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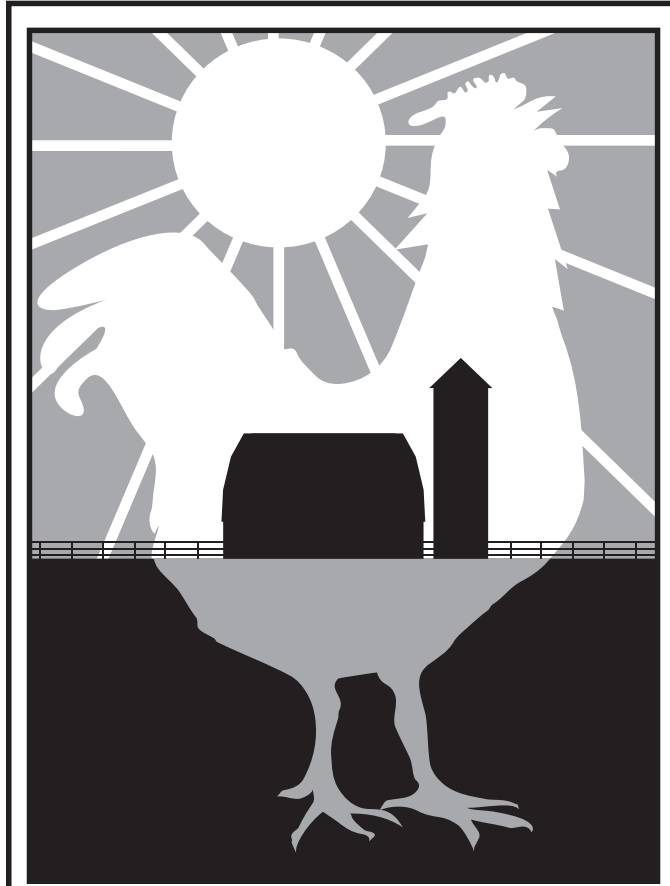
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# Farmer's Tax Guide

For use in preparing  
**2001** Returns

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



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## Contents

Introduction . . . . .	1
Important Changes for 2001 . . . . .	2
Important Changes for 2002 . . . . .	2
Important Reminders . . . . .	2
Important Dates . . . . .	3
<b>Chapter</b>	
1. Importance of Good Records . . . . .	4
2. Filing Requirements and Return Forms . . . . .	6
3. Accounting Periods and Methods . . . . .	11
4. Farm Income . . . . .	14
5. Farm Business Expenses . . . . .	24
6. Soil and Water Conservation Expenses . . . . .	32
7. Basis of Assets . . . . .	35
8. Depreciation, Depletion, and Amortization . . . . .	40
9. General Business Credit . . . . .	55
10. Gains and Losses . . . . .	57
11. Dispositions of Property Used in Farming . . . . .	66
12. Installment Sales . . . . .	70
13. Casualties, Thefts, and Condemnations . . . . .	75
14. Alternative Minimum Tax . . . . .	80
15. Self-Employment Tax . . . . .	82
16. Employment Taxes . . . . .	86
17. Retirement Plans . . . . .	91
18. Excise Taxes . . . . .	96
19. Your Rights as a Taxpayer . . . . .	100
20. Sample Return . . . . .	101
21. How To Get Tax Help . . . . .	120
Index . . . . .	121

## Introduction

You are in the business of farming if you cultivate, operate, or manage a farm for profit, either as owner or tenant. A farm includes stock, dairy, poultry, fish, fruit, and truck farms. It also includes plantations, ranches, ranges, and orchards.

This publication explains how the federal tax laws apply to farming. Use this publication as a guide to figure your taxes and complete your farm tax return. If you need more information on a subject, get the specific IRS tax publication covering that subject. We refer to many of these free publications throughout this publication. See chapter 21 for information on ordering these publications.

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

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

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

You can e-mail us while visiting our web site at [www.irs.gov](http://www.irs.gov).

You can write to us at the following address:

Internal Revenue Service  
Technical Publications Branch  
W:CAR:MP:FP:P  
1111 Constitution Ave. NW  
Washington, DC 20224

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

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

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## Important Changes for 2001

The following items highlight a number of administrative and tax law changes for 2001. They are discussed in more detail throughout the publication. More information on these and other changes can be found in Publication 553, *Highlights of 2001 Tax Changes*.

**Depreciation limits on business cars.** The total section 179 deduction and depreciation you can take on a car you use in your business and first place in service in 2001 is \$3,060. Special rules apply to certain clean-fuel vehicles. See chapter 8.

**Child tax credit.** For 2001, the child tax credit was increased. You may be able to take a credit of up to \$600 for each qualifying child. See your income tax package for details.

**Earned income credit.** The maximum earned income credit has been increased for 2001. To claim the credit, you must have earned income (including net earnings from self-employment) and modified adjusted gross income of less than \$32,121 and meet certain other requirements. For more information, including what counts as earned income, see Publication 596, *Earned Income Credit (EIC)*.

**Lower capital gain tax rate.** The capital gain tax rates for "qualified 5-year gain" have been lowered. See chapter 10.

**Section 179 deduction.** For 2001 and 2002, the total cost you can elect to deduct under section 179 of the Internal Revenue Code is increased to \$24,000. See chapter 8.

**Self-employed health insurance deduction.** The part of your self-employed health insurance premiums you can deduct as an adjustment to income is 60% for 2001. See chapter 5.

**Standard mileage rate.** The standard mileage rate for the cost of operating your car, van, pickup, or panel truck in 2001 is 34½ cents a mile for all business miles. See chapter 5.

**Tax rates and maximum net earnings for self-employment tax.** The maximum net self-employment earnings subject to the social security part (12.4%) of the self-employment tax increased to \$80,400 for 2001. There is no maximum limit on earnings subject to the Medicare part (2.9%). See chapter 15.

**Postponed tax deadlines in disaster areas.** The IRS may postpone for up to 120 days certain tax deadlines of taxpayers who are affected by a Presidentially declared disaster. The tax deadlines the IRS may postpone include those for filing income and employment tax returns, paying income and employment taxes, and making contributions to a traditional IRA or Roth IRA. See chapter 13.

**Marginal production of oil and gas.** The suspension of the taxable income limit on percentage depletion from the marginal production of oil and natural gas that was scheduled to expire for tax years beginning after 1999 has been extended to tax years beginning before 2002. For more information on marginal production, see section 613A(c) of the Internal Revenue Code.

**Accrual basis taxpayers.** For sales occurring after December 16, 1999, accrual basis taxpayers were required to report installment sales under an accrual method of accounting. The Installment Tax Correction Act of December 28, 2000, repealed that requirement.

If you entered into an installment sale after December 16, 1999, and reported it under an accrual method on your income tax return filed by April 16, 2001, you can revoke your effective election not to use the installment method. To revoke the election, you must file an amended return for the year of the installment sale (and any other year affected by the sale) reporting the gain on the installment method. See chapter 12 for information on installment sales.

**Backup withholding.** For amounts paid after December 31, 2001, the backup withholding rate is decreased to 30%. See chapter 2.

**Third party designee.** Beginning with your tax return for 2001, you can check the "Yes" box in the "Third Party Designee" area of your return to authorize the IRS to discuss your return with a friend, family member, or any other person you choose. This allows the IRS to call the person you identified as your designee to ask any questions that may arise during the processing of your return. It also allows your designee to perform certain actions. See your income tax package for details.

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## Important Changes for 2002

The following items highlight a number of administrative and tax law changes for 2002. More information on these and other changes can be found in Publication 553, *Highlights of 2001 Tax Changes*.

**Maximum net earnings for self-employment tax.** The maximum net self-employment earnings subject to the social security part of the self-employment tax for 2002 will be published in Publications 533 and 553. There is no maximum limit on earnings subject to the Medicare part.

**Wage limits for social security and Medicare taxes.** The maximum wages subject to the social security tax for 2002 will be published in Publication 51, *Circular A, Agricultural Employer's Tax Guide*. There is no limit on wages subject to the Medicare tax.

**Self-employed health insurance deduction.** The part of your self-employed health insurance premiums you can deduct as an adjustment to income is 70% for 2002. See chapter 5.

**Retirement plans.** Many changes to the tax laws for retirement plans were made by the Economic Growth and Tax Relief Reconciliation Act of 2001 that was enacted on June 7, 2001. However, most of those changes do not take effect until after December 31, 2001, and are not covered in this publication. For information about those changes, see Publication 560, *Retirement Plans for Small Business*, or Publication 553, *Highlights of 2001 Tax Changes*.

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## Important Reminders

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

**Photographs of missing children.** The Internal Revenue Service is a proud partner with the National Center for Missing and Exploited Children. Photographs of missing children selected by the Center may appear in this publication on pages that would otherwise be blank. You can help bring these children home by looking at the photographs and calling **1-800-THE-LOST (1-800-843-5678)** if you recognize a child.

**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,

since 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.

**Business use of your home.** You may be able to deduct expenses for your home office even if it is not where you perform your most important business activities or spend most of your business time. See chapter 5.

**Estimated tax.** When you figure your estimated tax, you must include any alternative minimum tax you expect to owe. See chapter 14 and Publication 505.

**Averaging of farm income.** You, as an individual farmer, can choose to average all or part of your taxable farm income when you figure your income tax. If you average your income, you may be able to use a negative taxable income amount for a base year when figuring your tax on Schedule J (Form 1040). See chapter 4.

**Voluntary withholding.** You can request income tax withholding from the following payments on Form W-4V, *Voluntary Withholding Request*.

- 1) Commodity Credit Corporation (CCC) loans.
- 2) Certain crop disaster payments received under the Agricultural Act of 1949 or title II of the Disaster Assistance Act of 1988.
- 3) Social security benefits.
- 4) Unemployment compensation.
- 5) Certain other government payments.

See chapter 4 for information on CCC loans and disaster relief payments.

**Direct deposit of refund.** If you are due a refund on your tax return, you can have it deposited directly into your account at a bank or other financial institution. See your income tax package for details.

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

**Written tax questions.** You can send written tax questions to the IRS. You should get an answer in about 30 days. Call 1-800-829-1040 if you need the address. Do not send questions with your 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.

- 1) Use an authorized IRS *e-file* provider.
- 2) Use a personal computer.
- 3) Use a telephone if you receive a Telefile Tax Package.
- 4) Visit a VITA or TCE site.
- 5) Use an employer or financial institution.

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

**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 2002 and thereafter if you deposited more than \$200,000 in federal depository taxes in 2000 or you had to use EFTPS in 2001. See chapter 16.

**Overdue tax bill.** If you receive a bill for overdue taxes, do not ignore it. If you owe the tax shown on the bill, you should make arrangements to pay it. If you believe it is incorrect, contact the IRS immediately to suspend action until the mistake is corrected. See Publication 594, *The IRS Collection Process*, for more information.

**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,
- Send an e-mail to [ombudsman@sba.gov](mailto:ombudsman@sba.gov), or
- Download the appraisal form at [www.sba.gov/regfair](http://www.sba.gov/regfair).

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

**Publication on employer identification numbers (EIN).** Publication 1635, *Understanding Your EIN*, provides general information on employer identification numbers. Topics include how to apply for an EIN and how to complete Form SS-4.

**Form W-4 for 2002.** You should make new Forms W-4 available to your employees and encourage them to check their income tax withholding for 2002. Those employees who owed a large amount of tax or received a large refund for 2001 may need to file a new Form W-4. See Publication 919, *How Do I Adjust My Tax Withholding*.

**Earned income credit.** You, as an employer, must notify employees who worked for you and from whom you did not withhold income tax about the earned income credit. See chapter 16.

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

**Children employed by parents.** Wages you pay to your children age 18 and older for services in your trade or business are subject to

social security and Medicare taxes. See chapter 16.

**Farmers and crew leaders must withhold income tax.** Farmers and crew leaders must withhold federal income tax from farm workers who are subject to social security and Medicare taxes. See chapter 16.

**Social security tests for seasonal farm workers.** If you pay seasonal farm workers less than \$150 in annual cash wages, the wages are not subject to social security and Medicare taxes, even if you pay \$2,500 or more to all your farm workers. The seasonal farm worker must meet certain tests. See chapter 16.

**Medical savings accounts (MSAs).** If you are covered only under a high deductible health plan, you may be able to participate in an Archer MSA program. You can deduct contributions to your Archer MSA even if you do not itemize your deductions. See Publication 969, *Medical Savings Accounts (MSAs)*.

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## Important Dates

You should take the action indicated on or before the dates listed. Saturdays, Sundays, and legal holidays have been taken into account, but statewide holidays have not. A statewide legal holiday delays a due date only if the IRS office where you are required to file is located in that state.

Due dates for deposits of withheld income taxes, social security taxes, and Medicare taxes are not listed here. For these dates, see Publication 509, *Tax Calendars for 2002*.

**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.

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## 2002 Calendar Year

### During January

**Farm employers.** Give your employees their copies of Form W-2 for 2001 by January 31, 2002.

### January 15

**Farmers.** Pay your estimated tax for 2001 using Form 1040-ES. You have until April 15 to file your 2001 income tax return (Form 1040). If you do not pay your estimated tax by January 15, you must file your 2001 return and pay any tax due by March 1, 2002, to avoid an estimated tax penalty.

### January 31

**Farm employers.** Give your employees their copies of Form W-2 for 2001.

**Social security, Medicare, and withheld income tax.** File Form 943 to report social

security and Medicare taxes and withheld income tax for 2001. Deposit any undeposited tax. (If your tax liability is less than \$2,500, you can pay it in full with a timely filed return.) If you deposited the tax for the year in full and on time, you have until February 11 to file the return. (Do not report wages for nonagricultural services on Form 943.)

**All farm businesses.** Give annual information statements to recipients of certain payments you made during 2001. You can use the appropriate version of Form 1099 or other information return. For more information, see *Information Returns* in chapter 2.

**Federal unemployment (FUTA) tax.** File Form 940 (or 940-EZ) for 2001. If your undeposited tax is \$100 or less, you can either pay it with your return or deposit it. If it is more than \$100, you must deposit it. However, if you deposited the tax for the year in full and on time, you have until February 11 to file the return. For more information on FUTA tax, see chapter 16.

## February 11

**Social security, Medicare, and withheld income tax.** File Form 943 to report social security, Medicare, and withheld income tax for 2001. This due date applies only if you deposited the tax for the year in full and on time.

**Federal unemployment (FUTA) tax.** File Form 940 (or 940-EZ) for 2001. This due date applies only if you deposited the tax for the year in full and on time.

## February 28

**All farm businesses.** File information returns (Form 1099) for certain payments you made during 2001. There are different forms for different types of payments. Use a separate Form 1096 to summarize and transmit the forms for different types of payments.

If you file Forms 1099 electronically (not by magnetic media), your due date for filing them with the IRS is extended to April 1. The due date for giving the recipient these forms is still January 31.

**Farm employers.** File Form W-3, *Transmittal of Wage and Tax Statements*, along with Copy A of all the Forms W-2 you issued for 2001.

If you file Forms W-2 electronically (not by magnetic media), your due date for filing them with the Social Security Administration (SSA) is extended to April 1. The due date for giving the recipient these forms is still January 31.

For more information, see *Form W-2* under *Information Returns* in chapter 2.

## March 1

**Farmers.** File your 2001 income tax return (Form 1040) and pay any tax due. However, you have until April 15 to file if you paid your 2001 estimated tax by January 15, 2002.

## March 15

**Corporations.** File a 2001 calendar year income tax return (Form 1120 or 1120-A) and pay any tax due. For more information, see *Paying and Filing Income Taxes* in Publication 542, *Corporations*.

## April 1

**Electronic filing of Forms 1099 and W-2.** File Forms 1099 with the IRS and Forms W-2 with the SSA. This due date applies only if you file electronically (not by magnetic media). Otherwise, the due date is February 28.

The due date for giving the recipient these forms is still January 31.

For information about filing Forms 1099 electronically, see Publication 1220, *Specifications for Filing Forms 1098, 1099, 5498, and W-2 Magnetically or Electronically*. For information about filing Forms W-2 electronically with the Social Security Administration, call 1-800-772-6270.

## April 15

**Farmers.** File an income tax return (Form 1040) for 2001 and pay any tax due if you did not file by March 1.

**Partnerships.** File a 2001 calendar year return (Form 1065). For more information, see *Partnership Return (Form 1065)* in Publication 541, *Partnerships*.

## April 30

**Federal unemployment (FUTA) tax.** If you are liable for FUTA tax, deposit the tax owed through March if more than \$100.

## July 31

**Federal unemployment (FUTA) tax.** If you are liable for FUTA tax, deposit the tax owed through June if more than \$100.

## October 31

**Federal unemployment (FUTA) tax.** If you are liable for FUTA tax, deposit the tax owed through September if more than \$100.

# 1.

## Importance of Good Records

### Introduction

A farmer, like other taxpayers, must keep records to prepare an accurate income tax return and determine the correct amount of tax. This

chapter explains why you must keep records, what kinds of records you must keep, and how long you must keep them for federal tax purposes.

Tax records are not the only type of records you need to keep for your farming business. You should also keep records that measure your farm's financial performance. This publication only discusses tax records.



For information on financial record-keeping, you may want to get a copy of *Financial Guidelines for Agricultural Producers*. You can order it from Countryside Marketing, Inc., by calling 1-630-637-0199 or you can write to:

Farm Financial Standards Council  
PMB 316  
1212 S. Naper Blvd., #119  
Naperville, IL 60540



You can also download the publication at [www.ffsc.org](http://www.ffsc.org).

### Topics

This chapter discusses:

- Why you should keep records
- What records to keep
- How long to keep records

### Useful Items

You may want to see:

#### Publication

- ❑ 51 Circular A, *Agricultural Employer's Tax Guide*
- ❑ 463 *Travel, Entertainment, Gift, and Car Expenses*

See chapter 21 for information about getting publications.

## Why Keep Records?

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

**Monitor the progress of your farming business.** You need good 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. Good records can increase the likelihood of business success.

**Prepare your financial statements.** You need good 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.

**Identify source of receipts.** You will receive money or property from many sources. Your records can identify the source of your receipts. You need this information to separate farm from nonfarm receipts and taxable from nontaxable income.



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

**Prepare your tax returns.** You need good records to prepare your tax return. These 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 special kind of records. You can choose any recordkeeping system suited to your farming business that clearly shows 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 3. 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. They must show your gross income, as well as your deductions and credits. In addition, you must keep supporting documents. Purchases, sales, payroll, and other transactions you have in your business generate supporting documents such as invoices and receipts. These documents contain the information you need to record in your journals and ledgers.

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

**Travel, transportation, entertainment, and gift expenses.** Special 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 18 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.

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

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



*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.*

## How Long To Keep Records

You must keep your records as long as they may be needed for the administration of any provi-

sion of the Internal Revenue Code. Generally, this means you must keep records that support an item of income or deduction on a return until the period of limitations for that return runs out.

The period of limitations is the period of time in which you can amend your return to claim a credit or refund or the IRS can assess additional tax. The following table contains the periods of limitations that apply to income tax returns. Unless otherwise stated, the years refer to the period beginning after the return was filed. Returns filed before the due date are treated as being filed on the due date.

IF you...	THEN the period is...
1 Owe additional tax and (2), (3), and (4) do not apply to you	3 years
2 Do not report income that you should report and it is more than 25% of the gross income shown on your return	6 years
3 File a fraudulent return	No limit
4 Do not file a return	No limit
5 File a claim for credit or refund after you filed your return	Later of 3 years or 2 years after tax was paid
6 File a claim for a loss from worthless securities	7 years



*Keep copies of your filed tax returns. They help in preparing future tax returns and making computations if you later file an amended return.*

**Employment taxes.** If you have employees, you must keep all employment tax records for at least 4 years after the date the tax becomes due or is paid, whichever is later.

**Assets.** Keep records relating to property until the period of limitations expires for the year in which you dispose of the property in a taxable disposition. You must keep these records to figure any depreciation, amortization, or depletion deduction and to figure your basis for computing gain or loss when you sell or otherwise dispose of the property.

Generally, if you receive property in a nontaxable exchange, your basis in that property is the same as the basis of the property you gave up, increased by any money you paid. You must keep the records on the old property, as well as on the new property, until the period of limitations expires for the year in which you dispose of the new property in a taxable disposition.

**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.

# Filing Requirements and Return Forms

## Important Change for 2002

**Backup withholding.** For amounts paid after December 31, 2001, the backup withholding rate is decreased from 31% to 30%. See *Backup withholding* under *Information Returns*.

## Important Reminder

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

## Introduction

If you are a citizen or resident of the United States and your gross income for the tax year is at least the amount shown for your status under *Filing Requirements*, later, you must file a 2001 federal income tax return. This is true even if no tax is due. Gross income is explained later.

If you do not meet the gross income requirement, you may still need to file a tax return if any of the following apply.

- You have net earnings of \$400 or more from self-employment.
- You are entitled to certain credits.
- You are entitled to a complete refund of tax withheld.

If you are a “qualified” farmer, defined later, you are subject to the special rules covered in this chapter for paying estimated tax and filing your tax return. This chapter also includes information about various forms and returns you may need to file.

## Topics

This chapter discusses:

- Filing requirements
- Taxpayer identification number
- Estimated tax payment and return due dates
- Forms you may need to file

- Partnership
- Limited liability company (LLC)
- Corporation
- S corporation

## Useful Items

You may want to see:

### Publication

- 505** Tax Withholding and Estimated Tax
- 541** Partnerships
- 542** Corporations

### Form (and Instructions)

We have not listed the various forms you may have to file with the IRS because they are discussed later in this chapter under *Forms You May Need To File*.

See chapter 21 for information about getting publications and forms.

## Filing Requirements

The following table will help you determine whether you must file a tax return, based on your:

- Age at the end of the tax year,
- Gross income, and
- Filing status.

### Who Must File

Filing Status Is:	Income Was At Least:
<b>Single</b>	
Under 65	\$7,450
65 or older	8,550
<b>Married, filing jointly</b>	
Both under 65	13,400
One spouse 65 or older	14,300
Both 65 or older	15,200
Not living with spouse at end of year (or on date spouse died)	2,900
<b>Married, filing separately</b>	
All (any age)	2,900
<b>Head of household</b>	
Under 65	9,550
65 or older	10,650
<b>Qualifying widow(er) with dependent child</b>	
Under 65	10,500
65 or older	11,400

**Dependent's return.** If you can claim someone as a dependent on your tax return (for example, your child or parent), that person must generally also file his or her own tax return if any of the following apply.

- Your dependent had only earned income, such as salary or wages, and the total was more than \$5,650 (\$6,750 if 65 or older and blind).
- Your dependent had only unearned income, such as interest and dividends, and the total was more than \$750.

- Your dependent had both earned and unearned income, and the total was more than \$750.

**Self-employed.** You must file an income tax return if you are self-employed and you had net earnings of \$400 or more from self-employment, even if you do not otherwise have to file a return. See chapter 15.

**Certain credits.** You must also file a return if you received any advance earned income credit payments from your employer. In addition, you should file a return if you are eligible for the earned income credit or the additional child tax credit.

**Refund.** Even if you do not otherwise have to file a return, you should file one if you are due a refund of any income tax withheld.

**More information.** See the Form 1040 instructions for more information on who must file a return.

## Taxpayer Identification Number

You must enter your taxpayer identification number (generally your social security or employer identification number) on all returns, statements, or documents you file. For example, you must enter it on your federal income tax return, your estimated tax payment voucher, and all information returns, such as Forms 1096 and 1099. You may be subject to a penalty of \$50 for each failure to enter the number.

**Schedule F.** Enter your social security number (SSN) in the space provided on the first line of Schedule F. You need an employer identification number (EIN) if you have a qualified retirement plan or must file an employment, excise, estate, trust, partnership, or alcohol, tobacco, and firearms tax return. Enter that EIN on line D of Schedule F.

**Other forms and schedules.** Enter your SSN on your individual income tax return (Form 1040), schedule of self-employment tax (Schedule SE), and estimated tax payment voucher (Form 1040–ES), regardless of which number you entered on your business returns.

If you are married, enter the SSNs for you and your spouse on your Form 1040, whether filing jointly or separately. If you are filing a joint return, list the SSNs in the same order as the names are shown on your label. Also enter both SSNs on your Form 1040–ES if you make joint estimated tax payments. Enter them in the same order as they appear on the joint return.



**Applying for a social security number.** To apply for a social security number (SSN), use Form SS–5. You can get the form from any social security office, by calling 1–800–772–1213, or on the web at [www.ssa.gov](http://www.ssa.gov). If you are under 18 years of age, you must furnish evidence of age, identity, and U.S. citizenship (or lawful alien status) with your Form SS–5. If you are 18 or older, you must appear in person with this evidence at a social security office. It usually takes about 2 weeks to get an SSN.



**Applying for an employer identification number.** To apply for an employer identification number, use Form SS-4. See chapter 21 for information about ordering this form.

## Estimated Tax Payment and Return Due Dates

When you must pay estimated tax and file your tax return depends on how much of your gross income comes from farming. If you receive at least two-thirds of your total gross income from farming in the current or prior year, special estimated tax and return due dates apply to you. See the discussion under *Due Dates for Qualified Farmers*, later.

Figure 2-A presents an overview of the special estimated tax rules that apply to farmers.

### Gross Income

Gross income is all income you receive in the form of money, goods, property, and services that is not exempt from 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 2001 was from farming, use as your gross income the total of the following **income** (not loss) amounts from your tax return.

- Wages, salaries, tips, etc. from Form 1040, line 7.
- Taxable interest from Form 1040, line 8a.
- Ordinary dividends from Form 1040, line 9.
- Taxable refunds of state and local 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 4797, line 14.
- Taxable IRA distributions, pensions, annuities, and social security benefits.
- Gross rental income from Schedule E (Form 1040), line 3.
- Gross royalty income from Schedule E (Form 1040), line 4.
- Taxable net income from an estate or trust reported on Schedule E (Form 1040), line 36.
- Income from a REMIC reported on Schedule E (Form 1040), line 38.
- Gross farm rental income from Form 4835, line 7.

- Gross farm income from Schedule F (Form 1040), line 11.
- Your distributive share of gross income from a partnership, or limited liability company treated as a partnership, from Schedule K-1 (Form 1065).
- Your pro rata share of gross income from an S corporation, from Schedule K-1 (Form 1120S).
- Unemployment compensation from Form 1040, line 19.
- Other income reported on Form 1040, line 21, not included with any of the items listed above.



*Gross income is not the same as total income shown on line 22 of Form 1040.*

### Gross Income From Farming

Gross income from farming includes the following.

- Gross farm income from Schedule F (Form 1040), line 11.
- Gross farm rental income from Form 4835, line 7.
- Gross farm income from Schedule E (Form 1040), Parts II and III. See the instructions for line 41.
- Gains from the sale of livestock used for draft, breeding, sport, or dairy purposes reported on Form 4797.

For more information about income from farming, see chapter 4.



*Wages you receive as a farm employee are not farm income. Income you receive from contract grain harvesting and hauling with workers and machines you furnish is also not farm income.*

### Percentage From Farming

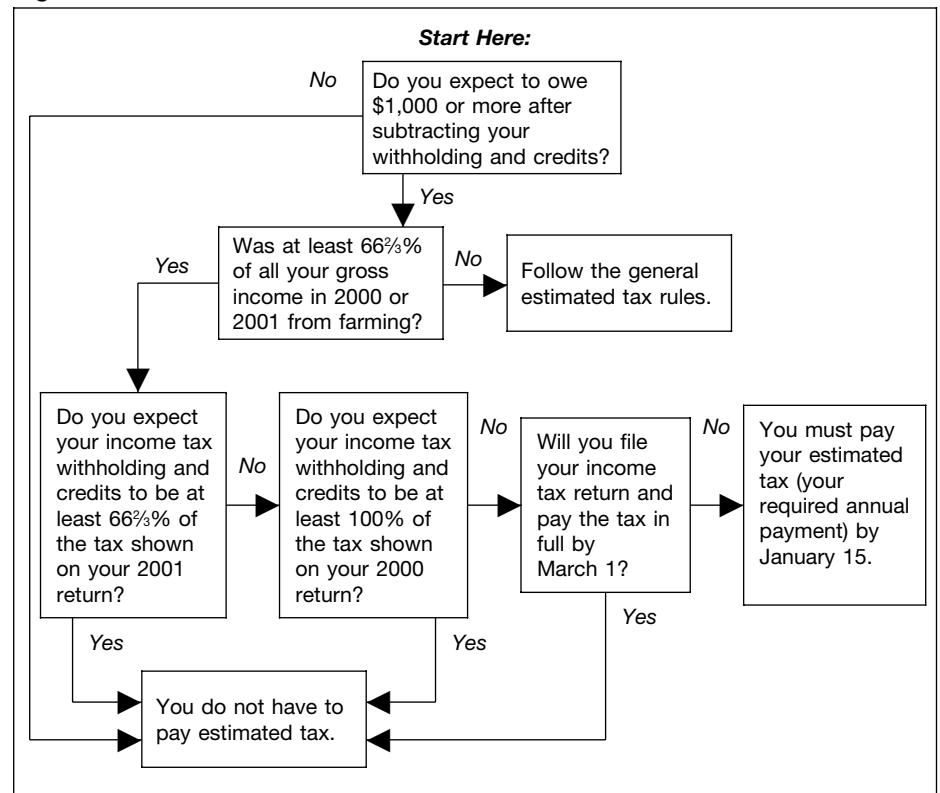
Figure your gross income from all sources. Then figure your gross income from farming. Divide your farm gross income by your total gross income to determine the percentage of gross income from farming.

**Example 1.** Jane Smith had the following total gross income and farm gross income in 2001.

	<u>Total</u>	<u>Farm</u>
Taxable interest . . . . .	\$3,000	
Dividends . . . . .	500	
Rental income (Sch E) . . . . .	41,500	
Farm income (Sch F) . . . . .	75,000	\$75,000
Gain (Form 4797) . . . . .	5,000	5,000
<b>Total . . . . .</b>	<b>\$125,000</b>	<b>\$80,000</b>

Schedule D showed gain from the sale of dairy cows carried over from Form 4797 (\$5,000) in addition to a loss from the sale of corporate stock (\$2,000). However, that loss is not netted against the gain to figure Ms. Smith's total gross income or her gross farm income. Her gross farm income is 64% of her total gross income (\$80,000 ÷ \$125,000 = 0.64). Therefore, based on her 2001 income, she does not qualify to use the special estimated tax payment and

Figure 2-A. Estimated Tax for Farmers





return due dates for 2001, discussed next. However, she does qualify if at least two-thirds of her 2000 gross income was from farming.

**Example 2.** Assume the same facts as in Example 1 except that Ms. Smith's farm income was \$90,000. This made her total gross income \$140,000 and her farm gross income \$95,000. She qualifies to use the special estimated tax payment and return due dates, discussed next, since 67.9% (at least two-thirds) of her gross income is from farming ( $\$95,000 \div \$140,000 = .679$ ).


## Due Dates for Qualified Farmers

If at least two-thirds of your gross income for 2000 or 2001 was from farming, **you are a qualified farmer** and can choose either of the following options for your 2001 tax.

- 1) Make your required annual payment, discussed next, by January 15, 2002, and file your Form 1040 by April 15, 2002.
- 2) File your Form 1040 by March 1, 2002, and pay all the tax due. You are not required to make the annual payment. If you pay all the tax due, you will not be penalized for failure to pay estimated tax.

**Required annual payment.** If at least two-thirds of your gross income for 2000 or 2001 was from farming, only one estimated tax payment is due. The required annual payment is the **smaller** of the following amounts.

- 66 $\frac{2}{3}$ % (.6667) of your total tax for 2001.
- 100% of the total tax shown on your 2000 return. (The return must cover all 12 months.)

 **2002 tax.** If at least two-thirds of your gross income for 2001 or 2002 is from farming, you can choose either of the following options.

- 1) Make your required annual payment by January 15, 2003, and file your Form 1040 by April 15, 2003.
- 2) File your Form 1040 by March 3, 2003, and pay all the tax due.

**Fiscal year farmers.** If you qualify to use these special rules but your tax year does not start on January 1, you can file your return and pay the tax by the first day of the 3rd month after the close of your tax year. Or you can make your required annual payment within 15 days after the end of your tax year. Then file your return and pay any balance due by the 15th day of the 4th month after the end of your tax year.

## Due Dates for Nonqualified Farmers

If less than two-thirds of your gross income for 2000 and 2001 was from farming, you cannot use these special estimated tax payment and return due dates for your 2001 tax year. Instead, you should have made quarterly estimated tax

payments on April 16, June 15, and September 17, 2001, and on January 15, 2002. You must file your return by April 15, 2002.

If less than two-thirds of your gross income for 2001 and 2002 is from farming, you cannot use these special estimated tax payment and return due dates for your 2002 tax year. You generally must make quarterly estimated tax payments on April 15, June 17, and September 16, 2002, and on January 15, 2003. You must file your return by April 15, 2003.

For more information on estimated taxes, see Publication 505.

## Estimated Tax Penalty for 2001

If you do not pay all your required estimated tax for 2001 by January 15, 2002, or file your 2001 return and pay the tax by March 1, 2002, you should use **Form 2210-F, Underpayment of Estimated Tax by Farmers and Fishermen**, to determine if you owe a penalty. If you owe a penalty but do not file Form 2210-F with your return and pay the penalty, you will get a notice from the IRS. You should pay the penalty as instructed by the notice.

If you file your return by April 15 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 test. 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 test.

## Extension of Time To File Form 1040

If you do not file your 2001 return by March 1, 2002, the due date for your return will be April 15, 2002. However, you generally can get an automatic 4-month extension of time to file your return. Your Form 1040 would then be due by August 15, 2002.

You get this extension by filing Form 4868, *Application for Automatic Extension of Time to File U.S. Individual Income Tax Return*, by April 15, 2002. You can also get an extension by using IRS **e-file**. Form 4868 does not extend the time for paying the tax. For more information, see the instructions for Form 4868.



**This extension does not extend the March 1, 2002, due date for qualified farmers who did not make the required annual payment and who want to avoid an estimated tax penalty. Therefore, if you did not make your required annual payment by January 15, 2002, and you file your tax return after March 1, 2002, you will be subject to a penalty for underpaying your estimated tax, even if you file Form 4868.**

## Forms You May Need To File

When filing your income tax return, arrange your forms and schedules in the correct order using the sequence number located in the upper right corner of each form. Attach all other statements or attachments last, arranged in the same order as the forms or schedules they support.

Farmers can use the following forms and schedules. Some of them are illustrated in chapter 20.

**Form 1040.** This form is the income tax return. List taxable income from all sources on Form 1040, including profit or loss from farming operations as figured on Schedule F (Form 1040). Figure the tax on this form, also.

**Schedule A, Itemized Deductions.** List non-business itemized deductions on this schedule.

**Schedule B, Interest and Ordinary Dividends.** Report interest or dividend income of more than \$400 on this schedule.

**Schedule C, Profit or Loss From Business.** List income and deductions and determine the net profit or loss from a nonfarm business on this schedule.

**Schedule C-EZ, Net Profit From Business.** You can use this schedule in place of Schedule C if nonfarm business expenses are \$2,500 or less and other requirements are met.

**Schedule D, Capital Gains and Losses.** Report gains and losses from the sale of capital assets on this schedule.

**Schedule E, Supplemental Income and Loss.** Report income or losses from rents, royalties, partnerships, estates, trusts, and S corporations on this schedule.

**Schedule F, Profit or Loss From Farming.** Use this schedule to list all farm income and deductions and to determine your net farm profit or loss.

**Schedule J, Farm Income Averaging.** Use this form to average farm income.

**Schedule SE, Self-Employment Tax.** Figure self-employment tax on this schedule. See chapter 15.

**Form 2210.** Figure any underpayment of estimated tax and any penalty on Form 2210, *Underpayment of Estimated Tax by Individuals, Estates, and Trusts*.

**Form 2210-F.** Figure any underpayment of estimated tax and the penalty on Form 2210-F, *Underpayment of Estimated Tax by Farmers and Fishermen*, if you are a qualified farmer.

**Form 3468.** Figure the investment credit on Form 3468, *Investment Credit*. See chapter 9.

**Form 3800.** Figure the general business credit on Form 3800, *General Business Credit*. See chapter 9.

**Form 4136.** Figure the credit for federal excise tax on gasoline and special fuels on Form 4136, *Credit for Federal Tax Paid on Fuels*. See chapter 18.



**Form 4255.** Figure the increase in tax from the recapture of investment credit on Form 4255, *Recapture of Investment Credit*. See chapter 9.

**Form 4562.** Claim deductions for depreciation and amortization and elect the section 179 deduction on Form 4562, *Depreciation and Amortization*. See chapter 8.

**Form 4684.** Report gains and losses from business and nonbusiness casualties and thefts on Form 4684, *Casualties and Thefts*. See chapter 13.

**Form 4797.** Report gains and losses from the sale or exchange of business property and from certain involuntary conversions on Form 4797, *Sales of Business Property*.

**Form 4835.** Report farm rental income on Form 4835, *Farm Rental Income and Expenses*, if you received it as a share of crops or livestock produced by a tenant and you, the landlord, did not have an arrangement that required you to materially participate or you did not materially participate in the operation or management of the farm. See chapter 4.

**Form 6251.** Figure the alternative minimum tax on Form 6251, *Alternative Minimum Tax—Individuals*. See chapter 14.

**Form 8594.** Report the purchase and sale of assets under certain circumstances on Form 8594, *Asset Allocation Statement under Sections 338 and 1060*.

**Form 8824.** Report the exchange of business or investment property for like-kind property on Form 8824, *Like-Kind Exchanges*. If you have any taxable gain, you must also file Schedule D (Form 1040) or Form 4797. See chapter 10.

## Other Forms

You may have to file the forms below in certain situations.



*If the last day for filing your form falls on a Saturday, Sunday, or legal holiday, your form will be on time if it is filed on the next business day.*

**Form 940.** If you paid wages subject to FUTA tax during a calendar year, file Form 940, *Employer's Annual Federal Unemployment (FUTA) Tax Return*, by January 31 of the following year. If all the tax due was deposited by January 31, you have 10 additional days to file. See chapter 16.

**Form 940–EZ.** Form 940–EZ is a simplified version of Form 940. See chapter 16.

**Form 943.** If you paid wages for farm labor that were subject to social security and Medicare taxes or income tax withholding, file Form 943, *Employer's Annual Tax Return for Agricultural Employees*, by January 31 of the following year. If you deposited all the tax due by January 31, you have 10 additional days to file.

**Form 1040–ES.** Figure and pay estimated tax on Form 1040–ES, *Estimated Tax for Individuals*. See *Estimated Tax Payment and Return Due Dates*, earlier.

**Form 1065.** A farm partnership files Form 1065, *U.S. Return of Partnership Income*, by the 15th day of the 4th month following the end of the partnership tax year. For a calendar year

partnership, the due date is April 15. See *Partnership*, later.

**Form 1120.** A corporation files Form 1120, *U.S. Corporation Income Tax Return*, by the 15th day of the 3rd month following the end of the corporation tax year. For a calendar year corporation, the due date is March 15. See *Corporation*, later.

**Form 1120–A.** Many small corporations can use Form 1120–A, *U.S. Corporation Short-Form Income Tax Return*, instead of Form 1120.

**Form 1120S.** An S corporation files Form 1120S, *U.S. Income Tax Return for an S Corporation*, by the 15th day of the 3rd month following the end of the S corporation tax year. For a calendar year S corporation, the due date is March 15. See *S Corporation*, later.

**Form 2290.** If you use certain vehicles registered or required to be registered in your name on public highways, such as a truck or truck tractor, file Form 2290, *Heavy Highway Vehicle Use Tax Return*, for the following purposes.

- To figure and pay the tax due on heavy highway vehicles (taxable gross weight 55,000 pounds or more) used during the period from July 1 to June 30.
- To claim suspension from the tax when the vehicle is expected to be used 5,000 miles or less (7,500 for agricultural vehicles) during the period.

See the instructions for Form 2290.

**Form 4868.** Apply for an extension of time to file your tax return on Form 4868, *Application for Automatic Extension of Time To File U.S. Individual Income Tax Return*. Filing this form **does not**, however, **extend the time to pay any tax due**.

**Form 8109.** Employment taxes are deposited manually with Form 8109, *Federal Tax Deposit Coupon*. In general, income tax withheld plus the employer and employee's share of social security and Medicare taxes that total \$2,500 or more for the year must be deposited. The IRS will send you a coupon book for making deposits 5 to 6 weeks after you receive an employer identification number (EIN) if you indicate you will pay wages.



*Under certain circumstances you must deposit taxes electronically. See chapter 16.*

**Form 8822.** If you move, notify the IRS of a change in your home or business address with Form 8822, *Change of Address*. Be sure to include your suite, room, or other unit number.

**Ordering forms.** See chapter 21 for information about getting any of the forms listed in this section.

## Information Returns

These returns provide information the IRS requires for effective tax compliance. There are many different information returns. This discussion, however, is limited to Form W–2, Form 1099–INT, Form 1099–MISC, and Form 1096.

**Form W–2.** If you are in a trade or business such as farming and you employ paid workers, prepare Form W–2, *Wage and Tax Statement*, for each employee, including any payment that was not in cash. Show, in the space marked *Wages, tips, other compensation*, the total paid to the employee. Send Copy A of each Form W–2 to the Social Security Administration with a completed Form W–3, *Transmittal of Wage and Tax Statements*, by the last day of February. See chapter 16.

**Form 1099–INT.** Report interest of \$600 or more paid during the calendar year in the course of your farm business, including interest on installment sale contracts, on Form 1099–INT, *Interest Income*.

**Form 1099–MISC.** If you make total payments of \$600 or more during the calendar year to another person, other than a corporation, in the course of your farm business, you must file information returns to report these payments. Report on Form 1099–MISC, *Miscellaneous Income*, payments of \$600 or more made for custom harvesting, crop spraying, services of a veterinarian, rents, commissions, fees, prizes, awards, and services provided by nonemployees. Payments of \$10 or more for royalties are also reported on Form 1099–MISC.

Form 1099–MISC is used to report to the payee, and to the IRS, payments you made that were subject to backup withholding and the amounts you withheld, regardless of the amount of the payment.

Report payments for compensation to employees on Form W–2, **not** on Form 1099–MISC. See chapter 16.

**Preparation of returns.** If you are required to file Forms 1099–INT or Forms 1099–MISC, prepare a separate form for each payee. File one copy of each form with the IRS by February 28 (March 31 if filing electronically) of the year following the calendar year the payments were made. Give the payee a statement (or copy of the form) by January 31 of the following year. These forms are read by machine and there are very specific instructions for their preparation and submission. See the *Instructions for Forms 1099, 1098, 5498, and W–2G*.

**Form 1096.** When sending copies to the IRS, use a separate transmittal, Form 1096, *Annual Summary and Transmittal of U.S. Information Returns*, for each different type of 1099 form.

**Penalties.** If you file information returns late, without all the information required to be on the return, or with incorrect information, you may be subject to a penalty. See the *Instructions for Forms 1099, 1098, 5498, and W–2G* for information on Form 1099 penalties.

**Backup withholding.** In certain cases, the law requires you to withhold income tax at a rate of 30% (backup withholding) on payments reportable on information returns, including commissions, nonemployee compensation, and other payments you make for services in your farm business or other business activities. The backup withholding rules do not apply to wages, pensions, or annuities.

See the *Instructions for Forms 1099, 1098, 5498, and W–2G* for more information.

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## Partnership

A partnership is the relationship between two or more persons who join to carry on a trade or business, including farming. Each person contributes money, property, labor, or skill, and expects to share in the profits and losses.

For federal income tax purposes, the term “partnership” includes a syndicate, group, pool, joint venture, or similar organization carrying on a trade or business and not classified as a trust, estate, or corporation.

**Family partnership.** Members of a family can be partners. To be recognized as a partnership for federal tax purposes, a partner relationship must be established and certain requirements must be met. For information on these requirements, see *Family Partnership* in Publication 541. Merely doing chores, helping with the harvest, or keeping house and cooking for the family and hired help does not establish a partnership.

If a husband and wife are partners in a farm operation or other business, they should report their partnership income or loss on Form 1065. See *Form 1065*, later.

**Co-ownership and sharing expenses.** Mere co-ownership of property that is maintained and leased does not constitute a partnership. For example, if an individual or tenants-in-common of farm property lease that property for a cash rental or a share of the crops, a partnership is not necessarily created. However, tenants-in-common may be partners if they actively carry on a farm or other business operation and share in its profits and losses. A joint undertaking merely to share expenses is not a partnership.

**Example.** Barbara Lee Brown and Judith Green are neighboring farmers. Each agrees to pay half the cost of buying and maintaining a combine to harvest their crops. They do not have a partnership.

**Partner’s distributive share.** Each partner’s distributive share of partnership income, gain, loss, etc., must be included on that partner’s tax return, even if the items were not distributed.

**Self-employment tax.** Unless you are a limited partner, your distributive share of income from a partnership is self-employment income. If you and your spouse are partners, each should report his or her share of partnership income or loss on a separate Schedule SE (Form 1040), *Self-Employment Tax*. This will give each of you credit for social security earnings on which retirement benefits are based. The self-employment tax of a member of a partnership engaged in farming is discussed in chapter 15.

**Selling or exchanging a partnership.** When you create a partnership, you generally do not recognize gain or loss on contributions of money or property you make to the partnership. However, you generally recognize gain or loss when you sell or exchange your interest in the partnership.

**Form 1065.** Partnerships file a return on Form 1065, *U.S. Return of Partnership Income*. This is an information return showing the income and deductions of the partnership, the name and address of each partner, and each partner’s

distributive share of income, gain, loss, deductions, credits, etc.

Form 1065 is not required until the first tax year the partnership has income or deductions. In addition, it is not required for any tax year a partnership has no income and expenses.

**Schedule F (Form 1040).** Use Schedule F (Form 1040) to report a farm partnership profit or loss. This schedule should be filed with Form 1065. The profit or loss shown on Schedule F, adjusted for separately-stated items to be reported on Schedule K-1 and Schedule K of Form 1065, is entered on line 5 of Form 1065. See Form 1065 instructions for more information.

**Other schedules.** Each partner’s distributive share of partnership items, such as ordinary income or loss, capital gain or loss, net earnings from self-employment, etc., is entered on Schedule K-1 of Form 1065. Fill in all schedules that apply to the partnership.

**Filing penalty.** In the following situations a penalty is assessed against a partnership that is required to file a partnership return.

- The return is not filed on time, including extensions.
- The return does not show all the information required.

The penalty is \$50 times the total number of partners in the partnership during any part of the tax year for each month (or part of a month), up to 5 months, the return is late or incomplete.

**Exception to filing penalty.** A partnership does not have to pay the penalty if it can show reasonable cause for failure to file a return. A small farm partnership with 10 or fewer partners is generally considered to meet this requirement if the following information can be shown.

- All partners have reported their share of all partnership items on timely filed income tax returns.
- All partners are individuals (other than nonresident aliens), deceased partners’ estates, or C corporations.
- The partnership has not elected to be subject to the rules for “consolidated audit procedures.”

**Consolidated audit procedures.** In a consolidated audit proceeding, the tax treatment of any partnership item is generally determined at the partnership level, rather than at the individual partner’s level. After the proper tax treatment is determined at the partnership level, the IRS can automatically make related adjustments to the tax returns of the partners, based on their share of the adjusted items.

**More information.** For more information on partnerships, see Publication 541.

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## Limited Liability Company (LLC)

An LLC is an entity formed under state law by filing articles of organization as an LLC.

An LLC with two or more members is classified as a partnership for federal income tax pur-

poses unless it elects to be taxed as a corporation or was formed before 1997 and was taxed as a corporation. An LLC with one member is not treated as a separate entity for income tax purposes unless it elects to be taxed as a corporation.

If an LLC is not treated as a separate entity, its member reports the LLC income and expenses on Schedule C or C-EZ (Form 1040) or Schedule F (Form 1040) as if the LLC were a sole proprietorship. If the LLC is classified as a partnership, it files Form 1065. If the LLC is classified as a corporation, it files Form 1120. If the LLC is classified as a corporation and makes the election to be taxed as an S corporation, it files Form 1120S.

If an LLC is treated as a partnership, see Publication 541 for information on partnerships. If it is treated as a corporation, see Publication 542 for information on corporations.

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## Corporation

The rules you must use to determine whether your business is taxed as a corporation changed for businesses formed after 1996. However, if your business was formed before 1997 and taxed as a corporation under the old rules, it will generally continue to be taxed as a corporation.

**Businesses formed after 1996.** Certain businesses formed after 1996 are taxed as corporations. They include the following.

- A business formed under a federal or state law that refers to it as a corporation, body corporate, or body politic.
- A business formed under a state law that refers to it as a joint-stock company or joint-stock association.
- Any other business that elects to be taxed as a corporation by filing Form 8832.

For more information, see the instructions for **Form 8832, Entity Classification Election**.

**Forming a corporation.** A corporation is formed by a transfer of money, property, or both by prospective shareholders in exchange for capital stock in the corporation.

If you transfer property (or money and property) to a corporation solely in exchange for stock in that corporation, and immediately thereafter you are in control of the corporation, the exchange is usually not taxable.

If, in an otherwise nontaxable exchange, you also receive money or property other than stock, you may have to recognize gain. See Publication 544 or Publication 542 for more information.

**Corporate tax.** Corporate profits are taxed to the corporation. If the profits are distributed as dividends, the dividends are taxed to the shareholders.

In figuring its taxable income, a farm corporation generally takes the same deductions that a noncorporate farmer would claim on Schedule F (Form 1040).

**Form 1120 and Form 1120-A.** Unless exempt under section 501 of the Internal Revenue Code, all domestic corporations (including corporations in bankruptcy) must file an income tax return whether or not they have taxable income.

A corporation must generally file Form 1120 to report its income, gains, losses, deductions, credits, and to figure its income tax liability. However, a corporation may file Form 1120-A if its gross receipts, total income, and total assets are each under \$500,000 and it meets certain other requirements. For more information, see the instructions for Forms 1120 and 1120-A.

**More information.** For more information on corporations, see Publication 542.

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## S Corporation

An S corporation is a qualifying corporation that elects to have its income taxed to the shareholders rather than to the corporation itself, except as noted next under *Taxes*. Its shareholders include in income their share of the corporation's nonseparately stated income or loss and separately stated items of income, deduction, loss, and credit.

To make this election, a corporation, in addition to other requirements, must not have more than 75 shareholders and each must consent to the election.

**Taxes.** Although it is generally not liable for federal income tax itself, an S corporation may have to pay the following taxes.

- 1) A tax on the following items.
  - a) Excess net passive income.
  - b) Certain built-in gains.
- 2) The tax from the recapture of a prior year's investment credit.
- 3) LIFO recapture tax.

An S corporation may have to make quarterly estimated tax payments for these taxes.

**Form 1120S.** An S corporation files Form 1120S.

**More information.** For more information on S corporations, see the instructions for Form 1120S.

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## 3.

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# Accounting Periods and Methods

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## Introduction

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

## Topics

This chapter discusses:

- Cash method
- Accrual method
- Farm inventory
- Special methods of accounting
- Change in accounting method

## Useful Items

You may want to see:

### Publication

- 538** Accounting Periods and Methods

### Form (and Instructions)

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

See chapter 21 for information about getting publications and forms.

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## Accounting Periods

When preparing a statement of income and expenses (generally your farm income tax return), you must use books and records kept for a specific interval of time called an accounting period. The annual accounting period for your tax return is called a **tax year**. You can generally use one of the following tax years.

- A calendar year.
- A fiscal year.

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

You adopt a tax year when you file your first income tax return. You must adopt your first tax year by the due date (not including extensions) for filing a return for that year.

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

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

- You do not keep adequate records.
- You have no annual accounting period.
- Your present tax year does not qualify as a fiscal year.

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

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

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

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

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

**Change in tax year.** Once you have chosen your tax year, you must, with certain exceptions, get IRS approval to change it. To get approval, file **Form 1128**. You may have to pay a fee. For more information, see the Form 1128 instructions.

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## Accounting Methods

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

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

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

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

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

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

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

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

- 1) A corporation (other than a family corporation) that had gross receipts of more than \$1,000,000 for any tax year beginning after 1975.



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

For this purpose, an S corporation is not treated as a corporation. Also, items (1), (2), and (3) do not apply to a business engaged in operating a nursery or sod farm or in raising or harvesting trees (other than fruit and nut trees).

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

- 1) 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.
- 2) Members of two families who owned, directly or indirectly, on October 4, 1976, and since then, at least 65% of the total combined voting power of all classes of stock entitled to vote and at least 65% of the total shares of all other classes of stock of the corporation.
- 3) Members of three families who owned, directly or indirectly, on October 4, 1976, and since then, 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.

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

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

- 1) Its principal purpose is the avoidance or evasion of federal income tax.
- 2) It is a farming syndicate. A farming syndicate is an entity that meets either of the following tests.
  - a) Interests in the activity have been offered for sale in an offering required to be registered with a federal or state agency with the authority to regulate the offering of securities for sale, or
  - b) More than 35% of the losses during the tax year are allocable to limited partners or limited entrepreneurs.
    - i) 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.
    - ii) A "limited entrepreneur" is a person who has an interest in an enterprise other than as a limited partner and does not actively participate in the management of the enterprise.

## Cash Method

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

### Income

Under the cash method, include in your gross income all items of income you actually or constructively receive during the tax year. If you receive property or services, you must include their fair market value in income. See chapter 4 for information on how to report farm income on your income tax return.

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

**Production flexibility contract payments.** If you receive production flexibility payments under the Federal Agriculture Improvement and Reform Act of 1996, you are **not** considered to constructively receive a payment merely because you have the option to receive it in the year before it is required to be paid. You disregard that option in determining when to include the payment in your income. This rule applies to any farm production flexibility payment made under the 1996 Act as in effect on December 17, 1999.

**Delaying receipt of income.** You cannot hold checks or postpone taking possession of similar property from one tax year to another to avoid paying tax on the income. You must report the income in the year the property is received or made available to you without restriction.

**Example.** Frances Jones, a farmer, was entitled to receive a \$10,000 payment on a contract in December 2001. The contract was not a production flexibility contract. She was told in December that her payment was available. At her request, she was not paid until January 2002. She must still include this payment in her 2001 income because it was made available to her in 2001.

**Debts paid by another person or canceled.** If your debts are paid by another person or are canceled by your creditors, you may have to report part or all of this debt relief as income. If you receive income in this way, you constructively receive the income when the debt is canceled or paid. See *Cancellation of Debt* in chapter 4.

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

**Example.** You are a farmer who uses the cash method and a calendar tax year. You sell

grain in December 2001 under a bona fide arm's-length contract that calls for payment in 2002. You include the sale proceeds in your 2002 gross income since that is the year payment is received. However, if the contract says that you have the right to the proceeds from the buyer at any time after the grain is delivered, you must include the sale price in your 2001 income, regardless of when you actually receive payment.

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

### Expenses

Under the cash method, you generally deduct expenses in the tax year in which you actually pay them. This includes business expenses for which you contest liability. However, you may not be able to deduct an expense paid in advance or you may be required to capitalize certain costs, as explained under *Uniform Capitalization Rules* in chapter 7. See chapter 5 for information on how to deduct farm business expenses on your income tax return.

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

**Example.** In 2001, you signed a 3-year insurance contract. Even though you paid the premiums for 2001, 2002, and 2003 when you signed the contract, you can only deduct the premium for 2001 on your 2001 tax return. Deduct in 2002 and 2003 the premium allocable to those years.

## Accrual Method

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

### Income

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

If you use an accrual method of accounting, complete Part III of Schedule F.

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

## Expenses

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

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

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

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

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

**Example.** Jane is a farmer who uses a calendar tax year and an accrual method of accounting. She enters into a contract with Waterworks in 2001. The contract states that Jane must pay Waterworks \$200,000 in December 2001 and they will install a complete irrigation system, including a new well, by the close of 2003. She pays Waterworks \$200,000 in December 2001, they start the installation in May 2003, and they complete the irrigation system in December 2003.

Economic performance for Jane's liability in the contract occurs as the property and services are provided. Jane incurs the \$200,000 cost in 2003.

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

Related persons include members of your immediate family, including only brothers and sisters (either whole or half), your spouse, ancestors, and lineal descendants. For a list of other related persons, see *Related Persons* in Publication 538.

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

payment or transfer, you must meet certain conditions. For more information, see *Contested Liability* under *Accrual Method* in Publication 538.

## Farm Inventory

If you keep an inventory, you must generally use an accrual method of accounting to determine your gross income. You should keep a complete record of your inventory as part of your farm records. This record should show the actual count or measurement of the inventory. It should also show all factors that enter into its valuation, including quality and weight if they are required.

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

**Accounting for inventory.** Generally, if you produce, purchase, or sell merchandise in your business, you must keep an inventory and use the accrual method for purchases and sales of merchandise. However, if you are a qualifying taxpayer, you can use the cash method of accounting, even if you produce, purchase, or sell merchandise. If you qualify, you can also choose to not keep an inventory, even if you do not change to the cash method.

You are a qualifying taxpayer only if you meet the gross receipts test for each tax year ending after December 16, 1998. Your average annual gross receipts must be \$1,000,000 or less for the 3 tax years ending with the prior tax year. A tax shelter cannot be a qualifying taxpayer. See Publication 538 for more information.

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

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

**Fur-bearing animals.** If you are in the business of breeding and raising chinchillas, mink, foxes, or other fur-bearing animals, you are a farmer and these animals are livestock.

**Growing crops.** You are generally not required to inventory growing crops. However, if the crop has a preproductive period of more than 2 years, you may have to capitalize (or include in inventory) costs associated with the crop. See *Uniform Capitalization Rules* in chapter 7.

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

- 1) 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.
- 2) 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.

- 1) Cost.
- 2) Lower of cost or market.
- 3) Farm-price method.
- 4) Unit-livestock-price method.

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



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

**Farm-price method.** Under this method, each item, whether raised or purchased, is valued at its market price less the direct cost of disposition. Market price is the current price at the nearest market in the quantities you usually sell. Cost of disposition includes broker's commissions, freight, hauling to market, and other marketing costs. If you use this method, you must use it for your entire inventory, except that livestock can be inventoried on the unit-livestock-price method.

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

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

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

You must include in inventory all livestock purchased primarily for sale. You can choose either to include in inventory or depreciate livestock purchased for draft, breeding, sport or dairy purposes. However, you must be consistent from year to year, regardless of the practice you have chosen. You cannot change your practice without IRS approval.

You must inventory animals purchased after maturity or capitalize them at their purchase price. If the animals are not mature at purchase, increase the cost at the end of each tax year

according to the established unit price. However, in the year of purchase, do not increase the cost of any animal purchased during the last 6 months of the year. This rule does not apply to tax shelters which must make an adjustment for any animal purchased during the year.

**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 2001, but you are not paid until January 2002. You must include both the sale proceeds and the costs incurred in producing the grain on your 2001 tax return.

**Example 2.** Assume the same facts as in *Example 1* except that you use the cash method and there was no constructive receipt of the sale proceeds in 2001. Under this method, you include the sale proceeds in income for 2002, the year you receive payment. You deduct the costs of producing the grain in the year you pay for them.

## Special Methods of Accounting

There are special methods of accounting for certain items of income and expense.

**Crop method.** If you do not harvest and dispose of your crop in the same tax year that you plant it, you can, with IRS approval, use the crop method of accounting. Under this method, you deduct the entire cost of producing the crop, including the expense of seed or young plants, in the year you realize income from the crop.

You cannot use this method for timber or any commodity subject to the uniform capitalization rules.

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

- Amortization, see chapter 8.
- Casualties, see chapter 13.
- Condemnations, see chapter 13.
- Depletion, see chapter 8.
- Depreciation, see chapter 8.
- Farm business expenses, see chapter 5.
- Farm income, see chapter 4.
- Installment sales, see chapter 12.
- Soil and water conservation expenses, see chapter 6.
- Thefts, see chapter 13.

## Combination Method

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

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

## Change in Accounting Method

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

- 1) Your overall method, such as from cash to an accrual method, and
- 2) Your treatment of any material item, such as a change in your method of valuing inventory (for example, a change from the “farm-price method” to the “unit-livestock-price method”).

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

# 4.

## Farm Income

### Introduction

You may receive income from many sources. You must report the income on your tax return, unless it is excluded by law. Where you report the income depends on its source.

