft loss of several assets at the same time without an allocation of reimbursement to specific assets, divide the lump-sum reimbursement among the assets according to the fair market value of each asset at the time of the loss. Figure the gain or loss separately for each asset that has a separate basis.

Adjustments to basis. If you have a casualty or theft loss, you must decrease your basis in the property by any insurance or other reimbursement you receive and by any deductible loss. The result is your adjusted basis in the property. Amounts you spend 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 your deduction for casualty or theft loss of personal-use property. You figure these limits on Form 4684.

$500 rule. You must reduce each casualty or theft loss on personal-use property by $500. 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 $500. Adjusted gross income is on line 38 of Form 1040. This rule does not apply to federally declared disasters (defined later under Disaster Area Losses).

Chapter 11 Casualties, Thefts, and Condemnations

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When Loss is Deductible

Generally, you can deduct casualty losses that are not reimbursable only in the tax year in which they occur. You generally can deduct theft losses that are not reimbursable only in the year you discover your property was stolen. However, losses in federally 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 2009. 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 2010, 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 2010. He can claim the $20,000 as a loss on his 2010 tax return.

Net operating loss (NOL). If your deductions, including casualty or theft loss deductions, are more than your income for the year, you may have an NOL. An NOL can be carried back or carried forward and deducted from income in other years. See Publication 536 for more information on NOLs.

Proof of Loss

To deduct a casualty or theft loss, you must be able to prove that there was a casualty or theft. You must have records to support the amount you claim for the loss.

Casualty loss proof. For a casualty loss, your records should show all the following information:

• The type of casualty (car accident, fire, storm, etc.) and when it occurred.
• That the loss was a direct result of the casualty.
• That you were the owner of the property or, if you leased the property from someone else, that you were contractually liable to the owner for the damage.
• Whether a claim for reimbursement exists for which there is a reasonable expectation of recovery.

Theft loss proof. For a theft loss, your records should show all the following information:

• When you discovered your property was missing.
• That your property was stolen.
• That you were the owner of the property.
• Whether a claim for reimbursement exists for which there is a reasonable expectation of recovery.

Figuring a Gain

A casualty or theft may result in a taxable gain. If you receive an insurance payment or other reimbursement that is more than your adjusted basis in the destroyed, damaged, or stolen property, you have a gain from the casualty or theft. You report the 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 on your tax return for the year you receive 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 property. 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 dis-
cussed 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, below.

Reposting dispositions of diseased live-
stock If you choose to postpone reporting gain on the disposition of diseased livestock, you must attach a statement to your return ex-
plaining that the livestock was disposed of be-
cause of disease. You must also include other information on this statement. See How To Post-
pone 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 ex-
change as an involuntary conversion. Only live-
stock sold in excess of the number you normally would sell under usual business practice, in the absence of weather-related conditions, are con-
sidered 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 re-
porting the gain. See Postponing Gain, below.

Example. It is your usual business practice to sell five of your dairy animals during the year. This year you sold 20 dairy animals because of drought. The sale of 15 animals is treated as an involuntary conversion.

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 8.

Tree Seedlings
If, because of an abnormal drought, the failure of
planted tree seedlings is greater than normally anticipated, you may have a deductible loss. Treat the loss as a loss from an involuntary conversion. The loss equals the previously cap-
italized reforestation costs you had to duplicate on replanting. You deduct the loss on the return for the year the seedlings died. If you took the investment credit for any of these costs, you may have to recapture all or part of the credit. See Form 4255, Recapture of Investment Credit.

Postponing Gain
Do not report a gain if you receive 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-
tverted 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 re-
lated in service or use to your destroyed, stolen, or other involuntarily converted property within a specific replacement period.

If you have a gain on damaged property, you can postpone reporting the gain if you spend the reimbursement to restore the property.

To postpone reporting all the gain, the cost of your replacement property must be at least as much as the reimbursement you receive. If the cost of the replacement property is less than the reimbursement, you must include the gain in your income up to the amount of the unspent reimbursement.

Example 1. In 1985, you constructed a barn to store farm equipment at a cost of $20,000. In 1987, you added a silo to the barn at a cost of $15,000 to store grain. In May of this year, the property was worth $100,000. In June the prop-
erty was destroyed by a tornado. You received $85,000 from the insurance company. You had a gain of $50,000 ($85,000 – $35,000).

You spent $80,000 to rebuild the barn and silo. Since this is less than the insurance pro-
ceeds received, you must include $5,000 ($85,000 – $80,000) in your income.

Example 2. 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 casually, theft, or other involuntary con-
version if you buy the replacement property from a related person (discussed later). This rule ap-
plies to the following taxpayers.

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 (1) and (2) above), and S corporations. The total realized gain for the tax year on all involuntarily converted properties on which there are realized gains is more than $100,000.

For involuntary conversions described in (3) above, gains cannot be offset by any losses when determining whether the total gain is more than $100,000. If the property is owned by a partnership, the $100,000 limit applies to the partnership and each partner. If the property is owned by an S corporation, the $100,000 limit applies to the S corporation and each 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 capital or profits interests. For more informa-
tion on related persons, see Nondeductible Loss under Sales and Exchanges Between Related Persons in chapter 2 of Publication 544.

Death of a taxpayer. If a taxpayer dies after having a gain, but before buying replacement property, the gain must be reported for the year in which the decedent realized the gain.

The executor of the estate or the person succeeding to the funds from the involuntarily conversion cannot postpone reporting the gain by buying replacement property.

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 for your old property to ac-
quire the new replacement property. If you spend the money you receive for other purposes, and bor-
row money to buy replacement property, you can still claim the gain from the involuntarily converted property 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-
This 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 live-

stock, you can treat other property (excluding real property) used for farming purposes, as property similar or related in service or use to the livestock you sold.

Standing crop destroyed by casualty. If a storm or other casualty destroyed your standing crop and you use the insurance money to ac-
id another standing crop or a har-
vested 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 after the replacement period, you cannot postpone reporting the gain.

Business or income-producing property located in a federally declared disaster area. If your destroyed business or income-producing property was located in a federally declared disaster area, any tangible replacement property you acquire for use in any business is treated as similar or related in service or use to the destroyed property. For more information, see Disaster Area Losses in Publication 547.

Substituting replacement property. Once you have acquired qualified replacement property that you designate as replacement property in a statement attached to your tax return, you cannot substitute other qualified replacement property. This is true even if you acquire the other property within the replacement period. However, if you discover that the original replacement property was not qualified replacement property, you can, within the replacement period, substitute the new qualified replacement property.

Basis of replacement property. You must reduce the basis of your replacement property (its cost) by the amount of postponed gain. In this way, tax on the gain is postponed until you dispose of the replacement property.

Replacement Period
To postpone reporting your gain, you must buy replacement property within a specified period of time. This is the replacement period.

The replacement period begins on the date your property was damaged, destroyed, stolen, sold, or exchanged. The replacement period generally ends 2 years after the close of the first tax year in which you realize any part of your gain from the involuntary conversion.

Example. You are a calendar year taxpayer. While you were on vacation, farm equipment that cost $2,200 was stolen from your farm. You discovered the theft when you returned to your farm on November 11, 2008. Your insurance company investigated the theft and did not settle your claim until January 5, 2009, when they paid you $3,000. You first realized a gain from the reimbursement for the theft during 2009, so you have until December 31, 2011, to replace the property.

Main home in disaster area. For your main home (or its contents) located in a federally declared disaster area, the replacement period ends 4 years after the close of the first tax year in which you realize any part of your gain from the involuntary conversion. See Disaster Area Losses, later.

Property in the Midwestern disaster areas. For property located in the Midwestern disaster areas (defined in Table 4 in the 2008 Publication 547) that was destroyed, damaged, stolen, or condemned, 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 Midwestern disaster areas.

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

Property in the Hurricane Katrina disaster area.
For property located in the Hurricane Katrina disaster area that was destroyed, damaged, stolen, or condemned after August 24, 2005, 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 of livestock due to drought, flood, or other weather-related conditions in an area eligible for federal assistance, the replacement period generally ends 4 years after the close of the first tax year in which you realize any part of your gain from the sale or exchange. The IRS may extend the replacement period on a regional basis if the weather-related conditions continue for longer than 3 years.


Condemnation. The replacement period for a condemnation begins on the earlier of the following dates.

1. The date on which you disposed of the condemned property.
2. 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 Main home in disaster area, Property in the Midwestern disaster areas, Property in the Kansas disaster area, and Property in the Hurricane Katrina disaster area earlier for exceptions.

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 5 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 should attach a statement to your return for the year you have the gain. This statement should include all of the following information:

1. The date and details of the casualty, theft, or other involuntary conversion.
2. The insurance or other reimbursement you received.
3. How you figured the gain.
4. Replacement property acquired before return filed. If you acquire replacement property before you file your return for the year you have the gain, your statement should also include detailed information about all the following items:
   a. The replacement property.
   b. The postponed gain.
   c. The basis adjustment that reflects the postponed gain.
   d. Any gain you are reporting as income.

Replacement property acquired after return filed. If you intend to buy replacement property after you file your return for the year you realize gain, your statement should 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 about the replacement property. If you acquire part of your replacement property in one year and part in another year, you must attach a statement to each year’s return. Include in the statement detailed information on the replacement property bought in that year.

Reporting weather-related sales of livestock. If you choose to postpone reporting the gain on weather-related sales or exchanges of livestock, show all the following information on a statement attached to your return for the tax year in which you first realize any of the gain:

1. Evidence of the weather-related conditions that forced the sale or exchange of the livestock.
Qualified disaster relief payments do not include:

- Payments for expenses otherwise paid for by insurance or other reimbursements,
- Income replacement payments, such as payments of lost wages, lost business income, or unemployment compensation.

Qualified disaster mitigation payments. Qualified disaster mitigation payments made under the Robert T. Stafford Disaster Relief and Emergency Assistance Act or the National Flood Insurance Act (as in effect on April 15, 2005) are not included in income. These are payments you, as a property owner, receive to reduce the risk of future property damage due to a disaster. You cannot 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 program. Generally, if you sell or otherwise transfer property, you must recognize any gain or loss for tax purposes unless the property is your main home. You report the gain or deduct the loss on your tax return for the year you realize it. (You cannot deduct a loss on personal-use property unless the loss resulted from a casualty, as discussed earlier.) However, if you sell or otherwise transfer property to the Federal Government, a state or local government, or an Indian tribal government under a hazard mitigation program, you can choose to postpone reporting the gain if you buy qualifying replacement property within a certain period. See Postponing Gain earlier for the rules that apply.

Postponed tax deadlines. The IRS may postpone for up to 1 year certain tax deadlines of taxpayers who are affected by a federally declared disaster. The tax deadlines the IRS may postpone include those for filing income, excise, and employment taxes, and making contributions to a traditional IRA or Roth IRA.

If any tax deadline is postponed, the IRS will publish a news release, revenue ruling, revenue procedure, notice, announcement, or other guidance in the Internal Revenue Bulletin (IRB).

Who is eligible. If the IRS postpones a tax deadline, the following taxpayers are eligible for the postponement:

- Any individual whose main home is located in a covered disaster area (defined next).
- Any business entity or sole proprietor whose principal place of business is located in a covered disaster area.
- Any individual who is a relief worker affiliated with a recognized government or philanthropic organization and who is assisting in a covered disaster area.
- Any individual, business entity, or sole proprietorship whose records are needed to meet a postponed tax deadline, provided those records are maintained in a covered disaster area. The main home or principal place of business does not have to be located in the covered disaster area.
Self-Employment Tax

What's New for 2009

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 $106,800 for 2009. There is no maximum limit on earnings subject to the Medicare part (2.9%).

What's New for 2010

Maximum net earnings. The maximum net self-employment earnings subject to the social security part of the self-employment tax is $106,800 for 2010. There is no maximum limit on earnings subject to the Medicare part.