This chapter discusses farm income you report on Schedule F (Form 1040). For information on where to report other income, see the instructions for Form 1040.

**Accounting method.** The rules discussed in this chapter assume you use the cash method of accounting. Under the cash method, you generally include an item of income in gross income when you receive it. See *Cash Method* in chapter 3.

If you use an accrual method of accounting, you may have to make changes to the rules in this chapter. See *Accrual Method* in chapter 3.

### 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
- Farm income averaging

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

See chapter 21 for information about getting publications and forms.

## Schedule F

Report your farm income on Schedule F (Form 1040). Use this schedule to figure the net profit or loss from regular farming operations.

Income from farming reported on Schedule F includes amounts you receive from cultivating, operating, or managing a farm for gain or profit, either as owner or tenant. This includes income from operating a stock, dairy, poultry, fish, fruit, or truck farm and income from operating a plantation, ranch, range, or orchard. It also includes income from the sale of crop shares if you materially participate in producing the crop. See *Rents (Including Crop Shares)*, later.

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

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

Gains and losses from most dispositions of farm assets are discussed in chapters 10 and



11. Gains and losses from casualties, thefts, and condemnations are discussed in chapter 13.

## Sales of Farm Products

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

**Where to report.** Table 4–1 shows where to report the sale of farm products on your tax return.

**Schedule F.** When you sell farm products bought for resale, your profit or loss is the difference between your basis in the item and any money plus the fair market value of any property you receive for it. Your basis is usually your cost. See chapter 7 for information on the basis of assets. You generally report these amounts on Schedule F for the year you receive payment.

**Example.** In 2000, you bought 20 feeder calves for \$6,000. You sold them in 2001 for \$11,000. You report the \$6,000 basis, the \$11,000 sales price, and the resulting \$5,000 profit in Part 1 of your 2001 Schedule F.

**Form 4797.** Sales of livestock held for draft, breeding, dairy, or sporting 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 10. 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 3.

## Sales Caused by Weather-Related Conditions

If you sell 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 selling 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 the 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 made before an area became eligible for federal assistance qualify if the weather-related condition that caused the sale 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 of livestock (other than poultry) held for draft, breeding, or dairy purposes is an involuntary conversion. If you plan to replace the livestock, see Other Involuntary Conversions in chapter 13 for more information.*

**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. The costs of meeting these affected requirements generally must also be a substantial part of the total costs of holding the livestock.

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

**Amount to be postponed.** Follow these steps to figure the amount to be postponed for each class of animals.

- 1) Divide the total income realized from the sale of all livestock in the class during the tax year by the total number of such livestock sold. For this purpose, do not treat any postponed gain from the previous year as income received from the sale of livestock.
- 2) Multiply the result in (1) by the excess number of such livestock sold solely because of weather-related conditions.

**Example.** You are a calendar year taxpayer and you normally sell 100 head of beef cattle a year. As a result of drought, you sold 135 head during 2001. You realized \$35,100 from the

sale. On August 9, 2001, as a result of drought, the affected area was declared a disaster area eligible for federal assistance. The income you can postpone until 2002 is \$9,100  $[(\$35,100 \div 135) \times 35]$ .

**How to postpone gain.** To postpone gain, attach a statement to your tax return for the year of the sale. The statement must include your name and address and give the following information for each class of livestock for which you are postponing gain.

- A statement that you are postponing gain under section 451(e) of the Internal Revenue Code.
- Evidence of the weather-related conditions that forced the early sale or exchange of the livestock and the date, if known, on which an area was designated as eligible for assistance by the federal government because of weather-related conditions.
- A statement explaining the relationship of the area affected by the weather-related condition to your early sale or exchange of the livestock.
- The number of animals sold in each of the 3 preceding years.
- The number of animals you would have sold in the tax year had you followed your normal business practice.
- The total number of animals sold and the number sold because of weather-related conditions during the tax year.
- A computation, as described earlier, of the income to be postponed for each class of livestock.

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 postponing gain, you can still postpone gain by filing an amended return within 6 months of the due date of the return (excluding extensions). Attach the statement to the amended return and write “Filed pursuant to section 301.9100–2” at the top of the return. File the amended return at the same address you filed the original return. Once you have filed the statement, you can cancel your postponement of gain only with the approval of the IRS.

## Rents (Including Crop Shares)

The rent you receive for the use of your farm land is generally rental income, not farm income. However, if you materially participate in farming

Table 4–1. Where To Report Sales of Farm Products

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

operations on the land, the rent is farm income. See *Landlord Participation in Farming* in chapter 15.

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

## 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 15.) Report the rental income on Schedule F.

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

**Crop shares you use to feed livestock.** Crop shares you receive as a landlord and feed to your livestock are considered converted to money when fed to the livestock. You must include the fair market value of the crop shares in income at that time. You are entitled to a business expense deduction for the livestock feed in the same amount and at the same time you include the fair market value of the crop share as rental income. Although these two transactions cancel each other for figuring adjusted gross income on Form 1040, they may be necessary to figure your self-employment tax. See chapter 15.

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

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

In this situation, you are considered to have received rental income and then made a gift of that income. You must include the fair market value of the crop shares in your income for the tax year you gave the crop shares to your children.

**Crop share loss.** If you are involved in a rental or crop-share lease arrangement, any loss from these activities may be subject to the limits

under the passive loss rules. See Publication 925 for information on these rules.

## Agricultural Program Payments

You must include in income most government payments, such as those for approved conservation practices and production flexibility contracts, whether you receive them in cash, materials, services, or commodity certificates. However, you can exclude 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 Part I of Schedule F. 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 loan. However, you can deduct the amount you refund or return or that reduces some other payment or loan to you. Claim the deduction on Schedule F for the year of repayment or reduction.

## Commodity Credit Corporation (CCC) Loans

Normally, you do not report loans you receive as income, and you report income from a crop for the year you sell it. 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 for the year you receive them. You do not need approval from the IRS to adopt this method of reporting CCC loans, even though you may have reported those received in earlier years as taxable income for the year you sold the crop.

Once you report a CCC loan as income for the year received, you must report all CCC loans in that year and later years in the same way, unless you get approval from the IRS to change to a different method. See *Change in Accounting Method* in chapter 3.



**TIP** You can request income tax withholding from CCC loan payments you receive. Use Form W-4V, Voluntary Withholding Request. See chapter 21 for information about ordering the form.

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

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

choice, you can change it only with the approval of the IRS.

When you make this choice, the amount you report as income becomes your basis in the commodity. See chapter 7 for information on the basis of assets. If you later repay the loan, redeem the pledged commodity, and sell it, you report as income at the time of sale the sale proceeds *minus* your basis in the commodity. If the sale proceeds are less than your basis in the commodity, you can report the difference as a loss on Schedule F.

If you forfeit the pledged crops to the CCC in full payment of the loan, the forfeiture is treated for tax purposes as a sale of the crops. If you did not report the loan proceeds as income for the year you received them you must include them in your income for the year of the forfeiture. If you reported the loan proceeds as income for the year you received them and the amount of the forfeited loan is less than your basis in the commodity, you can report the difference as a loss on Schedule F.

## Market Gain

Under the CCC nonrecourse marketing assistance loan program, your repayment amount for a loan secured by your pledge of an eligible commodity is generally based on the lower of the loan rate or the prevailing world market price for the commodity on the date of repayment. If you repay the loan when the world price is lower, the difference between that repayment amount and the repayment amount based on the loan rate is market gain. You will receive a Form CCC-1099-G showing the market gain you realized. If you chose to include the CCC loan in income in the year you received it, do not include the amount shown on Form CCC-1099-G in 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 2000, Mike pledged 1,000 pounds of cotton as collateral for a CCC price support loan of \$500 (a loan rate of \$.50 per pound). In 2001, he repaid the loan and redeemed the cotton for \$420 when the world price was \$.42 per pound. Later in 2001, he sold the cotton for \$600.

The market gain on the redemption was \$.08 (\$.50 - \$.42) per pound. Mike received a Form CCC-1099-G from the CCC showing 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 2000.

**Including CCC loan.** Because Mike reported the \$500 CCC loan as income for 2000, 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 2001 as an "Agricultural program payment" on line 6a of Schedule F, but does not include it as a taxable amount on line 6b.

Mike's basis in the cotton after he redeemed it was \$420, which is the redemption (repurchase) price paid for the cotton. His gain from

the sale is \$180 (\$600 – \$420). He reports the \$180 gain as income for 2001 on line 4 of Schedule F.

**Excluding CCC loan.** Mike has income of \$80 from market gain in 2001. He reports it on both line 6a and line 6b of Schedule F. Because his basis in the cotton is zero, his gain from its sale is \$600. He reports the \$600 gain as income for 2001 on line 4 of Schedule F.

**Example 2.** The facts are the same as in *Example 1* except that, instead of selling the cotton for \$600 after redeeming it, Mike entered into an option-to-purchase contract with Tom Merchant before redeeming the cotton. Under that contract, Mike authorized Tom to pay the CCC loan on Mike's behalf. In 2001, 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 2000.

**Including CCC loan.** As in *Example 1*, Mike is treated as though he sold the cotton for \$500 when he pledged it and repurchased the cotton for \$420 when Tom redeemed it for him. The \$80 market gain is not recognized on the redemption. Mike reports it for 2001 as an "Agricultural program payment" on line 6a of Schedule F, 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.

**Excluding CCC loan.** As in *Example 1*, Mike has income of \$80 from market gain in 2001. He reports it on both line 6a and line 6b of Schedule F. Because his basis in the cotton is zero, his gain from its sale is \$420. He reports the \$420 gain as income for 2001 on line 4 of Schedule F.

## Conservation Reserve Program (CRP)

Under the Conservation Reserve Program (CRP), if you own or operate highly erodible or other specified cropland, you may enter into a long-term contract with the USDA, agreeing to convert to a less intensive use of that cropland. You must include payments under the program on lines 6a and 6b of Schedule F. CRP payments are reported to you on Form CCC-1099-G.

## Crop Insurance and Crop Disaster Payments

You must include in income any crop insurance proceeds you receive as the result of crop damage. You generally include them in the year you receive them. Treat as crop insurance proceeds the crop disaster payments you receive from the federal government as the result of destruction or damage to crops, or the inability to plant crops because of drought, flood, or any other natural disaster.



*You can request income tax withholding from crop disaster payments you receive from the federal government.*

*Use Form W-4V, Voluntary Withholding Request. See chapter 21 for information about ordering the form.*

**Choice to postpone reporting until the following year.** You can choose to 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 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 2001, report the amount you received on line 8a of Schedule F, but do not include it as a taxable amount on line 8b. Check the box on line 8c and attach a statement to your tax return. The statement must include your name and address and contain the following information.

- A statement that you are making a choice under section 451(d) of the Internal Revenue Code and section 1.451-6 of the regulations.
- The specific crop or crops destroyed or damaged.
- A statement that under your normal business practice you would have included income from the destroyed or damaged crops in gross income for a tax year following the year the crops were destroyed or damaged.
- The cause of the destruction or damage and the date or dates it occurred.
- The total payments you received from insurance carriers, itemized for each specific crop, and the date you received each payment.
- The name of each insurance carrier from whom you received payments.

One choice covers all crops representing a single trade or business. If you have more than one farming business, make a separate choice for each one. For example, if you operate two separate farms on which you grow different crops and you keep separate books for each farm, you should make two separate choices to postpone reporting insurance proceeds you receive for crops grown on each of your farms.

A choice is binding for the year unless the IRS approves your request to change it. To request IRS approval to change your choice, write to the IRS director for your area giving your name, address, identification number, the year you made the choice, and your reasons for wanting to change it. Call 1-800-829-1040 if you need the address.

## 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.

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 in Part I, Schedule F, as agricultural program payments.

Include in income the market value of donated feed, the difference between the market value and the price you paid, or any cost reimbursement you receive. 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 6 for information on deducting soil and water conservation expenses.)
- 2) It does not substantially increase your annual income from the property for which it is made. An increase in annual income is substantial if it is more than the greater of the following amounts.
  - a) 10% of the average annual income derived from the affected property before receiving the improvement.
  - b) \$2.50 times the number of affected acres.
- 3) The Secretary of Agriculture certified that the payment was made primarily for conserving soil and water resources, protecting or restoring the environment, improving forests, or providing a habitat for wildlife.

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

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



- The rural abandoned mine program authorized by the Surface Mining Control and Reclamation Act of 1977.
- The water bank program authorized by the Water Bank Act.
- The emergency conservation measures program authorized by title IV of the Agricultural Credit Act of 1978.
- The agricultural conservation program authorized by the Soil Conservation and Domestic Allotment Act.
- The great plains conservation program authorized by the Soil Conservation and Domestic Policy Act.
- The resource conservation and development program authorized by the Bankhead-Jones Farm Tenant Act and by the Soil Conservation and Domestic Allotment Act.
- The forestry incentives program authorized by the Cooperative Forestry Assistance Act of 1978.
- Certain small watershed programs, listed later.
- Any program of a state, possession of the United States, a political subdivision of any of these, or the District of Columbia under which payments are made to individuals primarily for conserving soil, protecting or restoring the environment, improving forests, or providing a habitat for wildlife. Several state programs have been approved. For information about the status of those programs, contact the state offices of the Farm Service Agency (FSA) and the Natural Resources and Conservation Service (NRCS).

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

- The Stewardship Incentive Program authorized by the Food, Agriculture, Conservation, and Trade Act of 1990.
- The programs under the Watershed Protection and Flood Prevention Act.
- The flood prevention projects under the Flood Control Act of 1944.
- The Emergency Watershed Protection Program under the Flood Control Act of 1950.
- Certain programs under the Colorado River Basin Salinity Control Act.
- The Wetlands Reserve Program authorized by the Food Security Act of 1985 and by the Federal Agriculture Improvement and Reform Act of 1996.
- 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.

**Income realized.** The gross income you realize upon getting an improvement under these cost-sharing programs is the value of the improvement reduced by the sum of the excludable portion and your share of the cost of the improvement.

**Value of the improvement.** You determine the value of the improvement by multiplying its fair market value (defined in chapter 12) by a fraction. The numerator of the fraction is the total cost of the improvement (all amounts paid either by you or by the government for the improvement) reduced by the sum of the following items.

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

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

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

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



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

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

The present fair market value of the right to receive the annual income described in (1) above is \$1,380, and the 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
	<u>11,550</u>
<b>Amount included in income . . . . .</b>	<b><u>\$3,450</u></b>

**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 line 6a of Schedule F and the taxable amount on line 6b.

**Recapture.** If you dispose of the property within 20 years after you received the excluded payments, you must treat as ordinary income part or all of the cost-sharing payments you excluded. You must report the recapture on Form 4797. See *Section 1255 property* under *Other Gains* in chapter 11.

**Choosing not to exclude payments.** You can choose not to exclude all or part of any payments you receive under these programs. If you make this choice for all of these payments, none of the above restrictions and rules apply. You must make this choice by the due date, including extensions, for filing your return. If you timely filed your return for the year without making the choice, you can still make the choice by filing an amended return within 6 months of the due date of the return (excluding extensions). Write “Filed pursuant to section 301.9100–2” at the top of the amended return and file it at the same address you filed the original return.

## Production Flexibility Contract Payments

If you receive production flexibility payments under the Federal Agriculture Improvement and Reform Act of 1996, you must include them in income for the year you actually or constructively receive them. However, under a special rule, you are not considered to constructively receive a payment merely because you have the option to receive it in the year before it is required to be paid. You disregard that option in determining when to include the payment in your income. This special rule applies to any farm production flexibility payment made under the 1996 Act as in effect on December 17, 1999.

For information on the constructive receipt of income, see *Cash Method* under *Accounting Methods* in chapter 3.

## Other Payments

You must include most other government program payments in income.

## Fertilizer and Lime

Include in income the value of fertilizer or lime you receive under a government program. How to claim the offsetting deduction is explained under *Fertilizer and Lime* in chapter 5.

## Improvements

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

## Payment to More Than One Person

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

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

See chapter 21 for information about ordering Form 1099-G.

## Income From Cooperatives

If you buy farm supplies through a cooperative, you may receive income from the cooperative in the form of patronage dividends. 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 if you are required to file Form 6251, *Alternative Minimum Tax—Individuals*. For information on the alternative minimum tax, see chapter 14.

## Patronage Dividends

You generally report patronage dividends as income on lines 5a and 5b of Schedule F 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 dividend that is a nonqualified notice of allocation, that is for purchasing or selling capital assets or depreciable property, or that is for

purchasing personal items. Personal items include fuel purchased for personal use, basic local telephone service, and personal long distance calls.

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

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

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

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

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

**Loss on redemption.** You can deduct in Part II of Schedule F 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, as ordi-

nary income in Part I of Schedule F. However, do **not** include that amount in your income if the notice resulted from purchasing or selling capital assets or depreciable property or from purchasing 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.

**Purchasing or selling capital assets or depreciable property.** Do not include in income patronage dividends from the purchase of 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 as ordinary income on Schedule F for the tax year you receive them. Include all these dividends on line 5a of Schedule F, but include only the taxable part on line 5b.

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

**Example.** On July 1, 2000, 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 2000, he claimed a depreciation deduction of \$311, using the 10.71% depreciation rate from the 150% declining balance, half-year convention table (shown in *Table A-14* in Appendix A of Publication 946). On July 1, 2001, the cooperative association paid Mr. Brown a \$300 cash patronage dividend for his purchase of the machine. Mr. Brown adjusts the basis of the machine and figures his depreciation deduction for 2001 (and later years) as follows.

Cost of machine on July 1, 2000 . . . . .	\$2,900
Minus: 2000 depreciation . . . . .	\$311
2001 cash dividend . . . . .	300
	<u>611</u>

**Adjusted basis for depreciation for 2001:** \$2,289

Depreciation rate:  $1 \div 6\frac{1}{2}$  (remaining recovery period as of 1/1/01) =  $15.38\% \times 1.5 = 23.07\%$

**Depreciation deduction for 2001**  
**(\$2,289  $\times$  23.07%) . . . . .** \$528

**Exceptions.** If the dividends are for purchasing 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 as ordinary income on Schedule F unless one of the following rules applies.

- If the dividends relate to a capital asset you held for more than 1 year for which a loss was or would have been deductible, treat them as gain from the sale or exchange of a capital asset held for more than 1 year.

- If the dividends relate to a capital asset for which a loss was not or would not have been deductible, do not report them as income (ordinary or capital gain).

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

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

## Per-Unit Retain Certificates

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

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

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

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

## Cancellation of Debt

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

### General Rule

Generally, if your debt is canceled or forgiven, other than as a gift or bequest to you, you must include the canceled amount in gross income for tax purposes. Report the canceled amount on line 10 of Schedule F if you incurred the debt in your farming business. If the debt is a nonbusiness debt, report the canceled amount on line 21 of Form 1040.

**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.

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

**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.

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

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

### Exclusions

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

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

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

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

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

## Bankruptcy and Insolvency

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

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

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

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

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

**Example.** You had a \$15,000 debt canceled outside of bankruptcy. Immediately before the cancellation, your liabilities totaled \$80,000 and your assets totaled \$75,000. Since your liabilities were more than your assets, you were 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 business debt rules. If not, you must include it in income.

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

**Order of reduction.** You must use the excluded canceled debt to reduce the following tax benefits in the order listed unless you choose to reduce the basis of depreciable property first, as explained later.

- 1) **Net operating loss (NOL).** Reduce any NOL for the tax year of the debt cancellation, and then any NOL carryover to that year. Reduce the NOL or NOL carryover one dollar for each dollar of excluded canceled debt.
- 2) **General business credit carryover.** Reduce the credit carryover to or from the tax year of the debt cancellation. Reduce the carryover 33 $\frac{1}{3}$  cents for each dollar of excluded canceled debt.
- 3) **Minimum tax credit.** Reduce the minimum tax credit available at the beginning of the tax year following the tax year of the debt cancellation. Reduce the credit 33 $\frac{1}{3}$  cents for each dollar of excluded canceled debt.



- 4) **Capital loss.** Reduce any net capital loss for the tax year of the debt cancellation, and then any capital loss carryover to that year. Reduce the capital loss or loss carryover one dollar for each dollar of excluded canceled debt.
- 5) **Basis.** Reduce the basis of the property you hold at the beginning of the tax year following the tax year of the debt cancellation in the following order.
  - a) Real property (except inventory) used in your trade or business or held for investment that secured the canceled debt.
  - b) Personal property (except inventory and accounts and notes receivable) used in your trade or business or held for investment that secured the canceled debt.
  - c) Other property (except inventory and accounts and notes receivable) used in your trade or business or held for investment.
  - d) Inventory and accounts and notes receivable.
  - e) Other property.

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

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

- 6) **Passive activity loss and credit carryovers.** Reduce the passive activity loss and credit carryovers from the tax year of the debt cancellation. Reduce the loss carryover one dollar for each dollar of excluded canceled debt. Reduce the credit carryover 33 $\frac{1}{3}$  cents for each dollar of excluded canceled debt.
- 7) **Foreign and possession tax credits.** Reduce the credit carryover to or from the tax year of the debt cancellation. Reduce the carryover 33 $\frac{1}{3}$  cents for each dollar of excluded canceled debt.

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

**Choosing to reduce the basis of depreciable property first.** You can choose to apply any portion of the excluded canceled debt first to reduce the basis of depreciable property you

hold at the beginning of the tax year following the tax year of the debt cancellation, in the following order.

- 1) Depreciable real property used in your trade or business or held for investment that secured the canceled debt.
- 2) Depreciable personal property used in your trade or business or held for investment that secured the canceled debt.
- 3) Other depreciable property used in your trade or business or held for investment.
- 4) Real property held as inventory if you choose to treat it as depreciable property on Form 982.

The amount you apply cannot be more than the total adjusted bases of all the depreciable property. Depreciable property for this purpose means any property subject to depreciation, but only if a reduction of basis will reduce the depreciation or amortization otherwise allowable for the period immediately following the basis reduction.

You make this reduction before reducing the other tax benefits listed earlier. If the excluded canceled debt is more than the basis reduction you can make under this choice, use the difference to reduce the other tax benefits. In figuring the limit on the basis reduction in (5), *Basis*, use the remaining adjusted bases of your property after making this choice.

See *Form 982*, later, for information on how to make this choice. If you make this choice, you can revoke it only with the consent of the IRS.

**Recapture of basis reductions.** If you reduce the basis of property under these provisions and later sell or otherwise dispose of the property at a gain, the part of the gain due to this basis reduction is taxable as ordinary income under the depreciation recapture provisions. Treat any property that is not section 1245 or section 1250 property as section 1245 property. For section 1250 property, determine the straight-line depreciation adjustments as though there were no basis reduction for debt cancellation. Sections 1245 and 1250 property and the recapture of gain as ordinary income are explained in chapter 11.

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

## Qualified Farm Debt

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

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

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

debt cancellation were from your farming business.

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

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

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

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

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

**Adjusted tax benefits.** Adjusted tax benefits means the sum of the following items.

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

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

**Reduction of tax benefits.** If you exclude canceled debt from income under the qualified farm debt rules, you must use the excluded debt to reduce tax benefits. (If you also excluded canceled debt under the insolvency rules, you reduce the amount of the tax benefits remaining after reduction for the exclusion allowed under those rules.) You generally must follow the reduction rules previously explained under *Bankruptcy and Insolvency*. However, do not follow

the rules in item (5), *Basis*. Instead, follow the special rules explained next.

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

- 1) Depreciable qualified property. You may choose on Form 982 to treat real property held as inventory as depreciable property.
- 2) Land that is qualified property and is used or held for use in your farming business.
- 3) Other qualified property.

## Form 982

Use Form 982 to show the amounts of canceled debt excluded from income and the reduction of tax benefits in the order listed on the form. Also use it if you are choosing to apply the excluded canceled debt to reduce the basis of depreciable property before reducing tax benefits. You make this choice by showing the amount you choose to apply on line 5 of the form.

**When to file.** You must file Form 982 with your timely filed income tax return (including extensions) for the tax year in which the cancellation of debt occurred. If you timely filed your return for the year without choosing to apply the excluded canceled debt to reduce the basis of depreciable property first, you can still make the choice by filing an amended return within 6 months of the due date of the return (excluding extensions). For more information, see *When to file* in the form 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 the discussion on labor expense in chapter 5.

**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 10 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 line 9, Part I, of Schedule F.

**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 farm land, or both.

**Example.** You granted a right-of-way for a gas pipeline through your property for \$10,000. Only a specific part of your farm land 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 more than the basis of the affected part of your land, reduce the basis to zero and the rest 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 11.



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

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

**Fuel tax credit and refund.** Include any credit or refund of federal excise taxes on fuels in your gross income if you included the cost of the fuel as an expense deduction that reduced your income tax. See chapter 18 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 line 10 of Schedule F. You cannot take a deduction for the amount you must include in income.

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

**Prizes.** Report prizes you win on farm livestock or products at contests, exhibitions, fairs, etc., on Schedule F as *Other income*. If you receive a prize in cash, include the full amount in income. If you receive a prize in produce or other property, include the fair market value of the property. For prizes of \$600 or more, you should receive a Form 1099-MISC, *Miscellaneous Income*.

See chapter 15 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 10 through 13.

**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 8 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 8) falls to 50% or less in any tax year during the recovery period, you must include in income any excess depreciation you took on the property.

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

**Refund or reimbursement.** You must generally 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 2000. He deducted \$1,000 on his 2000 Schedule F and the entire deduction reduced his tax. The landowner reimbursed him \$500 of the cost of the fertilizer in February 2001. The tenant farmer must include \$500 in income on his 2001 tax return because the entire deduction decreased his 2000 tax.

**Sale of soil and other natural deposits.** If you remove and sell topsoil, loam, fill dirt, sand, gravel, or other natural deposits from your property, the proceeds are ordinary income. A reasonable allowance for depletion of the natural deposit sold may be claimed as a deduction. See *Depletion* in chapter 8.

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

**Granting the right to remove deposits.** If you enter into a legal relationship granting someone else the right to excavate and remove natural deposits from your property, you must determine whether the transaction is a sale or another type of transaction (for example, a lease).

If you receive a specified sum or an amount fixed without regard to the quantity produced and sold from the deposit and you retain no economic interest in the deposit, your transaction is a sale. You are considered to retain an economic interest if, under the terms of the legal relationship, you depend on the income derived from extraction of the deposit for a return of your capital investment in the deposit.

Your income from the deposit is capital gain if the transaction is a sale. Otherwise, it is ordinary income subject to an allowance for depletion. See chapter 8 for information on depletion and chapter 10 for the tax treatment of capital gains.

**Timber sales.** Timber sales, including sales of logs, firewood, and pulpwood, are discussed in chapter 10.

## Farm Income Averaging

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

**Who can use farm income averaging?** You can use farm 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. 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 farm income averaging.

## Elected Farm Income (EFI)

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

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

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

**Liquidation of a farming business.** If you (or your partnership or S corporation) liquidate your farming business, gains on property sold within a reasonable time after operations stop can be designated as EFI. A period of 1 year after stopping operations is a reasonable time. After that, what is a reasonable time depends on the facts and circumstances.

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

## How To Figure the Tax

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

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

**Schedule J for 1998 or 1999.** Although the Schedule J for 1998 and 1999 did not allow you to use negative taxable income for a base year, you can file amended returns on Form 1040X to do so. If you did not use Schedule J for 1998 or 1999 and this change would make using it beneficial, you can amend your returns to use it. If you used Schedule J for 1998 or 1999 and your taxable income for any base year was zero, you can amend your return to refigure your tax. For more information, see the Schedule J instructions.

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

## Effect on Other Tax Determinations

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

- The amount of your self-employment tax.
- Whether, in the aggregate, sales and other dispositions of business property (section 1231 transactions) produce long-term capital gain or ordinary loss.
- The amount of any net operating loss carryover or net capital loss carryover applied and the amount of any carryover to another year.

- The limit on itemized deductions based on your adjusted gross income.
- The amount of any net capital loss or net operating loss in a base year.

## Tax on Investment Income of Child Under 14

If your child's investment income is more than \$1,500, part of that income may be taxed at your tax rate instead of your child's tax rate.

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

## Alternative Minimum Tax

You cannot use income averaging to determine your alternative minimum tax (AMT). When figuring your AMT, the regular tax you subtract from your “tentative minimum tax” is the tax you computed using farm income averaging. This may cause you to owe AMT or increase your AMT but, generally, it will not increase your total tax.

**Credit for prior year minimum tax.** You may be able to claim a tax credit if you owed AMT in a prior year. See chapter 14.

## Schedule J

You can use farm income averaging by filing Schedule J (Form 1040) with your timely filed (including extensions) return for the year. You can use farm income averaging on a late return, or use, change, or cancel it on an amended return, only if you do so either in conjunction with another adjustment that affects the taxable income of that year or any of the base years. An adjustment may be caused by a variety of things. The following are examples of situations that may result in an adjustment.

- An NOL carryback.
- A disaster loss election.
- A change made as the result of an audit.
- Any other change that results in your filing an amended return.

You can also use farm income averaging on a late return or use, change, or cancel it on an amended return if you get the approval of the IRS. You can request approval by submitting a request for a private letter ruling to the IRS National Office. See Revenue Procedure 2002-1 in Internal Revenue Bulletin No. 2002-1.



## 5.

# Farm Business Expenses

## Important Changes for 2001

**Standard mileage rate.** The standard mileage rate for the cost of operating your car, van, pickup, or panel truck in 2001 is 34½ cents a mile for all business miles driven. See *Truck and Car Expenses*.

## Introduction

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

## Topics

This chapter discusses:

- Deductible expenses
- Capital expenses
- Nondeductible expenses
- Farm operating losses
- Net operating losses
- Not-for-profit farming

## Useful Items

You may want to see:

### Publication

- ❑ **463** Travel, Entertainment, Gift, and Car Expenses
- ❑ **535** Business Expenses
- ❑ **536** Net Operating Losses (NOLs) for Individuals, Estates, and Trusts
- ❑ **587** Business Use of Your Home
- ❑ **925** Passive Activity and At-Risk Rules
- ❑ **936** Home Mortgage Interest Deduction

### Form (and Instructions)

- ❑ **Sch A (Form 1040)** Itemized Deductions
- ❑ **Sch F (Form 1040)** Profit or Loss From Farming
- ❑ **1045** Application for Tentative Refund
- ❑ **5213** Election To Postpone Determination as To Whether the

Presumption Applies That an Activity Is Engaged in for Profit

See chapter 21 for information about getting publications and forms.

## Deductible Expenses

The ordinary and necessary costs of operating a farm for profit are deductible business expenses. Part II of Schedule F lists expenses common to farming operations. This chapter discusses many of these expenses, as well as others not listed on Schedule F.

**Reimbursed expenses.** If an expense is reimbursed, either reduce the expense or report the reimbursement as income when received. See *Refund or reimbursement* under *Income From Other Sources* in chapter 4.

**Personal and business expenses.** Some expenses you pay during the tax year may be partly personal and partly business. These may include expenses for gasoline, oil, fuel, water, rent, electricity, telephone, automobile upkeep, repairs, insurance, interest, and taxes.

You must allocate these mixed expenses between their business and personal parts. The personal part of these expenses is not deductible.

**Example.** You paid \$1,500 for electricity during the tax year. You used one-third of the electricity for personal purposes and two-thirds for farming. Under these circumstances, you can deduct two-thirds of your electricity expense (\$1,000) as a farm business expense.

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

## Prepaid Farm Supplies

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

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

**Deduction limit.** If you use the cash method of accounting to report your income and expenses, your deduction for prepaid farm supplies in the year you pay for them may be limited

to 50% of your other deductible farm expenses for the year (all Schedule F deductions except prepaid farm supplies). This limit does not apply if you meet one of the exceptions described later.

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

**Example.** During 2001, 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 2001 is \$5,500. Your other deductible farm expenses totaled \$10,000 for 2001. Therefore, your deduction for prepaid farm supplies may not exceed \$5,000 (50% of \$10,000) for 2001. The excess prepaid farm supplies expense of \$500 (\$5,500 – \$5,000) is deductible in the later tax year you use or consume the supplies.

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

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

You are a farm-related taxpayer if any of the following tests apply.

- 1) Your main home is on a farm.
- 2) Your principal business is farming.
- 3) A member of your family meets (1) or (2).

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



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

## Prepaid Livestock Feed

If you report your income and expenses under the cash method of accounting, you cannot deduct in the year paid the cost of feed your livestock will consume in a later year unless you meet **all** of the following tests.

- 1) The payment is for the purchase of feed rather than a deposit.
- 2) The prepayment has a business purpose and is not merely for tax avoidance.

- 3) Deducting the prepayment does not result in a material distortion of your income.

If you meet all three tests, you can deduct the prepayment 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 re-purchase.

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

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

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

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

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

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

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

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

## Labor Hired

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

If you must withhold social security, Medicare, and income taxes from your employees' cash wages, you can still deduct the full amount of wages before withholding. See chapter 16 for more information on employment taxes. Also, deduct the employer's share of the social security and Medicare taxes you must pay on your employees' wages as a farm business expense on the *Taxes* line of Schedule F (line 31). See *Taxes*, later.

**Property for services.** If you transfer property to an employee in payment for services, you can deduct as wages paid the fair market value of the property on the date of transfer. If the employee pays you anything for the property, deduct as wages the fair market value of the property minus the payment by the employee for the property. Treat the wages deducted as an amount received for the property. You may have a gain or loss to report if the property's adjusted basis on the date of transfer is different from its fair market value. Any gain or loss has the same character the exchanged property had in your hands. For more information, see chapter 10.

**Child as an employee.** You can deduct reasonable wages or other compensation you pay to your child for doing farm work if a **true employer-employee relationship** exists between you and your child. Include these wages in the child's income. The child may have to file an income tax return. These wages may also be subject to social security and Medicare taxes if your child is age 18 or older. For more information, see *Family Employees* in chapter 16.

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

**Spouse as an employee.** You can deduct reasonable wages or other compensation you pay to your spouse if a **true employer-employee relationship** exists between you and your spouse. Wages you pay to your spouse are subject to social security and Medicare taxes. For more information, see *Family Employees* in chapter 16.

## Nondeductible Pay

You cannot deduct wages paid for certain household work, construction work, and maintenance of your home. However, those wages may be subject to the employment taxes discussed in chapter 16.

**Household workers.** Do not deduct amounts paid to persons engaged in household work, except to the extent their services are used in boarding or otherwise caring for farm laborers.

**Construction labor.** Do not deduct wages paid to hired help for the construction of new buildings or other improvements. These wages are part of the cost of the building or other improvement. You must capitalize them.

**Maintaining your home.** If your farm employee spends time maintaining or repairing your home, the wages and employment taxes you pay for that work are nondeductible personal expenses. For example, assume you have a farm employee for the entire tax year and the employee spends 5% of the time maintaining your home. The employee devotes the remaining time to work on your farm. You cannot deduct 5% of the wages and employment taxes you pay for that employee.

## Employment Credits

Reduce your deduction for wages by the amount of any employment credits you claim. The following are employment credits and their related forms.

- Empowerment zone employment credit (Form 8844).
- Indian employment credit (Form 8845).
- Welfare-to-work credit (Form 8861).
- Work opportunity credit (Form 5884).

For more information, see the forms and their instructions.

## Repairs and Maintenance

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

## Interest

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

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

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

**Accrual method.** If you use an accrual method of accounting, you can deduct only interest that has accrued during the tax year. However, you cannot deduct interest owed to a

related person who uses the cash method until payment is made and the interest is includible in the gross income of that person. For more information, see *Accrual Method* in chapter 3.

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

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

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

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

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

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

**TIP** *If the property that secures the loan is your home, you generally do not allocate the loan proceeds or the related interest. The interest is usually deductible as qualified home mortgage interest, regardless of how the loan proceeds are used. 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 5 in Publication 535.

## Breeding Fees

You can deduct breeding fees as a farm business expense. However, if you use an accrual method of accounting, you must capitalize breeding fees and allocate them to the cost basis of the calf, foal, etc. For more information on who must use an accrual method of accounting, see *Accrual method required under Accounting Methods* in chapter 3.

## Fertilizer and Lime

You can deduct in the year paid or incurred the cost of fertilizer, lime, and other materials ap-

plied to farm land to enrich, neutralize, or condition it. 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, it can only be changed with IRS approval.

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

Include government payments you receive for lime or fertilizer in income. See *Fertilizer and Lime* under *Agricultural Program Payments* in chapter 4.

## 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, farm land, and farm buildings. You can also 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 16.

**Allocation of taxes.** The taxes on the part of your farm you use as your home (including the furnishings and surrounding land not used for farming) are nonbusiness taxes. You may be able to deduct these nonbusiness taxes as itemized deductions on Schedule A (Form 1040). To determine the nonbusiness part, allocate the taxes between the farm assets and nonbusiness assets. The allocation can be done from the assessed valuations. If your tax statement does not show the assessed valuations, you can usually get them from the tax assessor.

**State and local general sales taxes.** State and local general sales taxes on nondepreciable farm business expense items are deductible as part of the cost of those items. Include state and local general sales taxes imposed on the purchase of assets for use in your farm business as part of the cost you depreciate. Also treat the taxes as part of your cost if they are imposed on the seller and passed on to you.

**State and federal income taxes.** Individuals cannot deduct state and federal income taxes as farm business expenses. Individuals can deduct state income tax only as an itemized deduction on Schedule A (Form 1040). You cannot deduct federal income tax.

**Highway use tax.** You can deduct the federal use tax on highway motor vehicles paid on a truck or truck tractor used in your farm business. For information on the tax itself, including information on vehicles subject to the tax, see the instructions for Form 2290, *Heavy Highway Vehicle Use Tax Return*.

**Self-employment tax deduction.** You can deduct one-half of your self-employment tax in

figuring your adjusted gross income on Form 1040. For more information, see chapter 15.

## Insurance

You can generally 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.

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

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

**Example.** On June 28, 2001, 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, 2001. Only the cost for the 6 months in 2001 is deductible as an insurance expense on your 2001 calendar year tax return. Deduct \$500, which is the premium for 6 months of the 36-month premium period, or  $\frac{1}{6}$  of \$3,000. In both 2002 and the year 2003, deduct \$1,000 ( $\frac{12}{36}$  of \$3,000). Deduct the remaining \$500 in 2004. Had the policy been effective on January 1, 2001, the deductible expense would have been \$1,000 for each of the years 2001, 2002, and 2003, based on one-third of the premium used each year.

**Business interruption insurance.** Use and occupancy and business interruption insurance premiums are deductible as a business expense. This insurance pays for lost profits if your business is shut down due to a fire or other cause. Report any proceeds in full in Part I of Schedule F.

**Self-employed health insurance deduction.** If you are self-employed, you can deduct, in figuring your adjusted gross income on your 2001 Form 1040, 60% of your payments for health insurance coverage for yourself, your spouse, and your dependents. Generally, this deduction cannot be more than the net profit from the business under which the plan was established.

**TIP** *The deductible percentage of health insurance coverage increases to 70% for 2002.*

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

Use the *Self-Employed Health Insurance Deduction Worksheet* in the Form 1040 instruc-



tions to figure your deduction. Include the remaining part of the insurance payment in your medical expenses on Schedule A (Form 1040) if you itemize your deductions.

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

## Rent and Leasing

If you lease property for use in your farm business, you can generally deduct the rent you pay on Schedule F. However, you cannot deduct rent you pay in crop shares because you deduct the cost of raising the crops as farm expenses.

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

**Farm home.** If you rent a farm, do not deduct the part of the rental expense that represents the fair rental value of the farm home in which you live.

## Lease or Purchase

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

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

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

- 1) The agreement applies part of each payment toward an equity interest you will receive.
- 2) You get title to the property after you make a stated amount of required payments.
- 3) The amount you must pay to use the property for a short time is a large part of the amount you would pay to get title to the property.
- 4) You pay much more than the current fair rental value of the property.

5) You have an option to buy the property at a nominal price compared to the value of the property when you may exercise the option. Determine this value when you make the agreement.

6) You have an option to buy the property at a nominal price compared to the total amount you have to pay under the agreement.

7) The agreement designates part of the payments as interest, or part of the payments can be easily recognized as interest.

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

- 1) Revenue Procedure 2001–28 in Internal Revenue Bulletin 2001–19.
- 2) Revenue Procedure 2001–29 in Internal Revenue Bulletin 2001–19.

**Motor vehicle leases.** Special rules apply to lease agreements that have a terminal rental adjustment clause. In general, this is a clause that provides for a rental price adjustment based on the amount the lessor is able to sell the vehicle for at the end of the lease. If your rental agreement contains a terminal rental adjustment clause, treat the agreement as a lease if the agreement otherwise qualifies as a lease. For more information, see section 7701(h) of the Internal Revenue Code.

## Depreciation

If property you acquire to use in your farm business is expected to last more than one year, you generally cannot deduct the entire cost in the year you acquire it. You must recover the cost over more than one year and deduct part of it each year on Schedule F as depreciation or amortization. However, you can choose to deduct part or all of the cost of certain qualifying property, up to a limit, as a section 179 deduction in the year you place it in service.

Depreciation, amortization, and the section 179 deduction are discussed in chapter 8.

## 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:

- 1) As the principal place of business for any trade or business in which you engage,
- 2) As a place to meet or deal with patients, clients, or customers in the normal course of your trade or business, or
- 3) In connection with your trade or business, if you are using a separate structure that is not attached to your home.

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

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

2) 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.

1) 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).

2) 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.

You can carry over to your next tax year deductions over the current year's limit. 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 2001, the rate is 34½ cents a mile for all business miles driven. You can use the standard mileage rate for a car or a light truck, such as a van, pickup, or panel truck, you own or lease.

You cannot use the standard mileage rate if you operate two or more cars or light trucks at the same time. You are **not** using two or more vehicles at the same time if you alternate using

the vehicles (you use them at different times) for business.

**Example.** Maureen owns a car and a pickup truck that are both used in her farm business. Her farm employees use the truck and she uses the car for business. Maureen cannot use the standard mileage rate for the car or the truck. This is because both vehicles are used in Maureen's farm business at the same time. She must use actual expenses for both 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. If you choose this method of substantiating business use, you may not change to another method later. The following are used directly connected with the business of farming.

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

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

**More information.** For more information on deductible truck and car expenses, see chapter 4 of Publication 463. If you pay your employees for the use of their truck or car in your farm business, see *Reimbursements to employees under Travel Expenses*, next.

## Travel Expenses

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

- 1) Your duties require you to be absent from your farm substantially longer than an ordinary work day, and
- 2) 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.

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

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

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



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

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

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

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

**Reimbursements to employees.** You can generally deduct reimbursements you pay to your employees for travel and transportation expenses they incur in the conduct of your business. Employees may be reimbursed under an accountable or nonaccountable plan. Under an accountable plan, the employee must provide evidence of expenses. Under a nonaccountable plan, no evidence of expenses is required. If you reimburse expenses under an accountable plan, deduct them as travel and transportation expenses. If you reimburse expenses under a nonaccountable plan, you must report the reimbursements as wages on Form W-2 and deduct them as wages. For more information, see chapter 13 of Publication 535.

## Marketing Quota Penalties

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

## Tenant House Expenses

You can deduct the costs of maintaining houses and their furnishings for tenants or hired help as

farm business expenses. These costs include repairs, heat, light, insurance, and depreciation.

The value of a dwelling you furnish to a tenant under the usual tenant-farmer arrangement is not taxable income to the tenant.

## Items Purchased for Resale

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

**Example.** You report on the cash method. In 2001, you buy 50 steers you will sell in 2002. You cannot deduct the cost of the steers on your 2001 tax return. You deduct their cost in Part I of your 2002 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 you pay the costs if you do it consistently and it does not distort income. You can also 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 8.

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 7.

**Example.** You use the cash method of accounting. In 2001, you buy 500 baby chicks to raise for resale in 2002. You also buy 50 bushels of winter seed wheat in 2001 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 2001.

**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 3.

**Choosing a method.** You can adopt either of these methods 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 3.

## Other Expenses

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

- Accounting fees.
- Advertising.
- Chemicals.
- Custom hire (machine work).
- Educational expenses (to maintain and improve farming skills).
- Farm-related attorney fees.
- Farm fuels and oil.
- Farm magazines.
- Freight and trucking.
- Ginning.
- Insect sprays and dusts.
- Litter and bedding.
- Livestock fees.
- Recordkeeping expenses.
- Service charges.
- Small tools expected to last one year or less.
- Stamps and stationery.
- Storage and warehousing.
- Subscriptions to professional, technical, and trade journals that deal with farming.
- Tying material and containers.
- Veterinary fees and medicine.

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

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

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

## Capital Expenses

A capital expense is a payment, or a debt incurred, for the acquisition, improvement, or restoration of an asset that is expected to last more than one year. You include the expense in the basis of the asset. Uniform capitalization rules also require you to capitalize or include in inventory certain other expenses. See chapters 3 and 7.

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

- 1) The cost of fertilizer, lime, etc. (See *Fertilizer and Lime* under *Deductible Expenses*, earlier.)
- 2) Soil and water conservation expenses. (See chapter 6.)
- 3) The cost of property that qualifies for a deduction under section 179. (See chapter 8.)
- 4) The cost of qualifying clean-fuel vehicle property and clean-fuel vehicle refueling property. (See chapter 12 in Publication 535.)

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

- 1) Business start-up costs. (See *Going Into Business* in chapter 8.)
- 2) Land and buildings.
- 3) Additions, alterations, and improvements to buildings, etc.
- 4) Cars and trucks.
- 5) Equipment and machinery.
- 6) Fences.
- 7) Breeding, dairy, and draft livestock.
- 8) Reforestation.
- 9) Repairs to machinery, equipment, cars, and trucks that prolong their useful life, increase their value, or adapt them to different use.
- 10) Water wells, including drilling and equipping costs.
- 11) Land preparation costs, such as:

- a) Clearing land for farming,
- b) Leveling and conditioning land,
- c) Purchasing and planting trees,
- d) Building irrigation canals and ditches,
- e) Laying irrigation pipes,
- f) Installing drain tile,
- g) Modifying channels or streams,
- h) Constructing earthen, masonry, or concrete tanks, reservoirs, or dams, and
- i) Building roads.

**Crop production expenses.** The uniform capitalization rules generally require you to capi-

talize expenses incurred in producing plants. However, except for certain taxpayers required to use an accrual method of accounting, the capitalization rules do not apply to plants with a preproductive period of 2 years or less. For more information, see *Uniform Capitalization Rules* in chapter 7.

**Timber.** Capitalize the cost of acquiring timber. Do not include the cost of land in the cost of the timber. You must generally capitalize direct costs incurred in reforestation. These costs include the following.

- 1) Site preparation costs, such as:
  - a) Girdling,
  - b) Applying herbicide,
  - c) Baiting rodents, and
  - d) Clearing and controlling brush.
- 2) The cost of seed or seedlings.
- 3) Labor and tool expenses.
- 4) Depreciation on equipment used in planting or seeding.
- 5) Costs incurred in replanting to replace lost seedlings.

You can choose to capitalize certain indirect reforestation costs.

These capitalized amounts are your basis for the timber. Recover your basis when you sell the timber or take depletion allowances when you cut the timber. However, you may recover a limited amount of your costs for forestation or reforestation before cutting the timber through amortization deductions. For more information, see *Depletion* and *Amortization* in chapter 8.



For more information about timber, see Agriculture Handbook Number 708, *Forest Owners' Guide to the Federal Income Tax*. Copies are \$15 each and are available from the U.S. Government Printing Office. Place your order using Stock #001-000-04621-7. The address, telephone number, and web site are:

Superintendent of Documents  
U.S. Government Printing Office  
P.O. Box 371954  
Pittsburgh, PA 15250-7954  
(202) 512-1800  
[www.access.gpo.gov/su\\_docs](http://www.access.gpo.gov/su_docs)

**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 8.

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

Capitalize the cost of land improvements, such as road grading, ditching, and fire breaks, that have a useful life beyond the tax year. If the



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

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## 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 13 for more information.

#### Repayment of loans.

#### 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 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 11.

#### 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 gift or any later year. For example, you cannot deduct the cost of raising cattle or the cost of planting and raising unharvested wheat on parcels of land given as a gift to your children.

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

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

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

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

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## Losses From Operating a Farm

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

- 1) The at-risk limits.
- 2) The passive activity limits.

The following discussions explain these limits.

If your deductible loss after applying these limits is more than your other income for the year, you may have a net operating loss. See *Net Operating Losses*, later.



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

## At-Risk Limits

The at-risk rules limit your deduction for losses from most business or income-producing activities, including farming. The at-risk rules limit the losses you can deduct when figuring your taxable income. The deductible loss from an activity is limited to the amount you have at risk in the activity.

You are at risk in any activity for:

- 1) The money and adjusted basis of property you contribute to the activity, and
- 2) Amounts you borrow for use in the activity if:
  - a) You are personally liable for repayment, or
  - b) You pledge property (other than property used in the activity) as security for the loan.

You are not at risk, however, for amounts you borrow for use in a farming activity from a person who has an interest in the activity (other than as a creditor) or a person related to someone (other than you) having such an interest.

For more information, see Publication 925.

## Passive Activity Limits

A **passive activity** is generally any activity involving the conduct of any trade or business in which you do not materially participate. Generally, a rental activity is a passive activity.

If you have a passive activity, special rules limit the loss you can deduct in the tax year. You generally can deduct losses from passive activities only up to income from passive activities. Credits are similarly limited.

For more information, see Publication 925.

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## Net Operating Losses

If your deductible loss from operating your farm (after applying the at-risk and passive activity limits explained in the preceding discussion) is more than your other income for the year, you may have a net operating loss (NOL). You may also have an NOL if you had a personal or business-related casualty or theft loss that was more than your income.

If you have an NOL this year, you can use it to lower your taxable income in another year or years. You may be able to get a refund of all or part of the income tax you paid for past years, or reduce your tax in future years.

To determine if you have an NOL, complete your tax return for the year. You may have an NOL if a negative figure appears on the line shown below.

- 1) Individuals— line 37 of Form 1040.
- 2) Estates and trusts— line 22 of Form 1041.
- 3) Corporations— line 30 of Form 1120 or line 26 of Form 1120-A.

If the amount on that line is zero or more, you do not have an NOL.

There are rules that limit what you can deduct from gross income when figuring an NOL.

These rules are discussed in detail under *How To Figure an NOL* in Publication 536.

In general, these rules do not allow the following items.

- 1) Personal exemptions.
- 2) Capital losses in excess of capital gains. (Nonbusiness capital losses may only offset nonbusiness capital gains.)
- 3) The section 1202 exclusion of 50% of the gain from the sale or exchange of qualified small business stock.
- 4) Nonbusiness deductions in excess of nonbusiness income.
- 5) Net operating loss deduction.

**Example.** Glenn Johnson is a dairy farmer. He is single and has the following income and deductions on his Form 1040 for 2001.

<b>INCOME</b>	
Wages from part-time job . . . . .	\$1,225
Interest on savings . . . . .	425
Net long-term capital gain on sale of farm acreage . . . . .	<u>2,000</u>
<b>Glenn's total income</b> . . . . .	<b><u>\$3,650</u></b>
<b>DEDUCTIONS</b>	
Net loss from farming business (income of \$67,000 minus expenses of \$72,000) . . . . .	\$5,000
Net short-term capital loss on sale of stock . . . . .	1,000
Standard deduction . . . . .	4,550
Personal exemption . . . . .	<u>2,900</u>
<b>Glenn's total deductions</b> . . . . .	<b><u>\$13,450</u></b>

Glenn's deductions exceed his income by \$9,800 (\$13,450 – \$3,650). However, to figure whether he has an NOL, he must modify certain deductions. He can use **Schedule A (Form 1045)** to figure his NOL.

Glenn cannot deduct the following items.

Nonbusiness net short-term capital loss . . . . .	\$1,000
Nonbusiness deductions (standard deduction, \$4,550) minus nonbusiness income (interest, \$425) . . . . .	4,125
Personal exemption . . . . .	<u>2,900</u>
<b>Total adjustments to net loss</b> . . . . .	<b><u>\$8,025</u></b>

When these items are eliminated, Glenn's net loss is reduced to \$1,775 (\$9,800– \$8,025). This is his NOL for 2001.

**Carrybacks.** Generally, you carry an NOL back to the 2 tax years before the NOL year and deduct it from income you had in those years. You can choose not to carry back an NOL and only carry it forward. See *Waiving the carryback period*, later. There are rules for figuring how much of the NOL is used in each tax year and how much is carried to the next tax year. These rules are explained in Publication 536.

Unless you choose to waive the carryback period, as discussed later, you must first carry the entire NOL to the earliest carryback year. If your NOL is not used up, you can carry the rest to the next earliest carryback year, and so on.

Refigure your deductions, credits, and tax for each of the years to which you carried back an NOL. If your refigured tax is less than the tax you originally paid, you can apply for a refund by filing Form 1040X, *Amended U.S. Individual Income Tax Return*, for each year affected, or by filing Form 1045, *Application for Tentative Re-*

*fund*. You will usually get a refund faster by filing Form 1045, and you can use generally one Form 1045 to apply an NOL to all carryback years.

**Exceptions to 2-year carryback rule.** Eligible losses and farming losses qualify for longer carryback periods.

**Eligible loss.** The carryback period for an eligible loss is 3 years. An eligible loss is any part of an NOL that is:

- 1) From a casualty or theft, or
- 2) Attributable to a Presidentially declared disaster for a qualified small business.

Generally, an eligible loss does not include a farming loss (explained next).



*Only farming losses attributable to Presidentially declared disasters in tax years that begin after August 5, 1997, and before January 1, 1998, are considered "eligible losses" subject to a 3-year carryback period.*

**Farming loss.** The carryback period for a farming loss is 5 years. A farming loss is the **smaller** of:

- 1) The amount that would be the NOL for the tax year if only income and deductions attributable to farming businesses were taken into account, or
- 2) The NOL for the tax year.

You can choose to treat a farming loss as if it were not a farming loss. If you make this choice, the loss is subject to the 2-year carryback period. For more information, see *When To Use an NOL* in Publication 536.

**Carryovers.** If you do not use up the NOL in the carryback years, carry forward what remains of it to the 20 tax years following the NOL year. Start by carrying it to the first tax year after the NOL year. If you do not use it up, carry over the unused part to the next year. Continue to carry over any unused part of the NOL until you use it up or complete the 20-year carryforward period.



*For an NOL occurring in a tax year beginning before August 6, 1997, the carryforward period is 15 years.*

**Waiving the carryback period.** You can choose not to carry back your NOL. If you make this choice, you use your NOL only in the 20 year carryforward period. Once made, the choice is irrevocable.

To make this choice, attach a statement to your tax return for the NOL year filed on or before the due date of the return (including extensions). This statement must show you are choosing to waive the carryback period under section 172(b)(3) of the Internal Revenue Code. Also, if you filed your return timely without making that choice, you may still make the choice by filing an amended return within 6 months of the due date of the return (excluding extensions). Attach the statement to the amended return and write "Filed pursuant to section 301.9100-2" on the statement. File the amended return at the same address you filed the original return.

**Partnerships and S corporations.** Partnerships and S corporations generally cannot use an NOL. But partners or shareholders can use

their separate shares of the partnership's or S corporation's business income and business deductions to figure their individual NOLs.

## 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 these rules. So does an investment activity intended only to produce tax losses for the investors.

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:

- 1) You operate your farm in a businesslike manner,
- 2) The time and effort you spend on farming indicate you intend to make it profitable,
- 3) You depend on income from farming for your livelihood,
- 4) Your losses are due to circumstances beyond your control or are normal in the start-up phase of farming,
- 5) You change your methods of operation in an attempt to improve profitability,
- 6) You, or your advisors, have the knowledge needed to carry on the farming activity as a successful business,
- 7) You were successful in making a profit in similar activities in the past,
- 8) You make a profit from farming in some years and how much profit you make, and
- 9) 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 to be 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 to be carried on for profit if they produced a profit in at least 2 out 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, it is presumed to be 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 unless the IRS shows it is not valid.

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

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

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

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

Filing Form 5213 automatically extends the period of limitations on any year in the 5- (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 13), belong in this category. For the limits that apply to mortgage interest, see Publication 936, *Home Mortgage Interest Deduction*.

**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.

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

## 6.

# Soil and Water Conservation Expenses

## Introduction

If you are in the business of farming, you can choose to deduct certain expenses for soil or water conservation or for the prevention of erosion of land used in farming. Otherwise, these are capital expenses that must be added to the basis of the land. (See chapter 7 for information on determining basis.) Conservation expenses for land in a foreign country do not qualify for this special treatment.

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

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



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

## Topics

This chapter discusses:

- Business of farming
- Plan certification
- Conservation expenses
- Assessment by conservation district
- Limit on deduction
- Choosing to deduct
- Sale of a farm

## Business of Farming

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

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

**Farm rental.** If you own a farm and receive farm rental payments based on farm production, either in cash or crop shares, you are in the business of farming. If you receive a fixed rental payment not based on farm production, you are in the business of farming only if you materially participate in operating or managing the farm. See *Landlord Participation in Farming* in chapter 15.

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

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

## Plan Certification

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



**Conservation plans.** A conservation plan includes the farming conservation practices approved for the area where your farm land is located. There are three types of approved plans.

- **NRCS individual site plans.** These plans are issued individually to farmers who request assistance from NRCS to develop a conservation plan designed specifically for their farm land.
- **NRCS county plans.** These plans include a listing of farm conservation practices approved for the county where the farm land is located. You can deduct expenses for conservation practices not included on the NRCS county plans only if the practice is a part of an individual site plan.
- **Comparable state agency plans.** These plans are approved by state agencies and can be approved individual site plans or county plans. Individual site plans can be obtained from NRCS offices and comparable agencies.

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## Conservation Expenses

You can deduct conservation expenses only for land you or your tenant are using, or have used in the past, for farming. These expenses include, but are not limited to, expenses for the following.

- 1) The treatment or movement of earth, such as:
  - a) Leveling,
  - b) Conditioning,
  - c) Grading,
  - d) Terracing,
  - e) Contour furrowing, and
  - f) Restoration of soil fertility.
- 2) The construction, control, and protection of:
  - a) Diversion channels,
  - b) Drainage ditches,
  - c) Irrigation ditches,
  - d) Earthen dams, and
  - e) Watercourses, outlets, and ponds.
- 3) The eradication of brush.
- 4) The planting of windbreaks.

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



*If you choose to deduct soil and water conservation expenses, you cannot exclude from gross income any cost-sharing payments you receive for those*

*expenses. See chapter 4 for information about excluding cost-sharing payments.*

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

**Land not used for farming.** If your conservation expenses benefit both land that does not qualify as land used for farming and land that does qualify, you must allocate the expenses. For example, if the expenses benefit 200 acres of your land, but only 120 acres of this land are used for farming, then you can deduct 60% (120 ÷ 200) of the expenses. You can use another method to allocate these expenses if you can clearly show that your method is more reasonable.

**Depreciable conservation assets.** You generally cannot deduct your expenses for depreciable conservation assets. However, you can deduct certain amounts you pay or incur for an assessment for depreciable property that a soil and water conservation or drainage district levies against your farm. See *Assessment for Depreciable Property*, later.

You must capitalize direct expenses for structures or facilities subject to an allowance for depreciation, such as depreciable nonearthen property made of masonry or concrete. Expenses for depreciable property include those for materials, supplies, wages, fuel, hauling, and moving dirt when making structures such as tanks, reservoirs, pipes, culverts, canals, dams, wells, or pumps composed of masonry, concrete, tile, metal, or wood. You recover your capital investment through annual allowances for depreciation.

You can deduct soil and water conservation expenses for nondepreciable earthen items. Nondepreciable earthen items include certain dams, ponds, and terraces described in chapter 8.

**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 must also capitalize your cost for drilling a test hole. If the test hole produces no water and you continue drilling, the cost of the test hole is added to the cost of the producing well. You can recover the total cost through depreciation deductions.

If a test hole, dry hole, or dried-up well (resulting from prolonged lack of rain, for instance) is abandoned, you can deduct your unrecovered cost in the year of abandonment. Abandonment means that all economic benefits from the well are terminated. For example, filling or sealing a well excavation or casing so that all economic

benefits from the well are terminated would be abandonment.

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## 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 can generally 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 6–1* 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 conservation expense and the capital expense.