Introduction

Self-employment tax (SE tax) is a social security and Medicare tax primarily for individuals who work for themselves. It is similar to the social security and Medicare taxes withheld from the pay of most wage earners.

You usually have to pay SE tax if you are self-employed. You are usually self-employed if you operate your own farm on land you either own or rent. You have to figure SE tax on Schedule SE (Form 1040).

Farmers who have employees may have to pay the employer’s share of social security 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
  - 1065 U.S. Return of Partnership Income
  - Sch K-1 (Form 1065) Partner’s Share of Income, Deductions, Credits, etc.

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 2009. You can earn a maximum of four credits per year. For 2009, you earn one credit for each $1,090 of combined wages and self-employment earnings subject to social security tax. You need $4,360 ($1,090 x 4) of combined wages and self-employment earnings subject to social security tax to earn four credits in 2009. 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:

- Obtain an SSN or ITIN, and
- Pay your SE tax using estimated tax.

An ITIN does not entitle you to social security benefits. Obtaining an ITIN does not change your immigration or employment status under U.S. law.

Obtaining a social security number. If you have never had an SSN, apply for one using Form SS-5, Application for a Social Security Card. The application is also available in Spanish. You can get this form at any Social Security office or by calling 1-800-772-1213.

You can also download Form SS-5 from the Social Security Administration website at www.socialsecurity.gov.

If you have a social security number from the time you were an employee, you must use that number. Do not apply for a new one.

Replacing a lost social security card. If you have a number but lost your card, file Form SS-5. You will get a new card showing your original number, not a new number.

Name change. If your name has changed since you received your social security card, complete Form SS-5 to report a name change.

Obtaining an individual taxpayer identification number. The IRS will issue you an ITIN, for tax use only, if you are a nonresident or resident alien and you do not have, and are not eligible to get, an SSN. To apply for an ITIN, file Form W-7, Application for IRS Individual Taxpayer Identification Number. You can get this form by calling 1-800-829-3676. For more information on ITINs, see Publication 1915. Understanding Your IRS Individual Taxpayer Identification Number. Form W-7 and Publication 1915 are also available in Spanish.

You can also download Form W-7 from the IRS website at www.irs.gov.

Pay estimated tax. Estimated tax is the method used to pay tax (including SE tax) on income not subject to withholding. You generally have to make estimated tax payments if you expect to owe tax, including SE tax, of $1,000 or more when you file your return. Use Form 1040-ES, Estimated Tax for Individuals, to figure and pay the tax.

However, if at least two-thirds of your gross income for 2009 or 2010 was from farming and you file Form 1040 and pay all the tax due by March 1, 2011, you do not have to pay any estimated tax. For more information about estimated tax for farmers, see chapter 15.

Penalty for underpayment of estimated tax. You may have to pay a penalty if you do not pay enough estimated tax by its due date.

Who Must Pay Self-Employment Tax?

You must pay SE tax and file Schedule SE (Form 1040) if your net earnings from self-employment were $400 or more.

The SE tax rules apply no matter how old you are and even if you are already receiving social security or Medicare benefits.

Aliens. Generally, resident aliens must pay self-employment tax under the same rules that apply to U.S. citizens. Nonresident aliens are not subject to self-employment tax. However, residents of the Virgin Islands, Puerto Rico, Guam, the Commonwealth of the Northern Mari- anas Islands, or American Samoa are subject to self-employment tax, as they are considered U.S. residents for self-employment tax purposes. For more information on aliens, see Publication 519, U.S. Tax Guide for Aliens.

Are you self-employed? You are self-employed if you carry on a trade or business (such as running a farm) as a sole proprietor, an independent contractor, a member of a partner- ship, or are otherwise in business for yourself. A trade or business is generally an activity carried on for a livelihood or in good faith to make a profit.

Share farmer. You are a self-employed farmer under an income-sharing arrangement if both the following apply:

1. You produce a crop or raise livestock on land belonging to another person.
2. Your share of the crop or livestock, or the proceeds from their sale, depends on the amount produced.

Your 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 em- ployee 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 crop-share basis. Under the terms of their agreement, the share farmer furnishes the labor and half the cost of seed and fertilizer. The landowner furnishes the machinery and equipment used to produce and harvest the crop, and half the cost of seed and fertilizer. The share farmer is provided a house in which to live. The grower determines how much of the tract should be planted in cotton and how much in other crops.

The share farmer is a self-employed farmer for purposes of the agreement to produce the cotton and other crops, and the share farmer’s part of the profit or loss from the crop is re- ported 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 com- pany. 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 par- ticipates in a 4-H Club or FFA project, any net income received from sales or prizes related to the project may be subject to income tax. Report the net income on line 21 of Form 1040. If necessary, attach a statement showing the gross income and expenses. The net income may not be subject to SE tax if the project is primarily for educational purposes and not for profit, and is completed by the individual under the rules and economic restrictions of the spon- soring 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 partner- ship 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 partner- ship are subject to SE tax and should be re- ported to you 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 in the profits and losses, you are partners in a partnership whether or not you have a formal partnership agreement and must file Form 1065 instead of Schedule F. However, if you and your spouse materially participate as the only mem- bers of a jointly owned and operated farm and you 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 be- tween 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 partner
ership 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.

Partnership income or loss. If you are a member of a partnership that carries on a trade or business, the partnership should report your self-employment earnings 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 are reporting to your partners your self-employment earnings. You must combine the net profit or loss from each partner's Schedule K-1 (Form 1065) for the partnership during the year. These tests may be used as guides for

• More than one business. If you have 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 partner
ship, 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 pay
ments 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 farm
ning 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. Gain or loss from the disposi
tion of property that is neither stock in trade nor held primarily for sale to customers is not in
cluded in self-employment earnings. It does not matter whether the disposition is a sale, ex
 change, or involuntary conversion. For example, gains or losses from the disposition of the follow
ing 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 to customers. Whether livestock is held while being used in your trade or business or during periods of 5 weeks or more in activities connected with your trade or business.

• 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 cut
ting 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 are generally included in self-employment earnings. If you are a partner in a trade or business, 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 com
bine earnings from farm and nonfarm busi
nesses if you are using one of the optional
methods (discussed later) to figure net 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 retire
ment 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.

Conservation Reserve Program (CRP) pay
ments. CRP payments are excluded from self-employment tax for individuals receiving so
cial security benefits for retirement or disability. See the Instructions for Schedule SE (Form 1040).

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 gov
ernment commodity program payments re
ceived by a landlord who rents land, are included if the rental arrangement provides that

the landlord will, and does, materially partici
pate in the production or management of pro
duction 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 participation tests (discussed earlier) at the time the crop shares are produced. Feeding such crop shares to livestock is considered us
ing them. Your gross income for figuring your self-employment earnings includes the fair mar
ket value of the crop shares when they are used as feed.

Material participation for landlords. You materially participate if you have an arrange
ment 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, equip
ment, and livestock used in the produc
tion activities.
   c. Advise or consult with your tenant.
   d. Inspect the production activities periodi
cally.

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 con
nected with agricultural production.

4. You do things, that is, considered in their to
tality, show you are materially and signifi
cantly involved in the production of the farm commodi
ities. These tests may be used as general guides for determining whether you are a material partici
pant.

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 cot
ton. 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 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. 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.”

Farm Optional Method
Use the farm optional method only for self-employment earnings from a farming business. You can use this method if you meet either of the following tests.

1. Your gross farm income is $6,540 or less.
2. Your net farm profits are less than $4,721.

Gross farm income. Your gross farm income is the total of the amounts from:
• Schedule F (Form 1040), line 11, and
• Schedule K-1 (Form 1065), box 14, code B (from farm partnerships).

Net farm profits. Net farm profits generally are the total of the amounts from:
• Schedule F (Form 1040), line 36, and
• Schedule K-1 (Form 1065), box 14, code A (from farm partnerships). However, you may need to adjust the amount reported on Schedule K-1 if you are a general partner or if it is a loss. For more information, see Partnership income or loss, earlier.

Figuring farm net earnings. If you meet either of the two tests explained above, use Table 12-1, Figuring Farm Net Earnings, to figure your net earnings from self-employment under the farm optional method.

Effects of using an optional method. Using an optional method could increase your SE tax.

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

START here to determine if you can use the farm optional method.

Are your net nonfarm profits less than $4,721?

Yes

Are your net nonfarm profits less than 72.189% of your gross nonfarm income?

Yes

Were your actual net earnings from self-employment $400 or more in at least 2 of the 3 tax years before this year?

Yes

Have you previously used this method less than 5 years? (Note: There is a 5-year lifetime limit.)

Yes

You can use the farm optional method.” See Table 12-1.

No

You cannot use the farm optional method.

No

START here to determine if you can use the nonfarm optional method.

Are your net nonfarm profits less than $4,721?

No

Are your net nonfarm profits less than 72.189% of your gross nonfarm income?

Yes

Is your gross farm income $6,540 or less?

Yes

You can use the farm optional method.” See Table 12-1.

No

Are your net farm profits less than $4,721?

Yes

You cannot use the farm optional method.

No

You cannot use the farm optional method.

"If you use both optional methods, see Using Both Optional Methods, later, for limits on the amount to report."
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>$6,540 or less</td>
<td>Two-thirds of your gross farm income.</td>
</tr>
<tr>
<td>More than $6,540</td>
<td>$4,360.</td>
</tr>
</tbody>
</table>

Optional method can reduce or eliminate SE tax. If your gross farm income is $6,540 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 $360 (2/3 of $540) and your actual net earnings are $425 (92.35% of $460). 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 934.

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 can report no more than $4,360 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 56 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 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 self-employment earnings or your Schedule 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.

In both cases, 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.

Employment Taxes

What’s New for 2009

Wage limit for social security tax. The limit on wages subject to the social security tax for 2009 is $106,800. There is no limit on wages subject to the Medicare tax.

New employment tax adjustment process in 2009. If you discover an error on a previously filed Form 943, Employer’s Annual Federal Tax Return for Agricultural Employees, after 2008, make the correction using Form 943-X, Adjusted Employer’s Annual Federal Tax Return for Agricultural Employees or Claim for Refund. Previously, taxpayers made corrections to Form 943 using Form 941c, Supporting Statement To Correct Information, that is filed once a year with Form 943. Form 943-X is a stand-alone form, meaning taxpayers can file Form 943-X when an error is discovered, rather than waiting until the end of the year to file Form 941c with Form 943.

If both of you have self-employment earnings, deposits of withheld federal income taxes, social security tax, and Medicare tax. This deduction only affects your income tax. It does not affect either your net self-employment earnings or your Schedule 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.

Electronic deposits of taxes. You must use the Electronic Federal Tax Payment System (EFTPS) to make electronic deposits of all depository tax liabilities you incur in 2009 and thereafter if you deposited more than $200,000 in federal depository taxes in 2007 or you had to use EFTPS in 2008 or a prior year. See Electronic Federal Tax Payment System (EFTPS) under Reporting and Paying Social Security, Medicare, and Withheld Federal Income Taxes.

Reminder

Electronic deposits of taxes. You must use the Electronic Federal Tax Payment System (EFTPS) to make electronic deposits of all depository tax liabilities you incur in 2009 and thereafter if you deposited more than $200,000 in federal depository taxes in 2007 or you had to use EFTPS in 2008 or a prior year. 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 by the dates listed. See By February 15 and On February 16 for Form W-4, Employee’s Withholding Allowance Certificate. 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 2010.

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 envelope containing the tax return or form is properly addressed, contains sufficient postage, and is postmarked by the due date, or sent by an IRS-designated delivery service by the due date. See Private delivery services in Publication 51 (Circular A), Agricultural Employer’s Tax Guide.