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

**Table 6–1. Limits on Deducting an Assessment for Depreciable Property**

Total Limit on Deduction for Assessment	Yearly Limit on Deduction for Assessment	Yearly Limit for All Conservation Expenses
<b>10% of:</b>	<b>\$500 + 10% of:</b>	<b>25% of:</b>
Total assessment against all members of the district for the property.	Your deductible share of the cost to the district for the property.	Your gross income from farming.
<ul style="list-style-type: none"> <li>● No one taxpayer can deduct more than 10% of the total assessment.</li> <li>● Any amount over 10% is a capital expense and is added to the basis of your land.</li> <li>● If an assessment is over 10% and payable in installments, each payment must be prorated between the conservation expense and the capital expense.</li> </ul>	<ul style="list-style-type: none"> <li>● 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.</li> <li>● You can deduct the remainder in equal amounts over the next 9 tax years.</li> </ul>	<ul style="list-style-type: none"> <li>● Limit for all conservation expenses, including assessments for depreciable property.</li> <li>● 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.</li> </ul>

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

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

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

To figure the maximum amount you can deduct for the depreciable equipment this year, multiply your deductible share of the total assessment (\$700) by 10%. Add \$500 to the result for a total of \$570. Since your deductible share, \$700, is greater than the maximum amount deductible in one year, you can deduct only \$70 of the amount you paid or incurred for depreciable property this year (10% of \$700). You can deduct the balance at the rate of \$70 a year over the next 9 years.

You add \$70 to the \$1,500 portion of the assessment for drainage ditches. You can deduct \$1,570 of the \$2,400 assessment as a soil and water conservation expense this year, subject to the 25% of gross income from farming limit on the deduction, discussed later.

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

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

deductible in one year, you can deduct the entire \$550 this year. You can deduct the entire assessment, \$2,400, as a soil and water conservation expense this year, subject to the 25% of gross income from farming limit on the deduction, discussed later.

**Sale or disposal of land during 9-year period.** If you sell or 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 the farmer dies during the 9-year period, any remaining amounts not yet deducted are deducted in the year of death.

## 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 livestock held for draft, breeding, or dairy 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 2001, 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 2002 and added to deductible soil and water conservation expenses made in that year. The total of the 2001 carryover plus 2002 expenses is deductible in 2002, subject to the limit of 25% of your gross income from farming in 2002. Any expenses

over the limit in that year are carried to 2003 and later years.

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

## Choosing To Deduct

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

**Change of method.** If you want to change your method of treating soil and water conservation expenses, or you want to treat the expenses for a particular project or a single farm in a different manner, you must get the approval of the IRS. To get this approval, submit a written request by the due date of your return for the first tax year you want the new method to apply. You or your authorized representative must sign the request.

The request must include the following information.

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

# 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 farm land.** 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 11.

## 7.

# Basis of Assets

## Introduction

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

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



It is important to keep an accurate record of your basis. For information on keeping records, see chapter 1.

## Topics

This chapter discusses:

- Cost basis
- Adjusted basis
- Basis other than cost

## Useful Items

You may want to see:

### Publication

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

- 551 Basis of Assets

### Form (and Instructions)

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

See chapter 21 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 unless you choose to capitalize them, as discussed in chapter 5 of Publication 535.

You may also 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.

If you buy improvements, such as buildings, and the land on which they stand for a lump sum, allocate your cost basis between the land and improvements to figure the basis for depreciation of the improvements. Allocate the cost basis according to the respective fair market values of the land and improvements at the time of purchase.

**Real estate taxes.** If you pay real estate taxes the seller owed on real property you bought, and the seller did not reimburse you, treat those taxes as part of your basis. You cannot deduct them as an expense.

If you reimburse the seller for taxes the seller paid for you, you usually can deduct that amount as an expense in the year of purchase. Do not include that amount in the basis of your property. If you did not reimburse the seller, you must reduce your basis by the amount of those taxes.

**Settlement costs.** You can include in the basis of property you buy the settlement fees and closing costs that are for buying the property. (A

fee for buying property is a cost that must be paid even if you bought the property for cash.) You cannot include fees and costs for getting a loan on the property.

The following items are some of the settlement fees or closing costs you can include in the basis of your property.

- Abstract fees (abstract of title fees).
- Charges for installing utility services.
- Legal fees (including title search and preparation of the sales contract and deed).
- Recording fees.
- Surveys.
- Transfer taxes.
- Owner's title insurance.
- Any amounts the seller owes that you agree to pay, such as back taxes or interest, recording or mortgage fees, charges for improvements or repairs, and sales commissions.

Settlement costs **do not include** amounts placed in escrow for the future payment of items such as taxes and insurance.

The following items are some settlement fees and closing costs you **cannot** include in the basis of the property.

- 1) Casualty insurance premiums.
  - 2) Rent for occupancy of the property before closing.
  - 3) Charges for utilities or other services related to occupancy of the property before closing.
  - 4) Fees for refinancing a mortgage.
  - 5) Charges connected with getting a loan.
- The following items are examples of these charges.

- a) Mortgage insurance premiums.
- b) Loan assumption fees.
- c) Cost of a credit report.
- d) Fees for an appraisal required by a lender.

If these costs relate to **business property**, items (1) through (3) are deductible as business expenses. Items (4) and (5) must be capitalized as costs of getting a loan and can be deducted over the period of the loan.

**Points.** If you pay points to get a loan (including a mortgage, second mortgage, or line-of-credit), do not add the points to the basis of the related property. Generally, you deduct the points over the term of the loan. For more information about deducting points, see *Points* in chapter 5 of Publication 535.

**Points on home mortgage.** Special rules may apply to points you and the seller pay when you get a mortgage to buy your main home. If certain requirements are met, you can deduct the points in full for the year in which they are paid. Reduce the basis of your home by the amount of any seller-paid points. For more information, see *Points* in Publication 936, *Home Mortgage Interest Deduction*.



**Assumption of a mortgage.** If you buy property and assume (or buy 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 items.

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

In addition, if you use your employees, farm materials, and equipment to build an asset, your basis would also include the following costs.

- 1) Wages paid for the construction work.
- 2) Depreciation on equipment you own while it is used in the construction.
- 3) Operating and maintenance costs for equipment used in the construction.
- 4) Business supplies and materials used in the construction.

Do not deduct these expenses. You **must** capitalize them (include them in the asset's basis).

Reduce the asset's basis by any work opportunity credit, welfare-to-work credit, Indian employment credit, or empowerment zone employment credit allowable on the wages you pay in (1). For information about these credits, see Publication 954, *Tax Incentives for Empowerment Zones and Other Distressed Communities*.



*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

If you buy multiple assets for a lump sum, allocate the amount you pay among the assets. Use this allocation to figure your basis for depreciation and gain or loss on a later disposition of any of these assets.

**Group of assets acquired.** If you buy multiple assets for a lump sum, 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.

**Example.** In March you bought property for \$36,000. In the sales contract, you and the seller (not a related person) agree to allocate the purchase price among the assets based on their

respective fair market values (FMV). FMV is defined later under *Basis Other Than Cost*. The following is an inventory of the property at its FMV on the date of purchase.

	<b>FMV</b>
Tractor .....	\$15,000
Plow .....	5,000
Mower .....	6,000
Manure spreader .....	4,000
<b>Total FMV .....</b>	<b><u>\$30,000</u></b>

Your basis in each of the assets is the portion of the purchase price (\$36,000) allocated to that asset.

	<b>Basis</b>
Tractor $(\$15,000 \div \$30,000) \times \$36,000$ ..	\$18,000
Plow $(\$5,000 \div \$30,000) \times \$36,000$ .. .	6,000
Mower $(\$6,000 \div \$30,000) \times \$36,000$ .. .	7,200
Manure spreader $(\$4,000 \div \$30,000)$ $\times \$36,000$ .....	4,800
<b>Total purchase price .....</b>	<b><u>\$36,000</u></b>

**Farming business acquired.** If you buy a group of assets that constitutes a farming business, there are special rules you must use to allocate the purchase price among the assets. See *Trade or Business Acquired under Real Property* 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. 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.

## Uniform Capitalization Rules

Under the uniform capitalization rules, you must capitalize all direct costs and an allocable part of indirect costs incurred due to your production or resale activities. The term **capitalize** means to include certain expenses in the basis of property you produce or in your inventory costs, rather than claiming them as a current deduction. You recover the costs through depreciation, amortization, or cost of goods sold when you use, sell, or otherwise dispose of the property.

**Activities subject to the rules.** You are subject to the uniform capitalization rules if you do any of the following, unless the property is pro-

duced for your use other than in a trade or business or an activity carried on for profit.

- 1) Produce real or tangible personal property.
- 2) Acquire property for resale. However, this rule does not apply to personal property if your average annual gross receipts for the three prior tax years are \$10 million or less.

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



*Generally, you are not required to capitalize the costs of producing animals and certain plants. See Exceptions, later.*

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

The term **plant** includes the following items.

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

The term **animal** includes any stock, poultry or other bird, and fish or other sea life.

**Exceptions.** The uniform capitalization rules do not apply to the following.

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

Exceptions (1) and (2) do not apply to a corporation, partnership, or tax shelter required to use an accrual method of accounting. See *Accrual method required* under *Accounting Methods* in chapter 3.

**Table 7–1. Preproductive Period of More Than 2 Years**

<b>Plants producing the following crops or yields have a nationwide weighted average preproductive period of more than 2 years.</b>		
Almonds • Apples	Grapes • Guavas	Peaches • Pears
Apricots • Avocados	Kumquats • Lemons	Pecans • Persimmons
Blackberries • Cherries	Limes • Macadamia Nuts	Pistachio Nuts • Plums
Blueberries • Chestnuts	Mangoes • Nectarines	Pomegranates • Prunes
Coffee Beans • Currants	Olives • Oranges	Raspberries • Tangelos
Dates • Figs • Grapefruit	Papayas • Kumquats	Tangerines • Walnuts

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

**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 cost and an allocable part of indirect costs incurred due to the production of the trees. However, you are not required to capitalize the costs of producing the 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 7-1* have a preproductive period of more than 2 years. Other plants may also have a preproductive period of more than 2 years.

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

## Adjusted Basis

Before figuring gain or loss on a sale, exchange, or other disposition of property or figuring allowable depreciation, depletion, or amortization, you must usually make certain adjustments to the basis of the property. The result of these adjustments is the adjusted basis of the property.

## Increases to Basis

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

The following costs increase the basis of property.

- Extending utility service lines to property.
- Legal fees, such as the cost of defending and perfecting title.
- Legal fees for obtaining a decrease in an assessment levied against property to pay for local improvements.

If you make additions or improvements to business property, keep separate accounts for them. Depreciate the basis of each addition or improvement according to the depreciation rules that would apply to the underlying property if you had placed it in service at the same time you

placed the addition or improvement in service. See chapter 8.

**Assessments for local improvements.** Increase the basis of property by assessments for items such as paving roads and building ditches that increase the value of the property assessed. Do not deduct them as taxes. However, you can deduct as taxes charges for maintenance, repairs, or interest charges related to the improvements.

**Deducting vs. capitalizing costs.** Do not add to your basis costs you can deduct as current expenses. For example, amounts paid for incidental repairs or maintenance are deductible as business expenses and are not added to basis. However, you can choose either to deduct or to capitalize certain other costs. See chapter 8 in Publication 535.

## Decreases to Basis

The following items reduce the basis of property.

- The section 179 deduction.
- The deduction for clean-fuel vehicles and clean-fuel vehicle refueling property.
- Investment credit (part or all) taken.
- Casualty and theft losses and insurance reimbursements.
- Amounts you receive for granting an easement.
- Deductions previously allowed or allowable for amortization, depreciation, and depletion.
- Exclusion from income of subsidies for energy conservation measures.
- Credit for qualified electric vehicles.
- Postponed gain from the sale of your home.
- Certain canceled debt excluded from income.
- Rebates.
- Patronage dividends received as a result of a purchase of property. See *Patronage Dividends* in chapter 4.
- Gas-guzzler tax.
- Employer-provided child care credit (effective for tax years beginning after 2001).

Some of these items are discussed next.

**Section 179 deduction.** If you take the section 179 deduction for all or part of the cost of qualifying business property, decrease the basis of the property by the deduction. For more information, see *Section 179 Deduction* in chapter 8.

**Deduction for clean-fuel vehicle and clean-fuel vehicle refueling property.** If you take the deduction for clean-fuel vehicles or clean-fuel vehicle refueling property, decrease the basis of the property by the deduction. For more information, see chapter 12 in Publication 535.

**Casualties and thefts.** If you have a casualty or theft loss, decrease the basis of the property by the amount of any insurance or other reimbursement. Also, decrease it by any deductible

loss not covered by insurance. See chapter 13 for information about figuring your casualty or theft loss.

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

**Easements.** The amount you receive for granting an easement is usually considered to be from the sale of an interest in the real property. It reduces the basis of the affected part of the property. If the amount received is more than the basis of the part of the property affected by the easement, reduce your basis in that part to zero and treat the excess as a recognized gain. See *Easements and rights-of-way* in chapter 4.

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

See chapter 8 for information on figuring the depreciation you should have claimed. See also *Changing Your Accounting Method* in chapter 8 for information that may benefit you if you deducted the wrong amount of depreciation.

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

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

**Credit for qualified electric vehicle.** If you claim the credit for a qualified electric vehicle, you must reduce your basis in that vehicle by the lesser of the following amounts.

- \$4,000.
- 10% of the vehicle's cost.

This reduction amount applies even if the credit allowed is less than that amount. For more information on this credit, see chapter 12 in Publication 535.

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

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

- 1) Debt canceled in a bankruptcy case or when you are insolvent.
- 2) Qualified farm debt.
- 3) Qualified real property business debt (provided you are not a C corporation).

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

For more information about canceled debt in a bankruptcy case, see Publication 908, *Bankruptcy Tax Guide*. For more information about insolvency and canceled debt that is qualified farm debt, see chapter 4. For more information about qualified real property business debt, see chapter 5 in Publication 334, *Tax Guide for Small Business*.

## Basis Other Than Cost

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

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

**Property changed to business or rental use.** When you hold property for personal use and 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 business use would be renting out your personal residence.

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

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

**Property received for services.** If you receive property for services, include the property's FMV in income. The amount you include in income becomes your basis. If the services were performed for a price agreed on beforehand, it will be accepted as the FMV of the property if there is no evidence to the contrary.

## Taxable Exchanges

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

of the property you receive is usually its FMV at the time of the exchange.

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

## Nontaxable Exchanges

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

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

## Like-Kind Exchanges

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

For an exchange to qualify as a like-kind exchange, you must hold for business or investment purposes both the property you transfer and the property you receive. There must also be an exchange of like-kind property. For more information, see *Like-Kind Exchanges* in chapter 10.

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

**Example.** You trade a machine (adjusted basis \$8,000) for another like-kind machine (FMV \$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 basis of the property you gave up plus the money you paid.

**Example.** You trade in a truck (adjusted basis \$3,000) for another truck (FMV \$7,500) and pay \$4,000. Your basis in the new truck is \$7,000 (the \$3,000 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. 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 10.

**Exchange of business property.** Exchanging the property of one business for the property of another business is a multiple property exchange. For information on figuring basis, see *Multiple Property Exchanges* in chapter 1 of Publication 544, *Sales and Other Dispositions of Assets*.

## Partially Nontaxable Exchange

A partially nontaxable exchange is an exchange in which you receive unlike property or money in addition to like property. The basis of the property you receive is the same as the 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 farm land (basis \$10,000) for another tract of farm land (FMV \$11,000) and \$3,000 cash. You realize a gain of \$4,000. This is the FMV of the land received plus the cash minus the basis of the land you traded (\$11,000 + \$3,000 - \$10,000). Include your gain in income (recognize gain) only to the extent of the cash received. Your basis in the land you received is figured as follows.

Basis of land traded . . . . .	\$10,000
Minus: Cash received (adjustment 1(a))	- 3,000
	<u>7,000</u>
Plus: Gain recognized (adjustment 2(b))	+ 3,000
<b>Basis of land received . . . . .</b>	<b><u>\$10,000</u></b>

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

Adjusted basis of truck traded . . . . .	\$22,750
Minus: Cash received (adjustment 1(a))	-10,000
	<u>\$12,750</u>
Plus: Gain recognized (adjustment 2(b))	+ 7,250
<b>Basis of truck received . . . . .</b>	<b><u>\$20,000</u></b>



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

**Example.** You had an adjusted basis of \$15,000 in a tractor you traded for another tractor that had an FMV of \$12,500. You also received \$1,000 cash and a truck that had an FMV of \$3,000. The truck is unlike property. You realized a gain of \$1,500. This is the FMV of the tractor received plus the FMV of the truck received plus the cash minus the adjusted basis of the tractor you traded (\$12,500 + \$3,000 + \$1,000 – \$15,000). You include in income (recognize) all \$1,500 of the gain because it is less than the FMV of the unlike property plus the cash received. Your basis in the properties you received is figured as follows.

Adjusted basis of old tractor . . . . .	\$15,000
Minus: Cash received (adjustment 1(a))	<u>-1,000</u>
	\$14,000
Plus: Gain recognized (adjustment 2(b))	<u>+1,500</u>
<b>Total basis of properties received . . .</b>	<b><u>\$15,500</u></b>

Allocate the total basis of \$15,500 first to the unlike property—the truck (\$3,000). This is the truck's FMV. The rest (\$12,500) is the basis of the tractor.

## Sale and Purchase

If you sell property and buy similar property in two mutually dependent transactions, you may 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 depreciation for the new tractor would then be \$13,500 (\$11,500 + \$2,000, the basis of your old tractor). However, you want a higher basis for depreciating the new tractor, so you agree to pay the dealer \$15,500 for the new tractor if he will pay you \$4,000 for your old tractor. Because the two transactions are dependent on each other, you are treated as having exchanged your old tractor for the new one and paid \$11,500 (\$15,500 – \$4,000). Your basis for depreciating the new tractor is \$13,500, the same as if you traded the old tractor.

## Involuntary Conversions

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

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

- 1) Decrease the basis by the following amounts.

- a) Any loss you recognize on the involuntary conversion.
  - b) Any money you receive that you do not spend on similar property.
- 2) Increase the basis by the following amounts.
    - a) Any gain you recognize on the involuntary conversion.
    - b) Any cost of acquiring the replacement property.

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

For more information about involuntary conversions, see chapter 13.

## Property Received as a Gift

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

**FMV equal to or more than donor's adjusted basis.** If the FMV of the property is equal to or more than the donor's adjusted basis, your basis is the donor's adjusted basis when you received the gift. Increase your basis by all or part of any gift tax paid, depending on the date of the gift.

Also, for figuring gain or loss from a sale or other disposition of the property, or for figuring depreciation, depletion, or amortization deductions on business property, you must increase or decrease your basis (the donor's adjusted basis) by any required adjustments to basis while you held the property. See *Adjusted Basis*, earlier.

**Gift received before 1977.** If you received a gift before 1977, increase your basis in the gift (the donor's adjusted basis) by any gift tax paid on it. However, do not increase your basis above the FMV of the gift when it was given to you.

**Example 1.** You were given a house in 1976 with an FMV of \$21,000. The donor's adjusted basis was \$20,000. The donor paid a gift tax of \$500. Your basis is \$20,500, the donor's adjusted basis plus the gift tax paid.

**Example 2.** If, in Example 1, the gift tax paid had been \$1,500, your basis would be \$21,000. This is the donor's adjusted basis plus the gift tax paid, limited to the FMV of the house at the time you received the gift.

**Gift received after 1976.** If you received a gift after 1976, increase your basis in the gift (the donor's adjusted basis) by the part of the gift tax paid on it that is due to the net increase in value of the gift. Figure the increase by multiplying the gift tax paid by the following fraction.

$$\frac{\text{Net increase in value of the gift}}{\text{Amount of the gift}}$$

The net increase in value of the gift is the FMV of the gift minus the donor's adjusted basis. The amount of the gift is its value for gift tax purposes after reduction by any annual exclusion and marital or charitable deduction that applies to the gift. For information on the gift tax, see Publication 950, *Introduction to Estate and Gift Taxes*.

**Example.** In 2001, 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 \$40,000 (\$50,000 minus the \$10,000 annual exclusion). She paid a gift tax of \$9,000. Your basis, \$26,750, is figured as follows:

Fair market value . . . . .	\$50,000
Minus: Adjusted basis . . . . .	<u>-20,000</u>
Net increase in value . . . . .	<u>\$30,000</u>
Gift tax paid . . . . .	\$9,000
Multiplied by (\$30,000 ÷ \$40,000) . . . . .	<u>× .75</u>
Gift tax due to net increase in value . . . . .	\$6,750
Adjusted basis of property to your mother	<u>+20,000</u>
<b>Your basis in the property . . . . .</b>	<b><u>\$26,750</u></b>

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

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

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

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

## Property Transferred From a Spouse

The basis of property transferred to you or transferred in trust for your benefit by your spouse is the same as your spouse's adjusted basis. The same rule applies to a transfer by your former spouse if the transfer is incident to divorce. However, adjust your basis for any gain recognized by your spouse or former spouse on property transferred in trust. This rule applies only to a transfer of property in trust in which 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 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 is generally one of the following.

- 1) The FMV of the property at the date of the individual's death.
- 2) The FMV on the alternate valuation date, if the personal representative for the estate chooses to use alternate valuation. For information on the alternate valuation date, see the instructions for Form 706.
- 3) 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. For information on a qualified conservation easement, see the instructions for Form 706.
- 4) The value under the special-use valuation method for real property used in farming or other closely held business, if chosen for estate tax purposes. This method is discussed next.

If a federal estate tax return does not have to be filed, your basis in the inherited property is its appraised value at the date of death for state inheritance or transmission taxes.

**Special use valuation.** Under certain conditions, when a person dies, the executor or personal representative of that person's estate may choose to value the 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 chooses this method of valuation for estate tax purposes, this value is the basis of the property for the 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 the 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 may apply if you dispose of the property in a like-kind exchange or involuntary conversion. The tax does not apply if you transfer the property to a member of your family and certain requirements are met. See Form 706-A and its instructions for more information on this tax.

You can elect to increase your basis in special-use valuation property if it becomes subject to the additional estate tax. To increase your basis, you must make an irrevocable election and pay interest on the additional estate tax figured from the date 9 months after the decedent's death until the date of payment of the additional estate tax. If you meet these requirements, increase your basis in the property to its FMV on the date of the decedent's death or the alternate valuation date. The increase in your basis is considered to have occurred immediately before the event that resulted in the additional estate tax.

You make the election by filing with Form 706-A, a statement that does all the following.

- 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.
- Provides any additional information required by the Form 706-A instructions.

**Community property.** In community property states (Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin), husband and wife are each usually considered to own half the community property. When either spouse dies, the total value of the community property, even the part belonging to the surviving spouse, generally becomes the basis of the entire property. For this rule to apply, at least half the value of the community property interest must be includible in the decedent's gross estate, whether or not the estate must file a return.

**Example.** You and your spouse owned community property that had a basis of \$80,000. When your spouse died, half the FMV of the community interest was includible in your spouse's estate. The FMV of the community interest was \$100,000. The basis of your half of the property after the death of your spouse is \$50,000 (half of the \$100,000 FMV). The basis of the other half to your spouse's heirs is also \$50,000.

For more information about community property, see Publication 555, *Community Property*.

## 8.

# Depreciation, Depletion, and Amortization

## Important Change for 2001

**Increase in the section 179 deduction.** The maximum section 179 deduction you can elect for property you placed in service during 2001 has increased to \$24,000. See *Dollar limit*.

## Important Reminder

**Marginal production of oil and gas.** The suspension of the taxable income limit on percentage depletion from the marginal production of oil and natural gas has been extended to tax years beginning after 1999 and before 2002. For more information on marginal production, see section 613A(c) of the Internal Revenue Code.

## Introduction

If you buy farm property such as machinery, equipment, 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 more than one year and deduct part of it each year. For most types of property, this is called depreciation.

This chapter gives information on depreciation methods that do not generally apply to property placed in service before 1987. For information on depreciating such property, see Publication 534, *Depreciating Property Placed in Service Before 1987*.



**CAUTION** For property used in a farming business, you must use the 150% declining balance method rather than the 200% declining balance method, or you can elect an alternative method. The methods you can use are discussed later under Which Depreciation Method Applies.



**TIP** To help you understand depreciation and how to complete Form 4562, Depreciation and Amortization, see the filled-in Form 4562 and related discussion in chapter 20.

This chapter also provides information on figuring both cost depletion (including timber depletion) and percentage depletion.

The last section of this chapter discusses amortization of the costs of going into business, reforestation costs, the costs of pollution control

facilities, and the costs of section 197 intangibles.

## Topics

This chapter discusses:

- Overview of depreciation
- Section 179 deduction
- Modified Accelerated Cost Recovery System (MACRS)
- Listed property rules
- Basic information on depletion and amortization

## Useful Items

You may want to see:

### Publication

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

### Form (and Instructions)

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

See chapter 21 for information about getting publications and forms.

# Overview of Depreciation

The first part of this chapter gives you basic information on what property can be depreciated, when depreciation begins and ends, whether MACRS can be used to figure depreciation, what the basis of your depreciable property is, and how to treat improvements. It also explains whether you must file Form 4562 and 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, vehicles, furniture, and equipment. You can also depreciate certain intangible property, such as copyrights, patents, and computer software. To be depreciable, the property must meet all the following requirements.

- It must be property you own.
- It must be used in your business or income-producing activity.
- It must have a determinable useful life.
- It must be expected to last more than one year.
- It must *not* be excepted property.

The following discussions provide information about these requirements.

## 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 for the property (explained later). This means you bear the burden of exhaustion of the capital investment in the property. Therefore, if you lease property to use in your trade or business or for the production of income, you cannot depreciate its cost. You can, however, depreciate any capital improvements you make to the leased property. See *Additions and Improvements* in chapter 3 of Publication 946.

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

**Incidents of ownership.** Incidents of ownership include the following.

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

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

## Property Used in Your Business or Income-Producing Activity

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

**Partial business or investment use.** If you use property (including your car) for business or

investment purposes and for personal purposes, you can deduct depreciation only on the part used for business or investment.

For example, if you use your car for farm business, you can deduct depreciation for the part you use in farming. If you also use it for investment purposes, you can depreciate the part used for investment.

If you use part of your home for business, you may be able to take a depreciation deduction for its business use. For more information, see *Business Use of Your Home* in chapter 5.

**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.

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

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

## Property Having a Determinable Useful Life

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

**Land.** You can never depreciate the cost of land because land does not wear out, become obsolete, or get used up. The cost of land generally includes the cost of clearing, grading, planting, and landscaping because these expenses are all part of the cost of the land itself. For information on land preparation costs you may be able to depreciate, see chapter 1 of Publication 946.

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

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

**Intangible property.** The following are two types of intangible property that you can never depreciate.

**Goodwill.** You can never depreciate goodwill because its useful life cannot be determined. However, if you acquired a business after August 10, 1993 (July 25, 1991, if elected), and part of the price included goodwill, you may be able to amortize the cost of the goodwill over 15 years. For more information, see *Amortization*, later.



**Trademark or trade name.** In general, a trademark or trade name does not have a determinable useful life and, therefore, you cannot depreciate its cost. However, you may be able to amortize its cost over 15 years if you acquired it after August 10, 1993 (after July 25, 1991, if elected). For more information, see *Amortization*, later.

## Property Lasting More Than One Year

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

### Excepted Property

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

- Property placed in service and disposed of in the same year. Determining when property is placed in service is explained later.
- Equipment used to build capital improvements. You must add otherwise allowable depreciation on the equipment during the period of construction to the basis of your improvements. See *Uniform Capitalization Rules* in Publication 551.
- Section 197 intangibles.
- Certain term interests.

**Section 197 intangibles.** Intangible property that is a section 197 intangible, described later under *Amortization*, cannot be depreciated but can be amortized over a 15-year period.

**Computer software.** Computer software includes all programs designed to cause a computer to perform a desired function. It also includes any data base or similar item in the public domain and incidental to the operation of qualifying software.

Computer software is a section 197 intangible only if you acquired it in connection with the acquisition of assets constituting a business or a substantial part of a business. However, computer software is not a section 197 intangible and can be depreciated, 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.

**Certain term interests in property.** You cannot depreciate a term interest in property acquired by gift, bequest, or inheritance. In addition, 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. For more information, see Publication 946.

## When Does Depreciation Begin and End?

You begin to depreciate your property when you place it in service for use in your trade or business or for the production of income. You stop depreciating property either when you have fully recovered your cost or other basis or when you retire it from service, whichever happens first.

### Placed in Service

Property is placed in service when it is ready and available for a specific use, whether in a business activity, an income-producing activity, a tax-exempt activity, or a personal activity. Even if you are not using the property, it is in service when it is ready and available for its specific use.

**Example 1.** You bought a home and used it as your personal home for several years before you converted it to rental property. Although its specific use was personal and no depreciation was allowable, you placed the home in service when you began using it as your home. You can begin to claim depreciation in the year you converted it to rental property because its use changed to an income-producing use at that time.

**Example 2.** You bought a planter that was delivered for your farm business in December 2001 after harvest was over. You begin to depreciate the planter for 2001 because it was ready and available for its specific use in 2001, even though it will not be used until the spring of 2002.

**Example 3.** If your planter comes unassembled in December 2001 and is put together in February 2002, it is not placed in service until 2002. You begin to depreciate it in 2002.

**Example 4.** If your planter was delivered and assembled in February 2002 but not used until April 2002, it is placed in service in February 2002, since this is when the planter was ready for its specified use.

**Fruit or nut trees and vines.** If you acquire an orchard, grove, or vineyard before the trees or vines have reached the income-producing stage, and they have a preproductive period of more than 2 years, you must capitalize the preproductive-period costs under the uniform capitalization rules (unless you elect not to use these rules). See chapter 7 for information about the uniform capitalization rules. Your depreciation begins when the trees and vines reach the income-producing stage.

**Immature livestock.** If you acquire immature livestock for draft, dairy, or breeding purposes, your depreciation begins when they reach maturity. This means depreciation begins when the livestock reach the age when they can be worked, milked, or bred. When this occurs, your basis for depreciation is your initial cost for the immature livestock.

### Idle Property

You must claim a deduction for depreciation on property used in your business or for the produc-

tion of income even if it is temporarily idle. For example, if you stop using a machine because there is a temporary lack of market for a product made with that machine, you must continue to deduct depreciation on the machine.

### Cost or Other Basis Fully Recovered

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

### Retired From Service

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

- You sell or exchange the property.
- You convert the property to personal use.
- You abandon the property.
- The property is destroyed.

For information on abandonment of property, see chapter 10. For information on destroyed property, see chapter 13.

## Can You Use MACRS To Depreciate Your Property?

You must use the Modified Accelerated Cost Recovery System (MACRS) to depreciate **most** property. MACRS is explained later under *Figuring Depreciation Under MACRS*. This part discusses the kinds of property that cannot be depreciated under MACRS and must be depreciated using other methods.

You **cannot** use MACRS to depreciate the following property.

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

If your property is not described in the above list, figure the depreciation using MACRS.

### Property You Placed in Service Before 1987

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

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

## Pre-1987-Use Property

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

## Election To Exclude Property From MACRS

If you properly depreciate any property under a method not based on a term of years, such as the unit-of-production method, you can elect to exclude that property from MACRS. You make the election by reporting your depreciation for the property on line 18 of Part III of Form 4562 and attaching a statement as described in the instructions for Form 4562. You must make this election by the return due date (including extensions) for the year you place your property in service. However, if you timely filed your return for the year without making the election, you can still make the election by filing an amended return within 6 months of the due date of the return (excluding extensions). Attach the election to the amended return and write "Filed pursuant to section 301.9100-2" on the election statement. File the amended return at the same address you filed the original return.

**Use of standard mileage rate.** If you use the standard mileage rate to figure your tax deduction for your business automobile, you are treated as having made an election to exclude the automobile from MACRS. See Publication 463 for a discussion of the standard mileage rate.

## What Is the Basis of Your Depreciable Property?

To figure your depreciation deduction, you must determine the basis of your property. To determine basis, you need to know the cost or other basis of your property.

**Other basis.** Other basis refers to basis that is determined by the way you received the property. For example, your basis is other than cost if you acquired the property in an exchange for other property, as payment for services you performed, as a gift, or as an inheritance. If you acquired property in this or some other way, see chapter 7 to determine your basis.

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

**Property changed from personal use.** If you held property for personal use and later use it in your business or income-producing activity,

your depreciable basis is the *lesser* of the following.

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

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

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

For a discussion of adjustments to the basis of your property, see *Adjusted Basis* in chapter 7.

## How Do You Treat Improvements?

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

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

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

## Do You Have To File Form 4562?

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

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

- Amortization of costs that began in the current year. Amortization is discussed later.

For more information on whether you must file Form 4562, refer to its instructions.



It is important to keep good records for property you depreciate. Do not file these records with your return. Instead, you should keep them as part of the records of the depreciated property. They will help you verify the accuracy of the information on Form 4562. For general information on recordkeeping, see Publication 583, *Starting a Business and Keeping Records*. For specific information on keeping records for section 179 property and listed property, see Publication 946.

## How Do You Correct Depreciation Deductions?

If you deducted an incorrect amount of depreciation in any year, you may be able to make a correction by filing an amended return for that year. See *Filing an Amended Return*, later. If you are not allowed to make the correction on an amended return, you can change your accounting method to claim the correct amount of depreciation. See *Changing Your Accounting Method*, later.

**Basis adjustment.** Even if you do not claim depreciation you are entitled to deduct, you must reduce the basis of the property by the full amount of depreciation you were entitled to deduct. If you deduct more depreciation than you should have, you must decrease your basis by any amount deducted from which you received a tax benefit.

## Filing an Amended Return

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

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

You have adopted a method of accounting for the property if you deducted an incorrect amount of depreciation for it on two or more consecutively filed tax returns for reasons other than a mathematical or posting error.

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

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

## Changing Your Accounting Method

If you deducted an incorrect amount of depreciation for property on two or more consecutively filed tax returns, you have adopted a method of accounting for that property. You can claim the correct amount of depreciation only by changing your method of accounting for depreciation for that property. You can then take into account any unclaimed or excess depreciation from years before the year of change.

**Approval required.** You must get IRS approval to change your method of accounting. File **Form 3115, *Application for Change in Accounting Method***, to request a change to a permissible method of accounting for the depreciation. Revenue Procedure 97–27 in Cumulative Bulletin 1997–1 gives general instructions for getting approval.

**Automatic approval.** You may be able to get automatic approval from the IRS to change your method of accounting if you used an allowable method of accounting for depreciation in at least the 2 years immediately before the year of change and the property for which you are changing the method meets all the following conditions.

- 1) It is property for which, under your allowable method of accounting, you claimed either no depreciation or an incorrect amount.
- 2) It is property for which you figured depreciation using one of the following.
  - a) Pre-1981 rules.
  - b) Accelerated Cost Recovery System (ACRS).
  - c) Modified Accelerated Cost Recovery System (MACRS).
- 3) It is property you owned at the beginning of the year of change.

File Form 3115 to request a change to a permissible method of accounting for depreciation. Revenue Procedure 99–49 and section 2.01 of its Appendix in Cumulative Bulletin No. 1999–2 have instructions for getting automatic approval and list exceptions to the automatic approval procedures.

**Exceptions.** You generally cannot use the automatic approval procedure in any of the following situations.

- You are under examination by the IRS.
- You are before a federal court or an appeals office for any income tax issue and the method of accounting for depreciation to be changed is an issue under consideration by the federal court or appeals office.
- During the last 5 years (including the year of change), you changed the same method of accounting for depreciation (with or without obtaining IRS approval).
- During the last 5 years (including the year of change), you filed a Form 3115 to change the same method of accounting for depreciation but did not make the change because the Form 3115 was with-

drawn, not perfected, denied, or not granted.

Also, see other exceptions listed in section 4.02 of Revenue Procedure 99–49 and section 2.01(2)(b) in the Appendix of this revenue procedure.

## Section 179 Deduction

Under section 179 of the Internal Revenue Code, you can choose to recover the cost of certain qualifying property, up to a limit, by deducting it in the year you place the property in service. This part of the chapter explains the rules for the section 179 deduction. It explains what property qualifies for the deduction, the limits that may apply, and how to elect the deduction. You can recover through depreciation certain costs not recovered through the section 179 deduction.

### What Property Qualifies?

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

- 1) It must be eligible property.
- 2) It must be acquired for business use.
- 3) It must have been acquired by purchase.
- 4) It must **not** be excepted property.

### Eligible Property

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

- 1) Tangible personal property.
- 2) Other tangible property (except buildings and their structural components) used as:
  - a) An integral part of manufacturing, production, or extraction or of furnishing transportation, communications, electricity, gas, water, or sewage disposal services,
  - b) A research facility used in connection with any of the activities in (a) above, or
  - c) A facility used in connection with any of the activities in (a) for the bulk storage of fungible commodities.
- 3) Single purpose agricultural (livestock) or horticultural structures.
- 4) Storage facilities (except buildings and their structural components) used in connection with distributing petroleum or any primary product of petroleum.

**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 compo-

ments), 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.

Land and land improvements, such as buildings and other permanent structures and their components, are real property, not personal 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.

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

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

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

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

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

For this purpose, livestock includes poultry.

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

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

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

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



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

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

## Property Acquired for Business Use

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

**Partial business use.** When you use property for business and nonbusiness purposes, you can elect the section 179 deduction only if you use it more than 50% for your business in the year you place it in service. If you used the property more than 50% for business, multiply the cost of the property by the percentage of business use. Use the resulting business cost to figure your section 179 deduction.

## Property Acquired by Purchase

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

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

- 1) It is acquired by one member of a controlled group from another member of the same group.
- 2) Its basis is determined in either of the following ways.
  - a) In whole or in part by its adjusted basis in the hands of the person from whom it was acquired.
  - b) Under stepped-up basis rules for property acquired from a decedent.
- 3) It is acquired from a related person. A **related person** generally means a member of your immediate family (including your spouse, an ancestor, and a lineal descendant) or a partnership or corporation in which you hold an interest.

For more information on related persons, see Publication 946.

## Excepted Property

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

- Certain property you lease to others (if you are a noncorporate lessor).

- Certain property used predominantly to furnish lodging or in connection with the furnishing of lodging.
- Air conditioning or heating units.
- Property used predominantly outside the United States (except property described in section 168(g)(4) of the Internal Revenue Code).
- Property used by certain tax-exempt organizations.
- Property used by governmental units.
- Property used by foreign persons or entities.

## How Much Can You Deduct?

Your section 179 deduction is generally the cost of the qualifying property. However, the total amount you can elect to deduct under section 179 is subject to a dollar limit and a business income limit. These limits apply to each taxpayer, not to each business. However, see *Married individuals* under *Dollar Limit*, later.

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

**Trade-in of other property.** If you buy qualifying property with cash and a trade-in, its cost for purposes of the section 179 deduction includes only the cash you paid. For example, if you buy (for cash and a trade-in) a new tractor for use in your business, your cost for the section 179 deduction does not include the adjusted basis of the old tractor you trade for the new tractor. For more information on figuring your adjusted basis, see *Adjusted Basis* in chapter 7.

**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 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 and paid \$10,000 cash for the new pickup truck.

J-Bar Farms' basis in the new property includes both the adjusted basis of the property traded and the cash paid. However, only the cash paid by J-Bar qualifies for the section 179 deduction. J-Bar's business costs that qualify for a section 179 deduction are \$15,200 (\$5,200 + \$10,000), the part of the cost of the new property not determined by the property traded.

**Depreciating the excess cost.** If you deduct only part of the cost of your qualifying property as a section 179 deduction, you can generally depreciate the cost you do not deduct. To figure your basis for depreciation using MACRS (discussed later), you must subtract the section 179 deduction from the cost of the qualifying property. You use the result to figure any depreciation deduction. For information on how to figure depreciation, see *Figuring Depreciation Under MACRS*, later.

## Dollar Limit

The total amount you can elect to deduct under section 179 for 2001 cannot be more than \$24,000. If you acquire and place in service

more than one item of qualifying property during the year, you can allocate the section 179 deduction among the items in any way, as long as the total deduction is not more than \$24,000. You do not have to claim the full \$24,000.

Beginning in 2003, the total amount you can elect to deduct under section 179 will increase to \$25,000.



*You cannot take depreciation on the cost of property you deduct under section 179.*

**Example.** This year, you bought and placed in service a tractor for \$20,000 and a mower for \$6,200 for use in your farming business. You elect to deduct the entire \$6,200 for the mower and \$17,800 for the tractor, a total of \$24,000. This is the most you can deduct. Your \$6,200 deduction for the mower completely recovered its cost. Your basis for depreciation is zero. The basis of your tractor for depreciation is \$2,200. You figure this by subtracting the amount of your section 179 deduction, \$17,800, from the cost of the tractor, \$20,000.

**Reduced dollar limit for cost exceeding \$200,000.** If the cost of your qualifying section 179 property placed in service in a year is over \$200,000, you must reduce the dollar limit (but not below zero) by the amount of cost over \$200,000. If the cost of your section 179 property placed in service during 2001 is \$224,000 or more, you cannot take a section 179 deduction and you cannot carry over the cost that is more than \$224,000.

**Example.** This year, James Smith placed in service machinery costing \$207,000. Because this cost is \$7,000 more than \$200,000, he must reduce his dollar limit to \$17,000 (\$24,000 – \$7,000).

**Additional limit for passenger automobiles.** For passenger automobiles placed in service in 2001, your total section 179 and depreciation deductions generally cannot be more than \$3,060. For more information, see *Maximum Depreciation Deduction* under *Do the Passenger Automobile Limits Apply*, later.

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

**Joint return.** If you file a joint return, you and your spouse are treated as one taxpayer in determining any reduction to the dollar limit, regardless of which of you purchased the property or placed it in service.

**Separate returns.** If you and your spouse file separate returns, you are treated as one taxpayer for the dollar limit, including the reduction for costs over \$200,000. You must allocate the limit amount (after any reduction) between you. You must allocate 50% to each, unless you both elect a different allocation. If the percentages elected by each of you do not total 100%, 50% will be allocated to each of you.

**Joint return after separate returns.** If you and your spouse elect to file a joint return after the due date for filing the 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 \$200,000).
- The total cost of section 179 property you and your spouse elected to expense on your separate returns.

## Business Income Limit

The total cost you can deduct each year after you apply the dollar limit is limited to the taxable income from the active conduct of any trade or business during the year. Generally, you are considered to actively conduct a trade or business if you meaningfully participate in the management or operations of the trade or business.

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

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

- Section 1231 gains (or losses) as discussed in chapter 11.
- Interest from working capital of your trade or business.
- Wages, salaries, tips, or other pay earned as an employee.

In addition, figure taxable income without regard to any of the following.

- The section 179 deduction.
- The self-employment tax deduction.
- Any net operating loss carryback or carryforward.
- Any unreimbursed employee business expenses.

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

Step	Action
1	Figure taxable income without the section 179 deduction or the other deduction.
2	Figure a hypothetical section 179 deduction using the taxable income figured in Step 1.
3	Subtract the hypothetical section 179 deduction figured in Step 2 from the taxable income figured in Step 1.
4	Figure a hypothetical amount for the other deduction using the amount figured in Step 3 as taxable income.

5	Subtract the hypothetical other deduction figured in Step 4 from the taxable income figured in Step 1.
6	Figure your actual section 179 deduction using the taxable income figured in Step 5.
7	Subtract your actual section 179 deduction figured in Step 6 from the taxable income figured in Step 1.
8	Figure your actual other deduction using the taxable income figured in Step 7.

**Example.** During the year, the XYZ farm corporation purchased and placed in service qualifying section 179 property that cost \$10,000. It elects to expense as much as possible under section 179. The XYZ corporation also gave a charitable contribution of \$1,000 during the year. A corporation's deduction for charitable contributions cannot be more than 10% of its taxable income, figured after subtracting any section 179 deduction. The business income limit for the section 179 deduction is figured after subtracting any allowable charitable contributions. XYZ's taxable income figured without the section 179 deduction or the deduction for charitable contributions is \$12,000. XYZ figures its section 179 deduction and its deduction for charitable contributions as follows.

**Step 1.** Taxable income figured without either deduction is \$12,000.

**Step 2.** Using \$12,000 as taxable income, XYZ's hypothetical section 179 deduction is \$10,000.

**Step 3.** \$2,000 (\$12,000 – \$10,000).

**Step 4.** Using \$2,000 (from Step 3) as taxable income, XYZ's hypothetical charitable contribution (limited to 10% of taxable income) is \$200.

**Step 5.** \$11,800 (\$12,000 – \$200).

**Step 6.** Using \$11,800 (from Step 5) as taxable income, XYZ figures the actual section 179 deduction. Because the taxable income is at least \$10,000, XYZ can take a \$10,000 section 179 deduction.

**Step 7.** \$2,000 (\$12,000 – \$10,000).

**Step 8.** Using \$2,000 (from Step 7) as taxable income, XYZ's actual charitable contribution (limited to 10% of taxable income) is \$200.

**Carryover of disallowed deduction.** You can carry over the cost of any section 179 property you elected to expense but were unable to because of the business income limit.

The amount you carry over is used in determining your section 179 deduction in the next year. However, it is subject to the limits in that year. If you place more than one property in service in a year, you can select the properties for which all or a part of the cost will be carried forward. Your selections must be shown in your books and records.

**Example.** Last year, Joyce Jones placed in service a machine that cost \$8,000. The taxable income from her business (determined without regard to both a section 179 deduction for the cost of the machine and the self-employment tax deduction) was \$6,000. Her section 179 deduc-

tion was limited to \$6,000. The \$2,000 cost that was not allowed as a section 179 deduction (because of the business income limit) is carried to this year.

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

See *Carryover of disallowed deduction* in chapter 2 of Publication 946 for more information on figuring the carryover.

## Partnerships and S Corporations

The section 179 deduction limits apply both to the partnership or S corporation and to each partner or shareholder. The partnership or S corporation determines its section 179 deduction subject to the limits. It then allocates the deduction among its partners or shareholders.

If you are a partner in a partnership or shareholder of an S corporation, you add the amount allocated from the partnership or S corporation to any section 179 costs not related to the partnership or S corporation and then apply the dollar limit to this total. To determine any reduction in the dollar limit for costs over \$200,000, you do not include any of the cost of section 179 property placed in service by the partnership or S corporation. After you apply the dollar limit, you apply the business income limit to any remaining section 179 costs. For more information, see chapter 2 of Publication 946.

## How Do You Elect the Deduction?

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



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

File Form 4562 with either of the following.

- Your original tax return filed for the year the property was placed in service (whether or not you filed it timely).
- An amended return filed by the due date (including extensions) for your return for the year the property was placed in service. (You cannot make an election for the section 179 deduction on an amended return filed after the due date (including extensions) of the original return.)

However, if you timely filed your return for the year without making the election, you can still make the election by filing an amended return within 6 months of the due date of the return (excluding extensions). For more information, see the instructions for Part I of Form 4562.

## When Must You Recapture the Deduction?

You may have to recapture the section 179 deduction if, in any year during the property's recovery period, the percentage of business use drops to 50% or less. In the year the business use drops to 50% or less, you include the recapture amount as ordinary income. You also increase the basis of the property by the recapture amount. Recovery periods for property are discussed later.



*If you sell, exchange, or otherwise dispose of the property, do **not** figure the recapture amount under the rules explained in this discussion. Instead, use the rules for recapturing depreciation explained in chapter 11 under Section 1245 Property.*

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

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

**Example.** In 1999, Paul Lamb, a calendar year taxpayer, bought and placed in service section 179 property costing \$10,000. The property is not listed property. He elected a \$5,000 section 179 deduction for the property. He used the property only for business in 1999 and 2000. During 2001, he used the property 40% for business and 60% for personal use. He figures his recapture amount as follows.

Section 179 deduction claimed (1999) . . . . .	\$5,000
<b>Minus:</b> Allowable depreciation (instead of section 179):	
1999 . . . . .	\$1,250
2000 . . . . .	1,875
2001 (\$1,250 × 40% (business)) . . . . .	500
<b>2001 — Recapture amount . . . . .</b>	<b><u>\$1,375</u></b>

Paul must include \$1,375 in income for 2001.

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

## 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 it.

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

- All property used predominately 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 for business. For information on listed property, see *Additional Rules for Listed Property*, later.
- Any tax-exempt use property.
- Any tax-exempt bond-financed property.
- Any imported property covered by an executive order of the President of the United States.
- Any tangible property used predominately outside the United States during the year.

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

You make the election by completing line 16 in Part II 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) 25-year property.
- 7) 20-year property.
- 8) Residential rental property.
- 9) Nonresidential real property.

See chapter 3 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 the production of income. The placed-in-service date for your property is the date the property is ready and available for a specific use. It is therefore not necessarily the date it is first used. If you converted property held for personal use to use in a trade or business or for the production of income, treat the property as being placed in service on the conversion date. See *Placed in Service under When Does Depreciation Begin and End*, earlier, for examples illustrating when property is placed in service.

## What Is the Basis for Depreciation?

The basis for depreciation of MACRS property is the property's cost or other basis multiplied by the percentage of business/investment use. Reduce that amount by the following items.

- Any deduction for section 179 property.
- Any deduction for removal of barriers to the disabled and the elderly.
- Any investment credit, disabled access credit, or enhanced oil recovery credit.

For information about how to determine the cost or other basis of property, see *What Is the Basis of Your Depreciable Property*, earlier.

## Which Recovery Period Applies?

The recovery period of property is the number of years over which you recover its cost or other basis. It is determined based on the depreciation system (GDS or ADS) used.

**Recovery periods.** See *Table 8-1* 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 10-year recovery period under ADS.
- A 7-year recovery period under GDS.



**Table 8–1. Farm Property Recovery Periods**

Assets	Recovery Period in Years	
	GDS	ADS
Agricultural structures (single purpose)	10	15
Airplanes (including helicopters) <sup>1</sup>	5	6
Automobiles	5	5
Calculators and copiers	5	6
Cattle (dairy or breeding)	5	7
Communication equipment <sup>2</sup>	7	10
Computers and peripheral equipment	5	5
Cotton ginning assets	7	12
Drainage facilities	15	20
Farm buildings <sup>3</sup>	20	25
Farm machinery and equipment	7	10
Fences (agricultural)	7	10
Goats and sheep (breeding)	5	5
Grain bin	7	10
Hogs (breeding)	3	3
Horses (age when placed in service)		
Breeding and working (12 years or less)	7	10
Breeding and working (more than 12 years)	3	10
Racing horses (more than 2 years)	3	12
Horticultural structures (single purpose)	10	15
Logging machinery and equipment <sup>4</sup>	5	6
Nonresidential real property	39 <sup>5</sup>	40
Office equipment (not calculators, copiers, or typewriters)	7	10
Office furniture or fixtures	7	10
Residential rental property	27.5	40
Tractor units (over-the-road)	3	4
Trees or vines bearing fruit or nuts	10	20
Truck (heavy duty, unloaded weight 13,000 lbs. or more)	5	6
Truck (weight less than 13,000 lbs.)	5	5
Typewriter	5	6
Water wells	15	20

<sup>1</sup> Not including airplanes used in commercial or contract carrying of passengers.

<sup>2</sup> Not including communication equipment listed in other classes.

<sup>3</sup> Not including single purpose agricultural or horticultural structures.

<sup>4</sup> Used by logging and sawmill operators for cutting of timber.

<sup>5</sup> For property placed in service after May 12, 1993; for property placed in service before May 13, 1993, the recovery period is 31.5 years.

40% of the total depreciable bases of all MACRS property you placed in service during the year. However, see *Exception*, next.

Under this convention, you treat all property placed in service or disposed of during any quarter of the tax year as placed in service or disposed of at the midpoint of that quarter. This means that 1½ months of depreciation is allowed for the quarter the property is placed in service or disposed of.

**Exception.** If the third quarter of your tax year includes September 11, 2001, you can elect to apply the half-year convention, discussed next, to all property (other than nonresidential real property and residential rental property) placed in service during the 2001 tax year. The third quarter begins on the first day of the seventh month of the tax year. To make this election, write “Election pursuant to Notice 2001–70” across the top of your 2001 Form 4562.

**The half-year convention.** Use this convention if neither the mid-quarter convention nor the mid-month convention applies.

Under this convention, you treat all property placed in service or disposed of during a tax year as placed in service or disposed of at the midpoint of the year. This means that a one-half year of depreciation is allowed for the year the property is placed in service or disposed of.

### Which Depreciation Method Applies?

MACRS provides three depreciation methods under GDS and one depreciation method under ADS.

- The 200% declining balance method over a GDS recovery period.
- 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.



**You cannot use the 200% declining balance method for farm property placed in service after 1988.**

**Farm property.** For personal property placed in service in a farming business after 1988 you must use the 150% declining balance method over a GDS recovery period or you can elect one of the following methods.

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



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

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

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

**Water wells.** Water wells used to provide water for raising poultry and livestock are land improvements. To depreciate them, 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 under *Irrigation systems and water wells*.

### Which Convention Applies?

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

the year you dispose of the property. Use one of the following conventions.

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

**The mid-month convention.** Use this convention for all nonresidential real property and residential rental property.

Under this convention, you treat all property placed in service or disposed of during a month as placed in service or disposed of at the midpoint of the month. This means that a one-half month of depreciation is allowed for the month the property is placed in service or disposed of.

**The mid-quarter convention.** Use this convention if the mid-month convention does not apply and the total depreciable bases of MACRS property you placed in service during the last 3 months of the tax year (excluding nonresidential real property, residential rental property, and property placed in service and disposed of in the same year) are more than

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

**Depreciation table.** The following table lists the types of property you can depreciate under each method. The declining balance method is abbreviated as DB and the straight line method is abbreviated as SL.

Depreciation Table

System/Method	Type of Property
GDS using 150% DB	<ul style="list-style-type: none"> <li>All farm property (except real property)</li> <li>All 15- and 20-year property</li> <li>Nonfarm 3-, 5-, 7-, and 10-year property<sup>1</sup></li> </ul>
GDS using SL	<ul style="list-style-type: none"> <li>Nonresidential real property</li> <li>Residential rental property</li> <li>Trees or vines bearing fruit or nuts</li> <li>All 3-, 5-, 7-, 10-, 15-, and 20-year property<sup>1</sup></li> </ul>
ADS using SL	<ul style="list-style-type: none"> <li>Property used predominantly outside the U.S.</li> <li>Tax-exempt property</li> <li>Tax-exempt bond-financed property</li> <li>Imported property<sup>2</sup></li> <li>Any property for which you elect to use this method<sup>1</sup></li> </ul>
GDS using 200% DB	<ul style="list-style-type: none"> <li><b>Nonfarm</b> 3-, 5-, 7-, and 10-year property</li> </ul>

<sup>1</sup>Elective method

<sup>2</sup>See section 168(g)(6) of the Internal Revenue Code

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

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

**ADS required for some farmers.** If you elect not to apply the uniform capitalization rules to any plant 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 7 for a discussion of the application of the uniform capitalization rules to farm property.

**Farming business.** A farming business is any trade or business involving cultivating land or raising or harvesting any agricultural or horticultural commodity and includes certain incidental processing activities (discussed next). A farming business includes any of the following.

- Operating a nursery or sod farm.
- Raising or harvesting crops.
- Raising or harvesting trees bearing fruit, nuts, or other crops.

- Raising ornamental trees. (An evergreen tree is not considered an ornamental tree if it is more than 6 years old when it is severed from its roots.)
- Raising, shearing, feeding, caring for, training, and managing animals.

**Processing activities.** In general, a farming business includes processing activities that are normally part of the growing, raising, or harvesting of agricultural products. However, a farming business generally does not include the processing of commodities or products beyond those activities that are normally part of the growing, raising, or harvesting of such products.

**Example 1.** If you are in the trade or business of growing fruits and vegetables, you can harvest, wash, inspect, and package the fruits and vegetables for sale. Such activities are normally part of the raising of these crops by farmers. You will be considered to be in the business of farming with respect to the growing of fruits and vegetables and the processing activities that are part of their harvest.

**Example 2.** You are in the business of growing and harvesting wheat and other grains. You also process grain you have harvested in order to produce breads, cereals, and other similar food products. You then sell these products to customers in the course of your business. Although you are in the farming business with respect to the growing and harvesting of grain, you are not in the farming business with respect to the processing of the grain to produce the food products.

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



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

**Straight line election.** Instead of using the declining balance method, you can elect to use the straight line method over the GDS recovery period. Make the election by entering "SL" in column (f) of Part II 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 fixed ADS recovery periods. The ADS recovery periods for many assets used in the business of

farming are listed in *Table 8-1*. Additional ADS recovery periods for other classes of property may be found in the *Table of Class Lives and Recovery Periods* in Appendix B of Publication 946.

Make the election by completing line 16, Part II of Form 4562.

## How Is the Depreciation Deduction Figured?

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

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



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

## Using the MACRS Percentage Tables

To help you figure your deduction under MACRS, the IRS has established percentage tables that incorporate the applicable 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** (defined later).
- 2) You cannot use the percentage tables for a short tax year. See chapter 3 of Publication 946 for information on how to figure the deduction in a short tax year.
- 3) You must generally continue to use them for the entire recovery period of the property.
- 4) You must stop using the tables if you adjust the basis of the property for **any** reason other than—
  - a) Depreciation allowed or allowable, or
  - b) An addition or improvement to the property. (An addition or improvement is depreciated as a separate property.)

**Basis adjustment due to casualty loss.** If you reduce the basis of your property because of a casualty, you cannot continue to use the percentage tables. For the year of the adjustment and the remaining recovery period, you must figure the depreciation yourself using the property's adjusted basis at the end of the year. See *Figuring the Deduction Without Using the Tables* in chapter 3 of Publication 946.

**Figuring the unadjusted basis of your property.** You must apply the table rates to your property's unadjusted basis each year of the recovery period. **Unadjusted basis** is the same basis amount you would use to figure gain on a sale but figured without reducing your original basis by any depreciation taken in earlier years. However, you do reduce your original basis by the following amounts.

- Any amortization taken on the property.
- Any section 179 deduction claimed on the property.
- Any deduction claimed for a clean-fuel vehicle or clean-fuel vehicle refueling property.
- Any electric vehicle credit. (The lesser of \$4,000 or 10% of the cost of the vehicle, even if the credit is less than that amount.)

The clean-fuel vehicle and clean-fuel vehicle refueling property deductions and the credit for electric vehicles are discussed in chapter 12 of Publication 535.

For business property you purchase during the year, the unadjusted basis is its cost minus these adjustments. If you trade property, your unadjusted basis in the property received is the cash paid plus the adjusted basis of the property traded minus these adjustments.

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

The following examples show how to figure depreciation under MACRS using the percentages in Table 8–2.

**Example 1.** During the year, you bought an item of 7-year property for \$10,000 and placed it in service. You do not elect a section 179 deduction for this property. The unadjusted basis of the property is \$10,000. You use the percentages in Table 8–2 to figure your deduction.

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

**Example 2.** You had a barn constructed on your farm at a cost of \$20,000. You placed the barn in service this year. The barn is 20-year property and you use the table percentages to figure your deduction. You figure this year's depreciation by multiplying \$20,000 (unadjusted basis) by 3.75% to get \$750. For next year, your depreciation will be \$1,443.80 ( $\$20,000 \times 7.219\%$ ).

**Figuring depreciation using straight line and the half-year convention.** The following table has the straight line percentages for 3-, 5-, 7-, and 20-year property using the half-year convention. The table covers only the first 8 years for 20-year property. See Appendix A in Publication 946 for complete MACRS tables, including tables for the mid-quarter and mid-month convention.

**Straight Line Percentages**

Year	3-Year	5-Year	7-Year	20-Year
1	16.67%	10%	7.14%	2.5%
2	33.33	20	14.29	5.0
3	33.33	20	14.29	5.0
4	16.67	20	14.28	5.0
5		20	14.29	5.0
6		10	14.28	5.0
7			14.29	5.0
8			7.14	5.0

The following example shows how to figure depreciation under MACRS using the straight line percentages in the table.

**Example.** If in Example 2 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 ( $\$20,000 \times 5\%$ ).

### Figuring Depreciation Without the Tables.

If you are required to or would prefer to figure your own depreciation without using the tables, see *Figuring the Deduction Without Using the Tables* in chapter 3 of Publication 946.

### Figuring the Deduction for Carried-Over-Basis Property

If your property has a carried-over basis because you acquired it in an exchange or involuntary conversion of other property or in a nontaxable transfer, you may have to figure depreciation for the property as if the exchange, conversion, or transfer had not occurred.

**Property acquired in an exchange or involuntary conversion.** You generally must depreciate MACRS property that you acquired in a like-kind exchange or an involuntary conversion of other MACRS property over the remaining recovery period of the exchanged or involuntarily converted property. You also generally continue to use the same depreciation method and convention. You can depreciate the part of the acquired property's basis in excess of its carried-over basis (the adjusted basis of the exchanged or converted property) as newly purchased MACRS property. For information on like-kind exchanges, see chapter 10. For information on involuntary conversions, see chapter 1 in Publication 544.



*If you placed the acquired MACRS property in service before January 3, 2000, you continue to use your original method of depreciating that property.*

### Property acquired in a nontaxable transfer.

You must depreciate MACRS property acquired by a corporation or partnership in certain nontaxable transfers over the property's remaining recovery period in the transferor's hands, as if the transfer had not occurred. You must continue to use the same depreciation method and convention as the transferor. You can depreciate the part of the property's basis in excess of its carried-over basis (the transferor's adjusted basis in the property) as newly purchased MACRS property. For information on the kinds of nontaxable transfers covered by this rule, see chapter 3 of Publication 946.

## How Do You Use General Asset Accounts?

To make it easier to figure MACRS depreciation, you can group separate properties into one or more general asset accounts (GAAs). You can then depreciate all the properties in each account as a single item of property. Each account can include only property with the same asset class (if any), recovery period, depreciation method, and convention. You cannot include property if you use it in both a personal activity and a trade or business (or for the production of income) in the year in which you first place it in service.

After you have set up a GAA, you generally figure the depreciation for it by using the applicable depreciation method, recovery period, and convention for the property in the GAA. For each GAA, record the depreciation allowance in a separate depreciation reserve account.

There are additional rules for grouping property in a GAA, figuring depreciation for a GAA, disposing of GAA property, and terminating GAA treatment. For more information on GAAs, see chapter 3 in Publication 946.

## When Do You Recapture MACRS Depreciation?

When you dispose of property you depreciated using MACRS, any gain on the disposition is generally recaptured (included in income) as ordinary income up to the amount of the depreciation previously allowed for the property. Depreciation, for this purpose, includes any section 179 deduction claimed on the property and any deduction claimed for clean-fuel vehicles and clean-fuel vehicle refueling property. **There is no recapture** for residential rental and nonresidential real property. For more information on depreciation recapture, see chapter 11.

**Table 8–2. 150% Declining Balance Method**

Year	3-Year	5-Year	7-Year	20-Year
1	25.0%	15.00%	10.71%	3.750%
2	37.5	25.50	19.13	7.219
3	25.0	17.85	15.03	6.677
4	12.5	16.66	12.25	6.177
5		16.66	12.25	5.713
6		8.33	12.25	5.285
7			12.25	4.888
8			6.13	4.522



## Additional Rules for Listed Property

This part discusses the depreciation deduction limits and other special rules that apply to certain listed property. It also discusses the recordkeeping rules for listed property. Listed property includes cars and other property used for transportation, property used for entertainment, and certain computers and cellular phones.

Deductions for listed property (other than certain leased property) are subject to the following limits and special rules.

- **Limit for employees.**
- **Business-use limits and rules.**
- **Passenger automobile limits and rules.**

## What Is Listed Property?

Listed property is any of the following.

- Any passenger automobile.
- Any other vehicle used for transportation, unless it is an excepted vehicle.
- Any property of a type generally used for entertainment, recreation, or amusement.
- Any computer and related peripheral equipment *unless* it is used only at a regular business establishment and owned or leased by the person operating the establishment.
- Any cellular telephone (or similar telecommunication equipment).

**Passenger automobiles.** A passenger automobile is any four-wheeled vehicle made primarily for use on public streets, roads, and highways and rated at 6,000 pounds or less of unloaded gross vehicle weight (6,000 pounds or less of gross vehicle weight for trucks and vans). It includes any part, component, or other item physically attached to the automobile or usually included in the purchase price of an automobile.

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

**Excepted vehicles.** The following vehicles are *not* listed property.

- Tractors and other special purpose farm vehicles.
- Bucket trucks (cherry pickers), dump trucks, flatbed trucks, and refrigerated trucks.
- Combines, cranes and derricks, and forklifts.
- Buses with a capacity of at least 20 passengers that are used as passenger buses.

## Does the Limit for Employees Apply?

If you are an employee, the use of your listed property (whether owned or rented) in performing services as an employee is a business use only if both the following requirements are met.

- The use is for your employer's convenience.
- The use is required as a condition of your employment.

If these requirements are not met, you cannot deduct depreciation (including the section 179 deduction) or rent expenses for your use of the property as an employee.

**Employer's convenience.** Whether the use of listed property is for your employer's convenience must be determined from all the facts. The use is for your employer's convenience if it is for a substantial business reason of the employer. The use of listed property during your regular working hours to carry on your employer's business is generally for the employer's convenience.

**Condition of employment** Whether the use of listed property is a condition of your employment depends on all the facts and circumstances. The use of property must be required for you to perform your duties properly.

## Do the Business-Use Limits Apply?

The business-use limits apply to listed property not used predominantly (more than 50% of its total use) for qualified business use. The use of property to produce income in a nonbusiness activity (investment use) is *not* a qualified business use. However, you can treat the investment use as business use to figure the depreciable basis of the property.

Under this limit, the following rules apply.

- Property not used predominantly for qualified business use during the year it is placed in service does not qualify for the section 179 deduction.
- Any depreciation deduction under MACRS for property not used predominantly for qualified business use during *any* year must be figured using the straight line method over the ADS recovery period. This rule applies each year of the recovery period.
- Excess depreciation on property previously used predominantly for qualified business use must be recaptured (included in income) in the first year in which it is no longer used predominantly for qualified business use.
- A lessee must include an amount in income if the leased property is not used predominantly for qualified business use.

To determine whether this limit applies, you must allocate the use of any item of listed property used for more than one purpose during the year among its various uses.

## Do the Passenger Automobile Limits Apply?

The depreciation deduction (including the section 179 deduction) you can claim for a passenger automobile each year is limited. (For the definition of a passenger automobile, see *What Is Listed Property*, earlier.)

**Exception for clean fuel modifications.** The passenger automobile limits do *not* apply to any costs you pay to retrofit parts and components to modify an automobile to run on clean fuel. The limits apply only to the cost of the automobile without this modification.

**Exception for leased cars.** The passenger automobile limits generally do not apply to passenger automobiles leased or held for leasing by anyone regularly engaged in the business of leasing passenger automobiles.

## Maximum Depreciation Deduction

Determine the maximum depreciation deduction you can claim for a passenger automobile based on the date you placed it in service. The maximum deductions (in dollar amounts) for most passenger automobiles for 2000 are shown in the following table.

**Maximum Depreciation Deduction for Passenger Automobiles**

Year Placed in Service	1st Year	2nd Year	3rd Year	4th Year and Later
2001 . . . . .	\$3,060	\$4,900	\$2,950	\$1,775
2000 . . . . .		4,900	2,950	1,775
1999 . . . . .			2,950	1,775
1998 – 1995 . . . . .				1,775
1994 – 1993 . . . . .				1,675
1992 – 1991 . . . . .				1,575
Pre-1991 . . . . .				1,475



*If your business/investment use of the automobile is less than 100%, you must reduce the maximum deduction amount proportionately.*

**Clean-fuel vehicles.** The maximum depreciation deductions for passenger automobiles that run on clean fuel are higher than those for other automobiles. The maximum deductions (in dollar amounts) for clean-fuel vehicles for 2001 are shown in the following table.

**Maximum Depreciation Deduction for Clean-Fuel Vehicles**

Year Placed in Service	1st Year	2nd Year	3rd Year	4th Year and Later
2001 . . . . .	\$9,280	\$14,800	\$8,850	\$5,325
2000 . . . . .		14,800	8,850	5,325
1999 . . . . .			8,950	5,325
1998 – 1997 . . . . .				5,425

For more information on clean-fuel vehicles, see chapter 12 of Publication 535, *Business Expenses*.

**Car expenses.** For information about deducting expenses for the business use of your pas-

senger automobile, see chapter 4 in Publication 463.

## What Records Must Be Kept?



You cannot take any depreciation or section 179 deduction for the use of listed property unless you can prove business and investment use with adequate records or sufficient evidence to support your own statements.

**Adequate records.** To meet the adequate records requirement, you must maintain an account book, diary, log, statement of expense, trip sheet, or similar record or other documentary evidence that, together with the receipt, is sufficient to establish each element of an expenditure or use. You do not have to record information in an account book, diary, or similar record if the information is already shown on the receipt. However, your records should back up your receipts in an orderly manner.

**How long to keep records.** For listed property, you must keep records for as long as any excess depreciation can be recaptured (included in income). Recapture can occur in any tax year of the recovery period.

For more information on records, see chapter 4 in Publication 946.

## Depletion

Depletion is the using up of natural resources by mining, quarrying, drilling, or felling. The depletion deduction allows an owner or operator to account for the reduction of a product's reserves.

### Who Can Claim Depletion

If you have an economic interest in mineral property or standing timber, 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.

- 1) You have acquired by investment any interest in mineral deposits or standing timber.
- 2) 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.

The term "mineral property" means each separate interest you own in each mineral deposit in each separate tract or parcel of land. You can treat two or more separate interests as one property or as separate properties. See section 614 of the Internal Revenue Code and

the related regulations for rules on how to treat separate mineral interests.

The term "timber property" means your economic interest in standing timber in each tract or block representing a separate timber account.

### Figuring Depletion

There are two ways of figuring depletion.

- Cost depletion.
- Percentage depletion.

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

### Cost Depletion

To figure cost depletion you must first determine the following.

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

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

Basis for depletion and recoverable units are explained in chapter 10 of Publication 535.

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

IF you use ...	THEN the units sold during the year are ...
The cash method of accounting	Units sold for which you receive payment during the tax year (regardless of year of sale).
An accrual method of accounting	Units sold based on your inventories.

The number of units sold during the tax year does not include any units for which depletion deductions were allowed or allowable in earlier years.

**Figuring the cost depletion deduction.** Once you have figured your property's basis for depletion, the total recoverable units, and the number of units sold during the tax year, you can figure your cost depletion deduction by taking the following steps.

Step	Action	Result
1	Divide your property's basis for depletion by total recoverable units.	Rate per unit.
2	Multiply the rate per unit by units sold during the tax year.	Cost depletion deduction.

**Cost depletion for ground water in Ogallala Formation.** Farmers who extract ground water from the Ogallala Formation for irrigation are allowed cost depletion. Cost depletion is allowed when it can be demonstrated the

ground water is being depleted and the rate of recharge is so low that, once extracted, the water is lost to the taxpayer and immediately succeeding generations.

To figure your cost depletion deduction, use the guidance provided in Revenue Procedure 66-11 in Cumulative Bulletin 1966-1.

For tax years ending before December 13, 1982, those extracting ground water for irrigation farming from the Ogallala Formation in areas outside the Southern High Plains were not required to reduce their basis in ground water by any allowable cost depletion not claimed.

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

To figure timber depletion, you 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 units acquired during the year and any additions to capital.
- 3) Figure the number of units to take into account by adding the units acquired during the year to the units on hand in the account at the beginning of the year and then adding (or subtracting) any correction to the estimate of the 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 10. 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.** Attach Form T to your income tax return if you are claiming a deduction for timber depletion or electing to treat the cutting of timber as a sale or exchange.

**Example.** Sam Brown bought a farm that included standing timber. This year Sam determined that the standing timber could produce 300,000 units when cut. At that time, the adjusted basis of the standing timber was \$24,000. Sam then cut and sold 27,000 units. Sam did not elect to treat the cutting of the timber as a sale or

exchange. Sam's depletion for each unit for the year is \$.08 ( $\$24,000 \div 300,000$ ). His deduction for depletion is \$2,160 ( $27,000 \times \$.08$ ). If Sam had cut 27,000 units but sold only 20,000 units during the year, his depletion for each unit would have remained at \$.08. However, his depletion deduction would have been \$1,600 ( $20,000 \times \$.08$ ) for this year and he would have included the balance of \$560 ( $7,000 \times \$.08$ ) in the closing inventory for the year.

## Percentage Depletion

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

To figure percentage depletion, you multiply a certain percentage, specified for each mineral, by your gross income from the property during the year. See *Mines and other natural deposits* in chapter 10 of Publication 535 for a list of the percentages.

**Taxable income limit.** The percentage depletion deduction cannot be more than **50%** (100% for oil and gas property) of your taxable income from the property figured without the depletion deduction. For tax years beginning after 1997 and before 2002, the 100-percent taxable income limit does not apply to percentage depletion on the marginal production of oil or natural gas. For information on marginal production, see section 613A(c)(6) of the Internal Revenue Code.

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

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

## More Information

For more information on depletion, see chapter 10 in Publication 535.

## Amortization

Amortization is a method of recovering (deducting) certain capital costs over a fixed period of time. It is similar to the straight line method of depreciation. See chapter 9 in Publication 535 for more information on the topics presented in this section.

## Going Into Business

When you go into business, treat all costs you incur to get your business started as capital expenses. Capital expenses are a part of your basis in the business. Generally, you recover costs for particular assets through depreciation deductions. However, you generally cannot recover other costs until you sell the business or otherwise go out of business.

You can choose to amortize over a period of 60 months or more certain costs for setting up your business, such as business start-up costs.

**Business start-up costs.** Start-up costs are costs for creating an active trade or business or investigating the creation or acquisition of an active trade or business. Start-up costs include any amounts paid or incurred in connection with any activity engaged in for profit and for the production of income before the trade or business begins, in anticipation of the activity becoming an active trade or business.

For more information, see *Going Into Business* in chapter 9 of Publication 535.

## Reforestation Costs

You can choose to amortize a limited amount of reforestation costs for qualified timber property over a period of 84 months.



*A trust cannot choose to amortize reforestation costs and cannot deduct its share of any amortizable reforestation costs of a partnership, S corporation, or estate.*

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

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

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

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

- 1) It is located in the United States.
- 2) 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.
- 3) 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 and ornamental trees, such as Christmas trees.

**Amortization period.** The 84-month amortization period starts on the first day of the first month of the second half of the tax year you incur the costs (July 1 for a calendar year taxpayer), regardless of the month you actually incur the costs. You can claim amortization deductions for no more than 6 months of the first and last (eighth) tax years of the period.

**Annual limit.** Each year you can choose to amortize up to \$10,000 (\$5,000 if you are married filing separately) of qualifying costs you pay or incur during the year. You cannot carry over or carry back qualifying costs over the annual limit. If your qualifying costs are more than \$10,000 for more than one piece of timber property, you can divide the annual limit among the properties in any manner you wish.

**Maximum annual amortization deduction.** The maximum annual deduction for costs incurred in any year is \$1,428.57 ( $\$10,000 \div 7$ ) or \$714.29 ( $\$5,000 \div 7$ ) if married filing separately. The maximum deduction in the first and last year of the 84-month period is one half ( $1/2$ ) of the maximum annual deduction or \$714.29 ( $\$357.15$  if married filing separately).

**Estates.** Estates can choose to amortize up to \$10,000 of qualifying reforestation costs each year. These amortizable costs are divided between the income beneficiary and the estate based on the income of the estate allocable to each. The amortizable cost allocated to the beneficiary is subject to the beneficiary's annual limit.

**Recapture.** If you dispose of qualified timber property within 10 years after the tax year you incur qualifying reforestation expenses, report any gain as ordinary income up to the amortization taken. For information on recapture, see *Depreciation Recapture* in chapter 11.

**Investment credit.** Amortizable reforestation costs qualify for the investment credit, whether or not they are amortized. See *Investment Credit* in chapter 9.

**How to make the choice.** To choose to amortize qualifying reforestation costs, enter your deduction in Part VI of Form 4562. Attach a statement containing the following information.

- A description of the costs and the dates you incurred them.
- A description of the type of timber being grown and the purpose for which it is grown.

Attach a separate statement for each property for which you amortize reforestation costs.

Generally, you must make the choice on a timely filed return (including extensions) for the year in which you incurred the costs. However, if you timely filed your return for the year without making the choice, you can still make the choice by filing an amended return within 6 months of the due date of your return (excluding extensions). Attach Form 4562 and the statement to the amended return and write "Filed pursuant to section 301.9100-2" on Form 4562. File the amended return at the same address you filed the original return.



## Pollution Control Facilities

You can choose to amortize over 60 months the cost of a certified pollution control facility.

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

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

**Example.** This year, you purchase a new \$7,500 manure control facility for use on your dairy farm. The farm has been in operation since you bought it in 1976 and all of the dairy plant was in operation before that date. You have no intention of recovering the cost of the facility through sale of the waste and a federal certifying authority has so certified.

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

In addition, to amortize its cost over 60 months, the facility must not significantly increase the output or capacity, extend the useful life, or reduce the total operating costs of the plant or other property. Also, it must not significantly change the nature of the manufacturing or production process or facility.

**Example.** This year, you converted your 100-sow farrow-to-finish swine operation, which has existed on your farm since 1975, to a 5,000-head finishing swine operation. Even though you are in a similar business after the conversion, you cannot amortize the cost of a manure control facility used in connection with your swine operation because you have significantly increased its output or capacity.

**More information.** For more information on the amortization of pollution control facilities see section 169 of the Internal Revenue Code and the related regulations.

## Section 197 Intangibles

You must generally amortize over 15 years the capitalized costs of "section 197 intangibles" you acquired after August 10, 1993. You must amortize these costs if you hold the section 197 intangible in connection with your farming business or in an activity engaged in for the production of income. Your amortization deduction each year is the applicable part of the intangible's adjusted basis (for purposes of de-

termining gain), figured by amortizing it ratably over 15 years. The 15-year period begins with the later of:

- The month the intangible is acquired, or
- The month the trade or business or activity engaged in for the production of income begins.

You cannot deduct amortization for the month you dispose of the intangible.

If you pay or incur an amount that increases the basis of a section 197 intangible after the 15-year period begins, amortize it over the remainder of the 15-year period beginning with the month the basis increase occurs.

You are not allowed any other depreciation or amortization deduction for an amortizable section 197 intangible.

**Cost attributable to other property.** The rules for section 197 intangibles do not apply to any amount included in determining the cost of property that is not a section 197 intangible. For example, if the cost of computer software is not separately stated from the cost of the hardware or other tangible property and you consistently treat it as part of the cost of the hardware or other tangible property, these rules do not apply. Similarly, none of the cost of acquiring real property held for the production of rental income is considered the cost of goodwill, going concern value, or any other section 197 intangible.

## Section 197 Intangibles Defined

The following assets are section 197 intangibles.

- 1) Goodwill.
- 2) Going concern value.
- 3) Workforce in place.
- 4) Business books and records, operating systems, or any other information base, including lists or other information concerning current or prospective customers.
- 5) A patent, copyright, formula, process, design, pattern, know-how, format, or similar item.
- 6) A customer-based intangible.
- 7) A supplier-based intangible.
- 8) Any item similar to items (3) through (7).
- 9) A license, permit, or other right granted by a governmental unit or agency (including issuances and renewals).
- 10) A covenant not to compete entered into in connection with the acquisition of an interest in a trade or business.
- 11) A franchise, trademark, or trade name (including renewals).
- 12) A contract for the use of, or a term interest in, any item in this list.



*You cannot amortize any intangible listed in items (1) through (8) that you created (rather than acquired), unless you created it in connection with the acquisition*

*of assets constituting a trade or business or a substantial part of a trade or business.*

### Assets that are not section 197 intangibles.

The following assets are not section 197 intangibles.

- 1) Any interest in land.
- 2) Most computer software (see *Computer software*, later).
- 3) An interest under either of the following.
  - a) An existing lease or sublease of tangible property.
  - b) A debt in existence when the interest was acquired.

Intangible property not amortizable under the rules for section 197 intangibles can be depreciated if it has a determinable useful life. You generally must use the straight line method over its useful life. For certain intangibles, the depreciation period is specified in the law and regulations. For example, the depreciation period for computer software that is not a section 197 intangible is 36 months. For more information on depreciating computer software, see *Computer software* under *Excepted Property*, earlier.

**Interest in land.** Section 197 intangibles do not include any interest in land. An interest in land includes a fee interest, life estate, remainder, easement, mineral right, timber right, grazing right, riparian right, air right, zoning variance, and any other similar right, such as a farm allotment, quota for farm commodities, or crop acreage base.

**Computer software.** Section 197 intangibles do not include the following types of computer software.

- 1) Software that meets the following requirements.
  - a) It is (or has been) readily available for purchase by the general public.
  - b) It is subject to a nonexclusive license.
  - c) It has not been substantially modified. This requirement is considered met if the cost of all modifications is not more than the greater of 25% of the price of the publicly available unmodified software or \$2,000.
- 2) Software not acquired in connection with the acquisition of a trade or business or a substantial part of a trade or business.

## Anti-Churning Rules

Anti-churning rules prevent you from amortizing most section 197 intangibles if the transaction in which you acquired them did not result in a significant change in ownership or use. These rules apply to goodwill and going concern value, and to any other section 197 intangible not otherwise depreciable or amortizable. For more information on the anti-churning rules, see chapter 9 in Publication 535.

## Anti-Abuse Rule

You cannot amortize any section 197 intangible acquired in a transaction for which the principal purpose was either of the following.

- To avoid the requirement that the intangible be acquired after August 10, 1993.
- To avoid any of the anti-churning rules.

## Dispositions

A section 197 intangible is treated as depreciable property used in your trade or business. If you held the intangible for more than one year, any gain on its disposition, up to the allowable amortization, is ordinary income (section 1245 gain). Any remaining gain or loss is a section 1231 gain or loss. If you held the intangible one year or less, any gain or loss on its disposition is an ordinary gain or loss. For more information, see chapter 2 in Publication 544.

**Nondeductible loss.** You cannot deduct any loss on the disposition or worthlessness of a section 197 intangible you acquired in the same transaction (or series of related transactions) as other section 197 intangibles you still have. Instead, increase the adjusted basis of each remaining amortizable section 197 intangible by a proportionate part of the nondeductible loss.

# 9.

# General Business Credit

## Introduction

Your general business credit for the year consists of your carryforward of business credits from prior years plus your total current year business credits. Current year business credits include the following.

- Credit for alcohol used as fuel (Form 6478).
- Credit for contributions to selected community development corporations (Form 8847).
- Credit for employer social security and Medicare taxes paid on certain employee tips (Form 8846).
- Disabled access credit (Form 8826).
- Empowerment zone employment credit (Form 8844).
- Enhanced oil recovery credit (Form 8830).
- Indian employment credit (Form 8845).
- Investment credit (Form 3468).
- Low-income housing credit (Form 8586).
- New markets tax credit (Form 8874).

- Orphan drug credit (Form 8820).
- Renewable electricity production credit (Form 8835).
- Research credit (Form 6765).
- Welfare-to-work credit (Form 8861).
- Work opportunity credit (Form 5884).



*The welfare-to-work and work opportunity credits do not apply to individuals who begin work for you after December 31, 2001.*

In addition, your general business credit for the current year may be increased later by the carryback of business credits from future years.

If you need more information about these credits than you find in this chapter, see the instructions for the forms listed above.

## Topics

This chapter discusses:

- How to claim the credit
- Carryback and carryforward
- Investment credit

## Useful Items

You may want to see:

### Form (and Instructions)

- ☐ **1040X** Amended U.S. Individual Income Tax Return
- ☐ **1045** Application for Tentative Refund
- ☐ **1120X** Amended U.S. Corporation Income Tax Return
- ☐ **1139** Corporation Application for Tentative Refund
- ☐ **3468** Investment Credit
- ☐ **3800** General Business Credit
- ☐ **4255** Recapture of Investment Credit
- ☐ **4626** Alternative Minimum Tax—Corporations
- ☐ **6251** Alternative Minimum Tax—Individuals
- ☐ **8582-CR** Passive Activity Credit Limitations
- ☐ **8844** Empowerment Zone Employment Credit

See chapter 21 for information about getting publications and forms.

## How To Claim the Credit

To claim a general business credit, you will first have to get the forms you need to claim your current year business credits. The introduction to this chapter contains a list of current year business credits. The form you use to claim each credit is shown in parentheses.

In addition to the credit form, you may also need to file Form 3800. See the next discussion to decide whether you need to file Form 3800.

**Who must file Form 3800?** You must file Form 3800 if any of the following apply.

- You have more than one of the credits listed in the introduction (other than the empowerment zone employment credit).
- You have a carryback or carryforward of any of these credits (other than the empowerment zone employment credit).
- Any of these credits (other than the low-income housing credit or the empowerment zone employment credit) is from a passive activity. (For information about passive activity credits, see Form 8582-CR.)

**Claiming the empowerment zone employment credit.** The empowerment zone employment credit is subject to different rules. The credit is figured separately on Form 8844 and is not carried to Form 3800. For more information, see the instructions for Form 8844.

## Carryback and Carryforward



*This discussion does not apply to the empowerment zone employment credit.*

There is a limit on the amount of general business credit you can take in any one tax year. If your credit is more than this limit, you can generally carry the difference to another tax year and subtract it from your income tax for that year. See *Rule for carryback and carryforward*, later.

**Credit limit.** Your general business credit is limited to your **net income tax** minus the **greater** of the following amounts.

- Your **tentative minimum tax**.
- 25% of your **net regular tax liability** that is more than \$25,000.

**Net income tax.** Your net income tax is your net regular tax liability plus any alternative minimum tax.

**Tentative minimum tax.** You must figure your tentative minimum tax before you figure your general business credit. Use Form 6251 (Form 4626 for a corporation) to figure your tentative minimum tax.

**Net regular tax liability.** Your net regular tax liability is your regular tax liability minus certain credits. For more information, see the instructions for Form 3800 or any of the credit forms listed in the introduction.

**Example.** Your general business credit for the year is \$30,000. Your net income tax is \$27,500. Your tentative minimum tax, figured on Form 6251, is \$18,487. The general business credit you can take for the tax year is limited to \$9,013. This is your net income tax, \$27,500, minus the greater of your tentative minimum tax, \$18,487, or 25% of your net regular tax liability

that is more than \$25,000 ( $25\% \times \$2,500 = \$625$ ).

**Married person filing separate return.** If you are married and file a separate return, you and your spouse must each figure your credit limit separately. In figuring your separate limit, use \$12,500 instead of \$25,000. However, if one spouse has no credit for the tax year and no carryforwards or carrybacks of any credit to that year, the other spouse can use the full \$25,000 in figuring the limit based on the separate tax.

**Rule for carryback and carryforward.** In general, you can carry the unused part of your credit back one tax year and then forward to each of the 20 tax years after the year of the credit.

There are limits on the carryback of a new credit to periods before the enactment of the credit provision. See the instructions for Form 3800 for more information on these limits.

In any tax year, credits must be used as follows.

- 1) Carryforwards to that year, the earliest ones first.
- 2) The credit earned in that year.
- 3) The carrybacks to that year.



*For a credit earned in a tax year before 1998, the carryforward period is 15 years. No part of your carryforward to 2001 should be from a tax year before 1986.*

**Unused carryforward.** If you have any unused credit carryforward in the year following the end of the 20-year (15 years for pre-1998 credits) carryforward period, you can generally deduct the unused amount in that year. If an individual dies or a corporation, trust, or estate ceases to exist, the deduction is generally allowed for the tax year in which the death or cessation occurs. The deduction may not be allowed to certain corporations whose assets are acquired by another corporation.

**Claiming a carryforward.** Use Form 3800 to claim a carryforward of an unused credit from a previous tax year. The carryforward becomes part of your general business credit for the tax year to which it is carried.

**Claiming a carryback.** You can claim a refund based on your general business credit carryback to a prior tax year by filing an amended return for the tax year to which you carry the unused credit. Use Form 1040X if your original return was a Form 1040, *U.S. Individual Income Tax Return*. Use Form 1120X if your original return was a Form 1120, *U.S. Corporation Income Tax Return*, or 1120-A, *U.S. Corporation Short-Form Income Tax Return*. Attach Form 3800 to your amended return.

Generally, you must file the amended return for the carryback year within 3 years after the due date, including extensions, for filing the return for the year that resulted in the credit carryback.

**Quick refund.** You can apply for a quick refund of taxes for a prior year by filing **Form 1045 (Form 1139** for a corporation) to claim a tentative refund from a general business credit carryback. Generally, the application must be

filed within 12 months after the end of the tax year in which you earn the credit.

## Investment Credit

The investment credit is the total of the following credits.

- Reforestation credit.
- Rehabilitation credit.
- Energy credit.

**Reforestation credit.** The 10% reforestation credit applies to up to \$10,000 (\$5,000 if you are married filing a separate return) of the amortizable costs you incur each year to forest or reforest property you hold for growing trees for sale or use in the commercial production of timber products. You can take the credit for reforestation costs whether you choose to amortize them or add them to the basis of your property. There is no carryforward or carryback of costs that are more than the dollar limit. For more information, see *Amortization* in chapter 8.

**Example.** You incurred \$9,000 of qualified reforestation costs during the year. You may take a reforestation credit of \$900 ( $10\% \times \$9,000$ ) for the year.

**Rehabilitation credit.** The rehabilitation credit applies to costs you incur for rehabilitation and reconstruction of certain buildings. Rehabilitation includes renovation, restoration, and reconstruction. It does not include enlargement or new construction. Generally, the percentage of costs you can take as a credit is 10% for buildings placed in service before 1936 and 20% for certified historic structures. See the instructions for Form 3468 for more information.

**Energy credit.** The 10% energy credit applies to certain costs for solar or geothermal energy property you placed in service during your tax year. See the instructions for Form 3468 for more information.

**Basis adjustment.** You generally must reduce the basis of assets on which you take an investment credit. The reduction is 100% of the rehabilitation credit and 50% of the reforestation and energy credits. See the instructions for Form 3468.

**Example.** You amortized qualified reforestation costs of \$9,000 incurred during the year. You are also taking a \$900 reforestation credit. You must reduce your amortizable basis by \$450 ( $50\% \times \$900$ ). As a result, your amortizable basis will be \$8,550 ( $\$9,000 - \$450$ ).

**How to take the investment credit.** Use **Form 3468** to figure your credit. You may also need to file Form 3800. See *How To Claim the Credit*, earlier.

## Recapture of Investment Credit

At the end of each tax year, you must determine whether you disposed of or stopped using in your business (either partially or entirely) any

property for which you claimed an investment credit in a prior year.

## Recapture Rule

If you dispose of investment credit property before the end of the recapture period, you must recapture, as an additional tax, part of the original credit you claimed. You may also have to recapture part or all of the credit if you change the use of investment credit property to one that would not have originally qualified for the credit.

**Recapture period.** The recapture period is the length of time the property must be used to get the full investment credit. The recapture period for investment credit property is 5 full years from the date it was placed in service.

The credit you must recapture depends on when during the recapture period you dispose of, or change the use of, the property. If you dispose of the property during the first full year of service, you must recapture the full amount of the credit that was used to reduce your tax. The recapture amount decreases for each year the property remains in qualified service.

**Form 4255.** Use Form 4255 to figure the recapture amount. The credit recapture is figured by multiplying the original investment credit taken by the recapture percentage from the tables shown on Form 4255. The result is the recapture amount. See Form 4255 for more information.

If the refigured credit is less than the credit you originally took, you must add the difference to your tax.

Instead of using **Form 4255** to figure the recapture tax, you can attach a detailed statement to your return for the year you dispose of the asset showing the computation of the recapture tax and the decrease in any investment credit carryforward.

**Net operating loss carryback.** If you have a net operating loss carryback from the recapture year or a later year that reduces your tax for the recapture year or an earlier year, you may have to refigure your recapture. See section 1.47-1(b)(3) of the regulations.

**At-risk reduction.** If your investment credit property is subject to the at-risk limits, you may have to recapture part of the credit if the amount at risk is decreased. See the instructions for Form 3468 for more information.

## Disposition

An outright sale of property is the clearest example of a disposition. Another type of disposition occurs when you exchange or trade worn-out or obsolete business assets for new ones. If the property ceases to be qualifying property, it is considered to be disposed of for investment credit recapture purposes. For example, the conversion of business property to personal use is considered a disposition.

Certain transactions result in dispositions for investment credit recapture. The following illustrate transactions that are dispositions and some that are not.

**Mortgaging and foreclosure.** There is no disposition if title to property is transferred as security for a loan. However, a disposition does



occur if there is a transfer of property by foreclosure.

**Leased property.** The leasing of investment credit property by the lessor who took the credit is generally not a disposition. However, if the lease is treated as a sale for income tax purposes, it is a disposition. A disposition also occurs if property ceases to be investment credit property in the hands of the lessor, the lessee, or any sublessee.

**Decrease in basis.** If the basis of investment credit property decreases, the decrease is considered to be a disposition of part of the property. This occurs, for example, if you buy property and later receive a refund of part of the original purchase price. You must then refigure the credit as if the decrease in basis was never part of the original basis. If your refigured credit is less than the credit you originally took, you must add the difference to your tax.

**Retirement or abandonment.** You dispose of property if you abandon or otherwise retire it from use. Normal retirements are also dispositions.

**Transfer due to death.** There is no disposition of investment credit property if the property is transferred because the owner-taxpayer died.

**Gift.** You are considered to have disposed of property you transferred by gift.

**Transfer between spouses.** If you transfer investment credit property to your spouse, or you transfer the property to your former spouse incident to a divorce, you generally are not considered to have disposed of the property. This also applies if the transfer is made in trust for the benefit of your spouse or former spouse. However, if your spouse or former spouse later transfers the property, your spouse or former spouse will receive the same tax treatment that would have applied to you if you had made the transfer.

**Casualty, theft, or involuntary conversion.** You are considered to have disposed of property that was destroyed by casualty or lost by theft or other involuntary conversion.

**Disposition of assets by S corporation, partnership, estate, or trust.** If you are a shareholder of an S corporation that disposes of assets on which you figured the investment credit, you are treated as having disposed of the share of the investment on which you figured your credit. This same rule applies if you are a member of a partnership or a beneficiary of an estate or trust.

**Change in form of doing business.** A disposition does not occur because of a change in the form of doing business if certain conditions are met. For more information, see section 1.47–3(f) of the regulations.

**Choosing S corporation status.** The choice by a corporation to become an S corporation generally will not cause the recapture of investment credit previously claimed by the corporation. The choice is treated as a change in the form of doing business and not as a disposition of property. No disposition occurs when an S corporation terminates or revokes its choice not to be taxed as a corporation.

**Sale and leaseback.** There is no disposition when investment credit property is sold by the

taxpayer who claimed the credit and it is then leased back to that taxpayer as part of the same transaction.

## 10.

# Gains and Losses

## Important Change

**Lower capital gain tax rates.** The capital gain tax rates for “qualified 5-year gain” have been lowered. See *Qualified 5-Year Gain*, later.

## Introduction

During the year, you may have sold or exchanged property. This chapter explains how to figure your gain or loss on the sale or exchange and determine the effect it has on your taxes.

### Topics

This chapter discusses:

- Sales and exchanges
- Ordinary or capital gain or loss

### Useful Items

You may want to see:

#### Publication

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

#### Form (and Instructions)

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

See chapter 21 for information about getting publications and forms.

# Sales and Exchanges

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

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

## Determining Gain or Loss

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

See chapter 7 for the definition of basis, adjusted basis, and fair market value.

**Amount realized.** The amount you realize from a sale or exchange is the total of all money you receive plus the fair market value of all property or services you receive. The amount you realize also includes any of your liabilities assumed by the buyer and any liabilities to which the property you transferred is subject, such as real estate taxes or a mortgage.

If the liabilities relate to an exchange of multiple properties, see *Treatment of liabilities* under *Multiple Property Exchanges* in chapter 1 of Publication 544.

**Amount recognized.** Your gain or loss realized from a sale or exchange of property is usually a recognized gain or loss for tax purposes. A **recognized gain** is a gain you must include in gross income and report on your income tax return. A **recognized loss** is a loss you deduct from gross income. For example, if your recognized gain from the sale of your tractor is \$5,300, you include that amount in gross income on Form 1040. However, your gain or loss realized from the exchange of property may not be recognized for tax purposes. See *Like-Kind Exchanges*, next. Also, a loss from the disposition of property held for personal use is not deductible.

## Like-Kind Exchanges

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



*The rules for like-kind property exchanges must be followed carefully to ensure the validity of these exchanges.*

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

- Qualifying property.
- Like-kind property.

These two requirements are discussed later.

Additional requirements apply to exchanges in which the property received is not received immediately upon the transfer of the property given up. See *Deferred exchange*, later.

If the like-kind exchange involves the receipt of money or unlike property or the assumption of your liabilities, you may have a recognized gain. See *Partially nontaxable exchange*, later.

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

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

**Basis of property received.** If you receive property in a like-kind exchange, the basis of the property will be the same as the basis of the property given up. See chapter 7 for more information about basis.

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

**Example.** Bill Smith trades an old tractor with an adjusted basis of \$1,500 for a new one. The new tractor costs \$30,000. He is allowed \$8,000 for the old tractor and pays \$22,000 cash. He has no recognized gain or loss on the transaction regardless of the adjusted basis of his old tractor. If Bill sold the old tractor to a third party for \$8,000 and bought a new one, he would have a recognized gain or loss on the sale of his old tractor equal to the difference between the amount realized and the adjusted basis of the old tractor.

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

If you have any recognized gain because you received money or unlike property, report it on Schedule D (Form 1040) or **Form 4797**, whichever applies. You may also have to report the recognized gain as ordinary income because of depreciation recapture on Form 4797. See chapter 11 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, and rental houses are examples of property that may qualify.

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

- Property you use for personal purposes, such as your home and your family car.

- Stock in trade or other property held primarily for sale, such as crops and produce.
- Stocks, bonds, notes, or other securities or evidences of indebtedness, such as accounts receivable.
- Partnership interests.

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

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

**Personal property.** Depreciable tangible personal property can be either “like kind” or “like class” to qualify for nontaxable exchange treatment. **Like-class properties** are depreciable tangible personal properties within the same General Asset Class or Product Class. Property classified in any General Asset Class may not be classified within a Product Class.

**General Asset Classes.** General Asset Classes describe the types of property frequently used in many businesses. They include the following property.

- 1) Office furniture, fixtures, and equipment (asset class 00.11).
- 2) Information systems, such as computers and peripheral equipment (asset class 00.12).
- 3) Data handling equipment except computers (asset class 00.13).
- 4) Airplanes (airframes and engines), except planes used in commercial or contract carrying of passengers or freight, and all helicopters (airframes and engines) (asset class 00.21).
- 5) Automobiles and taxis (asset class 00.22).
- 6) Buses (asset class 00.23).
- 7) Light general purpose trucks (asset class 00.241).
- 8) Heavy general purpose trucks (asset class 00.242).
- 9) Railroad cars and locomotives except those owned by railroad transportation companies (asset class 00.25).
- 10) Tractor units for use over the road (asset class 00.26).
- 11) Trailers and trailer-mounted containers (asset class 00.27).
- 12) Vessels, barges, tugs, and similar water-transportation equipment, except those used in marine construction (asset class 00.28).
- 13) Industrial steam and electric generation or distribution systems (asset class 00.4).

**Product Classes.** Product Classes include property listed in a 4-digit product class (except any ending in “9,” a miscellaneous category) in Division D of the Standard Industrial Classification

codes of the Executive Office of the President, Office of Management and Budget, Standard Industrial Classification Manual (SIC Manual). Copies of the manual may be obtained from the National Technical Information Service, an agency of the U.S. Department of Commerce. To order the manual, call **1-800-553-NTIS (1-800-553-6847)**. The cost of the manual is \$36 and the order number is PB87-100012.

**Examples.** An exchange of a truck for a tractor is an exchange of like-kind property, and so is an exchange of timber land for crop acreage. An exchange of a tractor for acreage, however, is not an exchange of like-kind property. Neither is the exchange of livestock of one sex for livestock of the other sex. An exchange of the assets of a business for the assets of a similar business cannot be treated as an exchange of one property for another property. Whether you engaged in a like-kind exchange depends on an analysis of each asset involved in the exchange.

**Partially nontaxable exchange.** If, in addition to like-kind property, you receive money or unlike property in an exchange on which you realize gain, you have a partially nontaxable exchange. You are taxed on the gain you realize, but only to the extent of the money and the fair market value of the unlike property you receive. A loss is not deductible.

**Example 1.** You trade farm land that cost \$30,000 for \$10,000 cash and other land to be used in farming with a fair market value of \$50,000. You have a realized gain of \$30,000, but only \$10,000, the cash received, is recognized (included in income).

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

**Example 3.** Assume in *Example 1* that the fair market value of the land you received was only \$15,000. Your \$5,000 loss is not deductible.

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

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

**Related persons.** Under these rules, related persons include, for example, you and a member of your family (spouse, brother, sister, parent, child, etc.), you and a corporation in

which you have more than 50% ownership, you and a partnership in which you directly or indirectly own more than a 50% interest of the capital or profits, and two partnerships in which you directly or indirectly own more than 50% of the capital or profits interests.

For the complete list of related persons, see *Nondeductible Loss under Sales and Exchanges Between Related Persons* in chapter 2 of Publication 544.

**Example.** You used a truck in your farming business. Your sister used a station wagon in her landscaping business. In December 2000, you exchanged your truck, plus \$200, for your sister's station wagon. At that time, the fair market value (FMV) of your truck was \$7,000 and its adjusted basis was \$6,000. The FMV of your sister's station wagon was \$7,200 and its adjusted basis was \$1,000. You realized a gain of \$1,000 (the \$7,200 FMV of the station wagon minus the \$200 you paid, minus the \$6,000 adjusted basis of the truck). Your sister realized a gain of \$6,200 (the \$7,000 FMV of your truck plus the \$200 you paid, minus the \$1,000 adjusted basis of the station wagon).

However, because this was a like-kind exchange, you recognized no gain. Your basis in the station wagon was \$6,200 (the \$6,000 adjusted basis of the truck plus the \$200 you paid). Your sister recognized gain only to the extent of the money she received, \$200. Her basis in the truck was \$1,000 (the \$1,000 adjusted basis of the station wagon minus the \$200 received, plus the \$200 gain recognized).

In 2001, you sold the station wagon to a third party for \$7,000. Because you sold it within 2 years after the exchange, the exchange is disqualified from nonrecognition treatment. On your tax return for 2001, you must report your \$1,000 gain on the exchange in 2000. You also report a loss on the sale of \$200 (the adjusted basis of the station wagon, \$7,200 (its \$6,200 basis plus the \$1,000 gain recognized), minus the \$7,000 realized from the sale).

In addition, your sister must report on her tax return for 2001 the \$6,000 balance of her gain on the 2000 exchange. Her adjusted basis in the truck is increased to \$7,000 (its \$1,000 basis plus the \$6,000 gain recognized).

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

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

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

- Transfer and receive properties in two or more exchange groups.

- Transfer or receive more than one property within a single exchange group.

For more information, see *Multiple Property Exchanges* in chapter 1 of Publication 544.

**Deferred exchange.** A deferred exchange is one in which you transfer property you use in business or hold for investment and later receive like-kind property you will use in business or hold for investment. (The property you receive is replacement property.) The transaction must be an exchange (that is, property for property) rather than a transfer of property for money used to buy replacement property unless the money is held by a qualified intermediary (defined later).

A deferred exchange for like-kind property may qualify for nonrecognition of gain or loss if the like-kind property is identified and transferred within the following time limits.

- 1) You must identify the property to be received within 45 days after the date you transfer the property given up in the exchange.
- 2) The property must be received by the **earlier** of the following dates.
  - a) The 180th day after the date on which you transfer the property given up in the exchange.
  - b) The due date, including extensions, for your tax return for the tax year in which the transfer of the property given up occurs.

A **qualified intermediary** is a person who enters into a written exchange agreement with you to acquire and transfer the property you give up and to acquire the replacement property and transfer it to you. This agreement must expressly limit your rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by the qualified intermediary. A qualified intermediary cannot be your agent at the time of the transaction or certain persons related to you or your agent.

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

## Transfer to Spouse

No gain or loss is recognized on a transfer of property from an individual to (or in trust for the benefit of) a spouse, or a former spouse if incident to divorce. This rule does not apply if the recipient is a nonresident alien. Nor does this rule apply to a transfer in trust to the extent the liabilities assumed and the liabilities on the property are more than the property's adjusted basis.

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

For more information on transfers of property incident to divorce, see *Property Settlements* in Publication 504.

## Ordinary or Capital Gain or Loss

You must classify your gains and losses as either ordinary or capital (and your capital gains or losses as either short-term or long-term). You must do this to figure your net capital gain or loss.

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

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

**Section 1231 transactions.** Section 1231 transactions are sales and exchanges of property held longer than 1 year and either used in a trade or business or held for the production of rents or royalties. They also include certain involuntary conversions of business or investment property, including capital assets. See *Section 1231 Gains and Losses* in chapter 11 for more information.

## Capital Assets

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

The following items are examples of capital assets.

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

**Personal-use property.** Property held for personal use is a capital asset. **Gain** from a sale or exchange of that property is a capital gain and is taxable. **Loss** from the sale or exchange of that property is not deductible. You can deduct a loss relating to personal-use property only if it results from a casualty or theft. For information about casualties and thefts, see chapter 13.

## 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.



**Table 10-1. What Is Your Maximum Capital Gain Rate?**

IF your net capital gain is from...	THEN your maximum capital gain rate is...
Collectibles gain	28%
Gain on qualified small business stock equal to the section 1202 exclusion	28%
Unrecaptured section 1250 gain	25%
Other gain, <sup>1</sup> and the regular tax rate that would apply is 27.5% or higher	20%
Other gain, <sup>1</sup> and the regular tax rate that would apply is lower than 27.5%	8% <sup>2</sup> or 10%
<sup>1</sup> “Other gain” means any gain that is not collectibles gain, gain on qualified small business stock, or unrecaptured section 1250 gain.	
<sup>2</sup> The rate is 8% only for qualified 5-year gain.	

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

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

**Example.** If you bought an asset on June 19, 2000, you should start counting on June 20, 2000. If you sold the asset on June 19, 2001, your holding period is not longer than 1 year, but if you sold it on June 20, 2001, 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. See chapter 4 of Publication 550.

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

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

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

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

holding period of the seller cannot end before that time.

### Figuring Net Gain or Loss

The totals for short-term capital gains and losses and the totals for long-term capital gains and losses must be figured separately.

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

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

**Net gain.** If the total of your capital gains is more than the total of your capital losses, the difference is taxable. However, the part 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 Gain Tax Rates*, later.

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

### Treatment of Capital Losses

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

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

- Your net loss on line 17 of Schedule D is more than the yearly limit.
- The amount shown on line 37, Form 1040 (your taxable income without your deduction for exemptions), is less than zero.

If either of these situations applies to you for 2001, complete the *Capital Loss Carryover Worksheet* in the instructions to Schedule D (Form 1040) to figure the amount you can carry over to 2002.

### Capital Gain 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 gain 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.

You will need to use Part IV of Schedule D (Form 1040), and the Schedule D Tax Worksheet in certain cases, to figure your tax using the capital gain rates if both the following are true.

- Both lines 16 and 17 of Schedule D are gains.
- Your taxable income on Form 1040, line 39, is more than zero.

The maximum capital gain rate can be 8%, 10%, 20%, 25%, or 28%. See *Table 10-1*.

The maximum capital gain rate does not apply if it is higher than your regular tax rate.

**Using the capital gain rates.** The part of a net capital gain subject to each rate is determined by first netting long-term capital gains with long-term capital losses in the following tax rate groups.

- 1) A 28% group, consisting of all the following gains and losses.
  - a) Collectibles gains and losses.
  - b) The part of the gain on qualified small business stock equal to the section 1202 exclusion.
  - c) Any long-term capital loss carryover.
- 2) A 25% group, consisting of unrecaptured section 1250 gain.
- 3) A 20% group, consisting of gains and losses not in the 28% or 25% group.

If any group has a net loss, the following rules apply.

- A net loss from the 28% group reduces any gain from the 25% group, and then any net gain from the 20% group.
- A net loss from the 20% group reduces any net gain from the 28% group, and then any gain from the 25% group.

If you have a net short-term capital loss, it reduces any net gain from the 28% group, then any gain from the 25% group, and finally any net gain from the 20% group.

The resulting net gain (if any) from each group is subject to the tax rate for that group.

(The 10% rate applies to a net gain from the 20% group to the extent that, if there were no capital gain rates, the net capital gain would be taxed at the 15% regular tax rate.)

**Collectibles gain or loss.** This is gain or loss from the sale or exchange of a work of art, rug, antique, metal, gem, stamp, coin, or alcoholic beverage held longer than 1 year. Collectibles gain includes gain from the sale of an interest in a partnership, S corporation, or trust attributable to an increase in value of the collectibles whether you sold them or not.

**Gain on qualified small business stock.** If you realized a gain from qualified small business stock you held longer than 5 years, you exclude up to one-half your gain from your income. The taxable part of your gain equal to your section 1202 exclusion is a 28% rate gain. See *Sales of Small Business Stock* in chapter 1 of Publication 544.

**Unrecaptured section 1250 gain.** This is the part of any long-term capital gain on section 1250 property (real property) due to straight-line depreciation minus any net loss in the 28% group. Unrecaptured section 1250 gain cannot be more than the net section 1231 gain or include any gain that is otherwise treated as ordinary income. Use the worksheet in the Schedule D instructions to figure your unrecaptured section 1250 gain. For more information about section 1250 property and net section 1231 gain, see chapter 3 of Publication 544.

## Qualified 5-Year Gain

Lower capital gain tax rates apply to a gain that is "qualified 5-year gain." Qualified 5-year gain is long-term capital gain from the sale of property you held longer than 5 years that would otherwise be subject to the 10% or 20% capital gain rate. The 10% and 20% rates are lowered in 2001 and 2006, respectively.

**2001.** Beginning in 2001, the 10% capital gain rate will be lowered to 8% for qualified 5-year gain.

**2006.** Beginning in 2006, the 20% capital gain rate will be lowered to 18% for qualified 5-year gain from property with a holding period that begins after 2000.

**Election to recognize gain on assets held on January 1, 2001.** Taxpayers (other than corporations) can elect to treat certain assets held on January 1, 2001, as sold and then reacquired on the same date, but they must pay tax for 2001 on any resulting gain. The purpose of the election is to make any future gain on the asset eligible for the 18% rate by giving the asset a new holding period.

You can make this election for either of the following types of assets.

- **Readily tradable stock that is a capital asset** that you held on January 1, 2001, and did not sell before January 2, 2001. If you make the election, you treat this stock as sold on January 2, 2001, at its closing market price on that date. You then treat it as reacquired on that date for the same amount. Readily tradable stock is any stock which is readily tradable on an es-

tablished securities market after December 31, 2000.

- **Any other capital asset or property used in a trade or business** that you held on January 1, 2001. If you make the election, you treat this type of asset as sold on January 1, 2001, for its fair market value on that date. You then treat it as reacquired on that date for the same amount.

Any gain on a deemed sale resulting from this election must be recognized. A loss is not allowed, but the asset will be eligible for the 18% rate on future gain.

For the election to apply, you cannot dispose of the asset (in a transaction in which gain or loss is recognized in whole or in part) within the 1-year period beginning on the date the asset would have been treated as sold under the election.

**How to make the election.** Report the deemed sale on your tax return for the tax year that includes the date of the deemed sale. If you are a calendar year taxpayer, this is your 2001 tax return. Attach to the return a statement that you are making an election under section 311 of the Taxpayer Relief Act of 1997 and specifying the assets for which you are making the election. Once made, the election is irrevocable.

**Net capital gain from disposition of investment property.** If you choose to include any part of a net capital gain from a disposition of investment property in investment income for figuring your investment interest deduction, you must reduce the net capital gain eligible for the capital gain tax rates by the same amount. You make this choice on Form 4952, *Investment Interest Expense Deduction*. For information on making this choice, see the instructions to Form 4952. For information on the investment interest deduction, see chapter 3 in Publication 550.

## Noncapital Assets

Noncapital assets include property such as inventory and depreciable property used in a trade or business. A list of properties that are not capital assets is provided in the Schedule D instructions.

**Property held for sale in the ordinary course of your farm business.** Property you hold mainly for sale to customers, such as livestock, poultry, livestock products, and crops, is a non-capital asset. Gain or loss from sales or other dispositions of this property is reported on Schedule F (not on Schedule D or Form 4797). The treatment of this property is discussed in chapter 4.

**Land and depreciable properties.** Noncapital assets include land and depreciable property you use in farming. They also include livestock held for draft, breeding, dairy, or sporting purposes. However, your gains and losses from sales and exchanges of your farm land and depreciable properties must be considered together with certain other transactions to determine whether the gains and losses are treated as capital or ordinary gains and losses. The sales of these business assets are reported on Form 4797. See chapter 11 for more information.

## Hedging (Commodity Futures)

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

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

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

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

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

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

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

Gain or loss on transactions that hedge supplies of a type regularly used or consumed in the ordinary course of its trade or business may be ordinary.



If you have numerous transactions in the commodity futures market during the year, you must be able to show which transactions are hedging transactions. Clearly identify a hedging transaction on your books and records before the end of the day you entered into the transaction. It may be helpful to have separate brokerage accounts for your hedging and speculation transactions.

The identification must not only be on, and retained as part of, your books and records but must specify both the hedging transaction and the item, items, or aggregate risk that is being hedged. Although the identification of the hedg-

ing transaction must be made before the end of the day it was entered into, you have 35 days after entering into the transaction to identify the hedged item, items, or risk.

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

**Accounting methods for hedging transactions.** Hedging transactions must be accounted for under special rules unless the transaction is subject to mark-to-market accounting under section 475 of the Internal Revenue Code or you use an accounting method other than the following methods.

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

Under these rules, the accounting method you use for a hedging transaction must clearly reflect income. This means that your accounting method must reasonably match the timing of income, deduction, gain, or loss from a hedging transaction with the timing of income, deduction, gain, or loss from the item or items being hedged. There are requirements and limits on the method you can use for certain hedging transactions. See section 1.446-4(e) of the regulations for those requirements and limits.

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

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

**Example of a hedging transaction.** You file your income tax returns on the cash method. On July 2, 2001, you anticipate a yield of 50,000 bushels of corn this crop year. The present December futures price is \$2.75 a bushel, but there are indications that by harvest time the price will drop. To protect yourself against a drop in the sales price of your corn inventory, you enter into the following hedging transaction. You sell 10 December futures contracts of 5,000 bushels each for a total of 50,000 bushels of corn at \$2.75 a bushel.

The price did not drop as anticipated but rose to \$3 a bushel. In November, you sell your crop at a local elevator for \$3 a bushel. You also close out your futures position by buying 10 December contracts for \$3 a bushel. You paid a broker's commission of \$700 (\$70 per contract) for the complete in and out position in the futures market.

The result is that the price of corn rose 25 cents a bushel and the actual selling price is \$3 a bushel. Your loss on the hedge is 25 cents a bushel. In effect, the net selling price of your corn is \$2.75 a bushel.

Report the results of your futures transactions and your sale of corn separately on Schedule F.

The loss on your futures transactions is \$13,200, figured as follows.

July 2, 2001—Sold Dec. corn futures (50,000 bu. @ \$2.75)	\$137,500
Nov. 6, 2001—Bought Dec. corn futures (50,000 bu. @ \$3 plus broker's commission)	150,700
<b>Futures loss</b>	<b><u>(\$ 13,200)</u></b>

This loss is reported as a negative figure on line 10, Part I of Schedule F.

The proceeds from your corn sale at the local elevator are \$150,000 (50,000 bu. × \$3). Report it on line 4, Part I of Schedule F.

Assume you were right and the price went down 25 cents a bushel. In effect, you would still net \$2.75 a bushel, figured as follows.

Sold cash corn, per bushel	\$2.50
Gain on hedge, per bushel	.25
	<b><u>\$2.75</u></b>

The gain on your futures transactions would have been \$11,800, figured as follows.

July 2, 2001—Sold Dec. corn futures (50,000 bu. @ \$2.75)	\$137,500
Nov. 6, 2001—Bought Dec. corn futures (50,000 bu. @ \$2.50 plus broker's commission)	125,700
<b>Futures gain</b>	<b><u>\$ 11,800</u></b>

The \$11,800 is reported on line 10, Part I of Schedule F.

The proceeds from the sale of your corn at the local elevator, \$125,000, are reported on line 4, Part I of Schedule F.

## Livestock

This part discusses the sale or exchange of livestock used in your farm business. Gain or loss from the sale or exchange of this livestock may qualify as a section 1231 gain or loss. However, any part of the gain that is ordinary income from the recapture of depreciation is not included as section 1231 gain. See chapter 11 for more information on section 1231 gains and losses and the recapture of depreciation under section 1245.



*The rules discussed here do not apply to the sale of livestock held primarily for sale to customers. The sale of this livestock is reported on Schedule F. See chapter 4.*

**Holding period.** The sale or exchange of **livestock used in your farm business** (defined later) qualifies as a section 1231 transaction if you held the livestock for 12 months or more (24 months or more for horses and cattle).

**Livestock.** For section 1231 transactions, livestock includes cattle, hogs, horses, mules, donkeys, sheep, goats, fur-bearing animals (such as mink), and other mammals. Livestock does not include chickens, turkeys, pigeons, geese, emus, ostriches, rheas, or other birds, fish, frogs, reptiles, etc.

**Livestock used in farm business.** If livestock is held primarily for draft, breeding, dairy, or sporting purposes, it is used in your farm business. The purpose for which an animal is held ordinarily is determined by a farmer's actual use of the animal. An animal is not held for draft, breeding, dairy, or sporting purposes merely because it is suitable for that purpose, or because it is held for sale to other persons for use by them for that purpose. However, a draft, breeding, or sporting purpose may be present if an animal is disposed of within a reasonable time

after it is prevented from its intended use or made undesirable as a result of an accident, disease, drought, or unfitness of the animal.

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

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

**Example 3.** You are in the business of raising hogs for slaughter. Customarily, before selling your sows, you obtain a single litter of pigs that you will raise for sale. You sell the brood sows after obtaining the litter. Even though you hold these brood sows for ultimate sale to customers in the ordinary course of your business, they are considered to be held for breeding purposes.

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

**Example 5.** You are in the business of breeding and raising mink that you pelt for the fur trade. You take breeders from the herd when they are no longer useful as breeders and pelt them. Although these breeders are processed and pelted, they are still considered to be held for breeding purposes. The same applies to breeders of other fur-bearing animals.

**Example 6.** You breed, raise, and train horses for racing purposes. Every year you cull horses from your racing stable. In 2001, you decided that to prevent your racing stable from getting too large to be effectively operated, you must cull six horses that had been raced at public tracks in 2000. 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 7.

**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, 2001, for \$1,250. Expenses of the sale were \$125. The cow was bought July 2, 1998, for \$1,300. Depreciation (not less than the amount allowable) was \$759.

Gross sales price . . . . .	\$1,250
Cost (basis) . . . . .	\$1,300
Minus: Depreciation deduction . . . . .	<u>759</u>
Unrecovered cost (adjusted basis) . . . . .	\$ 541
Expense of sale . . . . .	<u>125</u>
<b>Gain realized</b> . . . . .	<b><u>\$ 584</u></b>

## Converted Wetland and Highly Erodible Cropland

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

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

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

- It is mostly soil that, in its undrained condition, is saturated, flooded, or ponded long enough during a growing season to develop an oxygen-deficient state that supports the growth and regeneration of plants growing in water.
- It is saturated by surface or groundwater at a frequency and duration sufficient to support mostly plants that are adapted for life in saturated soil.
- It supports, under normal circumstances, mostly plants that grow in saturated soil.

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

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

## Timber

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

Farmers who cut timber on their land and sell it as logs, firewood, or pulpwood usually have no cost or other basis for that timber. These sales constitute a very minor part of their farm businesses. Amounts realized from these minor sales, and the expenses incurred in cutting, hauling, etc., are ordinary farm income and expenses reported on Schedule F (Form 1040).

Different rules apply if you owned the timber longer than 1 year and choose to treat timber cutting as a sale or exchange or you enter into a cutting contract, discussed later. Depletion on timber is discussed in chapter 8.