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 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 nonemployee compensation with a completed Form 1099 (for example, Form 1099-MISC, Miscellaneous Income).
The type and rule above prints on all proofs including departmental reproduction proofs. MUST be removed before printing.

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.

- 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 do not have to withhold or pay employment taxes for independent contractors who are not your employees. For more information, see Publication 15-A.

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 and click on the Employer ID Numbers link. You may also apply for an EIN by calling 1-800-829-4434 (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, Application for Employer Identification Number, to the IRS.

Employee’s social security number (SSN). An employee who does not have an SSN should have one assigned before they can work for you. You 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) or by calling 1-800-772-1213 (operates 24 hours per day). 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. If the employee does not give you a new Form W-4, withhold as if he or she is single, with zero withholding allowances. The Form W-4 previously given to you claiming exemption is now expired.

By December 1
Remind employees to submit a new Form W-4 if their withholding allowances have changed or will change for the next year.

On December 31
Form W-5, Earned Income Credit Advance Payment Certificate, expires. Employees who want to receive advance payments of the earned income credit for the next year must give you a new Form W-5.

**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.
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, later. Payments for the services of your child under age 21 employed by you in other than a trade or business, such as payments for household services in your home, are also not subject to social security or Medicare taxes. Payments for the services of your child under age 21 employed by you, whether or not in your trade or business, are not subject to 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 taxes.

Nonexempt services of a child or spouse. Payments for the services of your child or spouse are subject to federal income tax withholding as well as social security, Medicare, and FUTA taxes if he or she works for any of the following entities.

- A corporation, even if it is controlled by you.
- A partnership, even if you are a partner.
- An estate or trust, even if it is the estate of a deceased parent.

In these situations, the child or spouse is considered to work for the corporation, partnership, or estate, not you.

Exemptions for your parent. Payments for the services of your parent employed by you in your trade or business are subject to federal income tax withholding and social security and Medicare taxes. Social security and Medicare taxes do not apply to wages paid to your parent for services not in your trade or business, but they do apply to payments for household services in your home if both the following conditions are satisfied.

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

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

Crew Leaders

If farmworkers are provided by a crew leader, the crew leader may be the employer of the workers.

Social security and Medicare taxes. For social security and Medicare tax purposes, the crew leader is the employer of the workers if both of the following requirements are met.

- The crew leader pays (either on his or her own behalf or on behalf of the farmer) the workers for their farm labor.
- The crew leader has not entered into a written agreement with the farmer under which the crew leader is designated as an employee of the farmer.

Federal income tax withholding. If the crew leader is the employer for social security and Medicare tax purposes, the crew leader is the employer for federal income tax withholding purposes.

Federal unemployment (FUTA) tax. For FUTA tax purposes, the crew leader is the employer of the workers if, in addition to the earlier requirements, either of the following requirements are met.

- The crew leader is registered under the Migrant and Seasonal Agricultural Worker Protection Act.
- Substantially all crew members operate or maintain mechanized equipment provided by the crew leader as part of the service to the farmer.

The farmer is the employer of workers furnished by a crew leader in all other situations. In addition, the farmer is the employer of workers furnished by a registered crew leader if the workers are the employees of the farmer under the common-law test. For example, some farmers employ individuals to recruit farmworkers exclusively for them. Although these individuals may be required to register under the Migrant and Seasonal Agricultural Worker Protection Act, the workers are employed directly by the farmer.

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 employee 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, and
- Commutes daily from his or her permanent home to the farm, and
- Worked in agriculture less than 13 weeks in the preceding calendar year.

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

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

Cash wages. Only cash wages paid to 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 employee 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. For information on lodging pro-
vided as a condition of employment, see Pub-
cation 1.

Report the value of noncash wages on Form W-2 in box 1, Wages, tips, other compensation, together with cash wages. Do not show non-
cash wages in box 3, Social security wages, or in box 5, Medicare wages and tips (unless the substance of the transaction is a cash payment).

Tax rates and social security wage limit. For 2010, the employer and the employee will each pay both the following taxes.

- 6.2% of cash wages for social security tax (old-age, survivors, and disability insur-
ance).
- 1.45% of cash wages for Medicare tax (hospital insurance).

Wage limit. The limit on wages subject to the social security tax for 2010 is $106,800. There is no limit on wages subject to the Medi-
care tax. All covered wages are subject to the Medicare tax.

Pay employees’ share. If you would rather pay the employee’s share of social secur-
ity 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 em-
ployees’ 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. Su-
san enters $1,076.50 in box 1 of Mary’s Form W-2 ($1,000 wages plus $76.50 social security and Medicare taxes paid for Mary). She enters $1,000 in boxes 3 and 5.

Federal Income Tax Withholding

If the cash wages you pay to farmworkers are subject to social security and Medicare taxes, they are also subject to federal income tax with-
holding. Although noncash wages are subject to federal income tax, withholding 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 em-
ployee’s marital status and withholding al-
lowances claimed on the employee’s Form W-4.

In general, an employee can claim withholding allowances on Form W-4 equal to the number of exemptions the employee will be entitled to claim on his or her tax return. An employee may also be able to claim a special withholding allow-
ance and allowances for estimated deductions and credits.

Do not withhold federal income tax from the wages of an employee who, by filing Form W-4, certifies that he or she had no federal income tax liability last year and anticipates no liability for the current year.

You should give each new employee a Form W-4. As soon as you hire the employee, you must complete Form W-4. If the employee is a Spanish-speaking employee, you may use Formulario W-4(SP) which is the Spanish trans-
literation of Form W-4. Have the employee com-
plete and return the form to you before the first payday. If the employee does not return the completed form to you, you must withhold fed-
eral income tax. If the employee is single and claims no withholding allowances.

New Form W-4 for 2010. You should make the 2010 Form W-4 available to your employees and encourage them to check their income tax withholding for 2010. Those employees who owed a large amount of tax or received a large tax refund for 2009 may want to file a new Form W-4. You cannot accept substitute Forms W-4 developed by employees.

How to figure withholding. You can use one of several methods to determine the amount to withhold. The methods are described in Publica-
tion 51 (Circular A), which contains tables show-
ing the correct amount of federal income tax you should withhold. Publication 51 (Circular A) also contains additional information about federal in-
come tax withholding.

Nonemployee compensation. Generally, you do not have to withhold federal income tax on payments for services to individuals who are not your employees. However, you may be re-
quired to report those payments on Form 1099-MISC. Miscellaneous Income, and to with-
hold 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 in-
come credit (EIC) and who has a qualifying child is entitled to receive EIC payments with his or her pay during the year. To get these payments, the employee must give you a properly com-
pleted Form W-4. You are usually required to make advance EIC payments to employees who give you a properly completed Form W-5, but you do not have to make these payments to ten married workers paid on a daily basis.

The EIC payment is added to the employee’s pay each payday. It is figured from tables in Publication 51 (Circular A). You reduce your liability for federal income tax withholding, social security tax, and Medicare tax by the total ad-
vance EIC payments made. For more informa-
tion, see Publication 51 (Circular A).

Notification. You must provide notification about the EIC to each employee who worked for you at any time during the year and from whom you did not withhold any federal income tax. However, you do not have to notify employees who claim exemption from federal income tax withholding on Form W-4. You meet the notification requirement by giv-
ing each employee any of the following.

- Form W-2, which contains the EIC notifi-
cation on the back of Copy B.
- A substitute Form W-2 with the exact EIC wording shown on the back of copy B of Form W-2.
- Notice 797, Possible Federal Tax Refund Due to the Earned Income Credit (EIC).
- Your own written statement with the exact wording of Notice 797.

For more information about notification re-
quirements and claiming the EIC, see Notice 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 se-
curity, and Medicare taxes required to be withheld from the salaries and wages of your employees. You are liable for the payment of these taxes to the federal government whether or not you col-
lect them from your employees. For example, if you withhold less than the correct tax from an employee’s wages, you are still liable for the full amount. You must also pay the employer’s share of social security and Medicare taxes.

Form 943. Report withheld federal income tax and social security and Medicare taxes on Form 943. Your 2009 Form 943 is due by Febru-
ary 1, 2010 (or February 10, 2010, if you made deposits in time on full payment of the taxes due for the year).

Deposits. Generally, you must deposit both the employer and employee shares of social security and Medicare taxes and federal income tax withheld (minus any advance earned income credit payments) during the year. However, you may make payments with Form 943 instead of depositing them if you accumulate less than a $2,500 tax liability during the year (line 11 of Form 943) and you pay in full with a timely filed return.

For more information on deposit rules, see Publication 51 (Circular A).

Electronic Federal Tax Payment System (EFTPS). You may have to deposit taxes us-
ing EFTPS. You must use EFTPS to make de-
posits of all depository tax liabilities (including social security, Medicare, withheld federal in-
come, excise, and alternative minimum tax), on which you incurred in 2010 if you deposited more than $200,000 in federal depository taxes in 2008. If you first meet the $200,000 threshold in 2009, you must begin depositing using EFTPS in 2011. Once you meet the $200,000 threshold, you must continue to make deposits using
EFTPS in later years even if subsequent deposits are less than the $200,000 threshold. If you must use EFTPS but fail to do so, you may be subject to a 10% penalty.

If you do not have to use EFTPS because you did not meet the $200,000 threshold, you can voluntarily make deposits using EFTPS. If you are using EFTPS voluntarily, you will not be subject to the 10% penalty if you make a deposit using a paper coupon.

For information about EFTPS 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 you are responsible for withholding, accounting for, depositing, or paying federal withholding taxes and willfully fail to do so, you can be held liable for a penalty equal to the withheld tax not paid. A responsible person can be an officer of a corporation, a partner, a sole proprietor, or an employee of any form of business. A trustee or agent with authority over the funds of the business can also be held responsible for the penalty.

Willfully means voluntarily, consciously, and intentionally. Paying other expenses of the business instead of the taxes due is acting willfully.

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

Federal Unemployment (FUTA) Tax

You must pay FUTA tax if you meet either of the following tests.

- You paid cash wages of $20,000 or more 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-2(A) visa workers") are exempt from FUTA tax. However, include your employment of these workers and the wages you paid them to determine whether you meet either test above.

Commodity wages. Payments in kind for farm labor are not cash wages. Do not count them to figure whether you are subject to FUTA tax or to figure how much tax you owe.

Tax rate and credit. The gross FUTA tax is 6.2% of the first $7,000 cash wages you pay to each employee. However, if you are given a credit of up to 5.4% for the state unemployment tax you pay, the net tax rate, therefore, can be as low as 0.8% (6.2% − 5.4%). If your state tax rate (experience rate) is less than 5.4%, you may still be allowed the full 5.4% credit.

If you do not pay the state tax, you cannot take the credit. If you are exempt from state unemployment tax for any reason, the full 6.2% rate applies. See the Instructions for Form 940 for additional information.

More information. For more information on FUTA tax, see Publication 51 (Circular A).

Reporting and Paying FUTA Tax

The FUTA tax is imposed on you as the employer. In this case, you must not be collected or deducted from the wages of your employees.

Form 940. Report FUTA tax on Form 940. The 2009 Form 940 is due February 1, 2010 (or February 10, 2010, if you timely deposited the full amount of your 2009 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 can 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 February 1, 2010, 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

Reminders

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.

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.

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, Excise Taxes, 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
- Form (and Instructions) 720 Quarterly Federal Excise Tax Return
- 4136 Credit for Federal Tax Paid on Fuels
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, 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.

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 to cut trees or to prepare (other than sawing logs into lumber, chopping, 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 pesticides, below. If the other person performs any other services for you on your farm for purposes not included in list items (1) or (2) above, 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), above.