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

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

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

To choose this treatment, you must:

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

**Making the election.** You make the election on your return for the year the cutting takes place by including in income the gain or loss on the cutting and including a computation of your gain or loss. You do not have to make the election in the first year you cut the timber. You can make it in any year to which the election would apply. If the timber is partnership property, the election is made on the partnership return. This election cannot be made on an amended return.

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

**Canceling a post-1986 election.** You can cancel an election you made for a tax year beginning after 1986 only if you can show undue hardship and you get the approval of the IRS. Thereafter, you cannot make a new election unless you have the approval of the IRS.

**Canceling a pre-1987 election.** You can cancel an election you made for a tax year beginning before 1987 without the approval of the IRS. You can cancel the election by attaching a statement to your tax return for the year the cancellation is to be effective. If you make this cancellation, which can be made only once, you can make a new election without the approval of the IRS. Any further cancellation will require the approval of the IRS.

The statement must include all the following information.

- Your name, address, and taxpayer identification number.
- The year the cancellation is effective and the timber to which it applies.
- That the cancellation being made is of the election to treat the cutting of timber as a sale or exchange under section 631(a) of the Internal Revenue Code.
- That the cancellation is being made under section 311(d) of Public Law 99-514.
- That you are entitled to make the cancellation under section 311(d) of Public Law 99-514 and temporary regulations section 301.9100-7T.

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

Your adjusted basis for depletion of cut timber is based on the number of units (feet board measure, log scale, or other units) of timber cut during the tax year and considered to be sold or exchanged. Your adjusted basis for depletion is also based on the depletion unit of timber in the account used for the cut timber, and should be figured in the same manner as shown in section 611 of the Internal Revenue Code and section 1.611-3 of the regulations.

**Example.** In April 2001, you owned 4,000 MBF (1,000 board feet) of standing timber longer than 1 year. It had an adjusted basis for depletion of \$40 per MBF. You are a calendar year taxpayer. On January 1, 2001, the timber had a fair market value (FMV) of \$350 per MBF. It was cut in April for sale. On your 2001 tax return, you choose to treat the cutting of the timber as a sale or exchange. You report the difference between the FMV and your adjusted basis for depletion as a gain. This amount is reported on Form 4797 along with your other section 1231 gains and losses to figure whether it is treated as a capital gain or as ordinary gain. You figure your gain as follows.

FMV of timber January 1, 2001 . . . . .	\$1,400,000
Minus: Adjusted basis for depletion . . . . .	<u>160,000</u>
<b>Section 1231 gain</b> . . . . .	<b><u>\$1,240,000</u></b>

The FMV becomes your basis in the cut timber, and a later sale of the cut timber, including any by-product or tree tops, will result in ordinary business income or loss.

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

- You are the owner of the timber.

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

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

**Date of disposal.** The date of disposal is the date the timber is cut. However, if you receive payment under the contract before the timber is cut, you can choose to treat the date of payment as the date of disposal.

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

To make this choice, attach a statement to the tax return filed by the due date (including extensions) for the year payment is received. The statement must identify the advance payments subject to the choice and the contract under which they were made.

If you timely filed your return for the year you received payment without making the choice, you can still make the choice by filing an amended return within 6 months after the due date for that year's return (excluding extensions). Attach the statement to the amended return and write "Filed pursuant to section 301.9100-2" at the top of the statement. File the amended return at the same address the original return was filed.

**Owner.** An owner is any person who owns an interest in the timber, including a sublessor and the holder of a contract to cut the timber. You own an interest in timber if you have the right to cut it for sale on your own account or for use in your business.

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

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

## Sale of a Farm

The sale of your farm will usually involve the sale of both nonbusiness property (your home) and business property (the land and buildings used in the farm operation and perhaps machinery and livestock). If you have a gain from the sale, you may be allowed to exclude the gain on your home. The gain on the sale of your business property is taxable. A loss on the sale of your business property to an unrelated person is deducted as an ordinary loss. Losses from non-business property, other than casualty or theft

losses, are not deductible. If you receive payments for your farm in installments, your gain is taxed over the period of years the payments are received, unless you choose not to use the installment method of reporting the gain. See chapter 12 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. Except for assets exchanged under any nontaxable exchange rules, both the buyer and seller of a farm must use the residual method to allocate the consideration to each business asset transferred. This method determines gain or loss from the transfer of each asset. It also determines the buyer's basis in the business assets.

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

**Residual method.** The residual method must be used for any transfer of a group of assets that constitutes a trade or business and for which the buyer's basis is determined only by the amount paid for the assets. This applies to both direct and indirect transfers, such as the sale of a business or the sale of a partnership interest in which the basis of the buyer's share of the partnership assets is adjusted for the amount paid under section 743(b) of the Internal Revenue Code. Section 743(b) of the Internal Revenue Code applies if a partnership has an election in effect under section 754 of the Internal Revenue Code.

A group of assets constitutes a trade or business if either of the following applies.

- Goodwill or going concern value could, under any circumstances, attach to them.
- The use of the assets would constitute an active trade or business under section 355 of the Internal Revenue Code.

The residual method provides for the consideration to be reduced first by the cash, and general deposit accounts (including checking and sav-

ings accounts but excluding certificates of deposit). The consideration remaining after this reduction must be allocated among the various business assets in a certain order.

For asset acquisitions occurring **after March 15, 2001**, make the allocation among the following assets in proportion to (but not more than) their fair market value on the purchase date in the following order.

- 1) Certificates of deposit, U.S. Government securities, foreign currency, and actively traded personal property, including stock and securities.
- 2) Accounts receivable, other debt instruments, and assets that you mark to market at least annually for federal income tax purposes. However, see section 1.338-6(b)(2)(iii) of the regulations for exceptions that apply to debt instruments issued by persons related to a target corporation, contingent debt instruments, and debt instruments convertible into stock or other property.
- 3) Property of a kind that would properly be included in inventory if on hand at the end of the tax year or property held by the taxpayer primarily for sale to customers in the ordinary course of business.
- 4) All other assets except section 197 intangibles.
- 5) Section 197 intangibles (other than goodwill and going concern value).
- 6) Goodwill and going concern value (whether or not the goodwill or going concern value qualifies as a section 197 intangible).

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

For more information about the residual method, including rules for acquisitions **after January 6, 2000 and before March 16, 2001**, see chapter 2 in Publication 544.

**Property used in farm operation.** The rules for excluding the gain on the sale of your home, described later under *Sale of your home*, do not apply to the property used for your farming business. Recognized gains and losses on business property must be reported on your return for the year of the sale. If the property was held longer than 1 year, it may qualify for section 1231 treatment (see chapter 11).

**Example.** You sell your farm, including your main home, which you have owned since December 1996. You realize gain on the sale as follows.

	Farm With Home	Home Only	Farm Without Home
Selling price . . . . .	\$182,000	\$58,000	\$124,000
Cost (or other basis) . . . . .	40,000	10,000	30,000
<b>Gain . . . . .</b>	<b>\$142,000</b>	<b>\$48,000</b>	<b>\$94,000</b>

You must report the \$94,000 gain from the sale of the property used in your farm business. All or a part of that gain may have to be reported as ordinary income from the recapture of depre-

ciation or soil and water conservation expenses. Treat the balance as section 1231 gain.

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

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

**Adjusted basis of the part sold.** This is the properly allocated part of your original cost or other basis of the entire farm plus or minus necessary adjustments for improvements, depreciation, etc., on the part sold. If your home is on the farm, you must properly adjust the basis to exclude those costs from your farm asset costs, as discussed later.

**Example.** You bought a 600-acre farm for \$700,000. The farm included land and buildings. The purchase contract designated \$600,000 of the purchase price to the land. You later sold 60 acres of land on which you had installed a fence. Your adjusted basis for the part of your farm sold is \$60,000 ( $\frac{1}{10}$  of \$600,000), plus any unrecovered cost (cost not depreciated) of the fence on the 60 acres at the time of sale. Use this amount to determine your gain or loss on the sale of the 60 acres.

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

**Example.** Assume that in the preceding example there was no breakdown of the \$700,000 purchase price between land and buildings. However, in the year of purchase, local taxes on the entire property were based on assessed valuations of \$420,000 for land and \$140,000 for improvements, or a total of \$560,000. The assessed valuation of the land is  $\frac{3}{4}$  (75%) of the total assessed valuation. Multiply the \$700,000 total purchase price by 75% to figure basis of \$525,000 for the 600 acres of land. The unadjusted basis of the 60 acres you sold would then be \$52,500 ( $\frac{1}{10}$  of \$525,000).

**Sale of your home.** Your home is a capital asset and not property used in the trade or business of farming. If you sell a farm that includes a house you and your family occupy, you must determine the part of the selling price and the part of the cost or other basis allocable to your home. Your home includes the immediate surroundings and outbuildings relating to it that are not used for business purposes.

If you use part of your home for business, you must make an appropriate adjustment to the basis for depreciation allowed or allowable. For more information on basis, see chapter 7.

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

**Table 10–2. Worksheet for Foreclosures and Repossessions**  
(Keep for your records)



<b>Part 1.</b> Figure your income from cancellation of debt. ( <i>Note: If you are not personally liable for the debt, you do not have income from cancellation of debt. Skip Part 1 and go to Part 2.</i> )	
1. Enter amount of debt canceled by the transfer of property . . . . .	_____
2. Enter the fair market value of the transferred property . . . . .	_____
3. <b>Income from cancellation of debt.*</b> Subtract line 2 from line 1. If less than zero, enter zero . . . . .	_____
<b>Part 2.</b> Figure your gain or loss from foreclosure or repossession.	
4. Enter the <b>smaller</b> of line 1 or line 2. Also include any proceeds you received from the foreclosure sale. (If you are not personally liable for the debt, enter the amount of debt canceled by the transfer of property.) . . . . .	_____
5. Enter the adjusted basis of the transferred property . . . . .	_____
6. <b>Gain or loss from foreclosure or repossession.</b> Subtract line 5 from line 4 . . . . .	_____

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

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

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

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

- 1) \$250,000, or
- 2) \$500,000, if all the following are true.
  - a) You are married and file a joint return for the year.
  - b) Either you or your spouse meets the ownership test.
  - c) Both you and your spouse meet the use test.
  - d) During the 2-year period ending on the date of sale, neither you nor your spouse excluded gain from the sale of another home.

The exclusion may be reduced under certain circumstances. See Publication 523 for more information.

**Gain from condemnation.** If you have a gain from a condemnation or sale under threat of condemnation, you may use the preceding rules for excluding the gain, rather than the rules discussed under *Postponing Gain* in chapter 13. However, any gain that cannot be excluded (because it is more than the limit) may be postponed under the rules discussed under *Postponing Gain* in chapter 13.

**Loss on your home.** You cannot deduct a loss on your home from a voluntary sale, a condemnation, or a sale under threat of condemnation.

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

## Foreclosure or Repossession

If you do not make payments you owe on a loan secured by property, the lender may foreclose on the loan or repossess the property. The foreclosure or repossession is treated as a sale or exchange from which you may realize gain or loss. This is true even if you voluntarily return the property to the lender. You may also realize ordinary income from cancellation of debt if the loan balance is more than the fair market value of the property.

**Buyer's (borrower's) gain or loss.** You figure and report gain or loss from a foreclosure or repossession in the same way as gain or loss from a sale or exchange. The gain or loss is the difference between your adjusted basis in the transferred property and the amount realized. See *Determining Gain or Loss*, earlier.

**TIP** You can use Table 10–2 to figure your gain or loss from a foreclosure or repossession.

**Amount realized on a nonrecourse debt.** If you are not personally liable for repaying the debt (nonrecourse debt) secured by the transferred property, the amount you realize includes the full amount of the debt canceled by the transfer. The total canceled debt is included even if the fair market value of the property is less than the canceled debt.

**Example 1.** Ann paid \$200,000 for land used in her farming business. She paid \$15,000 down and borrowed the remaining \$185,000 from a bank. Ann is not personally liable for the loan (nonrecourse debt), but pledges the land as security. The bank foreclosed on the loan 2 years after Ann stopped making payments. When the bank foreclosed, the balance due on the loan was \$180,000 and the fair market value of the land was \$170,000. The amount Ann realized on the foreclosure was \$180,000, the debt canceled by the foreclosure. She figures her gain or loss in Part I, Form 4797, by comparing the amount realized (\$180,000) with her ad-



justed basis (\$200,000). She has a \$20,000 deductible loss.

**Example 2.** Assume the same facts as in *Example 1* except the fair market value of the land was \$210,000. The result is the same. The amount Ann realized on the foreclosure is \$180,000, the debt canceled by the foreclosure. Because her adjusted basis is \$200,000, she has a deductible loss of \$20,000, which she reports in Part I, Form 4797.

**Amount realized on a recourse debt.** If you are personally liable for repaying the debt (recourse debt), the amount realized on the foreclosure or repossession does not include the canceled debt that is income from cancellation of debt. However, if the fair market value of the transferred property is less than the canceled debt, the amount realized includes the canceled debt up to the fair market value of the property. You are treated as receiving ordinary income from the canceled debt for the part of the debt that is more than the fair market value. See *Cancellation of debt*, later.

**Example 3.** Assume the same facts as in *Example 1* earlier except Ann is personally liable for the loan (recourse debt). In this case, the amount she realizes is \$170,000. This is the canceled debt (\$180,000) up to the fair market value of the land (\$170,000). Ann figures her gain or loss on the foreclosure by comparing the amount realized (\$170,000) with her adjusted basis (\$200,000). She has a \$30,000 deductible loss, which she figures in Part I, Form 4797. She is also treated as receiving ordinary income from cancellation of debt. That income is \$10,000 (\$180,000 – \$170,000). This is the part of the canceled debt not included in the amount realized. She reports this income on line 10 of Schedule F.

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

**Cancellation of debt.** If property that is repossessed or foreclosed upon secures a debt for which you are personally liable (recourse debt), you generally must report as ordinary income the amount by which the canceled debt is more than the fair market value of the property. This income is separate from any gain or loss realized from the foreclosure or repossession. Report the income from cancellation of a business debt on Schedule F, line 10. Report the income from cancellation of a nonbusiness debt as miscellaneous income on line 21, Form 1040.



You can use Table 10–2 to figure your income from cancellation of debt.

However, income from cancellation of debt is not taxed if any of the following apply.

- The cancellation is intended as a gift.
- The debt is qualified farm debt (see chapter 4).
- The debt is qualified real property business debt (see chapter 5 of Publication 334).

- You are insolvent or bankrupt (see chapter 4).

**Forms 1099–A and 1099–C.** A lender who acquires an interest in your property in a foreclosure or repossession should send you Form 1099–A showing the information you need to figure your gain or loss. However, if the lender also cancels part of your debt and must file Form 1099–C, the lender may include the information about the foreclosure or repossession on that form instead of on Form 1099–A. The lender must file Form 1099–C and send you a copy if the amount of debt canceled is \$600 or more and the lender is a financial institution, credit union, federal government agency, or any organization that has a significant trade or business of lending money. For foreclosures or repossessions occurring in 2001, these forms should be sent to you by January 31, 2002.

## Abandonment

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

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

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

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

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

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

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

**Forms 1099–A and 1099–C.** If your abandoned property secures a loan and the lender knows the property has been abandoned, the lender should send you Form 1099–A showing the information you need to figure your loss from the abandonment. However, if your debt is canceled and the lender must file Form 1099–C, the lender may include the information about the abandonment on that form instead of Form 1099–A. The lender must file Form 1099–C and send you a copy if the canceled debt is \$600 or more and the lender is a financial institution, credit union, federal government agency, or any organization that has a significant trade or business of lending money. For abandonments of property and debt cancellations occurring in 2001, these forms should be sent to you by January 31, 2002.

# 11.

## Dispositions of Property Used in Farming

### Introduction

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

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

Gains and losses from property used in farming are reported on Form 4797. *Table 11–1* contains examples of items reported on Form 4797 and refers to the part of that form on which they first should be reported. Chapter 20, *Sample Return*, contains a sample filled-in Form 4797.

### Topics

This chapter discusses:

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

## Useful Items

You may want to see:

### Publication

- **544** Sales and Other Dispositions of Assets

### Form (and Instructions)

- **4797** Sales of Business Property

See chapter 21 for information about getting publications and forms.

## Section 1231 Gains and Losses

Section 1231 gains and losses are the taxable gains and losses from section 1231 transactions—generally, dispositions of property used in business. Their treatment as ordinary or capital depends on whether you have a net gain or a net loss from your section 1231 transactions in the tax year.



*If you have a gain from a section 1231 transaction, first determine whether any of the gain is ordinary income under the depreciation recapture rules (explained later). Do not take that gain into account as section 1231 gain.*

**Section 1231 transactions.** Gain or loss on the following transactions is subject to section 1231 treatment.

- **Sale or exchange of cattle and horses.** The cattle and horses must be held for draft, breeding, dairy, or sporting and held for 2 years or longer.
- **Sale or exchange of other livestock.** This livestock must be held for draft, breeding, dairy, or sporting and held for 1 year or longer. Other livestock includes hogs, mules, sheep, and goats, but does not include poultry.
- **Sale or exchange of depreciable personal property.** This property must be used in your business and held longer than 1 year. Generally, property held for the production of rents or royalties is considered to be used in a trade or business. Examples of depreciable personal property include farm machinery and trucks. It also includes amortizable section 197 intangibles.
- **Sale or exchange of real estate.** This property must be used in your business and held longer than 1 year. Examples are your farm or ranch (including barns and sheds).
- **Sale or exchange of unharvested crops.** The crop and land must be sold, exchanged, or involuntarily converted at the same time and to the same person, and the land must have been held longer than 1 year. You cannot keep any right or option to reacquire the land directly or indirectly (other than a right customarily incident to a mortgage or other security

transaction). Growing crops sold with a lease on the land, even if sold to the same person in a single transaction, are not included.

- **Distributive share of partnership gains and losses.** Your distributive share must be from the sale or exchange of property listed earlier and held longer than 1 year (or for the required period for certain livestock).
- **Cutting or disposal of timber.** You must treat the cutting or disposal of timber as a sale, as described in chapter 10 under *Timber*.
- **Condemnation.** The condemned property (described in chapter 13) must have been held longer than 1 year. It must be business property or a capital asset held in connection with a trade or business or a transaction entered into for profit, such as investment property. It cannot be property held for personal use.
- **Casualty or theft.** The casualty or theft must have affected business property, property held for the production of rents or royalties, or investment property (such as notes and bonds). You must have held the property longer than 1 year. However, if your casualty or theft losses are more than your casualty or theft gains, neither the gains nor the losses are taken into account in the section 1231 computation. Section 1231 does not apply to personal casualty gains and losses. See chapter 13 for information on how to treat these gains and losses.

**Property for sale to customers.** A sale, exchange, or involuntary conversion of property

held mainly for sale to customers is not a section 1231 transaction. If you will get back all, or nearly all, of your investment in the property by selling it rather than by using it up in your business, it is property held mainly for sale to customers.

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

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

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

**Example.** In 2001 Ben has a \$2,000 net section 1231 gain. To figure how much he has to report as ordinary income and long-term capital gain, he must first determine his section 1231 gains and losses from the previous 5-year period. From 1996 through 2000 he had the following section 1231 gains and losses.

Year	Amount
1996	-0-
1997	-0-
1998	(\$2,500)
1999	-0-
2000	\$1,800

Table 11–1. Where To Report Items on Form 4797

Type of property	Held 1 year or less	Held longer than 1 year
1 Depreciable trade or business property: a Sold or exchanged at a gain . . . . . b Sold or exchanged at a loss . . . . .	Part II	Part III (1245, 1250)
	Part II	Part I
2 Depreciable residential rental property: a Sold or exchanged at a gain . . . . . b Sold or exchanged at a loss . . . . .	Part II	Part III (1250)
	Part II	Part I
3 Farm land held less than 10 years for which soil, water, or land clearing expenses were deducted: a Sold at a gain . . . . . b Sold at a loss . . . . .	Part II	Part III (1252)
	Part II	Part I
4 Disposition of cost-sharing payment property described in section 126. . . . .	Part II	Part III (1255)
5 Cattle and horses used in a trade or business for draft, breeding, dairy, or sporting: a Sold at a gain . . . . . b Sold at a loss . . . . . c Raised cattle and horses sold at a gain .	<b>Held less than 24 mos.</b>	<b>Held 24 mos. or longer</b>
	Part II	Part III (1245)
	Part II	Part I
6 Livestock other than cattle and horses used in a trade or business for draft, breeding, dairy, or sporting: a Sold at a gain . . . . . b Sold at a loss . . . . . c Raised livestock sold at a gain . . . . .	<b>Held less than 12 mos.</b>	<b>Held 12 mos. or longer</b>
	Part II	Part III (1245)
	Part II	Part I

Using this information, Ben figures how to report his net section 1231 gain for 2001 as shown below.

1) Net section 1231 gain (2001) . . . . .	\$2,000
2) Net section 1231 loss (1998) . . . . .	(\$2,500)
3) Net section 1231 gain (2000) . . . . .	1,800
4) Remaining net section 1231 loss . . . . .	(\$700)
5) Gain treated as ordinary income . . . . .	\$700
<b>6) Gain treated as long-term capital gain</b> . . . . .	<b><u>\$1,300</u></b>

His net section 1231 loss from 1998 is completely recaptured in 2001.

## Depreciation Recapture

If you dispose of depreciable or amortizable property at a gain, you may have to treat all or part of the gain (even if it is otherwise nontaxable) as ordinary income.

### Section 1245 Property

A gain on the disposition of section 1245 property is treated as ordinary income to the extent of depreciation allowed or allowable. See *Gain Treated as Ordinary Income*, later.

Any recognized gain that is more than the part that is ordinary income because of depreciation is a section 1231 gain. See *Treatment as ordinary or capital* under *Section 1231 Gains and Losses*, earlier.

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

- 1) Personal property (either tangible or intangible).
- 2) Other tangible property (except buildings and their structural components) used as any of the following.
  - a) An integral part of manufacturing, production, or extraction, or of furnishing transportation, communications, electricity, gas, water, or sewage disposal services.
  - b) A research facility in any of the activities in (a).
  - c) A facility in any of the activities in (a) for the bulk storage of fungible commodities.
- 3) That part of real property (not included in (2)) with an adjusted basis reduced by certain amortization deductions (including those for certified pollution control facilities, child-care facilities, removal of architectural barriers to persons with disabilities and the elderly, or reforestation expenses) or a section 179 deduction.
- 4) Single purpose agricultural (livestock) or horticultural structures.
- 5) Storage facilities (except buildings and their structural components) used in distributing petroleum or any primary product of petroleum.

### Buildings and structural components.

Section 1245 property does not include buildings and structural components. The term building includes a house, barn, warehouse, or garage. The term structural component includes walls, floors, windows, doors, central air conditioning systems, light fixtures, etc.

Do **not** treat a structure that is essentially machinery or equipment as a building or structural component. Also, do not treat a structure that houses property used as an integral part of an activity as a building or structural component if the structure's use is so closely related to the property's use that the structure can be expected to be replaced when the property it initially houses is replaced.

The fact that the structure is specially designed to withstand the stress and other demands of the property and cannot be used economically for other purposes indicates it is closely related to the use of the property it houses. Structures such as oil and gas storage tanks, grain storage bins, and silos are not treated as buildings, but as section 1245 property.

**Storage facility.** This is a facility used mainly for the bulk storage of fungible commodities. Bulk storage means storage of a commodity in a large mass before it is used. For example, if a facility is used to store sorted and boxed oranges, it is not used for bulk storage. To be fungible, a commodity must be such that one part may be used in place of another.

### Gain Treated as Ordinary Income

The gain treated as ordinary income on the sale, exchange, or involuntary conversion of section 1245 property, including a sale and leaseback transaction, is the **lesser** of the following amounts.

- 1) The depreciation and amortization allowed or allowable on the property.
- 2) The gain realized on the disposition (the amount realized from the disposition minus the adjusted basis of the property).

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

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

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

- Amounts you claimed on property you exchanged for, or converted to, your section 1245 property in a like-kind exchange or involuntary conversion.
- Amounts a previous owner of the section 1245 property claimed if your basis is determined with reference to that person's adjusted basis (for example, the donor's depreciation deductions on property you received as a gift).

**Example.** Jeff Free paid \$120,000 for a tractor in 1999. He depreciated it using the 150% declining balance method. The tractor is 7-year property. In February 2000 he traded it for a chopper and paid an additional \$30,000. To figure his depreciation deduction for 2001, Jeff continues to depreciate the tractor as he would have before the trade. Because this is the third year of depreciation, he takes a deduction of \$18,036 ( $\$120,000 \times .1503$ ).

Jeff can also depreciate the additional \$30,000 basis on the chopper. Because this is the first year of depreciation on the \$30,000, he takes a depreciation deduction of \$3,213 ( $\$30,000 \times .1071$ ). The total depreciation he can deduct is \$21,249 ( $\$18,036 + \$3,213$ ). Unless Jeff disposes of the chopper before the end of the recovery period, he can continue to depreciate the \$120,000 for 5 more years and the \$30,000 for 7 more years.

**Depreciation and amortization.** Depreciation and amortization deductions that must be recaptured as ordinary income include (but are not limited to) the following items.

- 1) Ordinary depreciation deductions.
- 2) Amortization deductions for all the following costs.
  - a) Acquiring a lease.
  - b) Lessee improvements.
  - c) Pollution control facilities.
  - d) Reforestation expenses.
  - e) Section 197 intangibles.
  - f) Child care facility expenses incurred before 1982.
  - g) Franchises, trademarks, and trade names acquired before August 11, 1993.
- 3) The section 179 deduction.
- 4) Deductions for all the following costs.
  - a) Removing barriers to the disabled and the elderly.
  - b) Tertiary injectant expenses.
  - c) Depreciable clean-fuel vehicles and refueling property (minus any recaptured deduction).
- 5) Any basis reduction for the investment credit (minus any basis increase for a credit recapture).
- 6) Any basis reduction for the qualified electric vehicle credit (minus any basis increase for a credit recapture).

**Example.** You file your returns on a calendar year basis. In February 1999, you bought and placed in service for 100% use in your farming business a light-duty truck (5-year property) that cost \$10,000. You used the half-year convention, and your MACRS deductions for the truck were \$1,500 in 1999 and \$2,550 in 2000. You did not take the section 179 deduction on it. You sold the truck in May 2001 for \$7,000. The MACRS deduction in 2001, the year of sale, is \$893 ( $\frac{1}{2}$  of \$1,785). Figure the gain treated as ordinary income as follows.



1) Amount realized . . . . .	\$7,000
2) Cost (February 1999) . . . . .	\$10,000
3) Depreciation allowed or allowable (MACRS deductions: \$1,500 + \$2,550 + \$893) . . . . .	<u>4,943</u>
4) Adjusted basis (subtract line 3 from line 2) . . . . .	<u>\$5,057</u>
5) Gain realized (subtract line 4 from line 1) . . . . .	1,943
<b>6) Gain treated as ordinary income (lesser of line 3 or line 5) . . . . .</b>	<b><u>\$1,943</u></b>

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

This treatment applies only when figuring what part of the gain is treated as ordinary income under the rules for section 1245 depreciation recapture.

**Disposition of plants and animals.** If you made the choice not to apply the uniform capitalization rules (see chapter 7), you must treat any plant you produce, or any animal you produced in 1987 or 1988, as section 1245 property. If you have a gain on the property's disposition, you must recapture the preproductive expenses you would have capitalized if you had not made the choice by treating the gain, up to the amount of these expenses, as ordinary income. For section 1231 transactions, show these expenses as depreciation on line 22, Part III, of Form 4797. For plant sales that are reported on Schedule F, this recapture rule does not change the reporting of income because the gain is already ordinary income. You can use the farm-price method or the unit-livestock-price method discussed in chapter 3 to figure these expenses.

**Example.** Janet Maple sold her apple orchard in 2001 for \$80,000. Her adjusted basis at the time of sale was \$60,000. She bought the orchard in 1994, but the trees did not produce a crop until 1997. Her preproductive expenses were \$6,000. She chose not to apply the uniform capitalization rules. Janet must treat \$6,000 of the gain as ordinary income.

**Livestock costs incurred before 1989.** For livestock costs incurred before 1989, the IRS provided two safe-harbor choices for applying the uniform capitalization rules. These safe-harbor choices were not available to corporations, partnerships, or tax shelters required to use an accrual method of accounting. For information on these choices, see Notice 88-24 in Cumulative Bulletin 1988-1 and Notice 88-113 modifying Notice 88-24 in Cumulative Bulletin 1988-2.

## Section 1250 Property

Section 1250 property includes all real property subject to an allowance for depreciation that is not and never has been section 1245 property. It includes a leasehold of land or section 1250 property subject to an allowance for depreciation.

A fee simple interest in land is not section 1250 property because it is not depreciable.

Gain on the disposition of section 1250 property is treated as ordinary income to the extent of additional depreciation allowed or allowable. To determine the additional depreciation on section 1250 property, see *Additional Depreciation*, later.

You will not have additional depreciation if any of the following apply.

- You figured depreciation for the property using the straight line method or any other method that does not result in more depreciation than the amount figured by the straight line method, and you have held the property longer than a year.
- You chose the alternate ACRS (straight line) method for the types of 15-, 18-, or 19-year real property covered by the section 1250 rules.
- You dispose of residential rental property or nonresidential real property placed in service after 1986 (or after July 31, 1986, if the choice to use MACRS was made). These properties are depreciated using the straight line method.

## Gain Treated as Ordinary Income

To find what part of the gain from the disposition of section 1250 property is treated as ordinary income, follow these steps.

- 1) In a sale, exchange, or involuntary conversion of the property, figure the amount realized that is more than the adjusted basis of the property. In any other disposition of the property, figure the fair market value that is more than the adjusted basis.
- 2) Figure the additional depreciation for the periods after 1975.
- 3) Multiply the lesser of (1) or (2) by the applicable percentage, discussed later. Stop here if this is residential rental property or if (2) is equal to or more than (1). This is the gain treated as ordinary income because of additional depreciation.
- 4) Subtract (2) from (1).
- 5) Figure the additional depreciation for periods after 1969 but before 1976.
- 6) Add the lesser of (4) or (5) to the result in (3). This is the gain treated as ordinary income because of additional depreciation.

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

## Additional Depreciation

If you hold section 1250 property longer than 1 year, the additional depreciation is the actual depreciation adjustments that are more than the depreciation figured using the straight line method. For a list of items treated as depreciation adjustments, see *Depreciation and amortization under Section 1245 Property*, earlier.

If you hold section 1250 property for 1 year or less, all the depreciation is additional depreciation.

Figure straight line depreciation for ACRS real property by using its 15-, 18-, or 19-year recovery period as the property's useful life.

The straight line method is applied without any basis reduction for the investment credit.

You will have additional depreciation if you use the regular ACRS method, the declining balance method, the sum-of-the-years-digits method, the units-of-production method, or any other method of rapid depreciation. You also have additional depreciation if you choose amortization, other than amortization on real property that qualifies as section 1245 property, discussed earlier.

**Depreciation taken by other taxpayers or on other property.** Additional depreciation includes all depreciation adjustments to the basis of section 1250 property whether allowed to you or another person (as for carryover basis property).

**Depreciation allowed or allowable.** You generally use the greater of depreciation allowed or allowable (to any person who held the property if the depreciation was used in figuring its adjusted basis in your hands) when figuring the part of the gain to be reported as ordinary income. If you can show the deduction allowed for any tax year was less than the amount allowable, the lesser figure will be the depreciation adjustment for figuring additional depreciation.

## Applicable Percentage

The applicable percentage used to figure the ordinary income because of additional depreciation depends on whether the real property you disposed of is nonresidential real property, residential rental property, or low-income housing. The applicable percentages for nonresidential real property and residential rental property are explained next. The applicable percentage for low-income housing is explained in chapter 3 of Publication 544.

**Nonresidential real property.** For real property that is not residential rental property, the applicable percentage for periods after 1969 is 100%. For periods before 1970, the percentage is zero and no ordinary income will result from its disposition because of additional depreciation taken before 1970.

**Residential rental property.** For residential rental property (80% or more of the gross income is from dwelling units) other than low-income housing, the percentage for periods after 1975 is 100%. The applicable percentage for periods before 1976 is zero. No ordinary income will result from a disposition of residential rental property because of additional depreciation before 1976.

**More information.** For more information about depreciation recapture on section 1250 property, see chapter 3 of Publication 544.

## Installment Sale

If you report the sale of property under the installment method, any depreciation recapture under section 1245 or 1250 is taxable as ordinary income in the year of sale. This applies even if no payments are received in that year. If the gain is more than the depreciation recapture

income, report the rest of the gain using the rules of the installment method. For this purpose, add the recapture income to the property's adjusted basis.

If you dispose of **more than one asset** in a single transaction, you must separately figure the gain on each asset so that it may be properly reported. To do this, allocate the selling price and the payments you receive in the year of sale to each asset. Report any depreciation recapture income in the year of sale before using the installment method for any remaining gain.

For more information on installment sales, see chapter 12.

## Other Dispositions

Chapter 3 of Publication 544 discusses the tax treatment of the following transfers of depreciable property.

- By gift.
- At death.
- In like-kind exchanges.
- In involuntary conversions.

Publication 544 also explains how to handle a single transaction involving multiple properties.

## Other Gains

This section discusses gain on the disposition of farm land 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 farm land you held less than 10 years at a gain and you were allowed deductions for soil and water conservation expenses for the land, as discussed in chapter 6, you must treat part of the gain as ordinary income and treat the balance as section 1231 gain.

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

- Disposition of farm land by gift.
- Transfer of farm property at death (except for income in respect of a decedent).

For more information, see section 1.1252-2 of the regulations.

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

- Your gain (determined by subtracting the adjusted basis from the amount realized from a sale, exchange, or involuntary conversion, or the fair market value for all other dispositions).
- The total deductions allowed for soil and water conservation expenses multiplied by the applicable percentage, discussed next.

**Applicable percentage.** The applicable percentage is based on the length of time you held the land. If you dispose of your farm land within 5 years after the date you got it, the percentage is 100%. If you dispose of the land within the 6th through 9th year after you got it, the applicable percentage is reduced by 20% a year for each year or part of a year you hold the land after the 5th year. If you dispose of the land 10 or more years after you got it, the percentage is 0%, and the entire gain is a section 1231 gain.

**Example.** You acquired farm land on January 19, 1994. On October 3, 2001, you sold the land at a \$30,000 gain. Between January 1 and October 3, 2001, you make soil and water conservation expenditures of \$15,000 for the land that are fully deductible in 2001. The applicable percentage is 40% since you sold the land within the 8th year after you got it. You treat \$6,000 (40% of \$15,000) of the \$30,000 gain as ordinary income and the \$24,000 balance as a section 1231 gain.

**Section 1255 property.** If you receive certain cost-sharing payments on property and you exclude those payments from income (as discussed in chapter 4), you may have to treat part of any gain as ordinary income and treat the balance as a section 1231 gain. If you chose not to exclude these payments, you will not have to recognize ordinary income under this provision.

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

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

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

**Applicable percentage.** The applicable percentage of the excluded cost-sharing payments to be reported as ordinary income is based on the length of time you hold the property after receiving the payments. If the property is held less than 10 years, the percentage is 100%. After 10 years, the percentage is reduced by 10% a year or part of a year until the rate is 0%.

**Form 4797, Part III.** Use Form 4797, Part III, to figure the ordinary income part of a gain from the sale, exchange, or involuntary conversion of section 1252 property and section 1255 property.

# 12.

## Installment Sales

### Important Change

For sales occurring after December 16, 1999, accrual basis taxpayers were required to report installment sales under an accrual method of accounting. The Installment Tax Correction Act of December 28, 2000, repealed that requirement.

If you entered into an installment sale after December 16, 1999, and reported it under an accrual method on your income tax return filed by April 16, 2001, you can revoke your effective election not to use the installment method. To revoke the election, you must file an amended return for the year of the installment sale (and any other year affected by the sale) reporting the gain on the installment method. For more information, see Publication 537.

## Introduction

An installment sale is a sale of property where you receive at least one payment after the tax year of the sale. In an installment sale you report part of your gain when you receive each payment. You cannot use the installment method to report a loss.

The buyer's "installment obligation" to make future payments to you can be in the form of a deed of trust, note, land contract, mortgage, or other evidence of the buyer's debt to you.

### Topics

This chapter discusses:

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

### Useful Items

You may want to see:

#### Publication

- 523** Selling Your Home
- 535** Business Expenses
- 537** Installment Sales
- 538** Accounting Periods and Methods

#### Form (and Instructions)

- 4797** Sales of Business Property
- 6252** Installment Sale Income

See chapter 21 for information about getting publications and forms.

# Installment Method

An installment sale is a sale of property where you receive at least one payment after the tax year of the sale. A farmer who is not required to maintain an inventory can use the installment method to report gain from the sale of property used or produced in farming.

**TIP** *If you finance the buyer's purchase of your property, instead of having the buyer get a loan or mortgage from a third party, you probably have an installment sale. It is not an installment sale if the buyer borrows the money from a third party and then pays you the total selling price.*

If a sale qualifies as an installment sale, the gain must be reported under the installment method unless you elect out of using that method. See *Electing out*, later, for information on recognizing the entire gain in the year of sale.

When reporting a sale of **depreciable property**, you must include any **depreciation recapture income** (up to the amount of the gain) in income for the year of sale. Report any remaining gain on the installment method.

**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, deduct it only in the tax year of sale. You cannot deduct a loss on the sale of property owned for personal use.

**Form 6252.** Each year, including the year of sale, report your income from an installment sale on Form 6252. Attach this form to your tax return.

**Disposition of installment obligation.** If you sell or discount an installment obligation, generally you will have a gain or loss to report. It is considered gain or loss on the sale of the property for which you received the installment obligation. If you sell or discount the obligation during the year of sale, report your entire gain on your return for that year. If the transaction takes place in a later year, you may have a disposition of an installment obligation.

**Cancellation.** If an installment obligation is canceled or otherwise becomes unenforceable, it is treated as a disposition, not a sale or exchange. Your gain or loss is the difference between your basis in the obligation and its fair market value at the time you cancel it.

**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 obligation as a result of the seller's death is taxed on the installment payments the same as the seller would have been had the seller lived to receive the payments.

However, if the installment obligation is canceled, becomes unenforceable, or is transferred to the buyer because of the death of the holder of the obligation, it is a disposition. The estate must figure gain or loss on the disposition.

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

**Inventory.** The sale of farm inventory items cannot be reported on the installment method. All gain or loss on their sale must be reported in the year of sale. However, if you are not required to maintain an inventory, you may be able to use the installment method to report the sale of property you use or produce in your farming business. For examples of farm inventory, see *Farm Inventory* in chapter 3.

If inventory items are included in an installment sale, you may have an agreement stating which payments are for inventory and which are for the other assets being sold. If you do not, each payment must be allocated between the inventory and the other assets sold.

**Electing out.** 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. You then do not report any gain from the payments you receive in later years.

To make this election, report the sale on Schedule D (Form 1040) or Form 4797, whichever applies, not on Form 6252.

**When to elect out.** Make this election by the due date, including extensions, for filing your tax return for the year the sale takes place. Once made, the election generally cannot be revoked. However, if you timely file your return for the year the sale takes place you can still make the election by filing an amended return within 6 months of the due date of the return (excluding extensions). Write "Filed pursuant to section 301.9100-2" at the top of the amended return and file it where the original return was filed.

**More information.** See *Electing Out of the Installment Method* in Publication 537 for more information.



*You must continue to report the interest income on payments you receive in subsequent years.*

## Figuring Installment Income

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

- 1) Interest income.
- 2) Return of your adjusted basis in the property.
- 3) Gain on the sale.

In each year you receive a payment, include the interest part in income, as well as the part that is your gain on the sale. You do not include in income the part that is the return of your adjusted basis in the property.

**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. See *Unstated interest*, later.

**Return of basis and gain on sale.** The rest of each payment is treated as if it were made up of two parts. One part is a tax-free return of your adjusted basis. The other part is your gain.



**Figuring gain part of payment.** To figure what part of any payment is gain, multiply the payment (less interest) by the gross profit percentage, defined later. Use the following worksheet to figure the gross profit percentage.

1) Selling price	.....	_____
2) Installment sale basis:		
Adjusted basis of property	.....	_____
Selling expenses	.....	_____
Depreciation recapture	.....	_____
3) Gross profit (line 1 – line 2)	.....	_____
4) Contract price	.....	_____
5) <b>Gross profit percentage</b>		
(line 3 ÷ line 4)	.....	=====

**Selling price.** The selling price is the total cost of the property to the buyer. It includes any money and the fair market value of any property you are to receive. It also includes any debt the buyer pays, assumes, or takes, to which the property is subject. The debt could be a note, mortgage, or any other liability, such as a lien, accrued interest, or taxes owed on the property. If the buyer pays any of your selling expenses, that amount is also included in the selling price. The selling price does not include interest, whether stated or unstated.

**Installment sale basis.** Three items comprise installment sale basis.

- Adjusted basis
- Selling expenses
- Depreciation recapture

**Adjusted basis.** Basis is the amount of your investment in the property for tax purposes. The way you figure basis depends on how you first acquired the property. The basis of property you bought is generally its cost. The basis of property you inherited, received as a gift, built yourself, or received in a tax-free exchange is figured differently. See chapter 7 for information on determining basis.

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

**Selling expenses.** Selling expenses are any expenses that relate to the sale of the property. They include commissions and attorney fees. Selling expenses are added to the basis of the sold property.

**Depreciation recapture.** If you took depreciation deductions on the asset, you may need to recapture part of the gain on the sale of the asset as ordinary income. See *Sale of depreciable property*, later.

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

To figure your gross profit, subtract your installment sale basis from the selling price. If the property you sold was your home, subtract from the gross profit any gain you can exclude. See



Publication 523 for information on excluding gain on the sale of your home.

**Contract price.** The contract price is the total of all principal payments you are to receive on the installment sale. It also includes payments you are considered to receive. See *Payments Received*, later.

If part of the selling price is paid in cash and you hold a mortgage payable from the buyer to you for the remainder, then the contract price includes both. The selling price is the total cost of the property to the buyer.

**Gross profit percentage.** A certain percentage of each payment (after subtracting interest) is reported as gain from the sale. It is called the "gross profit percentage" and is figured by dividing your gross profit by the contract price.

The gross profit percentage generally remains the same for each payment you receive. However, see *Selling price reduced*, later, for an example of changing the gross profit percentage.

**Example.** You sell property at a contract price of \$200,000 and your gross profit is \$50,000. Your gross profit percentage is 25% ( $\$50,000 \div \$200,000$ ). After subtracting interest, you report 25% of each payment, including the down payment, as gain from the sale for the tax year you receive the payment.

**Amount to include in income.** Each year as you receive payments on the installment sale, multiply the payments (after subtracting interest) by the gross profit percentage to determine the amount you must include in income.

**Sale of depreciable property.** You cannot use the installment method to report any depreciation recapture income. However, report any gain greater than the recapture income on the installment method.

The recapture income reported in the year of sale is added to the property's adjusted basis to determine your gross profit on the installment sale.

You generally cannot report gain from the sale of depreciable property to a related person on the installment method. See *Sale to a Related Person* in Publication 537.

Figure your depreciation recapture income (including the section 179 deduction and the section 179A deduction recapture) in Part III of Form 4797. Report the depreciation recapture income in Part II of Form 4797 as ordinary income in the year of sale.

**TIP** *If you sell depreciable business property, prepare Form 4797 first in order to figure the amount to enter on line 12 of Part I, Form 6252. See the Form 6252 instructions for details.*

For more information on the section 179 deduction, see *Section 179 Deduction* in chapter 8. For more information on the section 179A deductions, see chapter 12 in Publication 535. For more information on depreciation recapture, see *Depreciation Recapture* in chapter 11.

**Selling price reduced.** If the selling price is reduced at a later date, the gross profit on the sale will also change. You must then refigure the gross profit percentage for the remaining payments. Refigure your gross profit using the re-

duced sale price and then subtract the gain already reported. Spread the remaining gain over the future installments.

**Example.** In 1999, you sold land with a basis of \$40,000 for \$100,000. Your gross profit was \$60,000. You received a \$20,000 down payment and the buyer's note for \$80,000. The note provides for four annual payments of \$20,000 each, plus 12% interest, beginning in 2000. Your gross profit percentage is 60%. You reported a gain of \$12,000 on each payment received in 1999 and 2000. In 2001, you and the buyer agreed to reduce the purchase price to \$85,000 and the payments for 2001, 2002, and 2003 are reduced to \$15,000 for each year.

The new gross profit percentage, 46.67%, is figured as follows.

1) Reduced selling price . . . . .	\$85,000	
2) Minus: Basis . . . . .	40,000	
3) Adjusted gross profit . . . . .	\$45,000	
4) Minus: Gain reported in 1999 & 2000 . . . . .	24,000	
5) Gain to be reported . . . . .	\$21,000	
6) Selling price to be received:		
Reduced selling price . . . . .	\$85,000	
Minus: Payments received in 1999 and 2000 . . . . .	40,000	\$45,000
7) <b>New gross profit percentage (line 5 ÷ line 6) . . . . .</b>		<b>46.67%</b>

You will report a gain of \$7,000 (46.67% of \$15,000) on each of the \$15,000 installments due in 2001, 2002, and 2003.

**Sale to a related person.** Special rules apply to installment sales between related persons. For purposes of these rules, spouses, children, grandchildren, brothers, sisters, and parents are all considered related persons. A partnership or corporation in which you have an interest, or an estate or trust with which you have a connection, can also be considered a related person.

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 10 for a discussion of like-kind property.

If the trade includes an installment obligation, the following rules apply.

- 1) The contract price is reduced by the FMV of the like-kind property received in the trade.
- 2) The gross profit is reduced by any gain on the trade that can be postponed.
- 3) Like-kind property received in the trade is not considered payment on the installment obligation.

include the down payment and each later payment of principal on the buyer's debt to you.

In certain situations, you are considered to have received a payment, even though the buyer does not pay you directly. These situations occur when the buyer assumes or pays any of your debts, such as a loan, or pays any of your expenses, such as a sales commission. See *Mortgage less than basis*, later for an exception to this rule.

**Buyer pays seller's expenses.** If the buyer pays any of the expenses related to the sale of your property, it is considered a payment to you in the year of sale. Include these expenses in the selling and contract prices when figuring the gross profit percentage.

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

**Mortgage less than basis.** If the buyer assumes a mortgage that is less than your installment sale basis, it is not considered a payment to you. It is actually a recovery of your basis. The selling price minus the mortgage equals the contract price. This difference is all that you will directly collect from the buyer.

**Example.** You sell property with an adjusted basis of \$19,000. You have selling expenses of \$1,000. The buyer assumes your existing mortgage of \$15,000 and agrees to pay you \$10,000 (a cash down payment of \$2,000 and \$2,000 (plus 12% interest) in each of the next 4 years).

The selling price is \$25,000 (\$15,000 + \$10,000). Your gross profit is \$5,000 (\$25,000 - \$20,000 installment sale basis). The contract price is \$10,000 (\$25,000 - \$15,000 mortgage). Your gross profit percentage is 50% ( $\$5,000 \div \$10,000$ ). 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, you recover your entire basis. You are also relieved of the obligation to repay the amount borrowed. The part of the mortgage greater than your basis is treated as a payment received in the year of sale.

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

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

**Example.** The selling price for your property is \$9,000. The buyer will pay you \$1,000 annually (plus 8% interest) over the next 3 years and assume an existing mortgage of \$6,000. Your 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 is treated as a payment

## Payments Received

### Including Payments Considered Received

You must figure your gain each year on the payments you receive, or are treated as receiving, from an installment sale. These payments

received in the year of sale. The contract price is \$4,000:

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

Your gross profit on the sale is also \$4,000:

Selling price	\$9,000
Minus: Installment sale basis	(5,000)
<b>Gross profit</b>	<b>\$4,000</b>

Your gross profit percentage is 100%. Report 100% of each payment as gain from the sale. Treat the \$1,000 difference between the mortgage and your installment sale basis as a payment and report 100% of it as gain in the year of sale.

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

If the buyer assumes the debt instead of paying it off, only part of it may have to be treated as a payment. Compare the debt to your installment sale basis in the property. 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 debts.

- 1) Those acquired from ownership of the property you are selling, such as a mortgage, lien, overdue interest, or back taxes.
- 2) Those acquired in the ordinary course of business, such as a balance due for inventory.

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

**Payment of property.** If you receive property rather than money from the buyer, it is still considered a payment. However, see *Trading property for like-kind property*, earlier. The amount of the payment is the property's FMV on the date you receive it.

**Fair market value (FMV).** This is the price at which property would change hands between a willing buyer and a willing seller, neither having to buy or sell, who both have reasonable knowledge of all the necessary facts. If your installment sale fits this description, the value assigned to property in your agreement with the buyer is good evidence of its FMV.

**Third-party note.** If the property the buyer gives you is a third-party note (or other obligation of a third party), you are considered to have received a payment equal to the note's FMV. Because the note is itself a payment on your installment sale, any payments you later receive on the note are not considered payments on your sale.

**Example.** You sold real estate in an installment sale. As part of the down payment, the buyer assigned to you a \$5,000, 8% third-party note. The FMV of the third-party note at the time of your sale was \$3,000. This amount, not \$5,000, is a payment to you in the year of sale. Because the third-party note had an FMV equal to 60% of its face value (\$3,000 ÷ \$5,000), 60% of each payment of principal you receive on this note is a nontaxable return of capital. The remaining 40% is taxed as ordinary income.

**Bond.** A bond or other evidence of debt you receive from the buyer that is payable on demand is treated as a payment in the year you receive it. If you receive a government or corporate bond that has interest coupons attached or that can be readily traded in an established securities market, you are considered to have received payment equal to the bond's FMV.


**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 you receive them.

**Guarantee.** If a third party or government agency guarantees the buyer's payments to you, the guarantee itself is not considered payment.

**Unstated interest.** An installment sale contract generally provides that each deferred payment on the sale will include interest or 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 each payment due more than 6 months after the date of sale may be treated as interest. The amount treated as interest is referred to as **unstated interest**.

When the stated interest rate in the contract is lower than the applicable federal rate, unstated interest is the difference between interest figured at the federal rate and interest figured at the rate specified in the sales contract.

 The applicable federal rates are published monthly in the Internal Revenue Bulletin (IRB). You can get this information by contacting an IRS office. IRBs are also available on the Internet at [www.irs.gov](http://www.irs.gov).

Generally, the unstated interest rules do not apply to a debt given in consideration for a sale or exchange of personal-use property.

**Personal-use property** is any property in which substantially all of its use by the buyer is not in connection with a trade or business or an investment activity.

Unstated interest reduces the stated selling price of the property and the buyer's basis in the property. It increases the seller's interest income and the buyer's interest expense.

**More information.** For more information, see *Unstated Interest and Original Issue Discount* in Publication 537.

## Installment Sale of a Farm

The installment sale of a farm for one overall price under a single contract is not the sale of a single asset. It generally includes the sale of real property and personal property reportable on the installment method. It may also include the sale of farm inventory, which cannot be reported on the installment method. See *Inventory*, earlier. The selling price must be allocated to determine the amount received for each class of asset.

The tax treatment of the gain or loss on the sale of each class of assets is determined by its classification as a capital asset or as property used in the business, and by the length of time held. (See chapters 10 and 11 for a discussion of capital assets.) Separate computations must be made to figure the gain or loss for each class of asset sold. See *Sale of a Farm* in chapter 10.

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 taxable as ordinary income in the year of sale. This applies even if no payments are received in that year.

### Example

On January 3, 2001, you sold your farm, including the equipment and livestock (cattle used for breeding). You received \$50,000 down and the buyer's note for \$200,000. In addition, the buyer assumed an outstanding \$50,000 mortgage on the farm land. The total selling price was \$300,000. The note payments of \$25,000 each, plus adequate interest, are due every July 1 and January 1, beginning in July 2001. Your selling expenses were \$15,000.

**Adjusted basis and depreciation.** The adjusted basis and depreciation claimed on each asset sold are as follows:

Asset	Depreciation Claimed	Adjusted Basis
Home*	-0-	\$30,000
Land	-0-	61,250
Buildings	\$31,500	28,500
Truck	3,001	1,499
Equipment	15,811	9,189
Tractor	15,811	9,189
Cattle**	1,977	2,023
Cattle***	19,167	833

\* Owned and used as main home for at least 2 of the 5 years prior to the sale

\*\* Held less than 2 years

\*\*\*Held 2 years or more

**Gain on each asset.** The following schedule shows the assets included in the sale, each asset's selling price based on its respective value, the selling expense allocated to each asset, the adjusted basis of each asset, and the gain on each asset. The selling expense for each asset is 5% of the selling price (\$15,000 selling expense ÷ \$300,000 selling price). The livestock and produce held for sale were sold before the end of 2000 in anticipation of selling the farm. The section 179 deduction was not claimed on any asset.

	Selling Price	Selling Expense	Adjusted Basis	Gain
Home*	\$50,000	\$2,500	\$30,000	\$17,500
Land	125,000	6,250	61,250	57,500
Buildings	55,000	2,750	28,500	23,750
Truck	5,000	250	1,499	3,251
Equip.	17,000	850	9,189	6,961
Tractor	23,000	1,150	9,189	12,661
Cattle**	5,000	250	2,023	2,727
Cattle***	20,000	1,000	833	18,167
	<u>\$300,000</u>	<u>\$15,000</u>	<u>\$142,483</u>	<u>\$142,517</u>

\* Owned and used as main home for at least 2 of the 5 years prior to the sale

\*\* Held less than 2 years

\*\*\*Held 2 years or more

**Depreciation recapture.** The buildings are section 1250 property. There is no depreciation recapture income for them because they were depreciated using the straight line method. See chapter 11 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 more than 2 years are also section 1245 property. Since the gain of \$18,167 is less than the depreciation claimed (\$19,167), the total gain is depreciation recapture income.

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

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

**Assets not reported on the installment method.** In the year of sale, the gain on the cattle held 2 years or more, the equipment, and the tractor is reported in full. Because the entire gain on the home can be excluded from income, the installment method does not apply to the sale of the home. See *Sale of your home* in chapter 10. The selling price of these assets (\$110,000) is subtracted from the total selling price (\$300,000). The selling price for the assets included in the installment sale is \$190,000.

**Installment sale basis and gross profit.** The following table shows each asset reported on the installment method, its selling price, installment sale basis, and gross profit.

	Selling Price	Installment Sale Basis	Gross Profit
Farm land . . . . .	\$125,000	\$67,500	\$57,500
Buildings . . . . .	55,000	31,250	23,750
Truck . . . . .	5,000	4,750	250
Cattle* . . . . .	5,000	4,250	750
	<u>\$190,000</u>	<u>\$107,750</u>	<u>\$82,250</u>

\* Held less than 2 years

**Section 1231 gains.** Since the ordinary income part of the gain on the truck is reported in the year of sale, the remaining gain (\$250) and the gain on the land and buildings are reported as section 1231 gains. The cattle held for less than 2 years do not qualify for section 1231 treatment. The \$750 gain on their sale is reported as ordinary gain in Part II of Form 4797 as payments are received. See *Section 1231 Gains and Losses* in chapter 11.

**Contract price and gross profit percentage.** The contract price is \$140,000 for the part of the sale reported on the installment method. This is the selling price (\$300,000) minus the mortgage assumed (\$50,000) minus the selling price of the assets with gains fully reported in the year of sale or excluded from income (\$110,000).

Gross profit percentage for the sale is 58.75% (\$82,250 gross profit ÷ \$140,000 contract price). The gross profit percentage for each asset is figured as follows:

	Percent
Farm land (\$57,500 ÷ \$140,000) . . . . .	41.0714
Buildings (\$23,750 ÷ \$140,000) . . . . .	16.9643
Truck (\$250 ÷ \$140,000) . . . . .	0.1786
Cattle* (\$750 ÷ \$140,000) . . . . .	0.5357
<b>Total</b> . . . . .	<u>58.75</u>

\* Held less than 2 years

**Figuring the gain to report on the installment method.** Only 56% of each payment is reported on the installment method [\$140,000 contract price ÷ \$250,000 to be received on the sale (\$300,000 selling price – \$50,000 mortgage assumed)]. The total amount received on the installment sale in 2001 is \$75,000 (\$50,000 down payment + \$25,000 payment on July 1). The installment sale part of the total payments received in 2001 is \$42,000 (\$75,000 × .56). Figure the gain to report for each asset by multiplying its gross profit percentage times \$42,000.

	Income
Farm land—41.0714% × \$42,000 . . . . .	\$17,250
Buildings—16.9643% × \$42,000 . . . . .	7,125
Truck—0.1786% × \$42,000 . . . . .	75
Cattle*—0.5357% × \$42,000 . . . . .	225
<b>Total installment income for 2001</b> . . . . .	<u>\$24,675</u>

\* Held less than 2 years

**Reporting the sale.** Report the installment sale on Form 6252. Then report the amounts

from Form 6252 on Form 4797 and Schedule D (Form 1040). Attach a separate page to Form 6252 that shows the computations in the example.



*If you sell depreciable business property, prepare Form 4797 first in order to figure the amount to enter on line 12 of Part I, Form 6252.*

**Section 1231 gains.** The gains on the land, buildings, and truck are section 1231 gain. They may be reported as either capital or ordinary gain depending on the net balance when combined with other section 1231 losses. A net 1231 gain is capital gain and a net 1231 loss is an ordinary loss.

**Depreciation recapture and gain on cattle.** In the year of sale, you must report the total depreciation recapture income on Form 4797. The \$225 gain on the cattle held less than 2 years is ordinary income reported in Part II of Form 4797. See *Table 11–1* in chapter 11.

**Installment income for years after 2001.** You figure installment income for the years after 2001 by applying the same gross profit percentages to the payments you receive each year. If you receive \$50,000 during the year, \$28,000 is considered received on the installment sale (56% × \$50,000). You realize income as follows:

	Income
Farm land—41.0714% × \$28,000 . . . . .	\$11,500
Buildings—16.9643% × \$28,000 . . . . .	4,750
Truck—0.1786% × \$28,000 . . . . .	50
Cattle*—0.5357% × \$28,000 . . . . .	150
<b>Total installment income</b> . . . . .	<u>\$16,450</u>

\* Held less than 2 years

In this example, no gain is ever recognized from the sale of your home. You will report the gain on cattle held less than 2 years as ordinary gain in Part II of Form 4797. You will combine your section 1231 gains with section 1231 losses in each of the later years to determine whether to report them as ordinary or capital gains. The interest received with each payment will be included in full as ordinary income.

**Summary.** The installment income (rounded to the nearest dollar) from the sale of the farm is reported as follows:

Selling price . . . . .	\$190,000
Minus: Installment basis . . . . .	(107,750)
<b>Gross profit</b> . . . . .	<u>\$82,250</u>
Gain reported in 2001 (year of sale) . . . . .	\$24,675
Gain reported in 2002: \$28,000 × 58.75% . . . . .	16,450
Gain reported in 2003: \$28,000 × 58.75% . . . . .	16,450
Gain reported in 2004: \$28,000 × 58.75% . . . . .	16,450
Gain reported in 2005: \$14,000 × 58.75% . . . . .	8,225
<b>Total gain reported</b> . . . . .	<u>\$82,250</u>



# 13.

## Casualties, Thefts, and Condemnations

### Important Change for 2001

**Postponed tax deadlines in disaster areas.** The IRS may postpone for up to 120 days certain tax deadlines of taxpayers who are affected by a Presidentially declared disaster. The tax deadlines the IRS may postpone include those for filing income and employment tax returns, paying income and employment taxes, and making contributions to a traditional IRA or Roth IRA. For more information, see *Postponed tax deadlines*, later under *Disaster Area Losses*.

### 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

- ❑ **536** Net Operating Losses (NOLs) for Individuals, Estates, and Trusts
- ❑ **544** Sales and Other Dispositions of Assets
- ❑ **547** Casualties, Disasters, and Thefts
- ❑ **584** Casualty, Disaster, and Theft Loss Workbook (Personal-Use Property)
- ❑ **584-B** Business Casualty, Disaster, and Theft Loss Workbook

#### Form (and Instructions)

- ❑ **Sch A (Form 1040)** Itemized Deductions
- ❑ **Sch D (Form 1040)** Capital Gains and Losses
- ❑ **Sch F (Form 1040)** Profit or Loss From Farming
- ❑ **4684** Casualties and Thefts
- ❑ **4797** Sales of Business Property

See chapter 21 for information about getting publications and forms.