Buyer of fuel, including undyed diesel fuel or undyed kerosene. If doubt exists whether the owner, tenant, or operator of the farm bought the fuel, determines 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 gasoil 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 pesticides. 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 Publication 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 any of the following ways:

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

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

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 Fuel1</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 and undyed kerosene</td>
<td>Credit or refund by the farmer only</td>
<td>Credit or refund2</td>
<td>Credit or refund2</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)2</td>
<td>Credit or refund by the farmer only</td>
<td>Credit or refund</td>
<td>None</td>
</tr>
</tbody>
</table>

1For a use other than as fuel in a propulsion engine.
2Applicable 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.

Chapter 14 Excise Taxes Page 81
Table 14-2. 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>
<tr>
<td><strong>Note</strong>: You may carry over an amount less than $750 to the next quarter.</td>
<td></td>
</tr>
</tbody>
</table>

1. Certain special fuel taxes (including some fuels used in off-highway business use) are not refundable. Amounts paid to claim these taxes are included in the claim for fuel tax credit on Form 4136. Amounts paid for fuels sold for use) in operating the truck on the highway after the first violatio on the highway, the $1,000 portion of the penalty increases depending on the number of violations. For more information on this penalty, see Publication 510.

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.
- 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 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.

### 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.

### Credits and Refunds

- 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.

### Other Payments

You may 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 “Credits 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.
- **Partnerships.** 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.
- **Other entities.** Corporations, S corporations, farmers’ cooperative associations, and trusts make the claim on the appropriate line of their income tax return.
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 525 for the estimated tax rules that apply.

Qualified Farmer

An individual is a qualified farmer for 2009 if at least two-thirds of his or her gross income from all sources for 2008 or 2009 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 income to your gross income. To decide whether two-thirds of your gross income for 2009 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.
- Taxable refunds, credits, or offsets of state and local income taxes from Form 1040, line 10.
- Alimony from Form 1040, line 11.
- Gross business income from Schedule C (Form 1040), line 7.
- Gross business receipts from Schedule C-EZ (Form 1040), line 1.
- Capital gains from Form 1040, line 13, including gains from Schedule D (Form 1040). Losses are not netted against gains.
- Gains on sales of business property from Form 1040, line 14.
- Taxable IRA distributions, pensions, annuities, and social security benefits from Form 1040, lines 15b, 16b, and 20b.
- 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.

Included in gross income are gains or losses from the sale or exchange of capital assets of a business. See year 2009 was from farming. See also Percentage From Farming, later, for information on how to determine the percentage of your gross income from farming.

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 withholdings). If you are a qualified farmer, defined below, 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 Fisheremen

See chapter 16 for information about getting publications and forms.
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 culti-
vating the soil or raising agricultural commodi-
ties. 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. • Income from a Real Estate Mortgage In-
vestment Conduit reported on Schedule E (Form 1040), line 59. • Gross farm rental income from Form 4385, line 7. • Gross farm income from Schedule F (Form 1040), line 11. • Your distributive share of gross income from a partnership, or limited liability com-
pany treated as a partnership, from Schedule K-1 (Form 1066). • 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.

Example 1. Jane Smith had the following total gross income and farm gross income amounts in 2009.

<table>
<thead>
<tr>
<th>Gross Income</th>
<th>Farm</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxable interest</td>
<td>$3,000</td>
</tr>
<tr>
<td>Dividends</td>
<td>$500</td>
</tr>
<tr>
<td>Rental income (Sch E)</td>
<td>$41,500</td>
</tr>
<tr>
<td>Farm income (Sch F)</td>
<td>$75,000</td>
</tr>
<tr>
<td>Gain (Form 4797)</td>
<td>$5,000</td>
</tr>
<tr>
<td>Total</td>
<td>$125,000</td>
</tr>
</tbody>
</table>

Gross 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.

Special Rules for Qualified Farmers

The following special estimated tax rules apply if you are a qualified farmer for 2009.

• You do not have to pay estimated tax if you file your 2009 tax return and pay all the tax due by March 1, 2010. • You do not have to pay estimated tax if you expect your 2009 income tax with-
holding (including any amount applied to your 2009 estimated tax from your 2008 return) to be at least 66 2/3% (0.6667) of the total tax to be shown on your 2009 tax return or 100% of the total tax shown on your 2008 return.

• If you must pay estimated tax, you are required to make only one estimated tax payment (your required annual payment) by January 15, 2010, using special rules to figure the amount of the payment. See Required Annual Payment, next, for de-
tails.

Figure 15-1 presents an overview of the spe-
cial estimated tax rules that apply to qualified farmers.

Example 2. Assume the same facts as in Example 1. Ms. Smith’s gross farm income is only 64% of her total income. Therefore, based on her 2009 income, she does not qualify to use the special estimated tax rules for qualified farm-
ers. However, she does qualify if at least two-thirds of her 2008 gross income was from farming.

Example 3. 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,
since 67.9% (at least two-thirds) of her gross income is from farming ($95,000 ÷ $140,000 = .679).

**Required Annual Payment**

If you are a qualified farmer and must pay estimated tax for 2009, 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 13b by 66.7% (the rate for qualified farmers).
- On line 14b, enter 100% of the tax shown on your 2008 tax return regardless of the amount of your adjusted gross income. For this purpose, the "tax shown on your 2008 tax return" is the amount on line 61 of your 2008 return modified by certain adjustments. For more information, see chapter 4 of Publication 505.

**Estimated Tax Penalty for 2009**

If you do not pay all your required estimated tax for 2009 by January 15, 2010, or file your 2009 return and pay the tax by March 1, 2010, you should use Form 2210-F, Underpayment of Estimated Tax by Farmers and Fisherwomen, 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, 2010, 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. **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 employee assists 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. Here are seven things every taxpayer should know about TAS:

- TAS is your voice at the IRS.
- Our service is free, confidential, and tailored to meet your needs.
- You may be eligible for TAS help if you have tried to resolve your tax problem through normal IRS channels and have gotten nowhere, or you believe an IRS procedure just isn’t working as it should.
- TAS helps taxpayers whose problems are causing financial difficulty or significant cost, including the cost of professional representation. This includes businesses as well as individuals.
- TAS employees know the IRS and how to navigate it. We will listen to your problem, help you understand what needs to be done to resolve it, and stay with you every step of the way until your problem is resolved.
- TAS has at least one local taxpayer advocate in every state, the District of Columbia, and Puerto Rico. You can call your local advocate, whose number is in your phone book, in Pub. 1546, Taxpayer Advocate Service—Your Voice at the IRS, and on our website at www.irs.gov/advocate. You can also call our toll-free line at 1-877-777-4778 or TTY/TDD 1-800-829-4059.
- You can learn about your rights and responsibilities as a taxpayer by visiting our online tax toolkit at www.taxtoolkit.irs.gov.