## Casualties and Thefts

If your property is destroyed, damaged, or stolen, you may have a deductible loss. If the insurance or other reimbursement is more than the adjusted basis of the destroyed, damaged, or stolen property, you may have a taxable gain.

**Casualty.** A casualty is the damage, destruction, or loss of property resulting from an identifiable event that is sudden, unexpected, or unusual.

**Deductible losses.** Deductible casualty losses can result from a number of different causes, including the following.

- Airplane crashes.
- Car or truck accidents not resulting from your willful act or willful negligence.
- Earthquakes.
- Fires (but see *Nondeductible losses*, next for exceptions).
- Floods.
- Freezing.
- Government-ordered demolition or relocation of a home that is unsafe to use because of a disaster as discussed under *Disaster Area Losses*, in Publication 547.
- Hurricanes.
- Lightning.
- Storms.
- Tornadoes.

**Nondeductible losses.** A casualty loss is not deductible if the damage or destruction is caused by the following.

- Accidentally breaking articles such as glassware or china under normal conditions.
- A family pet.
- A fire if you willfully set it, or pay someone else to set it.
- A car or truck accident if your willful negligence or willful act caused it. The same is true if the willful act or willful negligence of someone acting for you caused the accident.
- Progressive deterioration (explained next).

**Progressive deterioration.** Loss of property due to progressive deterioration is not deductible as a casualty loss. This is because the damage results from a steadily operating cause or a normal process, rather than from a sudden event. Examples of damage due to progressive deterioration include damage from rust, corrosion, or termites. However, weather-related conditions or disease may cause another type of involuntary conversion. See *Other Involuntary Conversions*, later.

**Theft.** A theft is the taking and removing of money or property with the intent to deprive the owner of it. The taking of property must be illegal under the law of the state where it occurred and it must have been done with criminal intent.

Theft includes the taking of money or property by the following means.

- Blackmail.
- Burglary.
- Embezzlement.
- Extortion.
- Kidnapping for ransom.
- Larceny.
- Robbery.
- Threats.

The taking of money or property through fraud or misrepresentation is theft if it is illegal under state or local law.

**Mislaid or lost property.** The simple disappearance of money or property is not a theft. However, an accidental loss or disappearance of property can qualify as a casualty if it results from an identifiable event that is sudden, unexpected, or unusual.

**Example.** A car door is accidentally slammed on your hand, breaking the setting of your diamond ring. The diamond falls from the ring and is never found. The loss of the diamond is a casualty.

## Farming Losses

You can deduct certain casualty or theft losses that occur in the business of farming. The following is a discussion of some losses you can deduct and some you cannot deduct.

**Livestock or produce purchased for sale.** Casualty or theft losses of livestock or produce bought for sale are deductible if you report your income on the cash method. If you report your income on an accrual method, take casualty and

theft losses on property bought for sale by omitting the item from the closing inventory for the year of the loss. You cannot take a separate deduction.

**Livestock, plants, produce, and crops raised for sale.** Losses of livestock, plants, produce, and crops raised for sale are generally not deductible if you report your income on the cash method. You have already deducted the cost of raising these items as farm expenses.

For plants with a preproductive period of more than 2 years, you may have a deductible loss if you have a tax basis in the plants. You usually have a tax basis if you capitalized the expenses associated with these plants under the uniform capitalization rules. The uniform capitalization rules are discussed in chapter 7.

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.** An ice storm damaged your standing timber by reducing its rate of growth and its quality. The storm did not cause any physical damage, but you determined that the timber will sell for less than you anticipated because of the reduced growth rate and quality. The loss of future income is not deductible.

**Loss of timber.** If you sell timber downed as a result of a casualty, treat the proceeds from the sale as a reimbursement. If you use the proceeds to buy qualified replacement property, you can postpone reporting the gain. See *Postponing Gain*, later.

**Property used in farming.** Casualty and theft losses of property used in your farm business usually result in deductible losses. If a fire or storm destroyed your barn, or you lose by casualty or theft an animal you bought for draft, breeding, dairy, or sport, you may have a deductible loss. See *How To Figure a Loss*, later.

**Raised draft, breeding, dairy, or sporting animals.** Generally, losses of raised, draft, breeding, dairy, or sporting animals do not result in deductible casualty or theft losses because you have no basis in the animals. However, you may be able to claim a deduction if either of the following situations applies to you.

- You use inventories to determine your income and you included the animals in your inventory.
- You capitalized the expenses associated with the animals under the uniform capitalization rules and therefore have a tax basis in the animals subject to a casualty or theft.

When you include livestock in inventory, its last inventory value is its basis. When you lose an inventoried animal held for draft, breeding, dairy, or sport by casualty or theft during the year, decrease ending inventory by the amount you included in inventory for the animal. You cannot take a separate deduction.

## How To Figure a Loss

How you figure a deductible casualty or theft loss depends on whether the loss was to farm or personal-use property and whether the property was stolen or partly or completely destroyed.

**Farm property.** Farm property is the property you use in your farming business. If your farm property was completely destroyed or stolen, your loss is figured as follows:

Your adjusted basis in the property  
MINUS  
Any salvage value  
MINUS  
Any insurance or other reimbursement you receive or expect to receive

**TIP** You can use the schedules in Publication 584-B to list your stolen, damaged, or destroyed business property and to figure your loss.

If your farm property was partially damaged, use the steps shown under *Personal-use property*, next, to figure your casualty loss. However, the deduction limits 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.

**TIP** 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 7.

**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 afterwards. FMV is defined in chapter 12 under *Payments Received*.

**Cost of cleaning up or making repairs.** The cost of cleaning up after a casualty is not part of a casualty loss. Neither is the cost of repairing damaged property after a casualty. But you can use the cost of cleaning up or making repairs after a casualty as a measure of the decrease in FMV if you meet all the following conditions.

- The repairs are actually made.

- The repairs are necessary to bring the property back to its condition before the casualty.
- The amount spent for repairs is not excessive.
- The repairs fix the damage only.
- The value of the property after the repairs is not, due to the repairs, more than the value of the property before the casualty.

**Related expenses.** The incidental expenses due to a casualty or theft, such as expenses for the treatment of personal injuries, temporary housing, or a rental car, are not part of your casualty or theft loss. However, they may be deductible as farm business expenses if the damaged or stolen property is farm property.

**Separate computations for more than one item of property.** Generally, if a single casualty or theft involves more than one item of property, you must figure your loss separately for each item of property. Then combine the losses to determine your total loss.

**CAUTION** There is an exception to this rule for personal-use real property. See *Exception for personal-use real property*, later.

**Example.** A fire on your farm damaged a tractor and the barn in which it was stored. The tractor had an adjusted basis of \$3,300. Its FMV was \$2,800 just before the fire and \$1,000 immediately afterward. The barn had an adjusted basis of \$28,000. Its FMV was \$55,000 just before the fire and \$25,000 immediately afterward. You received insurance reimbursements of \$600 on the tractor and \$26,000 on the barn. Figure your deductible casualty loss separately for the two items of property.

	Tractor	Barn
1) Adjusted basis . . . . .	\$3,300	\$28,000
2) FMV before fire . . . . .	\$2,800	\$55,000
3) FMV after fire . . . . .	1,000	25,000
4) Decrease in FMV (line 2 - line 3) . . . . .	\$1,800	\$30,000
5) Loss (lesser of line 1 or line 4) . . . . .	\$1,800	\$28,000
6) Minus: Insurance . . . . .	600	26,000
7) Deductible casualty loss . . . . .	\$1,200	\$2,000
8) Total deductible casualty loss . . . . .	<u>\$3,200</u>	

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

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

**Example.** You bought a farm in 1960 for \$20,000. The adjusted basis of the residential part is \$16,000. In 2001, a windstorm blew down shade trees and three ornamental trees planted at a cost of \$600 on the residential part. The adjusted basis of the residential part includes the \$600. The fair market value (FMV) of the residential part immediately before the storm was \$130,000, and \$126,000 immediately after the storm. The trees were not covered by insurance.

1) Adjusted basis . . . . .	\$16,000
2) FMV before the storm . . . . .	\$130,000
3) FMV after the storm . . . . .	126,000
4) Decrease in FMV (line 2 – line 3) . . . . .	\$4,000
5) Loss before insurance (lesser of line 1 or line 4) . . . . .	\$4,000
6) Minus: Insurance . . . . .	-0-
7) <b>Amount of loss</b> . . . . .	<u>\$4,000</u>

**Insurance and other reimbursements.** If you receive an insurance or other type of reimbursement, you must subtract the reimbursement when you figure your loss. You do not have a casualty or theft loss to the extent you are reimbursed.



*Do not subtract from your loss any insurance payments you receive for living expenses. You may have to include these payments in your income. See Publication 547 for details.*

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.

**Reimbursement received after deducting loss.** If you figure your casualty or theft loss using your expected reimbursement, you may have to adjust your tax return for the tax year in which you get your actual reimbursement.

**Actual reimbursement less than expected.** If you later receive less reimbursement than you expected, include that difference as a loss with your other losses (if any) on your return for the year in which you can reasonably expect no more reimbursement.

**Actual reimbursement more than expected.** If you later receive more reimbursement than you expected after you have claimed a deduction for the loss, you may have to include the extra reimbursement in your income for the year you receive it. However, if any part of your original deduction did not reduce your tax for the earlier year, do not include that part of the reimbursement in your income. Do not refigure your tax for the year you claimed the deduction. See *Recoveries* in Publication 525 to find out how much extra reimbursement to include in income.



*If the total of all the reimbursements you receive is more than your adjusted basis in the destroyed or stolen property, you will have a **gain** on the casualty or theft. See Publication 547 for information on how to treat a gain from the reimbursement of a casualty or theft.*

**Actual reimbursement same as expected.** If you receive exactly the reimbursement you expected to receive, you do not have to include any amount in your income or deduct any loss.

**Lump-sum reimbursement.** If you have a casualty or theft loss of several assets at the same time without an allocation of reimbursement to specific assets, divide the lump-sum reimbursement among the assets according to the fair market value of each asset at the time of the loss. Figure the gain or loss separately for each asset that has a separate basis.

**Adjustment to basis.** If you have a casualty or theft loss, you must decrease your basis in the property by any insurance or other reimbursement you receive and by any deductible

loss. The result is your adjusted basis in the property. Amounts you spend to restore your property after a casualty increase your adjusted basis. See *Adjusted Basis* in chapter 7 for more information.

## Deduction Limits on Losses of Personal-Use Property

Casualty and theft losses of property held for personal use may be deductible if you itemize deductions on Schedule A (Form 1040).

There are two limits on the deduction for casualty or theft loss of personal-use property. You figure these limits on Form 4684.

**\$100 rule.** You must reduce each casualty or theft loss on personal-use property by \$100. This rule applies after you have subtracted any reimbursement.

**10% rule.** You must further reduce the total of all your casualty or theft losses on personal-use property by 10% of your adjusted gross income. Apply this rule after you reduce each loss by \$100. Adjusted gross income is on line 33 of Form 1040.

**Example.** In June, you discovered that your house had been burglarized. Your loss after insurance reimbursement was \$2,000. Your adjusted gross income is \$57,000. Figure your theft loss deduction as follows:

1. Loss after insurance . . . . .	\$2,000
2. Subtract \$100 . . . . .	100
3. Loss after \$100 rule . . . . .	\$1,900
4. Subtract 10% × \$57,000 AGI . . . . .	\$5,700
5. <b>Theft loss deduction</b> . . . . .	<u>-0-</u>

You do not have a theft loss deduction because your loss (\$1,900) is less than 10% of your adjusted gross income (\$5,700).



*If you have a casualty or theft gain in addition to a loss, you will have to make a special computation to figure your 10% limit. See 10% Rule in Publication 547.*

## When Loss Is Deductible

Casualty losses are generally deductible only in the year in which they occur. Theft losses are generally deductible only in the year they are discovered. However, losses in Presidentially declared disaster areas are subject to different rules. See *Disaster Area Losses*, later, for an exception.

**Leased property.** If you lease property from someone else, you can deduct a loss on the property in the year your liability for the loss is fixed. This is true even if the loss occurred or the liability was paid in a different year. You are not entitled to a deduction until your liability under the lease can be determined with reasonable accuracy. Your liability can be determined when a claim for recovery is settled, adjudicated, or abandoned.

**Example.** Robert leased a tractor from First Implement, Inc., for use in his farm business. The tractor was destroyed by a tornado in June 2001. 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 2002, Robert and First Implement agreed to settle the suit for \$20,000, and the court entered a judgement in favor of First Implement. Robert paid \$20,000 in June 2002. He can claim the \$20,000 as a loss on his 2002 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 chapter 5 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.

**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.

## Figuring a Gain

A casualty or theft may result in a taxable gain. If you receive an insurance payment or other reimbursement that is more than your adjusted basis in the destroyed, damaged, or stolen property, you have a gain from the casualty or theft. You generally report your gain as income in the year you receive the reimbursement. However, depending on the type of property you receive, you may not have to report your gain. See *Postponing Gain*, later.

Your gain is figured as follows:

- The amount you receive, minus
- Your adjusted basis in the property at the time of the casualty or theft.

Even if the decrease in FMV of your property is smaller than the adjusted basis of your property, use your adjusted basis to figure the gain.

**Amount you receive.** The amount you receive includes any money plus the value of any property you receive, minus any expenses you have in obtaining reimbursement. It also includes any reimbursement used to pay off a mortgage or other lien on the damaged, destroyed, or stolen property.



**Example.** A tornado severely damaged your barn. The adjusted basis of the barn was \$25,000. Your insurance company reimbursed you \$40,000 for the damaged barn. However, you had legal expenses of \$2,000 to collect that insurance. Since your insurance minus your expenses to collect the insurance is more than your adjusted basis in the barn, you have a gain.

1) Insurance reimbursement . . . . .	\$40,000
2) Legal expenses . . . . .	<u>2,000</u>
3) Amount received (line 1 – line 2) . . . . .	\$38,000
4) Adjusted basis . . . . .	<u>25,000</u>
5) Gain on casualty (line 3 – line 4) . . . .	<u>\$13,000</u>

## Other Involuntary Conversions

In addition to casualties and thefts, other events cause involuntary conversions of property. Some of these are discussed in the following paragraphs.

Gain or loss from an involuntary conversion of your property is usually recognized for tax purposes. You report the gain or deduct the loss on your tax return for the year you realize it. However, depending on the type of property you receive, you may not have to report your gain on the involuntary conversion. See *Postponing Gain*, later.

### Condemnation

Condemnation is the process by which private property is legally taken for public use without the owner's consent. The property may be taken by the federal government, a state government, a political subdivision, or a private organization that has the power to legally take property. The owner receives a condemnation award (money or property) in exchange for the property taken. A condemnation is a forced sale, the owner being the seller and the condemning authority being the buyer.

**Threat of condemnation.** Treat the sale of your property under threat of condemnation as a condemnation, provided you have reasonable grounds to believe that your property will be condemned.

**Main home condemned.** If you have a gain because your main home is condemned, you generally can exclude the gain from your income as if you had sold or exchanged your home. For information on this exclusion, see Publication 523, *Selling Your Home*. If your gain is more than you can exclude, but you buy replacement property, you may be able to postpone 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

Property located within an irrigation project and sold or otherwise disposed of to conform to the

acreage limits of federal reclamation laws is an involuntary conversion.

## Livestock Losses

**Diseased livestock.** If your livestock die from disease, or are destroyed, sold, or exchanged because of disease, even though the disease is not of epidemic proportions, treat these occurrences as involuntary conversions. If the livestock was raised or purchased for resale, follow the rules for livestock discussed earlier under *Farming Losses*. Otherwise, figure the gain or loss from these conversions using the rules discussed under *Determining Gain or Loss* in chapter 10. If you replace the livestock, you may be able to postpone reporting the gain. See *Postponing Gain*, later.

**Reporting dispositions of diseased livestock.** If you choose to postpone gain on the disposition of diseased livestock, you must attach a statement to your return explaining that the livestock was disposed of because of disease. You must also include other information on this statement. See *How To Postpone Gain*, later, under *Postponing Gain*.

**Weather-related sales of livestock.** If you sell or exchange livestock (other than poultry) held for draft, breeding, or dairy purposes solely because of drought, flood, or other weather-related conditions, treat the sale or exchange as an involuntary conversion. Only livestock sold in excess of the number you normally would sell under usual business practice, in the absence of weather-related conditions, are considered involuntary conversions. Figure the gain or loss using the rules discussed under *Determining Gain or Loss* in chapter 10. If you replace the livestock, you may be able to postpone reporting the gain. See *Postponing Gain*, later.

**Example.** It is your usual business practice to sell five of your dairy animals during the year. This year you sold 20 dairy animals because of drought. The sale of 15 animals is treated as an involuntary conversion.



*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 poultry. See Sales Caused by Weather-Related Conditions in chapter 4.*

**Reporting weather-related sales of livestock.** If you choose to postpone the gain on weather-related sales of livestock, show all the following information on a statement attached to your return for the tax year in which you first realize any of the gain.

- Evidence of the weather-related conditions that forced the sale or exchange of the livestock.
- The gain realized on the sale or exchange.
- The number and kind of livestock sold or exchanged.
- The number of livestock of each kind you would have sold or exchanged under your usual business practice.

Show all the following information on the return for the year in which you replace the livestock.

- The date you bought replacement livestock.
- The cost of the replacement livestock.
- The number and kind of the replacement livestock.

## 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. The loss equals the previously capitalized reforestation costs you had to duplicate on replanting. You deduct the loss on the return for the year the seedlings died. If you took the investment credit for any of these costs, you may have to recapture all or part of the credit. See *Recapture of Investment Credit* in chapter 9.

## Postponing Gain

Do not report a gain if you receive reimbursement in the form of property similar or related in service or use to the destroyed, stolen, or other involuntarily converted property. Your basis in the new property is the same as your adjusted basis in the property it replaces.

You must ordinarily report the gain on your stolen, destroyed, or other involuntarily converted property if you receive money or unlike property as reimbursement. But you can choose to postpone reporting the gain if you purchase replacement property similar or related in service or use to your destroyed, stolen, or other involuntarily converted property within a specific replacement period.

To postpone all the gain, the cost of your replacement property must be at least as much as the reimbursement you receive. If the cost of the replacement property is less than the reimbursement, you must include the gain in your income up to the amount of the unspent reimbursement.

**Example.** In 1970, you bought a cottage in the mountains for your personal use at a cost of \$18,000. You made no further improvements or additions to it. When a storm destroyed the cottage this January, the cottage was worth \$250,000. You received \$146,000 from the insurance company in March. You had a gain of \$128,000 (\$146,000 – \$18,000).

You spent \$144,000 to rebuild the cottage. Since this is less than the insurance proceeds received, you must include \$2,000 (\$146,000 – \$144,000) in your income.

**Buying replacement property from a related person.** You cannot postpone reporting a gain from a casualty, theft, or other involuntary conversion if you buy the replacement property from a related person (discussed later). This rule applies to the following taxpayers.

- 1) C corporations.
- 2) Partnerships in which more than 50% of the capital or profits interest is owned by C corporations.
- 3) Individuals, partnerships (other than those in (2) above), and S corporations if the

total realized gain for the tax year on all involuntarily converted properties on which there are realized gains is more than \$100,000.

For involuntary conversions described in (3) above, gains cannot be offset by any losses when determining whether the total gain is more than \$100,000. If the property is owned by a partnership, the \$100,000 limit applies to the partnership and each partner. If the property is owned by an S corporation, the \$100,000 limit applies to the S corporation and each shareholder.

**Exception.** This rule does not apply if the related persons acquired the property from an unrelated person within the period of time allowed for replacing the involuntarily converted property.

**Related persons.** Under this rule, related persons include, for example, a corporation and an individual who owns more than 50% of its outstanding stock, and two partnerships in which the same C corporations own more than 50% of the capital or profits interests. For more information on related persons, see *Nondeductible Loss under Sales and Exchanges Between Related Persons* in chapter 2 of Publication 544.

**Death of a taxpayer.** If a taxpayer dies after having a gain, but before buying replacement property, the gain must be reported for the year in which the decedent realized the gain. The executor of the estate or the person succeeding to the funds from the casualty or theft cannot postpone the gain by buying replacement property.

## Replacement Property

You must buy replacement property for the specific purpose of replacing your property. Your replacement property must be similar or related in service or use to the property it replaces. You do not have to use the same funds you receive as reimbursement for your old property to acquire the replacement property. If you spend the money you receive for other purposes, and borrow money to buy replacement property, you can still choose to postpone the gain if you meet the other requirements. Property you acquire by gift or inheritance does not qualify as replacement property.

**Owner-user.** If you are an owner-user, similar or related in service or use means that replacement property must function in the same way as the property it replaces. Examples of property that functions in the same way as the property it replaces are a home that replaces another home, a dairy cow that replaces another dairy cow, and farm land that replaces other farm land. A passenger automobile that replaces a tractor does not qualify. Neither does a breeding cow that replaces a dairy cow.

**Soil or other environmental contamination.** If, because of soil or other environmental contamination, it is not practical for you to reinvest your insurance money from destroyed livestock in property similar or related in service or use to the livestock, you can treat other property, including real property used for farming purposes, as property similar or related in service or use to the destroyed livestock.

**Standing crop destroyed by casualty.** If a storm or other casualty destroyed your standing crop and you use the insurance money to acquire either another standing crop or a harvested crop, this purchase qualifies as replacement property. The costs of planting and raising a new crop qualify as replacement costs for the destroyed crop only if you use the crop method of accounting (discussed in chapter 3). In this case, the costs of bringing the new crop to the same level of maturity as the destroyed crop qualify as replacement costs to the extent they are incurred during the replacement period.

**Timber loss.** Standing timber you bought with the proceeds from the sale of timber downed as a result of a casualty, such as high winds, earthquakes, or volcanic eruptions, qualifies as replacement property. If you bought the standing timber within the replacement period, you can postpone reporting the gain.

**Business or income-producing property located in a Presidentially declared disaster area.** If your destroyed business or income-producing property was located in a Presidentially declared disaster area, any tangible replacement property you acquire for use in a 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.

## 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 ends 2 years after the close of the first tax year in which you realize any part of your gain from the involuntary conversion.

**Condemnation.** The replacement period for a condemnation begins on the earlier of the following dates.

- The date on which you disposed of the condemned property.
- The date on which the threat of condemnation began.

The replacement period ends 2 years after the close of the first tax year in which any part of the gain on the condemnation is realized.

If real property held for use in a trade or business or for investment (not including property held primarily for sale) is condemned, the replacement period ends 3 years after the close of the first tax year in which any part of the gain on the condemnation is realized.

**Extension.** You may get an extension of the replacement period if you apply to the IRS director for your area. You can call 1-800-829-1040 to get 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 your gain by reporting your choice on your tax return for the year you have the gain. You have the gain in the year you receive insurance proceeds or other reimbursements that result in a gain.

**Required statement.** You should attach a statement to your return for the year you have the gain. This statement should include all the following information.

- The date and details of the casualty, theft, or other involuntary conversion.
- The insurance or other reimbursement you received.
- How you figured the gain.

**Replacement property acquired before return filed.** If you acquire replacement property before you file your return for the year you have the gain, your statement should also include detailed information about all the following items.

- The replacement property.
- The postponed gain.
- The basis adjustment that reflects the postponed gain. (Reduce the basis of the replacement property by the postponed gain.)
- Any gain you are reporting as income.

**Replacement property acquired after return filed.** If you intend to buy replacement property after you file your return for the year you realize gain, your statement should also say that you are choosing to replace the property within the required replacement period.

You should then attach another statement to your return for the year in which you buy the replacement property. This statement should contain detailed information on the replacement property. If you acquire part of your replacement property in one year and part in another year, you must attach a statement to each year's return. Include in the statement detailed information on the replacement property bought in that year.

**Amended return.** You must file an amended return (Form 1040X) for the tax year of the gain in either of the following situations.

- You do not acquire replacement property within the replacement period, plus extensions. On this amended return, you must report the gain and pay any additional tax due.

- You acquire replacement property within the required replacement period, plus extensions but at a cost less than the amount you receive from the casualty, theft or other involuntary conversion. On this amended return, you must report the part of the gain that cannot be postponed and pay any additional tax due.

## Disaster Area Losses

Special rules apply to Presidentially declared disaster area losses. A **Presidentially declared disaster** is a disaster that occurred in an area declared by the President to be eligible for federal assistance under the Disaster Relief and Emergency Assistance Act.

This part discusses the special rules for when to deduct a disaster area loss and what tax deadlines may be postponed. For other special rules, see Publication 547.

**When to deduct the loss.** If you have a deductible loss from a Presidentially declared disaster area, you can choose to deduct that loss on your return or amended return for the immediately preceding tax year. If you make this choice, the loss is treated as having occurred in the preceding year.



*Claiming a qualifying disaster loss on the previous year's return may result in a lower tax for that year, often producing or increasing a cash refund.*

You must make this choice to take your casualty loss for the disaster in the preceding year by the later of the following dates.

- The due date (without extensions) for filing your tax return for the tax year in which the disaster actually occurred.
- The due date (with extensions) for the return for the preceding tax year.

**Postponed tax deadlines.** The IRS may postpone for up to 120 days certain tax deadlines of taxpayers who are affected by a Presidentially declared disaster. The tax deadlines the IRS may postpone include those for filing income and employment tax returns, paying income and employment taxes, and making contributions to a traditional IRA or Roth IRA.

If any tax deadline is postponed, the IRS will publicize the postponement in your area and publish a news release, revenue ruling, revenue procedure, notice, announcement, or other guidance in the Internal Revenue Bulletin (IRB).

**Who is eligible.** If the IRS postpones a tax deadline, the following taxpayers are eligible for the postponement.

- Any individual whose main home is located in a covered disaster area (defined later).
- Any business entity or sole proprietor whose principal place of business is located in a covered disaster area.
- Any individual who is a relief worker affiliated with a recognized government or philanthropic organization and who is assisting in a covered disaster area.

- Any individual, business entity, or sole proprietor whose records are needed to meet a postponed deadline, provided those records are maintained in a covered disaster area. The main home or principal place of business does **not** have to be located in the covered disaster area.
- Any estate or trust that has tax records necessary to meet a postponed tax deadline, provided those records are maintained in a covered disaster area.
- The spouse on a joint return with a taxpayer who is eligible for postponements.
- Any other person determined by the IRS to be affected by a Presidentially declared disaster.

**Covered disaster area.** This is an area of a Presidentially declared disaster area in which the IRS has decided to postpone tax deadlines for up to 120 days.

**Abatement of interest.** In addition to postponing the tax deadlines, the IRS may grant an extension to file income tax returns and pay income tax. In this case, the IRS will abate the interest for the length of the extension period and for the length of any postponement.

## Reporting Gains and Losses

You will have to file one or more of the following forms to report your gains or losses from involuntary conversions.

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

**Form 4797.** Use this form to report involuntary conversions (other than from casualty or theft) of property used in your trade or business and capital assets held in connection with a trade or business or a transaction entered into for profit.

**Schedule A (Form 1040).** Use this form to deduct your losses from casualties and thefts of personal-use property that you reported on Form 4684.

**Schedule D (Form 1040).** Use this form to report gain from an involuntary conversion (other than from casualty or theft) of personal-use property. Also, carry over the following gains to Schedule D.

- Net gain shown on Form 4797 from an involuntary conversion of business property held for more than 1 year.
- Net gain shown on Form 4684 from the casualty or theft of personal-use property.

**Schedule F (Form 1040).** Use this form to deduct your losses from casualty or theft of livestock or produce bought for sale under *Other expenses* in Part II, line 34, if you use the cash method of accounting and have not otherwise deducted these losses.

# 14.

## Alternative Minimum Tax

### Introduction

The tax laws give special treatment to some types of income, allow special deductions for some types of expenses, and allow credits for certain taxpayers. These laws enable some taxpayers with substantial economic income to significantly reduce their regular tax. The alternative minimum tax (AMT) ensures that these taxpayers pay at least a minimum amount of tax on their economic income.

This chapter discusses the AMT for individuals. For information about the AMT for corporations, see Publication 542, *Corporations*.

### Topics

This chapter discusses:

- Form 6251
- Records you must keep
- Credit for prior year minimum tax

### Useful Items

You may want to see:

#### Form (and Instructions)

- 1040** U.S. Individual Income Tax Return
- Sch A (Form 1040)** Itemized Deductions
- 6251** Alternative Minimum Tax—Individuals
- 8801** Credit For Prior Year Minimum Tax—Individuals, Estates, and Trusts

See chapter 21 for information about getting publications and forms.

## Form 6251

Individuals use Form 6251 to figure their AMT. They also use the form to figure certain credit limitations.

**Figuring AMT.** Use the worksheet in *Table 14-1* to see if you should fill in Form 6251 to figure the amount, if any, of your AMT.

**Exception.** Fill in Form 6251 instead of using the worksheet if you claimed or received any of the following items.

- Accelerated depreciation.
- Income or (loss) from tax-shelter farm activities or passive activities.
- Net operating loss deduction.



Table 14–1. **Worksheet To See if You Should Fill in Form 6251**  
(Keep for your records)

**Before you begin:** ✓ Be sure you have read the discussion under *Form 6251* in this chapter before using this worksheet.



1. Enter the amount from Form 1040, line 37. . . . .	1. _____
2. Are you filing Schedule A? <input type="checkbox"/> <b>Yes.</b> Leave line 2 blank and go to line 3. <input type="checkbox"/> <b>No.</b> Enter your standard deduction from Form 1040, line 36, and go to line 5 . . . . .	2. _____
3. Enter the <b>smaller</b> of the amount on Schedule A, line 4, or 2.5% (.025) of the amount on Form 1040, line 34	3. _____
4. Add lines 9 and 26 of Schedule A and enter the total . . . . .	4. _____
5. Add lines 1 through 4 above . . . . .	5. _____
6. Enter the amount shown below for your filing status. • Single or head of household—\$35,750 • Married filing jointly or qualifying widow(er)—\$49,000 • Married filing separately—\$24,500	6. _____
7. Is the amount on line 5 more than the amount on line 6? <input type="checkbox"/> <b>No.</b> You do not need to fill in Form 6251. <input type="checkbox"/> <b>Yes.</b> Subtract line 6 from line 5 . . . . .	7. _____
8. Enter the amount shown below for your filing status. • Single or head of household—\$112,500 • Married filing jointly or qualifying widow(er)—\$150,000 • Married filing separately—\$75,000	8. _____
9. Is the amount on line 5 more than the amount on line 8? <input type="checkbox"/> <b>No.</b> Enter -0- here and on line 10 and go to line 11. <input type="checkbox"/> <b>Yes.</b> Subtract line 8 from line 5.	9. _____
10. Multiply line 9 by 25% (.25) and enter the result but do not enter more than line 6 above . . . . .	10. _____
11. Add lines 7 and 10 . . . . .	11. _____
12. Is the amount on line 11 more than the amount shown below for your filing status? • Single, married filing jointly, head of household, or qualifying widow(er)—\$175,000 • Married filing separately—\$87,500 <input type="checkbox"/> <b>Yes.</b> Fill in Form 6251 to see if you owe the alternative minimum tax. <input type="checkbox"/> <b>No.</b> Multiply line 11 by 26% (.26) . . . . .	12. _____
13. Enter the amount from Form 1040, line 40, minus the total of any tax from Form 4972 and any amount on Form 1040, line 43. . . . .	13. _____
<b>Next.</b> Is the amount on line 12 more than the amount on line 13? <input type="checkbox"/> <b>Yes.</b> Fill in Form 6251 to see if you owe the alternative minimum tax. <input type="checkbox"/> <b>No.</b> Do not fill in Form 6251.	

- Stock by exercising an incentive stock option and you did not dispose of the stock in the same year.
- Tax-exempt interest from private activity bonds.
- Intangible drilling, circulation, research, experimental, or mining costs.
- Amortization of pollution-control facilities or depletion.
- Percentage-of-completion income from long-term contracts.
- Interest paid on a home mortgage *not* used to buy, build, or substantially improve your home.
- Investment interest expense reported on **Form 4952**.

- AMT adjustments from an estate, trust, electing large partnership, or a cooperative.
- Section 1202 exclusion.

After you fill in Form 6251, see *Who Must File* in the form instructions to see if you need to attach it to your tax return.

**Child under age 14.** Fill in Form 6251 for a child under age 14 if the child's adjusted gross income from Form 1040, line 34, exceeds the child's earned income by more than \$5,350.

**Earned income credit.** If you claim an earned income credit, you must reduce it by any AMT.

**Figuring credit limitations.** Although you may not owe AMT, you generally must still figure your tentative minimum tax on Form 6251 to

figure certain credits. Fill in Form 6251 if you claim any of the following credits.

- Any general business credit (see chapter 9).
- The qualified electric vehicle credit (see chapter 12 in Publication 535).
- The nonconventional source fuel credit (see section 29 of the Internal Revenue Code).
- The credit for prior year minimum tax (discussed later).

After you fill in Form 6251, attach it to your tax return.

## Records You Must Keep



Because of AMT adjustments, you may have a different AMT basis in certain property or activities. Because your AMT basis may affect the computation of AMT in future tax years, you may need to figure the adjustments that affect basis, even though you do not owe AMT this year. You should keep a separate record of your AMT adjusted basis, including an AMT depreciation schedule.

Carrybacks and carryovers of certain deductions and credits may have to be refigured for AMT purposes. You should keep a separate record of these AMT carrybacks and carryovers to assist you in preparing your return in other years.

## Credit for Prior Year Minimum Tax

Individuals use Form 8801 to figure their minimum tax credit, if any, for AMT incurred in prior tax years. They also use the form to figure any minimum tax credit carryforward.

**Form 8801.** Fill in Form 8801 if you had any of the following items in 2000.

- An AMT liability and adjustments or preferences that do not cause a permanent difference in taxable income over time.
- A minimum tax credit carryforward.
- An unallowed nonconventional source fuel credit or qualified electric vehicle credit.

For more information, see Form 8801.

**Reduction for canceled debt.** You may have to reduce the credit if you exclude from income a canceled debt from any of the following.

- A bankruptcy case.
- Insolvency.
- Qualified farm debt.

You must reduce the amount available at the beginning of the year after the debt was canceled before preparing Form 8801 for that year. For more information, see *Cancellation of Debt* in chapter 4.

## 15.

# Self-Employment Tax

## Important Change for 2001

**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 \$80,400 for 2001. There is no maximum limit on earnings subject to the Medicare part (2.9%).

## Important Change for 2002

**Maximum net earnings.** The maximum net self-employment earnings subject to the social security part of the self-employment tax will be published in Publications 533 and 553. There is no maximum limit on earnings subject to the Medicare part.

## Introduction

Self-employment tax (SE tax) is a social security and Medicare tax primarily for individuals who work for themselves. It is similar to the social security and Medicare taxes withheld from the pay of most wage earners.

You usually have to pay SE tax if you are self-employed. You are usually self-employed if you operate your own farm on land you either own or rent. You have to figure SE tax on Schedule SE (Form 1040).

Farmers who have employees may have to pay the employer's share of social security tax, as well. See chapter 16 for information on employment taxes.

**SE tax rate.** The self-employment tax rate is 15.3%. The rate consists of two parts: 12.4% for social security (old-age, survivors, and disability insurance) and 2.9% for Medicare (hospital insurance).

## Topics

This chapter discusses:

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

## Useful Items

You may want to see:

### Publication

- 533** Self-Employment Tax
- 541** Partnerships

### Form (and Instructions)

- SS-5** Application for a Social Security Card
- 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, Credits, Deductions, etc.

See chapter 21 for information about getting publications and forms.

## General Information

**Social security benefits.** Social security coverage provides you with retirement benefits, disability benefits, survivor benefits, and hospital insurance (Medicare) benefits. Your payments of self-employment tax (SE tax) help pay for your coverage under the social security system. Social security benefits are available to self-employed persons just as they are to wage earners.

**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 (quarters of coverage). It does not matter whether the income is earned in one quarter or is spread over two or more quarters.

**Earning credits in 2001.** You can earn a maximum of four credits per year. For 2001, you earn one credit for each \$830 of income subject to social security taxes. You need \$3,320 ( $\$830 \times 4$ ) of self-employment income and wages to earn four credits in 2001.

For an explanation of the number of credits you must have to be insured and the benefits available to you and your family under the social security program, consult your nearest Social Security Administration (SSA) office.



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

## How To Pay Self-Employment Tax

To pay SE tax, you must have a social security number (SSN) or an individual taxpayer identification number (ITIN). This section explains how to:

- Obtain an SSN or ITIN, and

- Pay your SE tax using estimated tax.



An ITIN does not entitle you to social security benefits.

**Obtaining a social security number.** If you have never had an SSN, apply for one using Form SS-5. You can get this form at any Social Security office or by calling 1-800-772-1213.



You can also download Form SS-5 from the Social Security Administration web site at [www.ssa.gov](http://www.ssa.gov).

If you have a social security number from the time you were an employee, you must use that number. Do not apply for a new one.

**Replacing a lost social security card.** If you have a number but lost your card, file Form SS-5. You will get a new card showing your original number, not a new number.

**Name change.** If your name has changed since you received your social security card, complete Form SS-5 to report a name change.

**Obtaining an individual taxpayer identification number.** The IRS will issue you an ITIN if you are a nonresident or resident alien and you do not have and are not eligible to get an SSN. To apply for an ITIN, file **Form W-7, Application for IRS Individual Taxpayer Identification Number**.

**Paying estimated tax.** Estimated tax is the method used to pay tax (including SE tax) on income not subject to withholding. You generally have to make estimated tax payments if you expect to owe tax, including self-employment 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 in 2001 or 2002 is from farming and you file your Form 1040 and pay all the tax due by March 3, 2003, you do not have to pay any estimated tax for farmers. See chapter 2 for more information about estimated tax for farmers.

**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.

**Social Security Administration (SSA) time limit for posting self-employment income.** Generally, the SSA will give you credit only for self-employment income reported on a tax return filed within 3 years, 3 months, and 15 days after the tax year you earned the income. If you file your tax return or report a change in your self-employment income after this time limit, the SSA may change its records, but only to remove or reduce the amount. The SSA will not change its records to increase your self-employment income.

## 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.

Your **net earnings from self-employment** are based on your earnings subject to SE tax. Most earnings from self-employment are subject to SE tax. Some earnings from employment (certain earnings that are not subject to social security and Medicare taxes) are subject to SE tax. This section provides information to help you determine whether you have earnings subject to SE tax.

If you have earnings subject to SE tax, use Schedule SE to figure your net earnings from self-employment. Before you figure your net earnings, you generally need to figure your total earnings subject to SE tax. For more information, see *Figuring Earnings Subject to SE Tax* and *Methods for Figuring Net Earnings*, later.



The SE tax rules apply no matter how old you are and even if you are already receiving social security or Medicare benefits.

**Are you self-employed?** You are self-employed if you carry on a trade or business (such as running a farm) as a sole proprietor, an independent contractor, or a member of a partnership or are otherwise in business for yourself. A trade or business is generally an activity carried on for a livelihood or in good faith to make a profit.

**Share farmer.** You are a self-employed farmer under an income-sharing arrangement if both the following apply.

- 1) You produce a crop or raise livestock on land belonging to another person.
- 2) Your share of the crop or livestock, or the proceeds from their sale, depends on the amount produced.

Your income from the income-sharing arrangement is your SE income.

If you produce a crop or livestock on land belonging to another person and are to receive a specified rate of pay, a fixed sum of money, or a fixed quantity of the crop or livestock, and not a share of the crop or livestock or their proceeds, you may be either self-employed or an employee of the landowner. This will depend on whether the landlord has the right to direct or control your performance of service.

**Example.** A share farmer produces a crop on land owned by another person on a 60-40 crop-share basis. Under the terms of their agreement, the share farmer furnishes the labor and half the cost of seed and fertilizer. The landowner furnishes the machinery and equipment used to produce and harvest the crop, and half the cost of seed and fertilizer. The share farmer is provided a house in which to live. The landowner and the share farmer decide how much of the tract should be planted in cotton and how much in other crops. In addition, the landowner is in the hog business and the share farmer agrees to take care of the landowner's hogs in return for ten hogs. The landowner furnishes the feed and other necessities and supervises the care of the hogs.

The share farmer is a self-employed farmer for purposes of the agreement to produce the cotton and other crops, and the share farmer's part of the income from the crops is SE income. The share farmer is an employee for the services performed in caring for the landowner's

hogs. The fair market value of the ten hogs received is not SE income but it is taxable for income tax purposes. For more information, see *Noncash wages* in chapter 16.

**4-H Club or FFA project.** If an individual participates in a 4-H Club or FFA project, any net income received from sales or prizes related to the project may be subject to income tax. Report the net income on line 21 of Form 1040. If necessary, attach a statement showing the gross income and expenses. The net income may not be subject to SE tax if the project is primarily for educational purposes and not for profit, and is completed by the individual under the rules and economic restrictions of the sponsoring 4-H or FFA organization. Such a project is generally not considered a trade or business.

**Partnership income or loss.** If you are a member of a partnership that carries on a trade or business, the partnership should report your earnings subject to SE tax on line 15a of your Schedule K-1 (Form 1065). The partnership can use the worksheet in the form instructions to figure these earnings.

If you are a general partner, you may need to reduce these reported earnings by amounts you claim as a section 179 deduction, unreimbursed partnership expenses, or depletion on oil and gas properties.

If the amount reported is a loss, see the *Partner's Instructions for Schedule K-1*.

For general information on partnerships, see Publication 541.

**Limited partner.** If you are a limited partner, your partnership earnings are generally not subject to SE tax. However, guaranteed payments you receive for services you perform for the partnership are subject to SE tax and should be reported to you on line 15a of your Schedule K-1.

**Husband and wife partners.** You and your spouse may operate a farm as a partnership. (Partnerships are discussed in chapter 2.) If you and your spouse operate a farm as partners, report the farm income and expenses on Form 1065, and attach separate Schedules K-1 showing each partner's share of earnings. Each spouse must report his or her share of partnership earnings on Form 1040 and file separate Schedules SE (Form 1040) to report each spouse's SE tax.

However, if your spouse is your employee, not your partner, you must withhold and pay social security and Medicare taxes for him or her. For more information on employment taxes, see chapter 16.

## Figuring Earnings Subject to Self-Employment Tax

Generally, you need to figure your total earnings subject to SE tax before you can figure your net earnings from self-employment. This section will help you figure these total earnings. If you are a self-employed farmer, use Schedule F (Form 1040) to figure your earnings subject to SE tax.

If you have earnings subject to SE tax from more than one trade, business, or profession,



you must combine the net profit (or loss) from each to determine your total net earnings subject to SE tax. A loss from one business reduces your profit from another business.

Various types of income included in earnings subject to SE tax are discussed next. The list is not all inclusive.

- 1) Taxable patronage dividends (distributions) from cooperatives.
- 2) Government agricultural program payments, including commodity program payments and conservation reserve program (CRP) payments. (If you do not materially participate in farming operations on the land, the CRP payment is not included in earnings subject to SE tax.)
- 3) Taxable Commodity Credit Corporation loans.
- 4) Refunds and rebates, if they represent a reduction in a deductible expense item, including a fuel tax credit included in income.
- 5) Prizes or awards on farm produce or livestock.
- 6) Crop damage payments.
- 7) Value of property and services received for farm products.
- 8) Sales of unharvested crops, if not sold with land that was held more than 1 year.
- 9) Rent you receive if you meet one of the four material participation tests explained later under *Landlord Participation in Farming*.  
If you receive the rent as crop shares, you must meet the test at the time the crop shares are produced. However, the crop shares are included in earnings subject to SE tax in the year they are converted to money or the equivalent of money.
- 10) Any amounts for depreciation, including any section 179 deduction, recaptured because the business use of the property was reduced to 50% or less. This does not include amounts recaptured on the disposition of property.
- 11) Lost income payments received from insurance or other sources for reducing or stopping farming activities. These include USDA payments to compensate for lost income resulting from reductions in tobacco quotas and allotments. Even if you are not farming when you receive the payment, it is included in earnings subject to SE tax if it relates to your farm business (even though it is temporarily inactive). A connection exists if it is clear the payment would not have been made but for your conduct of your farm business.

**Income not included in earnings subject to SE tax.** Certain kinds of income are not included in earnings subject to SE tax, even though they are included when figuring your income tax.

- 1) Rental income you receive from real estate and from personal property leased with real estate is not included in earnings subject to SE tax. It does not matter if the rent is received in crop shares, cash, or other

property. This rule applies only if the landlord does **not** materially participate in the production or management of production of farm products on the land. If the landlord materially participates, see *Landlord Participation in Farming*, later.

- 2) Interest is not included in earnings subject to SE tax unless you receive it in your trade or business, such as interest on accounts receivable.
- 3) Dividends on securities you own are not included in earnings subject to SE tax unless you are a dealer in securities who is not holding the securities for speculation or investment.
- 4) A gain or loss from the disposition of property that is neither stock in trade nor held primarily for sale to customers is not included in earnings subject to SE tax. It does not matter whether the disposition is a sale, exchange, or involuntary conversion. For example, gains or losses from the disposition of the following types of property are not included in earnings subject to SE tax.
  - a) Investment property.
  - b) Depreciable property or other fixed assets used in your trade or business.
  - c) Livestock held for draft, breeding, sport, or dairy purposes, and not held primarily for sale, regardless of how long the livestock was held, or whether it was raised or purchased.
  - d) Unharvested crops sold with land held more than one year.
  - e) Timber, coal, or iron ore held for more than one year if an economic interest was retained, such as a right to receive coal royalties.  
A gain or loss from the cutting of timber is not included in earnings subject to SE tax if the cutting is treated as a sale or exchange.
- 5) Wages and salaries received for services performed as an employee and covered by social security or railroad retirement are not included in earnings subject to SE tax.
- 6) Wages paid in kind to you for agricultural labor, such as commodity wages, are not included in earnings subject to SE tax.
- 7) Retirement income received by a partner from his or her partnership under a written plan is not included in earnings subject to SE tax if all the following apply.

- a) The retired partner performs no services for the partnership during the year.
- b) The retired partner is owed only the retirement payments.
- c) The retired partner's share (if any) of the partnership capital was fully paid to the retired partner.
- d) The payments to the retired partner are lifelong, periodic payments.

## Landlord Participation in Farming

As a general rule, income and deductions from rentals and from personal property leased with real estate are not included in determining earnings subject to SE tax. However, income and deductions from farm rentals, including government commodity program payments received by a landowner who rents land, are included if the rental arrangement provides that the landlord will, and does, materially participate in the production or management of production of the farm products on the land.

**Crop shares.** Rent paid in the form of crop shares is included in earnings subject to SE tax for the year you sell, exchange, give away, or use the crop shares if you meet one of the four material participation tests (discussed next) at the time the crop shares are produced. Feeding such crop shares to livestock is considered using them. Your gross income for figuring your earnings subject to SE tax under the *Farm Optional Method* includes the fair market value of the crop shares when they are used as feed.

**Material participation.** You materially participate if you have an arrangement with your tenant for your participation and you meet one of the following tests.

- 1) You do any three of the following.
  - a) Pay, using cash or credit, at least half the direct costs of producing the crop or livestock.
  - b) Furnish at least half the tools, equipment, and livestock used in the production activities.
  - c) Advise or consult with your tenant.
  - d) Inspect the production activities periodically.
- 2) You regularly and frequently make, or take an important part in making, management decisions substantially contributing to or affecting the success of the enterprise.
- 3) You work 100 hours or more spread over a period of 5 weeks or more in activities connected with agricultural production.
- 4) You do things that, considered in their totality, show you are materially and significantly involved in the production of the farm commodities.

These tests may be used as general guides for determining whether you are a material participant.

**Example.** Drew Houston agrees to produce a crop on J. Clarke's cotton farm with each receiving half the proceeds. Clarke furnishes all the necessary equipment and advises Houston when to plant, to chop, plow, spray, and pick the cotton. During the growing season, Clarke inspects the crop every few days to determine whether Houston is properly taking care of the crop. Houston furnishes all labor needed to grow and harvest the crop.

The management decisions made by J. Clarke in connection with the care of the cotton crop and his regular inspection of the crop, along with all the necessary equipment he furnishes,

establish that he participates to a material degree in the cotton production operations. The income Clarke receives from his cotton farm is included in computing his net earnings from self-employment.

## Methods for Figuring Net Earnings

There are three ways to figure your net earnings from self-employment.

- 1) The regular method.
- 2) The farm optional method.
- 3) The nonfarm optional method.

You must use the regular method unless you are eligible to use one or both of the optional methods. See *Figure 15-1*.

**Why use an optional method?** You may want to use the optional methods (discussed later) when you have a loss or a small net profit and any one of the following applies.

- You want to receive credit for social security benefit coverage.
- You incurred child or dependent care expenses for which you could claim a credit. (An optional method may increase your earned income, which could increase your credit.)
- You are entitled to the earned income credit. (An optional method may increase your earned income, which could increase your credit.)

**Effects of using an optional method.** Using an optional method could increase your SE tax. Paying more SE tax could result in your getting higher benefits when you retire.

If you use either or both optional methods, you must figure and pay the SE tax due under these methods even if you would have had a smaller tax or no tax using the regular method.

The optional methods are used only to figure your SE tax. To figure your income tax, include your actual earnings in gross income, regardless of which method you use to determine SE tax.

### Regular Method

Multiply your total earnings subject to SE tax by 92.35% (.9235) to get your net earnings under the regular method. See *Short Schedule SE*, line 4, or *Long Schedule SE*, line 4a.

### Farm Optional Method

Use the farm optional method only for earnings from a farming business. You can use this method if you meet either of the following tests.

- 1) Your gross farm income is \$2,400 or less.
- 2) Your net farm profit is less than \$1,733.

**Figuring farm net earnings.** If you meet either of the two tests explained earlier, use the following table to figure your net earnings from

self-employment under the farm optional method.

**Gross farm income.** Your gross farm income is the total of the amounts from:

- Line 11, Schedule F (Form 1040), and
- Line 15b, Schedule K-1 (Form 1065), (from farm partnerships).

**Net farm profit.** Net farm profit generally is the total of the amounts from:

- Line 36, Schedule F (Form 1040), and
- Line 15a, Schedule K-1 (Form 1065), (from farm partnerships).

However, you may need to adjust the amount reported on Schedule K-1 if you are a general partner or if it is a loss. For more information, see *Partnership Income or Loss*, earlier.

**Table 15-1. Figuring Farm Net Earnings**

IF your gross farm income is ...	THEN you ...
\$2,400 or less	Report two-thirds of your gross farm income as your net earnings from self-employment.
More than \$2,400, and your net farm profit is less than \$1,733	Report \$1,600 as your net earnings from self-employment.
More than \$2,400, and your net farm profit is \$1,733 or more	Cannot use this optional method. Use the regular method as discussed earlier.

**Social security credits.** Since two-thirds of \$2,400 is \$1,600, this counts for one credit (\$1,600 ÷ \$830) for social security coverage in 2001. You cannot use the full amount of your gross income to determine credits when you are figuring the SE tax on only two-thirds of that amount.

**Optional earnings less than actual earnings.** If your farm net earnings are less than your actual net earnings, you can still use the farm optional method. Your actual net earnings are your net earnings figured using the regular method explained, earlier.

**Example.** Your actual net earnings from self-employment are \$425 and your net earnings figured under the farm optional method are \$390. You owe no SE tax if you use the optional method, because your net earnings under the farm optional method are below \$400.

**Two or more farms.** If you operate your own farm and are also a partner in a farm partnership, or in any way have gross farm income from more than one farm, you must add your farm income from all farming sources to get your total earnings subject to SE tax. If you use the

farm optional method, you must add all gross income from farming to make the \$2,400 test.

**Example.** Your gross income from your own farm is \$600 and your distributive share of the gross income from a farm partnership is \$900. Since your gross income from farming is less than \$2,400 (\$1,500), your earnings subject to SE tax under the farm optional method are \$1,000 ( $\frac{2}{3} \times \$1,500$ ).

## Nonfarm Optional Method

This is an optional method available for determining net earnings from nonfarm self-employment, much like the farm optional method.

If you are also engaged in a nonfarm business, you may be able to use this method to compute your earnings subject to SE tax from your nonfarm business. You can use this method even if you do not use the farm optional method for determining your earnings subject to SE tax and even if you have a net loss from your nonfarm business. For more information about the nonfarm optional method, see Publication 533.



You cannot combine farming income with nonfarm income from self-employment to figure your earnings subject to SE tax under either of the optional methods.

## Using Both Optional Methods

If you use both optional methods, you must add together the net earnings figured under each method to arrive at your total net earnings from self-employment. You can report less than your total actual net earnings from farm and nonfarm self-employment. If you use both optional methods, you cannot report more than \$1,600 of 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 53 of Form 1040 and attach Schedule SE to Form 1040.



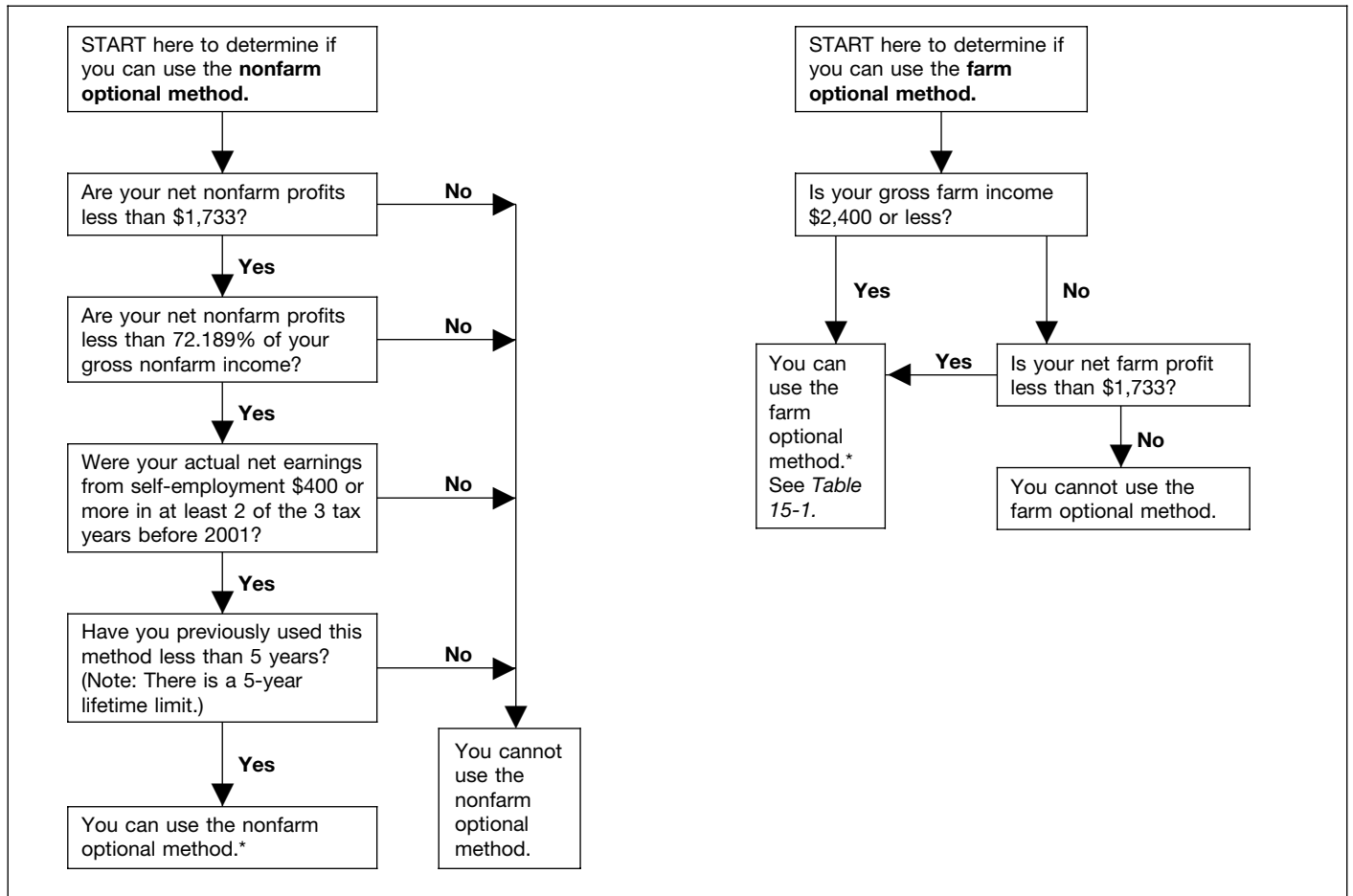
If you have to pay SE tax, you must file Form 1040 (with Schedule SE attached) even if you do not otherwise have to file a federal income tax return.

**Self-employment tax deduction.** You can deduct half of your SE tax in figuring your adjusted gross income. This deduction only affects your income tax. It does not affect either your net earnings from self-employment or your SE tax.

To deduct the tax, enter on Form 1040, line 27, the amount shown on the "Deduction for one-half of self-employment tax" line of the Schedule SE.

**Long Schedule SE.** Most taxpayers can use *Section A—Short Schedule SE* to figure their SE tax. However, the following taxpayers must use *Section B—Long Schedule SE*.

Figure 15-1. Can I Use the Optional Methods?



\*If you use both optional methods, see *Using Both Optional Methods* for limit on the amount to report.

- Individuals whose total wages and tips subject to social security or railroad retirement tax plus earnings subject to SE tax are more than \$80,400.
- Ministers, members of religious orders, and Christian Science practitioners not taxed on earnings from these sources (with IRS approval) who owe SE tax on other earnings.
- Employees who earned wages reported on Form W-2 of \$108.28 or more working for churches or church organizations that elected an exemption from employer social security and Medicare taxes.
- Individuals with tip income subject to social security or Medicare taxes that was not reported to their employers.
- Individuals who use one of the optional methods to figure earnings subject to SE tax.

**Joint return.** If you file a joint return, you cannot file a joint Schedule SE. This is true whether one spouse or both spouses have earnings subject to SE tax. Your spouse is not considered self-employed just because you are. If both of you have earnings subject to SE tax, each of you must complete a separate Schedule SE. However, if one spouse uses the *Short Schedule SE* and the other spouse has to use the *Long*

*Schedule SE*, both can use the same form. Attach both schedules to the joint return. If you and your spouse operate a business as a partnership, see *Husband and wife partners*, earlier, under *Who Must Pay Self-Employment Tax*.

**Community income.** If any of the income from a farm or business, other than a partnership, is community income under state law, it is included in the earnings subject to SE tax of the spouse carrying on the trade or business. The identity of the spouse carrying on the trade or business is determined by the facts in each case.

**Community income from a partnership.** If you are a partner and your distributive share of any income or loss from a trade or business carried on by the partnership is community income, treat your share as your earnings subject to SE tax. Do not treat any of your share as earnings of your spouse.

## 16.

# Employment Taxes

## Important Change for 2002

**Wage limit for social security tax.** The wage limit on wages subject to the social security tax for 2002 will be published in Publication 51, *Circular A, Agricultural Employer's Tax Guide*. There is no limit on wages subject to the Medicare tax.

## Important 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 2002 and thereafter if you deposited more than \$200,000



in federal depository taxes in 2000 or you had to use EFTPS in 2001.

See *Electronic Federal Tax Payment System (EFTPS)* under *Reporting and Paying Social Security, Medicare, and Withheld Income Taxes*.

## Introduction

You are generally required to withhold federal income tax from the wages of your employees. You may also be subject to social security and Medicare taxes under the Federal Insurance Contributions Act (FICA) and federal unemployment tax under the Federal Unemployment Tax Act (FUTA). This chapter includes information about these taxes.

You must also pay self-employment tax on your earnings from farming. See chapter 15 for information on self-employment tax.

## Topics

This chapter discusses:

- Farm employment
- Family employees
- Crew leaders
- Social security and Medicare taxes
- Income tax withholding
- Advance payment of the earned income credit
- Reporting and paying social security, Medicare, and withheld income taxes
- Federal unemployment (FUTA) tax

## Useful Items

You may want to see:

### Publication

- ❑ **15** Circular E, *Employer's Tax Guide*
- ❑ **15-A** *Employer's Supplemental Tax Guide*
- ❑ **51** Circular A, *Agricultural Employer's Tax Guide*

### Form (and Instructions)

- ❑ **W-2** Wage and Tax Statement
- ❑ **W-4** Employee's Withholding Allowance Certificate
- ❑ **W-5** Earned Income Credit Advance Payment Certificate
- ❑ **W-9** Request for Taxpayer Identification Number and Certification
- ❑ **940 (or 940-EZ)** Employer's Annual Federal Unemployment (FUTA) Tax Return
- ❑ **943** Employer's Annual Tax Return for Agricultural Employees
- ❑ **8109** Federal Tax Deposit Coupon

See chapter 21 for information about getting publications and forms.

## Farm Employment

In general, you are an employer of farm workers if your employees do any of the following types of work.

- Raising or harvesting agricultural or horticultural products on a farm.
- Operating, managing, conserving, improving, or maintaining your farm and its tools and equipment.
- Handling, processing, or packaging any agricultural or horticultural commodity if you produced more than half of the commodity.
- Work related to cotton ginning, turpentine, or gum resin products.
- Housework in your private home on a farm operated for profit. (You may report the taxes for household employees separately. See Publication 926, *Household Employer's Tax Guide*.)

For more information, see Publication 51.

Workers are generally your employees if they perform services subject to your control. You are not required to withhold or pay employment taxes for independent contractors who are not your employees. For more information, see Publication 15-A, *Employer's Supplemental Tax Guide*.

If you employ a family of workers, each worker subject to your control (not just the head of the family) is an employee.

Special rules apply to crew leaders. See *Crew Leaders*, later.

**Employer identification number (EIN).** If you have employees, you must have an EIN. If you do not have an EIN, request one on Form SS-4, *Application for Employer Identification Number*. Form SS-4 has information on how to apply for an EIN by mail or by telephone. Form SS-4 is available from either the IRS or the Social Security Administration (SSA).

**Employee's social security number (SSN).** An employee who does not have an SSN should submit Form SS-5, *Application for a Social Security Card*, to the SSA. Form SS-5 is available from any SSA office or by calling 1-800-772-1213. It is also available from the SSA's Internet web site at [www.ssa.gov](http://www.ssa.gov).

The employee must furnish evidence of age, identity, and U.S. citizenship with the Form SS-5. An employee who is 18 or older must appear in person with this evidence at an SSA office.

**INS Form I-9.** You must verify that each new employee is legally eligible to work in the United States. This includes completing the Immigration and Naturalization Service (INS) Form I-9, *Employment Eligibility Verification*. Form I-9 is available from INS offices or by calling 1-800-870-3676. It is also available from the INS's Internet web site at [www.ins.gov](http://www.ins.gov). You can contact the INS at 1-800-375-5283 for more information.

## Family Employees

Generally, the wages you pay to family members who are your employees are subject to employment taxes. However, certain exemptions may apply to wages paid to your child, spouse, or parent.

**Exemptions for your child.** Payments for the services of your child age 17 or younger who works for you in your trade or business (including a farm) are not subject to social security and Medicare taxes. However, see *Nonexempt services of a child or spouse*, later. Payments for the services of your child age 20 or younger who works for you, whether or not in your trade or business, are not subject to federal unemployment (FUTA) taxes. Although not subject to social security, Medicare, or FUTA tax, the child's wages still may be subject to 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 income tax withholding and social security and Medicare taxes, but not FUTA tax. However, payments for the services of your spouse employed by you in other than a trade or business, such as payments for household services in your home, are not subject to social security, Medicare, or FUTA taxes.

**Nonexempt services of a child or spouse.** Payments for the services of your child or spouse are subject to income tax withholding as well as social security, Medicare, and FUTA taxes if he or she works for any of the following entities.

- A corporation, even if it is controlled by you.
- A partnership, even if you are a partner. This does not apply to wages paid to your child if each partner is a parent of the child.
- An estate, even if it is the estate of a deceased parent.

In these situations, the child or spouse is considered to work for the corporation, partnership, or estate, not you.

**Exemptions for your parent.** Payments for the services of your parent employed by you in your trade or business are subject to income tax withholding and social security and Medicare taxes. Social security and Medicare taxes do not apply to wages paid to your parent for services not in your trade or business, but they do apply to payments for household services in your home if both the following conditions are satisfied.

- Your child lives in your home and is age 17 or younger or requires adult supervision for at least 4 continuous weeks in a calendar quarter due to a mental or physical condition.
- You are a widow or widower, divorced, or married to a person who, because of a physical or mental condition, cannot care for the child during such period.

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

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## Crew Leaders

If farm workers are provided by a crew leader, the crew leader may be the employer of the workers.

**Social security and Medicare taxes.** For social security and Medicare tax purposes, the crew leader is the employer of the workers if both the following requirements are met.

- The crew leader pays (either on his or her own behalf or on behalf of the farmer) the workers for their farm labor.
- The crew leader has not entered into a written agreement with the farmer under which the crew leader is designated as an employee of the farmer.

**Federal income tax withholding.** If the crew leader is the employer for social security and Medicare tax purposes, the crew leader is the employer for federal income tax withholding purposes.

**Federal unemployment (FUTA) tax.** For FUTA tax purposes, the crew leader is the employer of the workers if, in addition to the earlier requirements, either of the following requirements are met.

- The crew leader is registered under the Migrant and Seasonal Agricultural Worker Protection Act.
- Substantially all crew members operate or maintain mechanized equipment provided by the crew leader as part of the service to the farmer.

The farmer is the employer of workers furnished by a crew leader in all other situations. In addition, the farmer is the employer of workers furnished by a registered crew leader if the workers are the employees of the farmer under the common-law test. For example, some farmers employ individuals to recruit farm workers exclusively for them. Although these individuals may be required to register under the Migrant and Seasonal Agricultural Worker Protection Act, the workers are employed directly by the farmer. The farmer is the employer in these cases. For information about common-law employees, see section 1 of Publication 15–A.

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## Social Security and Medicare Taxes

All cash wages you pay to an employee during the year for farm work are subject to social security and Medicare taxes if you meet either of the following tests.

- You pay the employee \$150 or more in **cash** wages during the year for farm work (the \$150 test).

- You pay cash and noncash wages of \$2,500 or more during the year to all your employees for farm work (the \$2,500 test).

If the \$2,500 test for the group is not met, the \$150 test for an individual still applies. See *Table 16–1*.

**Exceptions.** The following wages are not subject to social security and Medicare taxes, even if you pay \$2,500 or more to all your farm workers. However, these wages count toward the \$2,500 test for determining whether other farm workers' wages are subject to social security and Medicare taxes.

- 1) Annual cash wages of less than \$150 paid to a seasonal farm worker. A seasonal farm worker is a worker who:
  - a) Works as a hand-harvest laborer,
  - b) Is paid piece rates in an operation usually paid on this basis in the region of employment,
  - c) Commutes daily from his or her permanent home to the farm, and
  - d) Worked in agriculture less than 13 weeks in the preceding calendar year.
- 2) Annual cash wages of less than \$1,300 paid to your household employee.

See Circular A for more information on these exceptions. See *Family Employees*, earlier, for certain exemptions from social security and Medicare taxes that apply to your child, spouse, and parent.

**Religious exemption.** An exemption from social security and Medicare taxes is available to members of a recognized religious sect opposed to insurance. This exemption is available only if both the employee and the employer are members of the sect.

For more information, see Publication 517, *Social Security and Other Information for Members of the Clergy and Religious Workers*.

**Cash wages.** Only cash wages paid to farm workers are subject to social security and Medicare taxes. Cash wages include checks, money orders, and any kind of money or cash.

Only cash wages subject to social security and Medicare taxes are credited to your employees for social security benefit purposes. Payments not subject to these taxes, such as commodity wages, do not contribute to your employees' social security coverage. For information about social security benefits, contact the Social Security Administration. Internet users can go to [www.ssa.gov](http://www.ssa.gov) for more information.

**Noncash wages.** Noncash wages include food, lodging, clothing, transportation passes, and other goods and services. Noncash wages paid to farm workers, including commodity wages, are not subject to social security and Medicare taxes. However, they **are** subject to these taxes if the substance of the transaction is a cash payment.

Report the value of noncash wages on Form W–2 in box 1, *Wages, tips, other compensation*, together with cash wages. Do not show noncash wages in box 3, *Social security wages*, or in box 5, *Medicare wages and tips*.

**Tax rates and social security wage limit.** For 2002, the employer and the employee will each pay both the following taxes.

- 6.2% of cash wages for social security tax (old-age, survivors, and disability insurance).
- 1.45% of cash wages for Medicare tax (hospital insurance).

**Wage limit.** The limit on 2002 wages subject to the social security tax will be published in Circular A. There is no limit on wages subject to the Medicare tax. All covered wages are subject to the Medicare tax.

**Paying employee's share.** If you would rather pay the employee's share of social security and Medicare taxes without deducting it from his or her wages, you may do so. If you do not deduct the employee's share, you must still pay it. It is additional income to the employee. You must include it on the employee's Form W–2 in box 1, but do not count it as social security and Medicare wages (boxes 3 and 5 on Form W–2) or as wages for federal unemployment (FUTA) tax purposes.

**Example.** Jane operates a small family fruit farm. She employs day laborers in the picking season to enable her to timely get her crop to market. She does not deduct the employees' share of social security and Medicare taxes from their pay; instead, she pays it on their behalf. When her accountant, Susan, prepares the employees' Forms W-2, she adds each employee's share of social security and Medicare taxes paid by Jane to the employee's wage income (box 1 of Form W–2), but does **not** include it in box 3 (social security wages) or box 5 (Medicare wages and tips).

Jane paid Mary \$1,000 during the year. Susan enters \$1,076.50 in box 1 of Mary's Form W–2 (\$1,000 wages plus \$76.50 social security and Medicare taxes paid for Mary). She enters \$1,000 in boxes 3 and 5.

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## Income Tax Withholding

If the cash wages you pay farm workers are subject to social security and Medicare taxes, they are also subject to income tax withholding. Although noncash wages are subject to income tax, withhold income tax only if you and the employee agree to do so. The amount to withhold is figured on gross wages without taking out social security and Medicare taxes, union dues, insurance, etc.

**Form W–4.** Generally, the amount of income tax you withhold is based on the employee's marital status and withholding allowances claimed on the employee's Form W–4. In general, an employee can claim withholding allowances on Form W–4 equal to the number of exemptions the employee will be entitled to claim on his or her tax return. An employee may also be able to claim a special withholding allowance and allowances for estimated deductions and credits.

Do not withhold income tax from the wages of an employee who, by filing Form W–4, certi-

files that he or she had no income tax liability last year and anticipates no liability for the current year.

You should give each new employee a Form W-4 as soon as you hire the employee. Have the employee complete and return the form to you before the first payday. If the employee does not return the completed form to you, you must withhold income tax as if the employee is single and claims no withholding allowances.

**New Form W-4 for 2002.** You should make the 2002 Form W-4 available to your employees and encourage them to check their income tax withholding for 2002. Those employees who owed a large amount of tax or received a large refund for 2001 may want to file a new Form W-4.

**How to figure withholding.** You can use one of several methods to determine the amount to withhold. The methods are described in Circular A, which contains tables showing the correct amount of income tax you should withhold. Circular A also contains additional information about income tax withholding.

**Nonemployee compensation.** Generally, you are not required to withhold tax on payments for services to individuals who are not your employees. However, you may be required to report these payments on Form 1099-MISC, *Miscellaneous Income*, and to withhold under the backup withholding rules. See *Information Returns* in chapter 2 for information.

## Advance Payment of Earned Income Credit

An employee who is eligible for the earned income credit (EIC) and who has a qualifying child is entitled to receive EIC payments with his or her pay during the year. To get these payments, the employee must give you a properly completed **Form W-5, Earned Income Credit Advance Payment Certificate**. You are usually required to make advance EIC payments to employees who give you a properly completed Form W-5, but you are not required to make these payments to farm workers paid on a daily basis.

The payment is added to the employee's pay each payday. It is figured from tables in Circular A. You reduce your liability for income tax withholding, social security tax, and Medicare tax by the total advance EIC payments made. For more information, see Circular A.

**Notification.** You must provide notification about the EIC to each employee who worked for you at any time during the year and from whom you did not withhold any income tax. However, you do not have to notify employees who claim exemption from withholding on Form W-4.

You meet the notification requirement by giving each employee any of the following.

- Form W-2, which contains the notification on the back of Copy B.
- A substitute Form W-2 with the exact EIC wording shown on the back of copy B of Form W-2.

- Notice 797, *Possible Federal Tax Refund Due to the Earned Income Credit (EIC)*.
- Your own written statement with the exact wording of Notice 797.

For more information about notification requirements and claiming the EIC, see Notice 1015, *Have You Told Your Employees About the Earned Income Credit (EIC)?*

## Reporting and Paying Social Security, Medicare, and Withheld Income Taxes

You must withhold income, social security, and Medicare taxes required to be withheld from the salaries and wages of your employees. You are liable for the payment of these taxes to the federal government whether or not you collect them from your employees. If, for example, you withhold less than the correct tax from an employee's wages, you are still liable for the full amount. You must also pay the employer's share of social security and Medicare taxes.

**Form 943.** Report withheld income tax and social security and Medicare taxes on Form 943. The 2001 form is due by January 31, 2002 (or February 11 if the taxes were timely deposited in full).

**Deposits.** You will generally have to make periodic tax deposits if you are liable for \$2,500 or more of social security and Medicare taxes and withheld income tax during the year.

For more information on deposit rules, see Circular A.

**Electronic Federal Tax Payment System (EFTPS).** You may have to deposit taxes using EFTPS. You must use EFTPS to make deposits of all depository tax liabilities (including social security, Medicare, withheld income, excise, and corporate income taxes) you incur in 2002 if you deposited more than \$200,000 in federal depository taxes in 2000. If you first meet the \$200,000 threshold in 2001, you must begin depositing using EFTPS in 2003. Once you meet the \$200,000 threshold, you must continue to make deposits using EFTPS in later years even if subsequent deposits are less than the \$200,000 threshold.

If you must use EFTPS but fail to do so, you may be subject to a 10% penalty.

If you do not have to use EFTPS because you did not meet the \$200,000 threshold, you can voluntarily make deposits using EFTPS. If you are using EFTPS voluntarily, you will not be subject to the 10% penalty if you make a deposit using a paper coupon.

For information about EFTPS, access the IRS web site on the Internet at [www.eftps.gov](http://www.eftps.gov), or see Publication 966, *Now a Full Range of Electronic Choices to Pay ALL Your Federal Taxes*.

To enroll in EFTPS, call one of the following phone numbers.

- 1-800-945-8400
- 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 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.

See *Form W-2 under Information Returns* in chapter 2.

**Trust fund recovery penalty.** If you are responsible for withholding, accounting for, depositing, or paying withholding taxes and **willfully** fail to do so, you can be held liable for a penalty equal to the tax not paid. A responsible person can be an officer of a corporation, a partner, a sole proprietor, or an employee of any form of business. A trustee or agent with authority over the funds of the business can also be held responsible for the penalty.

"Willfully" means voluntarily, consciously, and intentionally. Paying other expenses of the business instead of the taxes due is acting willfully.

## Federal Unemployment (FUTA) Tax

You must pay FUTA tax if you meet **either** of the following tests.

- You paid cash wages of \$20,000 or more to farm workers in any calendar quarter during the current or preceding calendar year.
- You employed 10 or more farm workers for some part of at least 1 day during any 20 or more different calendar weeks during the current or preceding calendar year.

These rules do not apply to exempt services of your spouse, your parents, or your children under age 21. See *Family Employees*, earlier.

**Alien farm workers.** Wages paid to aliens admitted on a temporary basis to the United States to perform farm work (also known as "H-2(A)" visa workers) are exempt from FUTA tax. However, include your employment of these workers and the wages you paid them to determine whether you meet either test above.

**Commodity wages.** Payments in kind for farm labor are not cash wages. Do not count them to figure whether you are subject to FUTA tax or to figure how much tax you owe.

**Tax rate and credit.** The gross FUTA tax is 6.2% of the first \$7,000 cash wages you pay each employee. However, you are given a credit of up to 5.4% for the state unemployment tax you pay. The net tax rate, therefore, can be as low as 0.8% (6.2% - 5.4%). If your state tax rate (experience rate) is less than 5.4%, you may still be allowed the full 5.4% credit.

If you do not pay the state tax, you cannot take the credit. If you are exempt from state unemployment tax for any reason, the full 6.2%



Table 16–1. **How Do Employment Taxes Apply to Farmwork?**

	<b>Income Tax Withholding, Social Security and Medicare</b>	<b>Federal Unemployment Tax</b>
<b>Farm Employment Includes:</b>		
<ol style="list-style-type: none"> <li>1. Cultivating soil; raising or harvesting any agricultural or horticultural commodity; the care of livestock, poultry, bees, fur-bearing animals, or wildlife.</li> <li>2. Work on a farm if major farm duties are in management or maintenance, etc., of farm, tools, or equipment, or salvaging timber, or clearing brush and other debris, left by hurricane.</li> <li>3. Work in connection with the production and harvesting of turpentine and other oleoresinous products.</li> <li>4. Cotton ginning.</li> <li>5. Operation or maintenance of ditches, reservoirs, canals, or waterways, not owned or operated for profit, used only for supplying or storing water for farming purposes.</li> <li>6. Processing, packaging, etc., any commodity in its unmanufactured state, if employed by farm operator or unincorporated group of not more than 20 farm operators who produced over half of commodity processed; or other groups of operators if they produced all of the commodity.</li> </ol>	Taxable if \$150 or \$2,500 test is met. See <i>Social Security and Medicare Taxes</i> .	Taxable if either test in the discussion <i>Federal Unemployment (FUTA) Tax</i> is met.
<b>Employment Not Considered Farmwork:</b>		
<ol style="list-style-type: none"> <li>1. Hatching poultry off the farm.</li> <li>2. Processing maple sap into maple syrup or sugar.</li> <li>3. Handling or processing commodities after delivery to terminal market for commercial canning or freezing.</li> <li>4. Operation or maintenance of ditches, canals, reservoirs, or waterways not meeting tests in (5) above.</li> <li>5. Processing, packaging, delivering, etc., any commodity in its unmanufactured state if group of farm operators do not meet the tests in (6) above.</li> </ol>	Taxable under general employment rules. (Special farm rules do not apply.) See Circular E.	Taxable under general FUTA rules. (Special farm rules do not apply.) See Circular E.
<b>Special Employment Situations:</b>		
1. Services not in the course of employer's trade or business on farm operated for profit (cash payments only).	Taxable if \$150 or \$2,500 test is met unless performed by employer's parent.	Taxable only if \$50 or more is paid in a quarter and employee works on 24 or more different days in current or prior quarter.
2. Workers admitted under section 101(a)(15)(H)(ii)(a) of the Immigration and Nationality Act on a temporary basis to perform agricultural labor (H-2(A) workers).	Exempt.	Exempt.
3. Family employment.	Exempt for employer's child under age 18, but counted for \$150 or \$2,500 test. Taxable for spouse of employer.	Exempt if services performed by employer's parent or spouse or by employer's child under age 21.

rate applies. See the instructions for Form 940 for additional information.

**More information.** For more information on FUTA tax, see Circular A.

## Reporting and Paying FUTA Tax

The FUTA tax is imposed on you as the employer. It must not be collected or deducted from the wages of your employees.

**Form 940.** Report FUTA tax on Form 940, *Employer's Annual Federal Unemployment (FUTA) Tax Return*. The 2001 form is due January 31, 2002, (or February 11, 2002, if you deposit the tax on time and in full.)

**Form 940–EZ.** You can use Form 940–EZ, a simplified version of Form 940, if you meet all the following tests.

- You paid unemployment contributions to only one state.

- You paid all state unemployment contributions by the due date of Form 940 or 940–EZ.

- All wages subject to FUTA tax were also subject to your state's unemployment tax.

**Deposits.** If at the end of any calendar quarter you owe, but have not yet deposited, more than \$100 in FUTA tax for the year, you must make a deposit by the end of the following month. If the undeposited tax is \$100 or less at the end of a quarter, you do not have to deposit it. You must

add it to the tax for the next quarter. If the total undeposited tax is more than \$100 at the end of the next quarter, a deposit will be required. If the total undeposited tax at the end of the 4th quarter is \$100 or less, you can either make a deposit or pay it with your return by the January 31 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 Income Taxes*, earlier, for a discussion of the requirement for making deposits electronically.

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## 17.

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# Retirement Plans

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## Important Changes for 2002

Many changes to the tax laws for retirement plans were made by the Economic Growth and Tax Relief Reconciliation Act of 2001 that was enacted on June 7, 2001. However, most of those changes do not take effect until after December 31, 2001, and are not covered in this chapter. For information about those changes, see Publication 560, *Retirement Plans for Small Business*, or Publication 553, *Highlights of 2001 Tax Changes*.

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## Introduction

This chapter discusses retirement plans you can set up and maintain for yourself and your employees. Retirement plans are savings plans that offer you tax advantages to set aside money for your own and your employees' retirement.

In general, a sole proprietor or a partner is treated as an employee for participating in a retirement plan.

SEP, SIMPLE, and qualified plans offer you and your employees a tax favored way to save for retirement. You can deduct contributions you make to the plan for your employees. If you are a sole proprietor, you can deduct contributions you make to the plan for yourself. You can also deduct trustees' fees if contributions to the plan do not cover them. Earnings on the contributions are generally tax free until you or your employees receive distributions from the plan in later years.

Under certain plans, employees can have you contribute limited amounts of their before-tax pay to a plan. These amounts (and the earnings on them) are generally tax free until your employees receive distributions from the plan in later years.

In general, individuals who are employed or self-employed can also set up and contribute to individual retirement arrangements (IRAs).

## Topics

This chapter discusses:

- Simplified employee pension (SEP)
- SIMPLE retirement plan
- Qualified plan
- Individual retirement arrangement (IRA)

## Useful Items

You may want to see:

### Publication

- ❑ **560** Retirement Plans for Small Business (SEP, SIMPLE, and Qualified Plans)
- ❑ **590** Individual Retirement Arrangements (IRAs)

### Form (and Instructions)

- ❑ **W-2** Wage and Tax Statement
- ❑ **5304-SIMPLE** Savings Incentive Match Plan for Employees of Small Employers (SIMPLE) (Not Subject to the Designated Financial Institution Rules)
- ❑ **5305-SIMPLE** Savings Incentive Match Plan for Employees of Small Employers (SIMPLE) (for Use With a Designated Financial Institution)

See chapter 21 for information about getting publications and forms.

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## Simplified Employee Pension (SEP)

A simplified employee pension (SEP) is a written plan that allows you to make deductible contributions toward your own and your employees' retirement without getting involved in more complex retirement plans. A corporation also can have a SEP and make deductible contributions toward its employees' retirement. But certain advantages available to qualified plans, such as the special tax treatment that may apply to lump-sum distributions, do not apply to SEPs.

Under a SEP, you make the contributions to a traditional individual retirement arrangement (called a SEP-IRA) set up by or for each eligible employee.

SEP-IRAs are set up for, at a minimum, each eligible employee. A SEP-IRA may have to be set up for a leased employee, but need not be set up for an excludable employee. For more information, see Publication 560.

**Form 5305-SEP.** You may be able to use Form 5305-SEP, *Simplified Employee Pension-Individual Retirement Accounts Contribution Agreement*, in setting up your SEP.

## Contribution Limits

Contributions you make for a year to a common-law employee's SEP-IRA are limited to the lesser of \$35,000 or 15% of the employee's compensation. Compensation generally does not include your contributions to the SEP, but does include certain elective deferrals unless you choose not to include them.

**Annual compensation limit.** You generally cannot consider an employee's compensation over \$170,000 when you figure your contribution limit for that employee.

**More than one plan.** If you also contribute to a defined contribution retirement plan (defined later), annual additions to all a participant's accounts are limited to the lesser of \$35,000 or 25% of the participant's compensation. When you figure this limit, you must add your contributions to all defined contribution plans. A SEP is considered a defined contribution plan for this limit.

**Contributions for yourself.** The annual limits on your contributions to a common-law employee's SEP-IRA also apply to contributions you make to your own SEP-IRA.

## Deduction Limit

The most you can deduct for employer contributions for a common-law employee is 15% of the compensation paid to him or her during the year from the business that has the plan.


**Deduction of contributions for yourself.** When figuring the deduction for employer contributions made to your own SEP-IRA, compensation is your net earnings from self-employment minus both the following amounts.

- 1) The deduction for one-half your self-employment tax.
- 2) The deduction for contributions to your own SEP-IRA.

The deduction for contributions to your own SEP-IRA and your net earnings depend on each other. For this reason, you determine the deduction for contributions to your own SEP-IRA indirectly by reducing the contribution rate called for in your plan. Use the *Rate Worksheet for Self-Employed* shown under *Qualified Plan*, later, to figure the rate.

**SEP and profit-sharing plans.** If you also contributed to a qualified profit-sharing plan, you must reduce the 15% deduction limit for that plan by the allowable deduction for contributions to the SEP-IRAs of those participating in both the SEP plan and the profit-sharing plan.

**SEP and another qualified plan.** If you also contributed to any other type of qualified plan, treat the SEP as a separate profit-sharing plan when applying the overall 25% deduction limit described in section 404(h)(3) of the Internal Revenue Code.

 **TIP** If your SEP contribution is more than the deduction limit (nondeductible contribution), you can carry over and deduct the difference in later years. However, the contribution carryover, when combined with the contribution for the later year, is subject to the deduction limit for that year.

**Employee contributions.** Employees can also make contributions of up to \$2,000 for 2001 to their SEP-IRAs independent of the employer's SEP contributions. However, the employee's deduction for IRA contributions may be reduced or eliminated because the employee is covered by an employer retirement plan (the SEP plan). See Publication 590 for details.

## Salary Reduction Simplified Employee Pension (SARSEP)



*An employer is no longer allowed to set up a SARSEP. However, participants in a SARSEP set up before 1997 (including employees hired after 1996) can continue to have their employer contribute part of their pay to the plan.*

A SARSEP is a SEP set up before 1997 that includes a salary reduction arrangement. Under the arrangement, employees can choose to have you contribute part of their pay to their SEP-IRAs rather than receive it in cash. This contribution is called an "elective deferral" because employees choose (elect) to set aside the money and the tax on the money is deferred until it is distributed.

This choice is available only if all the following requirements are met.

- The SARSEP was set up before 1997.
- At least 50% of the eligible employees choose the salary reduction arrangement.
- There were 25 or fewer eligible employees (or employees who would have been eligible if you had maintained a SEP) at any time during the preceding year.
- Each eligible highly compensated employee's deferral percentage each year is no more than 125% of the average deferral percentage (ADP) of all nonhighly compensated employees eligible to participate (the ADP test). See Publication 560 for the definition of a highly compensated employee and information on how to figure the deferral percentage.

**Limit on elective deferrals.** In general, the total income an employee can defer under a SARSEP and certain other elective deferral arrangements for 2001 is limited to the lesser of \$10,500 or 15% of the participant's compensation (as defined in Publication 560). This limit applies only to amounts that reduce the employee's pay, not to any contributions from employer funds.

**Employment taxes.** Elective deferrals that meet the ADP test are not subject to income tax in the year of deferral, but they are included in wages for social security, Medicare, and federal unemployment (FUTA) tax.

## Reporting SEP Contributions on Form W-2

Your contributions to an employee's SEP-IRA are excluded from the employee's income. Unless there are contributions under a salary reduction arrangement, do not include these

contributions in your employee's wages on Form W-2 for income, social security, or Medicare tax purposes. Your SEP contributions under a salary reduction arrangement are included in your employee's wages for social security and Medicare tax purposes.

**Example.** Jim's salary reduction arrangement calls for 10% of his salary to be contributed by his employer as an elective deferral to Jim's SEP-IRA. Jim's salary for the year is \$30,000 (before reduction for the deferral). The employer chose not to treat deferrals as compensation under the arrangement. To figure the deferral, the employer multiplies Jim's salary of \$30,000 by 9.0909%, the reduced rate equivalent of 10%, to get the deferral of \$2,727.27. (This method is the same one you, as a self-employed person, use to figure the contributions you make on your own behalf. See *Rate Worksheet for Self-Employed under Qualified Plan*.)

On Jim's Form W-2, his employer shows total wages of \$27,272.73 (\$30,000 - \$2,727.27), social security wages of \$30,000, and Medicare wages of \$30,000. Jim reports \$27,272.73 as wages on his individual income tax return.

If his employer does not make the choice explained above, Jim's deferral would be \$3,000 (\$30,000 x 10%). In this case, the employer uses the rate called for under the arrangement (not the reduced rate) to figure the deferral and the ADP test. On Jim's Form W-2, the employer shows total wages of \$27,000 (\$30,000 - \$3,000), social security wages of \$30,000, and Medicare wages of \$30,000. Jim reports \$27,000 as wages on his return.

In either case, the maximum deductible contribution would be \$3,913.05 (\$30,000 x 13.0435%).

**More information.** For more information on employer withholding requirements, see Publication 15, *Circular E, Employer's Tax Guide*.

For more information on SEPs, see Publication 560.

## SIMPLE Retirement Plans

A Savings Incentive Match Plan for Employees (SIMPLE plan) is a written arrangement that provides you and your employees with a simplified way to make contributions to provide retirement income. Under a SIMPLE plan, employees can choose to make salary reduction contributions to the plan rather than receiving these amounts as part of their regular pay. In addition, you will contribute matching or nonelective contributions.

SIMPLE plans can only be maintained on a calendar-year basis.

A SIMPLE plan can be set up in either of the following ways.

- Using SIMPLE IRAs (SIMPLE IRA plan).
- As part of a 401(k) plan (SIMPLE 401(k) plan).

See Publication 560 for information on SIMPLE 401(k) plans.



*Many financial institutions will help you set up a SIMPLE plan.*

## SIMPLE IRA Plan

A SIMPLE IRA plan is a retirement plan that uses SIMPLE IRAs for each eligible employee. Under a SIMPLE IRA plan, a SIMPLE IRA must be set up for each eligible employee. For the definition of an eligible employee, see *Who Can Participate in a SIMPLE IRA Plan*, later.

### Who Can Set Up a SIMPLE IRA Plan?

You can set up a SIMPLE IRA plan if you meet both the following requirements.

- You meet the employee limit.
- You do not maintain another qualified plan unless the other plan is for collective bargaining employees.

**Employee limit.** You can set up a SIMPLE IRA plan only if you had 100 or fewer employees who received \$5,000 or more in compensation from you for the preceding year. Under this rule, you must take into account **all** employees employed at any time during the calendar year regardless of whether they are eligible to participate. Employees include self-employed individuals who received earned income and leased employees.

Once you set up a SIMPLE IRA plan, you must continue to meet the 100-employee limit each year you maintain the plan.

**Grace period for employers who cease to meet the 100-employee limit.** If you maintain the SIMPLE IRA plan for at least 1 year and you cease to meet the 100-employee limit in a later year, you will be treated as meeting it for the 2 calendar years immediately following the calendar year for which you last met it.

A different rule applies if you do not meet the 100-employee limit because of an acquisition, disposition, or similar transaction. Under this rule, the SIMPLE IRA plan will be treated as meeting the 100-employee limit for the year of the transaction and the 2 following years if both the following conditions are satisfied.

- Coverage under the plan has not significantly changed during the grace period.
- The SIMPLE IRA plan would have continued to qualify after the transaction if you had remained a separate employer.



*The grace period for acquisitions, dispositions, and similar transactions also applies if, because of these types of transactions, you do not meet the rules explained under Other qualified plan or Who Can Participate in a SIMPLE IRA Plan, below.*

**Other qualified plan.** The SIMPLE IRA plan generally must be the only retirement plan to which you make contributions, or benefits accrue, for service in any year beginning with the year the SIMPLE IRA plan becomes effective.



**Exception.** If you maintain a qualified plan for collective bargaining employees, you are permitted to maintain a SIMPLE IRA plan for other employees.

## Who Can Participate in a SIMPLE IRA Plan?

**Eligible employee.** Any employee who received at least \$5,000 in compensation during any 2 years preceding the current calendar year and is reasonably expected to receive at least \$5,000 during the current calendar year is eligible to participate. The term “employee” includes a self-employed individual who received earned income.

You can use less restrictive eligibility requirements (but not more restrictive ones) by eliminating or reducing the prior year compensation requirements, the current year compensation requirements, or both. For example, you can allow participation for employees who received at least \$3,000 in compensation during any preceding calendar year. However, you cannot impose any other conditions on participating in a SIMPLE IRA plan.

**Excludable employees.** The following employees do not need to be covered under a SIMPLE IRA plan.

- Employees who are covered by a union agreement and whose retirement benefits were bargained for in good faith by the employees’ union and you.
- Nonresident alien employees who have received no U.S. source wages, salaries, or other personal services compensation from you.

**Compensation.** Compensation for employees is the total wages required to be reported on Form W-2. Compensation also includes the salary reduction contributions made under this plan, compensation deferred under a section 457 plan, and the employees’ elective deferrals under a section 401(k) plan, a SARSEP, or a section 403(b) annuity contract. If you are self-employed, compensation is your net earnings from self-employment (line 4 of Short Schedule SE (Form 1040)) before subtracting any contributions made to the SIMPLE IRA plan for yourself.

## How To Set Up a SIMPLE IRA Plan

You can use Form 5304-SIMPLE or Form 5305-SIMPLE to set up a SIMPLE IRA plan. Each form is a model savings incentive match plan for employees (SIMPLE) plan document. Which form you use depends on whether you select a financial institution or your employees select the institution that will receive the contributions.

Use **Form 5304-SIMPLE** if you allow each plan participant to select the financial institution for receiving his or her SIMPLE IRA plan contributions. Use **Form 5305-SIMPLE** if you require that all contributions under the SIMPLE IRA plan be deposited initially at a designated financial institution.

The SIMPLE IRA plan is adopted when you (and the designated financial institution, if any)

have completed all appropriate boxes and blanks on the form and you have signed it. Keep the original form. Do not file it with the IRS.

**Other uses of the forms.** If you set up a SIMPLE IRA plan using Form 5304-SIMPLE or Form 5305-SIMPLE, you can use the form to satisfy other requirements, including the following.

- Meeting employer notification requirements for the SIMPLE IRA plan. Page 3 of Form 5304-SIMPLE and Page 3 of Form 5305-SIMPLE contain a *Model Notification to Eligible Employees* that provides the necessary information to the employee.
- Maintaining the SIMPLE IRA plan records and proving you set up a SIMPLE IRA plan for employees.

### Deadline for setting up a SIMPLE IRA plan.

You can set up a SIMPLE IRA plan effective on any date between January 1 and October 1 of a year, provided you did not previously maintain a SIMPLE IRA plan. If you previously maintained a SIMPLE IRA plan, you can set up a SIMPLE IRA plan effective only on January 1 of a year. This requirement does not apply if you are a new employer that comes into existence after October 1 of the year the SIMPLE IRA plan is set up and you set up a SIMPLE IRA plan as soon as administratively feasible after you come into existence. A SIMPLE IRA plan cannot have an effective date that is before the date you actually adopt the plan.

**Setting up a SIMPLE IRA.** SIMPLE IRAs are the individual retirement accounts or annuities into which the contributions are deposited. A SIMPLE IRA must be set up for each eligible employee. **Forms 5305-S, SIMPLE Individual Retirement Trust Account, and 5305-SA, SIMPLE Individual Retirement Custodial Account,** are model trust and custodial account documents the participant and the trustee (or custodian) can use for this purpose.

A SIMPLE IRA cannot be designated as a Roth IRA. Contributions to a SIMPLE IRA will not affect the amount an individual can contribute to a Roth IRA.

**Deadline for setting up a SIMPLE IRA.** A SIMPLE IRA must be set up for an employee before the first date by which a contribution is required to be deposited into the employee’s IRA. See *Time limits for contributing funds* later under *Contribution Limits*.

## Notification Requirement

If you adopt a SIMPLE IRA plan, you must notify each employee of the following information before the beginning of the election period.

- 1) The employee’s opportunity to make or change a salary reduction choice under a SIMPLE IRA plan.
- 2) Your choice to make either reduced matching contributions or nonelective contributions (discussed later).
- 3) A summary description and the location of the plan. The financial institution should provide you with this information.

- 4) Written notice that his or her balance can be transferred without cost or penalty if you use a designated financial institution.

**Election period.** The election period is generally the 60-day period immediately preceding January 1 of a calendar year (November 2 to December 31 of the preceding calendar year). However, the dates of this period are modified if you set up a SIMPLE IRA plan in mid-year (for example, on July 1) or if the 60-day period falls before the first day an employee becomes eligible to participate in the SIMPLE IRA plan.

A SIMPLE IRA plan can provide longer periods for permitting employees to enter into salary reduction agreements or to modify prior agreements. For example, a SIMPLE IRA plan can provide a 90-day election period instead of the 60-day period. Similarly, in addition to the 60-day period, a SIMPLE IRA plan can provide quarterly election periods during the 30 days before each calendar quarter, other than the first quarter of each year.

## Contribution Limits

Contributions are made up of salary reduction contributions and employer contributions. You, as the employer, must make either matching contributions or nonelective contributions, defined later. No other contributions can be made to the SIMPLE IRA plan. These contributions, which you can deduct, must be made timely. See *Time limits for contributing funds*, later.

**Salary reduction contributions.** The amount the employee chooses to have you contribute to a SIMPLE IRA on his or her behalf cannot be more than \$6,500 for 2001. These contributions must be expressed as a percentage of the employee’s compensation unless you permit the employee to express them as a specific dollar amount. You cannot place restrictions on the contribution amount (such as limiting the contribution percentage), except to comply with the \$6,500 limit.

If an employee is a participant in any other employer plan during the year and has elective salary reductions or deferred compensation under those plans, the salary reduction contributions under a SIMPLE IRA plan also are elective deferrals that count toward the overall \$10,500 annual limit on exclusion of salary reductions and other elective deferrals.

If the other plan is a deferred compensation plan of a state or local government or a tax-exempt organization, the limit on elective deferrals is \$8,500.

**Employer matching contributions.** You are generally required to match each employee’s salary reduction contributions on a dollar-for-dollar basis up to 3% of the employee’s compensation. This requirement does not apply if you make nonelective contributions as discussed later.

**Example.** In 2001, your employee, John Rose, earned \$25,000 and chose to defer 5% of his salary. You make a 3% matching contribution. The total contribution you can make for John is \$2,000, figured as follows.

Salary reduction contributions (\$25,000 × .05) . . . . .	\$1,250
Employer matching contribution (\$25,000 × .03) . . . . .	750
<b>Total contributions</b> . . . . .	<b><u>\$2,000</u></b>

**Lower percentage.** If you choose a matching contribution less than 3%, the percentage must be at least 1%. You must notify the employees of the lower match within a reasonable period of time before the 60-day election period (discussed earlier) for the calendar year. You cannot choose a percentage less than 3% for more than 2 years during the 5-year period that ends with (and includes) the year for which the choice is effective.

**Nonelective contributions.** Instead of matching contributions, you can choose to make nonelective contributions of 2% of compensation on behalf of each eligible employee who has at least \$5,000 of compensation (or some lower amount of compensation that you select) from you for the year. If you make this choice, you must make nonelective contributions whether or not the employee chooses to make salary reduction contributions. Only \$170,000 of the employee's compensation can be taken into account to figure the contribution limit.

If you choose this 2% contribution formula, you must notify the employees within a reasonable period of time before the 60-day election period (discussed earlier) for the calendar year.

**Example 1.** In 2001, your employee, Jane Wood, earned \$36,000 and chose to have you contribute 10% of her salary. You make a 2% nonelective contribution. The total contributions you can make for her are \$4,320, figured as follows.

Salary reduction contributions (\$36,000 × .10) . . . . .	\$3,600
2% nonelective contributions (\$36,000 × .02) . . . . .	720
<b>Total contributions</b> . . . . .	<b><u>\$4,320</u></b>

**Example 2.** Using the same facts as in *Example 1*, above, the maximum contribution you can make for Jane if she earned \$75,000 is \$8,000, figured as follows.

Salary reduction contributions (maximum amount) . . . . .	\$6,500
2% nonelective contributions (\$75,000 × .02) . . . . .	1,500
<b>Total contributions</b> . . . . .	<b><u>\$8,000</u></b>

**Time limits for contributing funds.** You must make the salary reduction contributions to the SIMPLE IRA within 30 days after the end of the month in which the amounts would otherwise have been payable to the employee in cash. You must make matching contributions or nonelective contributions by the due date (including extensions) for filing your federal income tax return for the year.

### When To Deduct Contributions

You can deduct SIMPLE IRA contributions in the tax year with or within which the calendar year for which contributions were made ends. You can deduct contributions for a particular tax year if they are made for that tax year and are made by the due date (including extensions) of your federal income tax return for that year.

**Example 1.** Your tax year is the fiscal year ending June 30. Contributions under a SIMPLE IRA plan for the calendar year 2001 (including contributions made in 2001 before July 1, 2001) are deductible in the tax year ending June 30, 2002.

**Example 2.** You are a sole proprietor whose tax year is the calendar year. Contributions under a SIMPLE IRA plan for the calendar year 2001 (including contributions made in 2002 by April 15, 2002) are deductible in the 2001 tax year.

### Where To Deduct Contributions

Deduct contributions you make for your common-law employees on your tax return. For example, sole proprietors deduct them on Schedule C (Form 1040) or Schedule F (Form 1040), partnerships deduct them on Form 1065, and corporations deduct them on Form 1120, Form 1120-A, or Form 1120S.

Sole proprietors and partners deduct contributions for themselves on line 29 of Form 1040. (If you are a partner, contributions for yourself are shown on the Schedule K-1 (Form 1065) you receive from the partnership).

### Tax Treatment of Contributions

You can deduct your contributions and your employees can exclude these contributions from their gross income. SIMPLE IRA contributions are not subject to federal income tax withholding. However, salary reduction contributions are subject to social security, Medicare, and federal unemployment (FUTA) taxes. Matching and nonelective contributions are not subject to these taxes.

**Reporting on Form W-2.** Do not include SIMPLE IRA contributions in the "Wages, tips, other compensation" box of Form W-2. However, salary reduction contributions must be included in the boxes for social security wages and Medicare wages and tips. Also include the proper code in Box 12. For more information, see the instructions for Forms W-2 and W-3.

### Distributions (Withdrawals)

Distributions from a SIMPLE IRA are subject to IRA rules and generally are includible in income for the year received. Tax-free rollovers can be made from one SIMPLE IRA into another SIMPLE IRA. A rollover from a SIMPLE IRA to another IRA can be made tax free only after a 2-year participation in the SIMPLE IRA plan.

Early withdrawals generally are subject to a 10% additional tax. However, the additional tax is increased to 25% if funds are withdrawn within 2 years of beginning participation.

**More information.** See Publication 590 for information about IRA rules, including those on the tax treatment of distributions, rollovers, required distributions, and income tax withholding.

### More Information on SIMPLE IRA Plans

If you need more help to set up and maintain SIMPLE IRA plans, see the following IRS notice and revenue procedure.

**Notice 98-4.** This notice contains questions and answers about the implementation and operation of SIMPLE IRA plans, including the election and notice requirements for these plans. Notice 98-4 is in Cumulative Bulletin 1998-1.

**Revenue Procedure 97-29.** This revenue procedure provides guidance to drafters of prototype SIMPLE IRAs on obtaining opinion letters. Revenue Procedure 97-29 is in Cumulative Bulletin 1997-1.

### Qualified Plan

A qualified retirement plan is a written plan you can set up for the exclusive benefit of your employees and their beneficiaries. It is sometimes called a Keogh or H.R. 10 plan.

You, or you and your employees, can make contributions to the plan. If your plan meets the qualification requirements, you can generally deduct your contributions to the plan. For more information, see Publication 560.

Your employees generally are not taxed on your contributions or increases in the plan's assets until they are distributed. However, certain loans made from qualified plans are treated as taxable distributions. For more information, see Publication 575.

**Qualification requirements.** To be a qualified plan, the plan must meet many requirements. They include requirements that determine the following.

- Who must be covered by the plan.
- How contributions to the plan are to be invested.
- How contributions to the plan and benefits under the plan are to be determined.
- How much of an employee's interest in the plan must be guaranteed (vested).

For more information, see Publication 560.

**More than one job.** If you are self-employed and also work for someone else, you can participate in retirement plans for both jobs. Generally, your participation in a retirement plan for one job does not affect your participation in a plan for the other job. However, if you have an IRA, you may not be allowed to deduct part or all of your IRA contributions. See Publication 590.

### Kinds of Qualified Plans

There are two basic kinds of qualified retirement plans: defined contribution plans and defined benefit plans.

### Defined Contribution Plan

This plan provides for a separate account for each person covered by the plan. Benefits are based only on amounts contributed to or allocated to each account.

There are two types of defined contribution plans: profit-sharing and money purchase pension.

**Profit-sharing plan.** This plan lets your employees or their beneficiaries share in the profits of your business. The plan must have a definite formula for allocating the contribution among the participating employees and for distributing the accumulated funds in the plan.

**Money purchase pension plan.** Under this plan, contributions are fixed and are not based on your business profits. For example, if the plan requires contributions be 10% of each participating employee's compensation, regardless of whether you have a profit, the plan is a money purchase plan.

## Defined Benefit Plan

This is any plan that is not a defined contribution plan. In general, contributions to a qualified defined benefit plan are based on what is needed to provide definitely determinable benefits to plan participants. Your contributions to the plan are based on actuarial assumptions. Generally, you will need continuing professional help to administer a defined benefit plan.

## Setting Up a Plan

The plan can be an IRS-approved master or prototype plan offered by a sponsoring organization. Or it can be an individually designed plan.

**Master or prototype plan.** The following sponsoring organizations generally can provide IRS-approved master or prototype plans.

- Trade or professional organizations.
- Banks (including savings and loan associations and federally insured credit unions).
- Insurance companies.
- Mutual funds.

Adoption of a master or prototype plan does not mean your plan is automatically qualified. It must still meet all the qualification requirements stated in the law.

**Individually designed plan.** If you prefer, you can set up an individually designed plan to meet specific needs. Although advance IRS approval is not required, you can apply for approval by requesting a determination letter. You may need professional help with this. The following revenue procedure and announcement will help you decide whether to apply for approval.

- Revenue Procedure 2001-6 in Internal Revenue Bulletin 2001-1
- Announcement 2001-77 in Internal Revenue Bulletin 2001-30.

## Deduction Limit

The deduction limit for contributions to a qualified plan depends on the kind of plan you have.



*In figuring the deduction for contributions to these plans, you cannot take into account any contributions or benefits that are more than the limits discussed under Limits on Contributions and Benefits in Publication 560.*

**Defined contribution plans.** The deduction limit for a defined contribution plan depends on whether it is a profit-sharing plan or a money purchase pension plan.

**Profit-sharing plan.** Your deduction for contributions to a profit-sharing plan cannot be more than 15% of the compensation paid (or accrued) during the year to the eligible employees participating in the plan. You must reduce this limit in figuring the deduction for contributions you make for your own account. See *Deduction of contributions for yourself*, later.

**Money purchase pension plan.** Your deduction for contributions to a money purchase pension plan is generally limited to 25% of the compensation paid during the year to an eligible employee. You must reduce this limit in figuring the deduction for contributions you make for yourself, as discussed later.

**Defined benefit plans.** An actuary must figure the deduction for contributions to a defined benefit plan since it is based on actuarial assumptions and computations.

**Deduction of contributions for yourself.** To take a deduction for contributions you make to a plan for yourself, you must have net earnings from the trade or business for which the plan was set up.

**Limit on deduction.** If the qualified plan is a profit-sharing plan, your deduction for yourself is limited to the lesser of \$35,000 or 13.0435% (15% reduced as discussed later under *Net earnings reduced by adjusting contribution rate*) of your net earnings from the trade or business that has the plan. If the plan is a money purchase pension plan, the deduction is limited to the lesser of \$35,000 or 20% (25% reduced as discussed later under *Net earnings reduced by adjusting contribution rate*) of your net earnings.

**Net earnings.** Your net earnings must be from self-employment in a trade or business in which your personal services are a material income-producing factor. Your net earnings do not include items excluded from income (or deductions related to that income), other than foreign earned income and foreign housing cost amounts.

Your net earnings are your business gross income minus the allowable deductions from that business. Allowable business deductions include contributions to SEP and qualified plans for common-law employees and the deduction for one-half your self-employment tax.

Net earnings include a partner's distributive share of partnership income or loss (other than separately stated items such as capital gains and losses) and any guaranteed payments. If you are a limited partner, net earnings include only guaranteed payments for services rendered to or for the partnership. For more information, see *Partnership Income or Loss* under *Figuring Earnings Subject to Self-Employment Tax* in Publication 533.

Net earnings do not include income passed through to shareholders of S corporations.

**Adjustments.** You must reduce your net earnings by the deduction for one-half your self-employment tax. Also, net earnings must be reduced by the deduction for contributions you make for yourself. This reduction is made indirectly, as explained next.

**Net earnings reduced by adjusting contribution rate.** You must reduce net earnings by your deduction for contributions for yourself. The deduction and the net earnings depend on each other. You make the adjustment indirectly by reducing the contribution rate called for in the plan and using the reduced rate to figure your maximum deduction for contributions for yourself.

**Annual compensation limit.** You generally cannot take into account more than \$170,000 of your compensation in figuring your contribution to a defined contribution plan.

## Figuring Your Deduction

Use the following worksheet to find the reduced contribution rate for yourself. Make no reduction to the contribution rate for any common-law employees.

### Rate Worksheet for Self-Employed

- 1) Plan contribution rate as a decimal (for example, 10½% = .105) . . . . . \_\_\_\_\_
- 2) Rate in line 1 plus 1 (for example, .105 + 1 = 1.105) . . . . . \_\_\_\_\_
- 3) Self-employed rate as a decimal rounded to at least 3 decimal places (line 1 ÷ line 2) . . . . . \_\_\_\_\_

Now that you have figured your self-employed rate, you can figure your maximum deduction for contributions for yourself by completing the following steps.

### Deduction Worksheet for Self-Employed

- Step 1** Enter the rate shown on line 3 above . . . \_\_\_\_\_
- Step 2** Enter your net earnings (net profit) from line 31, Schedule C (Form 1040); line 3, Schedule C-EZ (Form 1040); line 36, Schedule F (Form 1040); or line 15a, Schedule K-1 (Form 1065) . . . . . \_\_\_\_\_
- Step 3** Enter your deduction for self-employment tax from line 27, Form 1040 . . . . . \_\_\_\_\_
- Step 4** Subtract step 3 from step 2 and enter the result . . . . . \_\_\_\_\_
- Step 5** Multiply step 4 by step 1 and enter the result . . . . . \_\_\_\_\_
- Step 6** Multiply \$170,000 by your plan contribution rate. Enter the result, but not more than \$35,000 . . . . . \_\_\_\_\_
- Step 7** Enter the lesser of step 5 or step 6. This is your **maximum deductible contribution**. Enter your deduction on line 29, Form 1040 . . . . . \_\_\_\_\_

**Example.** You are a self-employed farmer and you have employees. The terms of your plan provide that you contribute 8½% (.085) of your compensation (defined earlier) and 8½% of your participants' compensation. Your net earnings from line 36, Schedule F (Form 1040) are



\$200,000. In figuring this, you deducted your common-law employees' pay of \$100,000 and contributions for them of \$8,500 ( $8\frac{1}{2}\% \times \$100,000$ ). You figure your self-employed rate and maximum deduction for contributions on behalf of yourself as follows.

#### Rate Worksheet for Self-Employed

1) Plan contribution rate as a decimal (for example, $10\frac{1}{2}\% = .105$ ) . . . . .	0.085
2) Rate in line 1 plus 1 (for example, $.105 + 1 = 1.105$ ) . . . . .	1.085
3) Self-employed rate as a decimal rounded to at least 3 decimal places (line 1 + line 2) . . . . .	0.078

#### Deduction Worksheet for Self-Employed

<b>Step 1</b> Enter the rate shown on line 3 above . . . . .	0.078
<b>Step 2</b> Enter your net earnings (net profit) from line 31, Schedule C (Form 1040); line 3, Schedule C-EZ (Form 1040); line 36, Schedule F (Form 1040); or line 15a, Schedule K-1 (Form 1065) . . . . .	\$200,000
<b>Step 3</b> Enter your deduction for self-employment tax from line 27, Form 1040 . . . . .	7,663
<b>Step 4</b> Subtract step 3 from step 2 and enter the result . . . . .	192,337
<b>Step 5</b> Multiply step 4 by step 1 and enter the result . . . . .	15,002
<b>Step 6</b> Multiply \$170,000 by your plan contribution rate. Enter the result but not more than \$35,000 . . . . .	14,450
<b>Step 7</b> Enter the lesser of step 5 or step 6. This is your <b>maximum deductible contribution</b> . Enter your deduction on line 29, Form 1040 . . . . .	\$ 14,450

**When to make contributions.** To take a deduction for contributions for a particular year, you must make the contributions not later than the due date (generally April 15 for calendar year taxpayers), plus extensions, of your tax return for that year.

**More information.** See Publication 560 for more information on retirement plans for small business owners, including the self-employed. Publication 560 also discusses the reporting forms that must be filed for these plans.

## Individual Retirement Arrangement (IRA)

An individual retirement arrangement (IRA) is a personal savings plan that allows you to set aside money for your retirement or for certain education expenses. You do not have to set up IRAs for your employees or make contributions for them. You may be able to deduct your contributions, depending on the type of IRA and your circumstances. Generally, amounts in an IRA, including earnings and gains, are not taxed until they are distributed. In certain cases, your earnings and gains may not be taxed at all if they are distributed according to the rules. For more information on IRAs, see Publication 590.

# 18.

## Excise Taxes

### Important Reminders

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

**Undyed diesel fuel and undyed kerosene.** A registered ultimate vendor that sells undyed diesel fuel or undyed kerosene for use on a farm for farming purposes is allowed to claim a credit or refund of the excise tax on that fuel. Farmers **cannot** claim a credit or refund for the excise tax paid on that fuel. See *How To Buy Diesel Fuel and Kerosene Tax Free*.

### Introduction

You may be eligible to claim a credit on your income tax return for federal excise tax on certain fuels. You may also be eligible to claim a quarterly refund of the fuel taxes during the year, instead of waiting to claim a credit on your income tax return.

Whether you can claim a credit or refund depends on the kind of fuel you purchased, whether it was taxed, and the purpose (nontaxable use) for which you used the fuel. The nontaxable uses of fuel for which a farmer may claim a credit or refund are generally the following.

- Use on a farm for farming purposes.
- Off-highway business use.
- Uses other than as a fuel in a propulsion engine, such as home use.

Table 18-1 presents an overview of credits and refunds that may be claimed for fuels used for the nontaxable uses listed above. See Publication 378 for information about credits and refunds for fuels used for nontaxable uses not discussed in this chapter.

### Topics

This chapter discusses:

- Fuels used in farming
- How to buy diesel fuel and kerosene tax free
- Fuels used in off-highway business use
- Fuels used for household use
- How to claim a credit or refund
- Including the credit or refund in income

### Useful Items

You may want to see:

#### Publication

- 378 Fuel Tax Credits and Refunds
- 510 Excise Taxes for 2002

#### Form (and Instructions)

- 4136 Credit for Federal Tax Paid on Fuels
- 8849 Claim for Refund of Excise Taxes

See chapter 21 for information about getting publications and forms.

## Fuels Used in Farming

You may be eligible to claim a credit or refund of excise taxes on fuel used on a farm for farming purposes. This applies if you are the owner, tenant, or operator of a farm. You can claim only a credit for the tax on gasoline used on a farm for farming purposes. You can claim either a credit or refund for the tax on aviation fuel used on a farm for farming purposes. You **cannot** claim a credit or refund for the tax on undyed diesel fuel or undyed kerosene used on a farm for farming purposes or for any use of dyed diesel fuel or dyed kerosene.

Fuel is used on a farm for farming purposes only if used in carrying on a trade or business of farming, on a farm in the United States, and for farming purposes.

**Farm.** A farm includes livestock, dairy, fish, poultry, fruit, fur-bearing animals, and truck farms, orchards, plantations, ranches, nurseries, ranges, and feed yards for fattening 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, you use fuel on a farm for farming purposes if you use it in any of the following ways.

- 1) To cultivate the soil or to raise or harvest any agricultural or horticultural commodity.
- 2) To raise, shear, feed, care for, train, or manage livestock, bees, poultry, fur-bearing animals, or wildlife.
- 3) To operate, manage, conserve, improve, or maintain your farm and its tools and equipment.
- 4) To handle, dry, pack, grade, or store any raw agricultural or horticultural commodity. For this use to qualify, you must have produced more than half the commodity so treated during the tax year. The more-than-one-half test applies separately to each commodity. Commodity means a single raw product. For example, apples and peaches are two separate commodities.
- 5) To plant, cultivate, care for, or cut trees or to prepare (other than sawing logs into

lumber, chipping, or other milling) trees for market, but only if the planting, etc., is incidental to your farming operations. Your tree operations are incidental only if they are minor in nature when compared to the total farming operations.

If any other person, such as a neighbor or custom operator, performs a service for you on your farm for any of the purposes included in (1) or (2), you are considered to be the person who used the fuel on a farm for farming purposes. Therefore, you can still claim the credit or refund for the fuel so used (other than for diesel fuel or kerosene). However, see *Custom application of fertilizer and pesticide*, later. If the other person performs any other services for you on your farm for purposes not included in (1) or (2), no one can claim the credit or refund for fuel used on your farm for those other services.

**Example.** Farm owner Nancy Blue hired custom operator Harry Steele to cultivate the soil on her farm. Harry used 200 gallons of gasoline that he purchased to perform the work on Nancy's farm. In addition, she hired Contractor Brown to pack and store her apple crop. Brown bought 25 gallons of gasoline to use in packing the apples. Nancy can claim the credit for the 200 gallons of gasoline used by Harry 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 listed in (1) or (2) earlier.

**Buyer of fuel (other than diesel fuel or kerosene).** If doubt exists whether the owner, tenant, or operator of the farm bought the fuel, determine who actually bore the cost of the fuel. For example, if the owner of a farm and his tenant equally share the cost of gasoline used on the farm, each can claim a credit for the tax on half the fuel used.

**Diesel fuel and kerosene.** If undyed diesel fuel or undyed kerosene is used for any of the previously listed farming purposes, the fuel cannot be considered used for any other nontaxable use. The credit or refund is allowed only to the registered ultimate vendor. You **cannot** claim a credit or refund for this fuel if it is used for

farming purposes. See *How To Buy Diesel Fuel and Kerosene Tax Free*, later.

A **registered ultimate vendor** is the person who sells undyed diesel fuel or undyed kerosene to the user (ultimate purchaser) of the fuel for use on a farm for farming purposes. To claim a credit or refund of tax, the person must be registered with the Internal Revenue Service at the time the claim is made.

**Custom application of fertilizer and pesticide.** Fuel used on a farm for farming purposes includes fuel used in the aerial or other application of fertilizer, pesticides, or other substances. You, as the owner, tenant, or operator, can claim the credit or refund for the fuel (other than for diesel fuel or kerosene). Or, in the case of gasoline, you can waive your right to the claim and allow the applicator to make the claim. If you waive your right, the applicator is treated as having used the gasoline on a farm for farming purposes and can claim the credit or refund. See *How To Claim a Credit or Refund*, later.

To waive your right to the credit or refund, you must take the following actions.

- Before the applicator files his or her claim, sign an irrevocable agreement stating that you knowingly give up your right to the credit or refund. You can authorize an agent, such as a cooperative, to sign the waiver for you.
- Identify clearly the period the waiver covers. The effective period of your waiver cannot extend beyond the last day of your tax year.

The applicator must retain a copy of the waiver and give you a copy. Do **not** send a copy to the Internal Revenue Service unless requested to do so.

The waiver can be a separate document or it can appear on an invoice or another document from the applicator. If the waiver appears on an invoice or other document, it must be printed in a section clearly set off from all other material, and it must be printed in type large enough to put you on notice that you are waiving your right to the credit or refund. If the waiver appears as part of an invoice or other document, it must be signed

separately from any other item that requires your signature.