**Low Income Taxpayer Clinics (LITCs)**

The Low Income Taxpayer Clinic program serves individuals who have a problem with the IRS and whose income is below a certain level. LITCs are independent from the IRS. Most LITCs can provide representation before the IRS or in court on audits, tax collection disputes, and other issues for free or a small fee. If an individual’s native language is not English, some clinics can provide multilingual information about taxpayer rights and responsibilities. For more information, see Publication 4134, Low Income Taxpayer Clinic List. This publication is available at www.irs.gov, by calling 1-800-TAX-FORM (1-800-829-3676), 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 information sources, including publications, services, and free tax education and assistance programs. It also has an index of over 100 TeleTax topics (recorded tax information) you can listen to on your telephone. Accessible versions of IRS published products are available on request in a variety of alternative formats for people with disabilities.

**Free help with your return.** Free help in preparing your return is available nationwide from IRS-trained volunteers. The Volunteer Income Tax Assistance (VITA) program is designed to help low-income taxpayers and the Tax Counseling for the Elderly (TCE) program is designed to assist taxpayers age 60 and older with their tax returns. Many VITA sites offer free electronic filing and all volunteers will let you know about credits and deductions you may be entitled to claim. To find the nearest VITA or TCE site, call 1-800-829-1040.

As part of the TCE program, AARP offers the Tax-Aide counseling program. To find the nearest AARP Tax-Aide site, call 1-888-227-7669 or visit AARP’s website at www.aarp.org/money/taxaide.

For more information on these programs, go to www.irs.gov and enter keyword “VITA” in the upper right-hand corner.

**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 2009 refund. Go to www.irs.gov and click on Where’s My Refund? Wait at least 72 hours after the IRS acknowledges receipt of your e-filed return, or 3 to 4 weeks after mailing a paper return. If you filed Form 8379 with your return, wait 14 weeks (11 weeks if you e-filed your return electronically). Have your 2009 tax return available so you can provide 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.
- Use the online Internal Revenue Code, Regulations, or other official guidance.
- View Internal Revenue Bulletins (IRBs) published in the last few years.
- Figure your withholding allowances using the withholding calculator online at www.irs.gov/withholding.
• Determine if Form 6251 must be filed by 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-TAX FORM (1-800-829-3676) to order current-year forms, instructions, and publications, and prior-year forms and instructions. You should receive your order within 10 days.
• Asking tax questions. Call the IRS with your tax questions at 1-800-829-1040.
• Solving problems. You can get face-to-face help solving tax problems every business day in IRS Taxpayer Assistance Centers. An employee can explain IRS letters, request adjustments to your account, or help you set up a payment plan. Call your local Taxpayer Assistance Center for an appointment. To find the number, go to www.irs.gov/localcontacts or look in the phone book under United States Government, Internal Revenue Service.
• TTY/TDD equipment. If you have access to TTY/TDD equipment, call 1-800-829-4059 to ask tax questions or to order forms and publications.
• TeleTax topics. Call 1-800-829-4477 to listen to pre-recorded messages covering various tax topics.
• Refund information. To check the status of your 2009 refund, call 1-800-829-1954 during business hours or 1-800-829-4477 (automated refund information 24 hours a day, 7 days a week). Wait at least 72 hours after the IRS acknowledges receipt of your e-filed return, or 3 to 4 weeks after mailing a paper return. If you filed Form 8379 with your return, wait 14 weeks (11 weeks if you filed electronically). Have your 2009 tax return available so you can provide your social security number, your filing status, and the exact whole dollar amount of your refund. Refunds are sent out weekly on Fridays. If you check the status of your refund and are not given the date it will be issued, please wait until the next week before checking back.
• Other refund information. To check the status of a prior year refund or amended return refund, call 1-800-829-1954.

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 Bulletin 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 are 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—just walk in. If you prefer, you can call your local Center and leave a message requesting an appointment to resolve a tax account issue. A representative will call you back within 2 business days to schedule an in-person appointment at your convenience. If you have an ongoing, complex tax account problem or a special need, such as a disability, an appointment can be requested. All other issues will be handled without an appointment. To find the number of your local office, go to www.irs.gov/localcontacts or look in the phone book under United States Government, Internal Revenue Service.

Internal Revenue Service
1201 N. Mitsubishi Motorway
Bloomington, IL 61705-6613

DVD for tax products. You can order Publication 1796, IRS Tax Products DVD, and obtain:
• Current-year forms, instructions, and publications.
• Prior-year forms, instructions, and publications.
• Tax Map: an electronic research tool and finding aid.
• Tax law frequently asked questions.
• Tax Topics from the IRS telephone response system.
• Internal Revenue Code—Title 26 of the U.S. Code.
• Fill-in, print, and save features for most tax forms.
• Internal Revenue Bulletins.
• Toll-free and email technical support.
• Two releases during the year.
  – The first release will ship the beginning of January 2010.
  – The final release will ship the beginning of March 2010.

Purchase the DVD from National Technical Information Service (NTIS) at www.irs.gov/cdorders for $30 (no handling fee) or call 1-877-233-6767 toll free to buy the DVD for $30 (plus a $6 handling fee).
To help us develop a more useful index, please let us know if you have ideas for index entries. See “Comments and Suggestions” in the “Introduction” for the ways you can reach us.

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