The effective period of the waiver cannot extend beyond your taxable year. When the period covered by the waiver extends beyond the applicator's tax year, the applicator must wait until the next tax year to claim the portion for that period.

While no specific form is required, an acceptable waiver of your right to claim a credit or refund is shown in *Table 18–2*.

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

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

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

## How To Buy Diesel Fuel and Kerosene Tax Free

You buy **dyed** diesel fuel and **dyed** kerosene excise tax free. You must use them only for a nontaxable use, including use on a farm for farming purposes. If you use the dyed fuel for a taxable use, you could be subject to the excise tax and a penalty. For example, if a truck used on a farm for farming purposes is also used on the highway (even though in connection with operating the farm), tax applies to the diesel fuel used (or sold for use) in operating the truck on the highways. The fuel was used off the farm for a taxable use.

You can buy **undyed** diesel fuel and **undyed** kerosene tax free from a registered ultimate vendor for use on a farm for farming purposes. This applies to fuel bought by any of the following persons.

- The owner, tenant, or operator of a farm for use on a farm for any of the purposes listed earlier under *Farming purposes*.
- Any other person for use on a farm for any of the purposes in items (1) and (2) listed earlier under *Farming purposes*.

You must give the vendor a signed certificate, which should be substantially the same as the

Table 18–1. Fuel Tax Credits and Refunds at a Glance

Use this table to see if you can take a credit or refund for a nontaxable use of the fuel listed.

Fuel Used	On a Farm for Farming Purposes	Off-Highway Business Use	Household Use <sup>1</sup>
Gasoline and gasohol	Credit only	Credit or refund	None
Aviation gasoline	Credit only	None	None
Undyed diesel fuel and kerosene	Credit or refund by registered ultimate vendor only <sup>2</sup>	Credit or refund <sup>3</sup>	Credit or refund <sup>3</sup>
Dyed diesel fuel and kerosene	None	None	None
Aviation fuel	Credit or refund	None	None

<sup>1</sup> For a use other than as fuel in a propulsion engine.

<sup>2</sup> Fuel used for farming purposes cannot be considered as used for any other purpose.

<sup>3</sup> Applies to kerosene not sold from a blocked pump or, under certain circumstances, for blending with diesel fuel to be used for heating purposes.

sample certificate shown in *Table 18–3*. You can include the certificate as part of any business records you normally keep to document a sale and purchase.

You **cannot** claim a credit or refund for the excise tax on diesel fuel or kerosene used on a farm for farming purposes. The registered ultimate vendor who sells you the fuel claims the credit or refund.

## Fuels Used in Off-Highway Business Use

You may be eligible to claim a credit or refund for the excise tax on fuel used in an off-highway business use.

**Off-highway business use.** This is any use of fuel in a trade or business or in an income-producing activity. The use must not be in a highway vehicle registered or required to be registered for use on public highways. Off-highway business use generally does not include any use in a motorboat.



*If undyed diesel fuel or undyed kerosene is used on a farm for farming purposes (discussed earlier), the fuel is not considered used in an off-highway business use. Farmers cannot claim a credit or refund for the tax on diesel fuel or kerosene used on a farm for farming purposes. See How To Buy Diesel Fuel and Kerosene Tax Free, earlier.*

*Farmers also cannot claim a credit or refund for the tax on undyed kerosene used in an off-highway business use if the kerosene was sold from a blocked pump or for blending with diesel fuel in an area described in an IRS declaration of extreme cold if the blended fuel is used*

*for heating purposes. Only the registered ultimate vendor that sold the kerosene can claim the credit or refund under these circumstances. For more information, see Publication 378.*

**Examples.** Off-highway business use includes the use of fuels in any of the following ways.

- In stationary machines such as generators, compressors, power saws, and similar equipment.
- For cleaning purposes.
- In forklift trucks, bulldozers, and earthmovers.

Generally, it does not include nonbusiness, off-highway use of fuel, such as use by minibikes, snowmobiles, power lawn mowers, chain saws, and other yard equipment.

For more information about the credit or refund for fuels used in an off-highway business use, see Publication 378.

## Fuels Used for Household Use

You may be eligible to claim a credit or refund for the excise tax on undyed diesel fuel and undyed kerosene used for home use. This applies to fuel 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 (discussed earlier).



*If undyed diesel fuel or undyed kerosene is used on a farm for farming purposes (discussed earlier), the fuel is not considered used for household use. Farm-*

*ers cannot claim a credit or refund for the tax on diesel fuel or kerosene used on a farm for farming purposes. See How To Buy Diesel Fuel and Kerosene Tax Free, earlier.*

*Farmers also cannot claim a credit or refund for the tax on undyed kerosene used for household use if the kerosene was sold from a blocked pump or for blending with diesel fuel in an area described in an IRS declaration of extreme cold if the blended fuel is used for heating purposes. Only the registered ultimate vendor that sold the kerosene can claim the credit or refund under these circumstances. For more information, see Publication 378.*

## 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 (discussed later) are listed in *Table 18–4*.



Keep at your principal place of business all records needed to enable the IRS to verify that you are the person entitled to claim a credit or refund and the amount you claimed. You do not have to use any special form, but the records should establish the following information.

- The total number of gallons bought and used during the period covered by your claim.
- The dates of the purchases.
- The names and addresses of suppliers and amounts bought from each during the period covered by your claim.
- The nontaxable use for which you used the fuel.
- The number of gallons used for each nontaxable use.

It is important that your records show separately 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*.

**Taxpayer identification number.** To file a claim for credit or refund, you **must** have a taxpayer identification number. See *Taxpayer Identification Number* in chapter 2.

**Filing date on holiday or weekend.** If the last day for filing your claim falls on a Saturday, Sunday, or legal holiday, the due date is delayed until the next business day.

**Credit or refund.** A credit is an amount that reduces the tax on your income tax return when you file it at the end of the year. If you meet certain requirements, you can claim a refund during the year instead of waiting until you file your tax return.

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

- Tax on gasoline you used on a farm for farming purposes.

Table 18–2. **Sample Waiver**

<b>WAIVER OF RIGHT TO CREDIT OR REFUND</b>
I hereby waive my right as owner, tenant, or operator of a farm located at:
_____
<i>Address</i>
to receive credit or refund for fuel used by:
_____
<i>Name of Applicator</i>
on the farm in connection with cultivating the soil, or the raising or harvesting of any agricultural or horticultural commodity. This waiver applies to fuel used during the period:
_____
<i>Both Dates Inclusive</i>
I understand that by signing this waiver, I give up my right to claim any credit or refund for fuel used by the aerial applicator or other applicator of fertilizer or other substances during the period indicated, and I acknowledge that I have not previously claimed any credit for that fuel.
_____
<i>Signature</i>
_____
<i>Date</i>



**Table 18–3. Sample Exemption Certificate**

**EXEMPTION CERTIFICATE**

(To support vendor's claim for credit or payment under section 6427 of the Internal Revenue Code)

---

*Name, Address, and Employer Identification Number of Seller*

The undersigned buyer ("Buyer") hereby certifies the following under penalties of perjury:

A. Buyer will use the diesel fuel or kerosene to which this certificate relates either — (check one):

1.  On a farm for farming purposes (as defined in §48.6420-4 of the Manufacturers and Retailers Excise Tax Regulations) and Buyer is the owner, tenant, or operator of the farm on which the fuel will be used; or
2.  On a farm (as defined in §48.6420-4(c)) for any of the purposes described in ¶ (d) of that section (relating to cultivating, raising, or harvesting) (and Buyer is not the owner, tenant, or operator of the farm on which the fuel will be used).

B. This certificate applies to the following (complete as applicable):

1. If this is a single purchase certificate, check here  and enter:
  - a. Invoice or delivery ticket number \_\_\_\_\_
  - b. Number of gallons \_\_\_\_\_
2. If this is a certificate covering all purchases under a specified account or order number, check here  and enter:
  - a. Effective date \_\_\_\_\_
  - b. Expiration date \_\_\_\_\_  
(period not to exceed 1 year after effective date)
  - c. Buyer account or order number \_\_\_\_\_

- Buyer will provide a new certificate to the seller if any information in this certificate changes.
- If Buyer uses the diesel fuel or kerosene to which this certificate relates for a purpose other than stated in the certificate, Buyer will be liable for any tax.
- Buyer understands that the fraudulent use of this certificate may subject Buyer and all parties making such fraudulent use of this certificate to a fine or imprisonment, or both, together with the costs of prosecution.

---

*Signature and Date Signed*

---

*Printed or Typed Name and Title of Person Signing*

---

*Name, Address, and Employer Identification Number of Buyer*

- Tax on fuels you used for nontaxable uses if the total for the tax year is less than \$750.
- Tax on fuel you did not include in any claim for refund previously filed for 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 line 65 of your 2001 Form 1040. Check box b. If you would not otherwise have to file an income tax return, you must do so to get a fuel tax credit.

**Partnership.** A partnership cannot claim the credit on Form 1065, *U.S. Return of Partnership Income*. The partnership must include on line 25 of Schedule K-1 (Form 1065), *Partner's Share of Income, Credits, Deductions, etc.*, each partner's share of the number of gallons of each fuel sold or used for a nontaxable use, the type of use, and the applicable credit per gallon. Each partner claims the credit on his or her income tax return for the partner's share of the fuel used by the partnership.

An electing large partnership can claim the credit on line 27 of Form 1065–B, *U.S. Return of Income for Electing Large Partnerships*.

**Corporation.** To claim the credit, a corporation uses either line 32g of Form 1120, *U.S. Corporation Income Tax Return*, or line 28g of Form 1120–A, *U.S. Corporation Short-Form Income Tax Return*.

**S corporation.** To claim the credit, an S corporation uses line 23c of Form 1120S, *U.S. Income Tax Return for an S Corporation*.

**Farmers' cooperative association.** If a cooperative must file Form 990–C, *Farmers' Cooperative Association Income Tax Return*, it uses line 32g to claim the credit.

**Trust.** A trust required to file Form 1041, *U.S. Income Tax Return for Estates and Trusts*, uses line 24g to claim the credit.

**When to claim a credit.** You can claim a fuel tax credit on your income tax return for the year you used the fuel.



Once you have filed a Form 4136, you cannot file an amended return to show an increase in the number of gallons reported on a line of that form. See the following discussion for when you can file a claim on an amended return.

**Fuel tax claim on amended return.** You may be able to make a fuel tax claim on an amended return for the year you used the fuel. You can file an amended return to claim a fuel tax credit only in the following situations.

- You did not claim any credit for fuel taxes on Form 4136 for the tax year.
- Your credit is for gasohol blending, discussed in Publication 378.
- Your credit is for a claim group, explained next, for which you did not previously file a claim on Form 4136 for the tax year.

Claims on Form 4136 (other than for gasohol blending, line 9) are separated into seven **claim groups**. Once you file Form 4136 with a claim for a group, you cannot file an amended return with another claim for that group. However, you can file an amended return with a claim for another group.

The following tables show which claims are in each group. The numbers in the second column of each table refer to the line numbers on Form 4136. The numbers in the third column are from the *Type of Use Table* in the Form 4136 instructions. For each tax year, you can make only one claim for each group.

**Table 18–4. Claim Groups for Tax Years Before 2001**

Group	Line Number	Type of Use
I	1b, 1d-f, 2b	1
II	1a, 1d-f	2
	2a	See line instructions
III	1c-f	5, 7
IV	1c-f, 2b	3, 4, 9
V	3c, 7	5, 7
VI	3a-b, 4, 5, 6	See line instructions
VII	2b	10

**Table 18–5. Claim Groups for Tax Years After 2000**

Group	Line Number	Type of Use
I	1b, 1d-f, 2b	1
II	1a, 1d-f	2
	2a	See line instructions
III	1c-f	5, 7
IV	1c-f, 2b	3, 4, 9
V	3c, 4c, 8	5, 7
VI	3a-b, 4a-b, 5, 6, 7	See line instructions
VII	2b	10

**Example.** You file your 2001 income tax return and claim a fuel tax credit. Your Form 4136 shows an amount on line 1b for use of gasoline on a farm for farming purposes. This is a Group I claim. You cannot amend your return to claim a credit for an amount on line 2b for use of aviation gasoline on a farm for farming purposes (Type of Use 1), since that is also a Group I claim. However, if you used aviation fuel on a farm for farming purposes, you can amend your return to claim the credit for that fuel tax because that would be a Group VI claim reported on line 5b (Type of Use 1).

Generally, if you are allowed to file an amended return, you must file the amended return by the **later** of 3 years after the date you filed your original return or within 2 years after you paid the tax. A return filed early is considered filed on the due date.

## Claiming a Refund

You make a claim for refund of the excise tax on fuel on **Form 8849**.

Do not claim a refund on Form 8849 for any excise tax for which you have filed or will file a claim on Schedule C (Form 720) or Form 4136.

You can file a claim for refund for any quarter of your tax year for which you can claim \$750 or more. This amount is the excise tax paid on all fuels used for a nontaxable use during that quarter or any prior quarter (for which no other claim has been filed) during the tax year.

**Table 18–6. Claiming a Credit or Refund of Excise Taxes**

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

	Credit	Refund
<b>Which form to use</b>	Form 4136, <i>Credit for Federal Tax Paid on Fuels</i>	Form 8849, <i>Claim for Refund of Excise Taxes</i>
<b>Type of form</b>	Annual	Quarterly
<b>When to file</b>	With your income tax return	By the last day of the quarter following the last quarter included in the claim
<b>Amount of tax</b>	Any amount	\$750 or more

If you cannot claim at least \$750 at the end of a quarter, you carry the amount over to the next quarter of your tax year to determine if you can claim at least \$750 for that quarter. If you cannot claim at least \$750 at the end of the fourth quarter of your tax year, you must claim a credit on your income tax return using Form 4136. Only one claim can be filed for a quarter.



*You cannot claim a refund for excise tax on gasoline used on a farm for farming purposes. You must claim a credit on your income tax return for the tax.*

**How to file a quarterly claim.** File the claim for refund by filling out Schedule 1 (Form 8849) and attaching it to Form 8849. Send it to the address shown in the instructions. If you file Form 720, you can use the Schedule C portion of Form 720 for your refund claims. (See the Form 720 instructions.)

**When to file a quarterly claim.** You must file a quarterly claim by the last day of the first quarter following the last quarter included in the claim. If you do not file a timely refund claim for the fourth quarter of your tax year, you will have to claim a credit for that amount on your income tax return, as discussed earlier.

## Including the Credit or Refund in Income

Include any credit or refund of excise taxes on fuels in your gross income if you claimed the total cost of the fuel (including the excise taxes) as an expense deduction that reduced your income tax liability.

Which year you include a credit or refund in gross income depends on whether you use the cash or an accrual method of accounting.

**Cash method.** If you use the cash method and file a claim for refund, include the refund in gross income for the tax year in which you receive the refund. If you claim a credit on your income tax return, include the credit in gross income for the tax year in which you file Form 4136. If you file an amended return and claim a credit, include the credit in gross income for the tax year in which you receive the credit.

**Example.** Ed Brown, a cash basis farmer, filed his 2001 Form 1040 on March 1, 2002. On his Schedule F, he deducted the total cost of

gasoline (including \$110 of excise taxes) used on the farm for farming purposes. Then, on Form 4136, he claimed the \$110 as a credit. Ed reports the \$110 as other income on line 10 of his 2002 Schedule F.

**Accrual method.** If you use an accrual method, include the claim amount in gross income for the tax year in which you used the fuels. It does not matter whether you filed for a quarterly refund or claimed the entire amount as a credit.

**Example.** Todd Green, an accrual basis farmer, files his 2001 Form 1040 on April 15, 2002. On Schedule F, he deducts the total cost of gasoline (including \$155 of excise taxes) he used on the farm for farming purposes during 2001. On Form 4136, Todd claims the \$155 as a credit. He reports the \$155 as other income on line 10 of his 2001 Schedule F.

# 19.

## Your Rights as a Taxpayer

The first part of this chapter explains some of your most important rights as a taxpayer. The second part explains the examination, appeal, collection, and refund processes.

## Declaration of Taxpayer Rights

**Protection of your rights.** IRS employees will explain and protect your rights as a taxpayer throughout your contact with us.

**Privacy and confidentiality.** The IRS will not disclose to anyone the information you give us, except as authorized by law. You have the right to know why we are asking you for information, how we will use it, and what will happen if you do not provide requested information.

**Professional and courteous service.** If you believe that an IRS employee has not treated you in a professional, fair, and courteous manner, you should tell that employee's supervisor. If the supervisor's response is not satisfactory, you should write to the IRS director for your area or the center where you filed your return.

**Representation.** You may either represent yourself or, with proper written authorization, have someone else represent you in your place. Your representative must be a person allowed to practice before the IRS, such as an attorney, certified public accountant, or enrolled agent. If you are in an interview and ask to consult such a person, then we must stop and reschedule the interview in most cases.

You can have someone accompany you at an interview. You may make sound recordings

of any meetings with our examination, appeal, or collection personnel, provided you tell us in writing 10 days before the meeting.

**Payment of only the correct amount of tax.** You are responsible for paying only the correct amount of tax due under the law—no more, no less. If you cannot pay all of your tax when it is due, you may be able to make monthly installment payments.

**Help with unresolved tax problems.** The Taxpayer Advocate Service can help you if you have tried unsuccessfully to resolve a problem with the IRS. Your local Taxpayer Advocate can offer you special help if you have a significant hardship as a result of a tax problem. For more information, call toll free 1-877-777-4778 (1-800-829-4059 for TTY/ TDD) or write to the Taxpayer Advocate at the IRS office that last contacted you.

**Appeals and judicial review.** If you disagree with us about the amount of your tax liability or certain collection actions, you have the right to ask the Appeals Office to review your case. You may also ask a court to review your case.

**Relief from certain penalties and interest.** The IRS will waive penalties when allowed by law if you can show you acted reasonably and in good faith or relied on the incorrect advice of an IRS employee. We will waive interest that is the result of certain errors or delays caused by an IRS employee.

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## Examinations, Appeals, Collections, and Refunds

**Examinations (audits).** We accept most taxpayers' returns as filed. If we inquire about your return or select it for examination, it does not suggest that you are dishonest. The inquiry or examination may or may not result in more tax. We may close your case without change; or, you may receive a refund.

The process of selecting a return for examination usually begins in one of two ways. First, we use computer programs to identify returns that may have incorrect amounts. These programs may be based on information returns, such as Forms 1099 and W-2, on studies of past examinations, or on certain issues identified by compliance projects. Second, we use information from outside sources that indicates that a return may have incorrect amounts. These sources may include newspapers, public records, and individuals. If we determine that the information is accurate and reliable, we may use it to select a return for examination.

Publication 556, *Examination of Returns, Appeal Rights, and Claims for Refund*, explains the rules and procedures that we follow in examinations. The following sections give an overview of how we conduct examinations.

**By mail.** We handle many examinations and inquiries by mail. We will send you a letter with either a request for more information or a reason why we believe a change to your return may be needed. You can respond by mail or you can request a personal interview with an exam-

iner. If you mail us the requested information or provide an explanation, we may or may not agree with you, and we will explain the reasons for any changes. Please do not hesitate to write to us about anything you do not understand.

**By interview.** If we notify you that we will conduct your examination through a personal interview, or you request such an interview, you have the right to ask that the examination take place at a reasonable time and place that is convenient for both you and the IRS. If our examiner proposes any changes to your return, he or she will explain the reasons for the changes. If you do not agree with these changes, you can meet with the examiner's supervisor.

**Repeat examinations.** If we examined your return for the same items in either of the 2 previous years and proposed no change to your tax liability, please contact us as soon as possible so we can see if we should discontinue the examination.

**Appeals.** If you do not agree with the examiner's proposed changes, you can appeal them to the Appeals Office of IRS. Most differences can be settled without expensive and time-consuming court trials. Your appeal rights are explained in detail in both Publication 5, *Your Appeal Rights and How To Prepare a Protest If You Don't Agree*, and Publication 556, *Examination of Returns, Appeal Rights, and Claims for Refund*.

If you do not wish to use the Appeals Office or disagree with its findings, you may be able to take your case to the U.S. Tax Court, U.S. Court of Federal Claims, or the U.S. District Court where you live. If you take your case to court, the IRS will have the burden of proving certain facts if you kept adequate records to show your tax liability, cooperated with the IRS, and meet certain other conditions. If the court agrees with you on most issues in your case and finds that our position was largely unjustified, you may be able to recover some of your administrative and litigation costs. You will not be eligible to recover these costs unless you tried to resolve your case administratively, including going through the appeals system, and you gave us the information necessary to resolve the case.

**Collections.** Publication 594, *The IRS Collection Process*, explains your rights and responsibilities regarding payment of federal taxes. It describes:

- What to do when you owe taxes. It describes what to do if you get a tax bill and what to do if you think your bill is wrong. It also covers making installment payments, delaying collection action, and submitting an offer in compromise.
- IRS collection actions. It covers liens, releasing a lien, levies, releasing a levy, seizures and sales, and release of property.

Your collection appeal rights are explained in detail in Publication 1660, *Collection Appeal Rights*.

**Innocent spouse relief.** Generally, both you and your spouse are responsible, jointly and individually, for paying the full amount of any tax, interest, or penalties due on your joint return.

However, if you qualify for innocent spouse relief, you may not have to pay the tax, interest, and penalties related to your spouse (or former spouse). For information on innocent spouse relief and two other ways to get relief, see Publication 971, *Innocent Spouse Relief*, and Form 8857, *Request for Innocent Spouse Relief (And Separation of Liability and Equitable Relief)*.

**Refunds.** You may file a claim for refund if you think you paid too much tax. You must generally file the claim within 3 years from the date you filed your original return or 2 years from the date you paid the tax, whichever is later. The law generally provides for interest on your refund if it is not paid within 45 days of the date you filed your return or claim for refund. Publication 556, *Examination of Returns, Appeal Rights, and Claims for Refund*, has more information on refunds.

If you were due a refund but you did not file a return, you must file within 3 years from the date the return was originally due to get that refund.

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## 20.

# Sample Return

This sample return uses actual forms to show you how to prepare your income tax return. However, the information shown on the filled-in forms is not from any actual farming operation.

Walter Brown is a dairy farmer and his wife, Jane, is a substitute teacher for the county school system. They have three children. Their return has been prepared using the cash method of accounting. See chapter 3 for an explanation of the cash method and other methods of accounting.

**Rounding off to whole dollars.** You may round off to the nearest whole dollar on your return and schedules. This will make it easier to complete your return. To do so, drop amounts under 50 cents and increase amounts from 50 to 99 cents to the next dollar. For example, \$129.49 becomes \$129 and \$235.50 becomes \$236.

If you do round off, do so for all amounts. However, if you have to add two or more amounts to figure the total to enter on a line, include cents when adding the amounts and round off only the total.

**Losses from operating a farm.** The sample return shows a profit from the operation of the farm. However, if your deductible farm expenses are more than your farm income for the year, you have a loss from the operation of your farm. If your loss is more than your other income for the year, you may have a net operating loss (NOL). You may also have an NOL if you had a personal or business-related casualty or theft loss that was more than your income.

If you have an NOL this year, you may be able to reduce your income (and tax) in other years by carrying the NOL to those years and deducting it from income.



To determine if you have an NOL, complete your tax return for the year. You may have an NOL if a negative figure appears on line 37 of Form 1040. If this is the case, see *Losses From Operating a Farm* in chapter 5.

## Preparing the Return

### Schedule F (Form 1040)

The first step in preparing Mr. Brown's income tax return is to determine his net farm profit or loss on Schedule F. The income and expenses shown on this Schedule F are taken from his farm receipt and expense records. Data for the depreciation and section 179 deductions are taken from Form 4562 and the illustrated *Depreciation Worksheet* that follows Form 4562. Mr. Brown has filed all required Form 1099 information returns.

On line B he writes the number "112120" from the list of *Principal Agricultural Activity Codes* on page 2 of Schedule F (not shown). This indicates that his principal source of farm income is from dairy farming.

### Schedule F—Part I (Income)

Mr. Brown keeps records of the various types of farm income he receives during the year. (Farm income is discussed in chapter 4.) He uses this information to complete Part I of Schedule F.

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

**Line 1.** In 2001, he sold steers he had bought for resale. He enters sales of \$26,584.

**Line 2.** He enters the cost of the steers, \$6,523. He has kept a record of the cost of the livestock he bought and is careful to deduct the cost of an animal in the year of its sale.

**Line 3.** He subtracts his cost on line 2 from the sales on line 1 and reports the difference, \$20,061, as his profit on line 3. Had he sold any other items he bought for resale, he would combine the sales and costs of these items with the sales and costs of the steers and report only the totals on lines 1, 2, and 3. He does not report here sales of livestock held for draft, breeding, sport, or dairy purposes. He reports those sales on Form 4797.

**Line 4.** He enters the income he received during 2001 from sales of items he raised or produced on his farm. His principal source of farm income is dairy farming. The amount reported on this line, \$163,018, includes sales of all of the following.

Milk . . . . .	\$133,874
Steers and calves he raised . . . . .	2,914
Vegetables he grew . . . . .	1,457
Corn (\$7,286), hay (\$8,944), and wheat (\$8,543) he raised . . . . .	24,773
<b>Total reported on line 4 . . . . .</b>	<b>\$163,018</b>

**Lines 5a and 5b.** He reports the \$33 he received from cooperatives on line 5a. Since this is the dollar amount of a qualified written notice of allocation paid as part of a patronage divi-

dend, he enters \$33 as the taxable amount on line 5b.

**Lines 6a and 6b.** He received Farm Service Agency (FSA) cost-sharing payments of \$438 on a soil conservation project (diversion channels) completed in 2001. He received the income as materials and services paid for by the government and reports it on both line 6a and line 6b. The Department of Agriculture (USDA) generally reports such payments to the recipient on Form 1099-G. The entire \$438 has been included on line 14 of Schedule F as a conservation expense. He did not receive any cost-sharing payments this year that he could exclude from his farm income.

**Line 7a.** He reports the \$665 loan he received from the Commodity Credit Corporation (CCC) because he elected in a previous year to treat these loans as income in the year received. (If he had elected not to report his CCC loan as income in the year received and forfeited the loan in a later year, he would report the loan as income on lines 7b and 7c in the year of forfeiture.)

**Line 9.** He reports his \$1,258 of income from custom harvesting.

**Line 10.** On his 2000 income tax return, he claimed a credit of \$142 for excise taxes on gasoline used on his farm. He includes the entire \$142 in his 2001 income on line 10 because he deducted the total cost of gasoline (including the \$142 of excise taxes) as a farm business expense in 2000. He also includes \$250 he received as a director of the local milk marketing cooperative and \$175 received for firewood he cut and sold in 2001.

### Schedule F—Part II (Expenses)

Mr. Brown records his farm expenses during the year for tax purposes and summarizes these expenses at the end of the year. (Farm business expenses are discussed in chapter 5.) This gives him his deductible expenses, which he enters in Part II of Schedule F.

**Line items.** He fills in all applicable items of farm expense deductions.

**Line 12.** He uses his trucks 100% for his farming business and the actual cost (not including depreciation) of operating the trucks in 2001 was \$2,659. He uses his family car 60% for business (determined by records at year end). It cost \$2,307 to operate the car in 2001. He can deduct \$1,384 for the car ( $\$2,307 \times .60$ ). He enters a total of \$4,043 ( $\$2,659 + \$1,384$ ) on line 12. (Depreciation is reported on line 16.)

**Line 13.** The \$2,701 on this line is the amount he paid for pesticides and herbicides purchased during the year.

**Line 14.** He deducts the \$1,040 spent on diversion channels in 2001. The amount listed here includes the full cost of the government cost-sharing project, which he has reported as income on line 6. He continues the policy elected in previous years of deducting annual soil and water conservation expenses. The expenses are consistent with a conservation plan approved by the Natural Resources Conservation Service of the USDA. Because the amount was not more than 25% of Mr. Brown's gross

income from farming, the entire amount is deductible. See chapter 6 for more information on soil and water conservation expenses.

**Line 15.** The \$1,575 on this line is the amount he paid a company for spraying his crops. He made the payment to a corporation, so he does not file a Form 1099-MISC to report the payment.

**Line 16.** He enters the \$42,681 depreciation from Form 4562, discussed later.

**Line 18.** He enters the \$18,019 cost of feed bought for consumption by his livestock in 2001. He did not include the cost of feed bought for livestock he and his family intend to consume. He also did not include the value of feed grown on his farm.

**Line 19.** He enters \$6,544. This is the amount paid for fertilizer and lime.

**Line 20.** He deducts the \$5,105 he paid for trucking and milk marketing expenses. He chose to itemize the \$807 government milk assessment and lists it separately on line 34a.

**Line 21.** He deducts the \$3,521 cost of gasoline, fuel, and oil bought for farm use, other than amounts he included on line 12 for car and truck expenses. He did not deduct the cost of fuel used for heating, lighting, or cooking in his home.

**Line 22.** He deducts the \$1,070 cost of insurance on his farm buildings (but not on his home), equipment, livestock, and crops. He did not deduct the entire premiums on 3-year and 5-year insurance policies in the year of payment, but deducts each year only the part that applies to that year. For more information, see *Insurance* in chapter 5.

**Lines 23a and 23b.** He deducts on line 23a the \$3,175 interest paid on the farm mortgage for the land and buildings used in farming. He deducts on line 23b the \$1,043 interest paid on obligations incurred to buy livestock and other personal property used in farming or held for sale. He deducts his home mortgage interest on Schedule A (Form 1040), which is not shown.

**Line 24.** He enters the \$16,416 in wages he paid during the year for labor hired to operate his farm, including wages paid to his wife and children. He did not include amounts paid to himself. He has no employment credits that would reduce the amount of wages entered. For those wages paid that were subject to social security and Medicare taxes, he included the full amount of the wages before reduction for the employee's share of those taxes, or other amounts withheld. His share of the social security and Medicare taxes is included in the total taxes deducted on line 31. See chapter 16 for information on employment taxes.

**Line 26b.** He enters only the \$2,400 cash rent paid for the use of land he rented from a neighbor, Mr. Green. He did not deduct rent paid in crop shares. He completed a Form 1099-MISC for the rent paid to Mr. Green and sent Copy A to the IRS with Form 1096. He gave Mr. Green a copy of the Form 1099-MISC.

**Line 27.** The \$5,424 he enters includes \$4,902 for repairs to farm machinery and \$522 for repairs to farm buildings. He did not include the value of his own labor or the cost of repairs

on his home. He prepared Form 1099—MISC for the farm machinery repairs because the repair shop is a limited liability company (LLC) that is not classified as a corporation. He sent Copy A to the IRS with Form 1096 and gave a copy to the owner of the repair shop. If the repair shop had been a corporation, Mr. Brown would not have had to file a Form 1099—MISC. He does not have to file a Form 1099—MISC for the building repair because he paid less than \$600.

**Line 28.** He enters the \$2,132 cost of seeds and plants used in farming. He deducts these costs each year. He did not include the cost of plants and seeds purchased for the family garden.

**Line 30.** He enters the \$2,807 paid for livestock supplies and other supplies, including bedding.

**Line 31.** He enters \$3,201 for taxes paid during 2001, including state and local taxes on the real estate and personal property used in farming. He did not include the sales tax paid on farm supplies because this tax was included in the cost for supplies he deducted on line 30. He also did not include the gasoline tax on the gasoline bought for farm use, including the gasoline used in his trucks and family car for farm business, because these taxes were included in the costs for gasoline he deducted on lines 21 and 12. He included his share of social security and Medicare taxes paid for agricultural employees. He filed Form 943 (not shown) in January 2002, reporting these taxes for calendar year 2001.

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

**Line 32.** He enters \$3,997 for the cost of water, electricity, gas, and telephone service used only in farming. He cannot deduct personal utilities. He also cannot deduct the cost of basic local telephone service (including any taxes) for the first telephone line to his home.

**Line 33.** He enters \$3,217, the total paid during 2001 for veterinary fees (\$1,821), livestock medicines (\$650), and breeding fees (\$746). He does not prepare Form 1099—MISC for the veterinarian and the supplier of breeding services because both are incorporated.

**Line 34.** He enters other farm business expenses. These include: an \$807 government milk assessment; \$347 for commissions, dues, and fees; \$287 for financial records and office supplies; and \$534 for farm business travel and meals. Farm business travel includes expenses for the State Forage Tour and for attending the farm management conference at State University. He included only 50% of the cost of meals in the deduction.

**Line 36—Net farm profit.** To arrive at his net farm profit, he subtracts the amount on line 35 (\$132,086) from the amount on line 11 (\$186,040). His net farm profit, entered on line 36, is \$53,954. He also enters that amount on line 18 of Form 1040, and on line 1 of Section A, Schedule SE (Form 1040). Because he shows a net profit on line 36, he skips line 37.

## Form 4562 — Depreciation and Amortization

Mr. Brown follows the instructions and lists the information called for in Parts I through IV. He also completes Part V on page 2 to provide information on listed property used in his farming business. The three vehicles used in his business are listed property. The truck, sold in July and shown on Form 4797, was placed in service in 1992 and fully depreciated in 1997. No depreciation is allowed for 2001.

**Depreciation record.** He records information on his depreciable property in a book that he can use to figure his depreciation allowance for several years. He uses the *Depreciation Worksheet* from the Form 4562 instructions to figure his 2001 deduction.

**Basis for depreciation.** He bought his farm on January 8, 1978. Timber on the farm was immature and had no fair market value (FMV). He immediately allocated the total purchase price of the farm among the land, house, barn, and fences (no other capital improvements were included in the price of the farm). He made the allocation on the purchase date in proportion to (but not in excess of) the FMVs of the assets and in the required asset order. See *Trade or Business Acquired* in Publication 551 for more information.

He entered in his depreciation record the part of the purchase price for the depreciable barn and fences, giving him the basis for figuring his depreciation allowance. The fences were fully depreciated in 1987. Because he cannot depreciate the house and land, he keeps a separate record showing their bases.

**Methods of depreciation.** He depreciates all his property placed in service before 1981 using the straight-line method. He chose the alternate ACRS method for his machine shed placed in service in 1986. Using the Modified Accelerated Cost Recovery System (MACRS) and the half-year convention, he chose the following systems for all of his assets placed in service in the year indicated.

- 1997—straight line Alternative Depreciation System (ADS).
- 1998—150% declining balance ADS.
- 1999 & 2001—150% declining balance General Depreciation System (GDS).

**Depreciable property.** One of his purchased dairy cows (#42) was killed by lightning in July 2001. Two other purchased cows (#52 and #60) were sold in 2001. The cows were depreciated under MACRS (ADS), using a half-year convention. Therefore, he can claim a half-year's depreciation for each cow in 2001.

He has other breeding and dairy cows he raised. He did not claim depreciation on them since his basis in the cows is zero for income tax purposes.

During 2001 the Browns owned two family cars. One of them was not used for farm business. Mr. Brown cannot deduct depreciation on it. Using his written records, he determined at the end of the year that his other car was used 60% for his farm business and 40% for personal driving.

The *Depreciation Worksheet* contains an itemized list of Mr. Brown's assets for which he is deducting depreciation in 2001. He must list each item separately to keep track of its basis. The pickup truck and car purchased in 1998 are listed property in the 5-year property class.

**New assets.** Mr. Brown added three assets to his farming business in 2001.

- 1) In January, he completed and placed in service a dairy facility designed specifically for the production of milk and to house, feed, and care for dairy cattle (single purpose livestock structure). The building is depreciated separately from the milking equipment it houses. The cost of the building is \$56,500 and it is 10-year property under MACRS. The cost of the equipment is \$72,000 and it is 7-year property under MACRS.
- 2) In February, he made improvements to his machine shed for a total cost of \$1,300. The improvements are depreciated as if they were a separate building with a 20-year recovery period.
- 3) In July, he acquired tractor #5 by trading tractor #2 and paying \$33,729 cash. The adjusted basis of tractor #2 was \$1,378 when it was traded (Mr. Brown claimed half a year of depreciation). The new tractor has a basis of \$35,107 (\$33,729 + \$1,378). The portion of the new basis carried over from tractor #2 (\$1,378) is depreciated over the remaining life of tractor #2. Therefore, Mr. Brown left the depreciation of that portion of the basis on his Depreciation Worksheet as if he still owned tractor #2 but made a note that the remaining basis on that line is part of his basis in tractor #5. Mr. Brown made a new entry on his Depreciation Worksheet to depreciate the \$33,729 of new basis in tractor #5 over the new 7-year life of tractor #5. He completed Form 8824, *Like-Kind Exchanges*, (not shown) to report the trade and will include this form when he files his return. He elected to expense part of the cost of the tractor in 2001 and depreciate the rest of the new basis.

**Line items.** Form 4562 is completed by referring to the *Depreciation Worksheet*.

**Line 2.** Mr. Brown enters \$162,229 on line 2. This is the total cost of all section 179 property placed in service in 2001. In figuring his cost, he does not include the portion of the new basis in the acquired tractor that was carried over from the traded tractor (\$1,378). The dairy facility and equipment qualify as section 179 property. However, the machine shed improvement does not qualify. It is not a single purpose agricultural (livestock) structure.

**Line 6.** He enters the description of the property (tractor) he is electing to expense under section 179. His cost basis for the section 179 deduction is limited to the cash he paid for the tractor. He enters his cost basis of \$33,729 in column (b). He then enters the tentative deduction, \$24,000, in column (c). However, this amount is subject to the business income limit on line 11. (The total cost of his section 179 property did not exceed the investment limit,

\$200,000, and he is therefore subject to the maximum dollar limit, \$24,000.)

**Lines 11 and 12.** His taxable income from his farming business (without including the section 179 deduction and the self-employment tax deduction) exceeds the maximum dollar limit on line 5. He enters \$24,000 on lines 11 and 12. See chapter 8 for information on the section 179 deduction.

**Line 15.** All property placed in service in 2001 in each class is combined and entered in Part II, line 15. The abbreviation HY used in column (e) stands for the half-year convention. The 150 DB in column (f) stands for the 150% declining balance method under MACRS.

**Line 17.** He enters \$2,823, his MACRS depreciation deduction for assets placed in service from 1997 through 1999, on line 17 of Part III. None of the assets included are listed property. Listed property is entered in Part V as explained later under *Line 20*.

**Line 19.** On line 19, he enters \$574 for the asset placed in service before 1981 and the asset depreciated under ACRS.

**Line 20.** He enters his depreciation deduction for listed property, \$2,244, on line 20. This is the total shown on line 26, Part V, page 2 of the form. He has two depreciable assets that are listed property—the car used 60% for business and the pickup truck purchased in 1998. His deduction for the car cannot be more than 60% of the limit for passenger automobiles for the year he placed the car in service. The other truck, which he sold this year, was fully depreciated.

**Line 21.** He enters the total depreciation on line 21 and carries the total, \$42,681 to line 16 of Schedule F.

**Other items.** He completes Sections A and B of Part V to provide the information required for listed property. He does not complete Section C because he does not provide vehicles for his employees' use.

He follows the practice of writing down the odometer readings on his vehicles at the end of each year and when he places the vehicles in service and disposes of them. In addition, because he uses his car only partly for business, he writes down the number of business miles it is driven any day that it is used for business. He uses these records to answer the questions on lines 23a and 23b of Section A and lines 28 through 34 of Section B.

He has no amortization, so he does not use Part VI of Form 4562.

## Schedule SE (Form 1040) Self-Employment Tax

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

ployment income, she would file her own Schedule SE.

**Line items.** He figures his self-employment tax on the following lines.

**Line 1.** He enters his net farm profit, \$53,954. All the income, losses, and deductions listed on Schedule F are included in determining net earnings from farm self-employment (see the types of self-employment income listed in chapter 15). Consequently, he did not have to adjust his net profit to determine his self-employment net earnings from farming.

**Line 3.** If he were engaged in one or more other businesses in addition to farming, he would combine his net profits from all his trades or businesses on line 3 of this schedule. However, because farming was his only business, he enters his net profit from farming (the amount shown on line 1).

**Line 4.** He multiplies line 3 by .9235 to get his net earnings from self-employment and enters \$49,827 on line 4.

**Lines 5 and 6.** He multiplies line 4 by 15.3% and enters \$7,624 on line 5. This is his self-employment tax for 2001. He also enters \$7,624 on line 53 of Form 1040. He enters \$3,812 on line 6 and also on line 27 of Form 1040 (deduction for one-half of his self-employment tax).

## Form 4684—Casualties and Thefts

Mr. Brown's only business casualty occurred on July 7 when a dairy cow he purchased 4 years ago was killed by lightning. He shows the loss from the casualty on page 2 of Form 4684. Only page 2 is shown, since page 1 is for nonbusiness casualties.

He prints his name, his wife's name, and his identifying number at the top of page 2.

**Part I.** He shows the kind of property, "Dairy cow #42," its location, and the date acquired on line 19. He enters his adjusted basis in the cow, \$257, on line 20 and the \$109 insurance payment he received for the cow on line 21. Since line 20 is more than line 21, he skips line 22. On lines 23 and 24, he enters the FMVs before and after the casualty (\$500 and \$0, respectively), and he shows the difference, \$500, on line 25. He enters the amount from line 20 on line 26, subtracts line 21 from line 26, and enters \$148 on lines 27 and 28.

**Part II.** Since he owned the cow for more than one year, he identifies the casualty on line 34 and enters \$148 on lines 34(b)(i), 35(b)(i), 37, and 38a, and on Form 4797, Part II, line 14.

## Form 4797—Sales of Business Property

After completing Schedule F and Section B of Form 4684, Mr. Brown fills in Form 4797 to report the sales of business property. See *Table 11-1* in chapter 11 for the types of property reported on Form 4797.

He prints his name, his wife's name, and his identifying number at the top of Form 4797.

Before he can complete Parts I and II, he must complete Part III to report the sale of certain depreciable property.

**Part III.** Mr. Brown sold three depreciable assets in 2001 at a gain. They consisted of a truck, a mower, and purchased dairy cow #60. He has information about their cost and depreciation in his records. Only the dairy cow appears on the *Depreciation Worksheet*. The truck and mower were fully depreciated.

He sold the truck on July 9, the mower on August 12, and the cow on October 28. Since the gains on these items were gains from dispositions of depreciable personal property, as explained in chapter 11, he must determine the part of the gain for each item that was ordinary income.

He enters the description of each item on lines 19A through 19C and relates the corresponding property columns to the properties on those lines. He completes lines 20 through 25(b) for each disposition.

**Gain from dispositions.** The gain on each item is shown on line 24. His gain on the sale of the truck is \$700 (Property A). His gain on the sale of the mower is \$70 (Property B). His gain on the sale of the cow is \$82 (Property C). The gain on each item is entered in the appropriate property column on line 25(b).

**Summary of Part III gains.** On line 30, he enters \$852, the total of property columns A through C, line 24. On line 31, he enters \$852, the total of property columns A through C, line 25(b). This amount is the gain that is ordinary income. He also enters this amount on line 13, Part II.

He subtracts line 31 from line 30 and enters -0- on line 32. He has no long-term capital gain on the dispositions. All his gain is ordinary income.

**Part I.** All the animals in Part I met the required holding period.

Mr. Brown sold at a gain several cows he had raised and used for dairy purposes. His selling expense was \$325 for these cows, which he shows on line 2(f). He enters the gain from the sale on line 2(g). He also shows on line 2(f), a selling expense of \$20 for a raised dairy heifer and enters on line 2(g) the gain from the sale of the heifer and the loss from the sale of purchased dairy cow #52. Because he sold purchased dairy cow #52 at a loss, he entered it in Part I instead of Part III. See *Table 11-1* in chapter 11 for where to report items on Form 4797.

He combines the gains and loss on line 2(g) and enters \$14,770 on line 7. Since he has no nonrecaptured net section 1231 losses from prior years, he does not fill in lines 8, 9, and 12. If he had nonrecaptured section 1231 losses, part or all of the gain on line 7 would be ordinary income and entered on line 12. Following the instructions for line 7, he enters \$14,770 as a long-term capital gain on line 11(f) of Schedule D.

**Part II.** Mr. Brown enters on line 10 the \$250 gain from the sale of a raised dairy heifer held less than 24 months for breeding purposes. He had previously entered the \$852 gain from line 31, Part III, on line 13 and the \$148 loss from Form 4684 on line 14. He totals lines 10 through 17 and enters \$954 on line 18. He carries the gain from line 18 to line 18b(2) and shows it as ordinary income on line 14 of Form 1040.



## Schedule D (Form 1040) Capital Gains and Losses

After completing Form 4797, Mr. Brown fills in Schedule D to report gains and losses on capital assets. He prints his name, his wife's name, and his social security number at the top of Schedule D.

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

**Lines 1 and 3.** He reports as a short-term loss on line 1 his \$50 loss on the 2001 sale of H. T. Corporation stock held one year or less. He includes the gross sales price of the stock in column (d) on lines 1 and 3.

**Line 7.** He completes Part I of Schedule D by entering on line 7 the loss in column (f) on line 1.

**Lines 8 and 10.** He enters in column (f) on line 8 his \$745 long-term gain on the sale of Circle Corporation stock held more than one year. He includes the gross sales price in column (d) on lines 8 and 10.

**Line 11.** Mr. Brown had previously entered on line 11 the gain from line 7 of Form 4797.

**Line 16.** He combines the column (f) amounts on lines 8 and 11 and enters the result on line 16.

**Line 17.** In Part III, he combines lines 7 and 16 and enters his total capital gain on line 17. He also enters this amount on Form 1040, line 13.

After he completes his Form 1040 through line 39, he will use Part IV to figure his tax without regard to farm income averaging. See *Schedule J (Form 1040) Farm Income Averaging*, later.

He does not have a capital loss carryover this year, so he does not complete the *Capital Loss Carryover Worksheet* in the instructions.

**TIP** Although Mr. Brown must complete Schedule D (Form 1040) and attach it to his return, certain other taxpayers may be able to complete the Capital Gain Tax Worksheet in the Form 1040 instructions instead. See the instructions for line 13 of the 2001 Form 1040.

## Form 1040, Page 1

Mr. Brown is filing a joint return with his wife. He uses the form he received from the IRS.

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

**Line 6c.** He prints the name and social security number of each dependent child he claims. He also checks the boxes in column (4) since all of his children are qualifying children for the child tax credit.

**Line 7.** Mrs. Brown worked part time as a substitute teacher for the county school system during 2001. She also worked for Mr. Brown on the farm during 2001. He enters on line 7 her total wages, \$8,950 (\$7,750 from the school system and \$1,200 from the farm), as shown on the Forms W-2 that he and the school system gave her.

**Lines 8a and 9.** He did not actually receive cash payment for the interest he listed on line 8a

(\$375). It was credited to his account so that he could have withdrawn it in 2001. Therefore, he constructively received it and correctly included it in his income for 2001. He enters the \$220 in dividends he received from the Circle Corporation on line 9.

He received patronage dividends from farmers' cooperatives based on business done with these cooperatives. He does not list these dividends here, but properly included them on lines 5a and 5b, Part I of Schedule F.

Since he did not receive more than \$400 in interest or \$400 in dividends and none of the other conditions listed at the beginning of the Schedule B instructions applied, he is not required to complete Schedule B.

**Lines 13, 14, and 18.** He previously entered the following items.

- His capital gain on line 13 from Schedule D, line 17.
- His other gain on line 14 from Form 4797, line 18b(2).
- His net farm profit on line 18 from Schedule F, line 36.

**Line 22.** He adds the amounts on lines 7 through 21 and enters the total, \$79,918.

**Line 27.** He has already entered one-half of his self-employment tax, \$3,812, which he figured on Schedule SE.

**Line 28.** He paid premiums of \$8,400 during 2001 for health insurance coverage for himself and his family and qualifies for the self-employed health insurance deduction. He figures the part of his insurance payment that he can deduct by completing the *Self-Employed Health Insurance Deduction Worksheet* (not shown) in the instructions for Form 1040. He enters the result, \$5,040, on line 28 and includes the remaining part of his insurance payment in figuring his medical expense deduction on Schedule A (Form 1040), which is not shown.

**Line 32.** He adds the amounts on lines 23 through 31a and enters the total, \$8,852, on line 32.

**Lines 33 and 34.** He subtracts line 32 from line 22 to get his "adjusted gross income" and enters the result, \$71,066, on line 33 and also on line 34 of page 2.

## Form 1040, Page 2

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

**Line 36.** He enters \$7,800 from his Schedule A (Form 1040), which is not shown, because the total of his itemized deductions is larger than the \$7,600 standard deduction for his filing status (married filing jointly).

**Lines 37, 38, and 39.** He subtracts the \$7,800 on line 36 from the \$71,066 on line 34 and enters the result, \$63,266 on line 37. He enters \$14,500 (5 × \$2,900) on line 38 and subtracts this amount from the amount on line 37 to get a taxable income of \$48,766 on line 39.

**Line 40.** He enters \$6,537 from Schedule J, line 22. For information on how he figured his tax

using farm income averaging, see *Schedule J (Form 1040)*, later.

**Line 42.** Mr. Brown determined that they do not owe alternative minimum tax (line 41). Therefore, he enters on line 42 the tax shown on line 40.

**Line 47.** The Browns did not receive an advance payment of their 2001 taxes because their 2000 tax liability was \$0. Mr. Brown figures the rate reduction credit by completing the *Rate Reduction Credit Worksheet* (not shown) in the instructions for Form 1040. He enters his credit, \$600, on line 47.

**Line 48.** The Browns qualify for the child tax credit. He figures his credit by completing the *Child Tax Credit Worksheet* (not shown) in the instructions for Form 1040. He enters his credit, \$1,800, on line 48.

**Lines 51 and 52.** He adds the amounts on lines 43 through 50 and enters the total, \$2,400, on line 51. He subtracts that amount from the tax on line 42 and enters \$4,137 on line 52.

**Line 53.** He has already entered the \$7,624 self-employment tax he figured on Schedule SE.

**Line 58.** He adds the amounts on lines 52 through 57 and enters \$11,761, which is the total tax for 2001.

**Line 59.** He enters the income tax withheld from Mrs. Brown's wages, \$435, as shown on the Forms W-2 she received. He attaches a copy of her Forms W-2 to the front of Form 1040.

**Line 60.** He did not make 2001 estimated tax payments since two-thirds of his gross income for 2000 was from farming. He was sure that at least two-thirds of his gross income for 2001 would again be from farming. Farmers who meet either of these conditions do not have to make 2001 estimated tax payments. If he files his Form 1040 and pays the tax due no later than March 1, 2002, he will not be penalized for failure to pay estimated taxes. He makes no entry on line 60.

**Line 61a.** The Browns are not entitled to claim the earned income credit on line 61a, because their modified adjusted gross income is more than \$32,121.

**Line 63.** The Browns are not entitled to claim the additional child tax credit because they received the maximum amount (\$600) per qualifying child on line 48.

**Line 65.** Mr. Brown enters his credit for \$350 of federal excise tax on gasoline used in 2001. He checks box "b" and attaches Form 4136 (not shown) to his return, showing how he figured the credit. He must report the credit as other income on his Schedule F for 2002, since his deduction for the total cost of gasoline (including the \$350 of excise taxes) as a farm business expense on Schedule F reduced his 2001 taxes.

**Lines 66 and 70.** He adds the amounts on lines 59 through 65 and enters the total, \$785, on line 66. He subtracts that figure from the amount on line 58. The balance, \$10,976, is entered on line 70.

## Schedule J (Form 1040) Farm Income Averaging

In 2001, Mr. Brown's taxable income, \$48,766, is substantially higher than in each of the 3 previous years. His taxable income amounts were only \$2,500, \$1,050, and \$700 for 2000, 1999, and 1998, respectively. He elects to use farm income averaging by completing Schedule J to figure his tax.

First, he uses Part IV of Schedule D to figure his tax without regard to farm income averaging. Next, he uses Schedule J to figure his tax using farm income averaging.

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

**Line 1.** He enters \$48,766, his taxable income from line 39 of Form 1040.

**Line 2.** He enters the part of his farm income he is electing to average, \$29,766. He elects to treat this elected farm income as all coming out of his \$53,954 of ordinary farm income from Schedule F. He could have elected to treat up to \$14,770 of it as coming out of his gain from the sale of farm assets (other than land) that are reported in Part I of Form 4797. Reducing his ordinary income by this amount allows him to take advantage of the lowest tax brackets for this year and the 3 previous years.

**Line 3.** He subtracts the amount on line 2 from the amount on line 1 and enters \$19,000 on line 3.

**Line 4.** Because he has capital gains and losses this year, he computes the tax on \$19,000 using Part IV of Schedule D (not shown) and enters the result, \$2,076, on line 4. In this example, he decided to treat the elected farm income as all coming from his ordinary income. However, he could have made a different election to use some or all of the capital gains for 2001. In that case, the calculation for this line would have been made by reducing his capital gains for 2001 by the amount included in elected farm income and, unless all of the capital gains for 2001 were included in elected farm income, using Schedule D to compute the tax on line 4.

**Lines 5, 9, and 13.** He enters his taxable income from 1998, 1999, and 2000 on lines 5, 9, and 13, respectively.

**Lines 6, 10, and 14.** He divides the amount on line 2 by 3.0 and enters the result, \$9,922, on lines 6, 10, and 14.

**Lines 7, 11, and 15.** He figures his adjusted taxable income for the 3 previous years by adding the amounts on lines 6, 10, and 14 to the amounts on lines 5, 9, and 13, respectively.

**Lines 8, 12, and 16.** He figures the tax on the amounts on lines 7, 11, and 15 using the appropriate Tax Rate Schedules and enters the results on lines 8, 12, and 16, respectively. In this example, he decided to treat the elected farm income as all coming from his ordinary income for 2001 and he added one-third of the elected farm income to the ordinary income of each of the previous 3 years. His income is taxed at the 15% rate for each year. However, if he had made a different election to use some or all of the capital gains for 2001, one-third of that amount would be treated as capital gains for each of the previous 3 years and the tax on lines 8, 12, and 16 would be calculated using the appropriate Schedule D. The gains would be taxed at the appropriate capital gains rate for the previous years.

**Line 17.** He adds the amounts on lines 4, 8, 12, and 16 and enters the total, \$7,180, on line 17.

**Lines 18, 19, and 20.** He enters his tax from his 1998, 1999, and 2000 returns on lines 18, 19, and 20, respectively.

**Line 21.** He adds the amounts on lines 18, 19, and 20 and enters the total, \$643, on line 21.

**Line 22.** He subtracts the amount on line 21 from the amount on line 17 and enters \$6,537 on line 22. The tax on this line is less than the \$6,902 of tax he figured using Schedule D. Therefore, he enters on line 40 of his Form 1040 the amount from this line.

## Completing the Return

The Browns sign their names and enter the date signed, their occupations, and their telephone

number at the bottom of page 2 of Form 1040. (If they had not prepared their own tax return, the preparer would also sign the return and provide the information requested at the bottom of the page.) Mr. Brown attaches to the return the address label in the instructions after verifying the accuracy of the label. He writes his and his wife's social security numbers in the boxes next to the address label.

He writes a check payable to the U.S. Treasury for the full amount on line 70 of Form 1040. On the check, he writes his social security number, their telephone number, and "2001 Form 1040." His name and address are printed on the check. Mr. Brown could instead have chosen to pay his taxes by credit card (American Express® Card, Discover® Card, or MasterCard® card). For information about how to pay by credit card, see the Form 1040 Instructions.

After making a copy of their complete return for his records, he assembles the various forms and schedules behind Form 1040 in the following order, based on the "Attachment Sequence Number" shown in the upper right corner of each schedule or form and included after each item listed below.

- 1) Schedule A. (07) (not shown)
- 2) Schedule D. (12)
- 3) Schedule F. (14)
- 4) Schedule SE. (17)
- 5) Schedule J. (20)
- 6) Form 4136. (23) (not shown)
- 7) Form 4684. (26)
- 8) Form 4797. (27)
- 9) Form 4562. (67)
- 10) Form 8824. (109) (not shown)

He completes Form 1040-V, *Payment Voucher*, which was included in his tax package. He carefully follows the instructions for mailing his return and paying the tax.

Label

(See instructions on page 19.)

Use the IRS label. Otherwise, please print or type.

Presidential Election Campaign (See page 19.)

LABEL HERE

For the year Jan. 1–Dec. 31, 2001, or other tax year beginning , 2001, ending , 20
Your first name and initial Last name
Walter A. Brown
If a joint return, spouse's first name and initial Last name
Jane W. Brown
Home address (number and street). If you have a P.O. box, see page 19. Apt. no.
RR 1 Box 25
City, town or post office, state, and ZIP code. If you have a foreign address, see page 19.
Hometown, VA 22870

Your social security number

543 : 00 : 2111

Spouse's social security number

543 : 00 : 1222

Important!

You must enter your SSN(s) above.

You Spouse
Yes No Yes No

Filing Status

Check only one box.

- 1 Single
2 Married filing joint return (even if only one had income)
3 Married filing separate return. Enter spouse's social security no. above and full name here.
4 Head of household (with qualifying person). (See page 19.) If the qualifying person is a child but not your dependent, enter this child's name here.
5 Qualifying widow(er) with dependent child (year spouse died ). (See page 19.)

Exemptions

If more than six dependents, see page 20.

6a Yourself. If your parent (or someone else) can claim you as a dependent on his or her tax return, do not check box 6a.
6b Spouse
6c Dependents: (1) First name Last name (2) Dependent's social security number (3) Dependent's relationship to you (4) if qualifying child for child tax credit (see page 20)
MICHAEL BROWN 579 : 00 : 9999 Son
MATTHEW BROWN 579 : 00 : 9998 Son
SARAH BROWN 579 : 00 : 9997 Daughter
6d Total number of exemptions claimed 5

Income

Attach Forms W-2 and W-2G here. Also attach Form(s) 1099-R if tax was withheld.

If you did not get a W-2, see page 21.

Enclose, but do not attach, any payment. Also, please use Form 1040-V.

Table with 2 columns: Description and Amount. Rows include Wages, salaries, tips, etc. (8,950); Taxable interest (375); Ordinary dividends (220); Capital gain or (loss) (15,465); Total IRA distributions (954); Total pensions and annuities; Rental real estate, royalties, partnerships, S corporations, trusts, etc. (53,954); Social security benefits; Other income; Total income (79,918).

Adjusted Gross Income

Table with 2 columns: Description and Amount. Rows include IRA deduction, Student loan interest deduction, Archer MSA deduction, Moving expenses, One-half of self-employment tax (3,812), Self-employed health insurance deduction (5,040), Self-employed SEP, SIMPLE, and qualified plans, Penalty on early withdrawal of savings, Alimony paid, Adjusted gross income (71,066).



Tax and Credits

Standard Deduction for—

• People who checked any box on line 35a or 35b or who can be claimed as a dependent, see page 31.

• All others: Single, \$4,550; Head of household, \$6,650; Married filing jointly or Qualifying widow(er), \$7,600; Married filing separately, \$3,800

Table with columns for line number, description, and amount. Includes lines 34-52 for Tax and Credits.

Other Taxes

Table with columns for line number, description, and amount. Includes lines 53-58 for Other Taxes.

Payments

If you have a qualifying child, attach Schedule EIC.

Table with columns for line number, description, and amount. Includes lines 59-66 for Payments.

Refund

Direct deposit? See page 51 and fill in 68b, 68c, and 68d.

Table with columns for line number, description, and amount. Includes lines 67-70 for Refund.

Amount You Owe

Table with columns for line number, description, and amount. Includes lines 70-71 for Amount You Owe.

Third Party Designee

Do you want to allow another person to discuss this return with the IRS (see page 53)? Yes. Complete the following. No

Form for Third Party Designee with fields for name, phone number, and PIN.

Sign Here

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete.

Signature area with fields for signature, date, occupation, and phone number for both taxpayer and spouse.

Paid Preparer's Use Only

Form for Paid Preparer's Use Only with fields for signature, date, self-employed status, SSN/PITIN, firm name, EIN, and phone number.

**SCHEDULE D  
(Form 1040)**

Department of the Treasury  
Internal Revenue Service

**Capital Gains and Losses**

▶ Attach to Form 1040. ▶ See Instructions for Schedule D (Form 1040).  
▶ Use Schedule D-1 to list additional transactions for lines 1 and 8.

OMB No. 1545-0074

**2001**

Attachment  
Sequence No. **12**

Name(s) shown on Form 1040

WALTER A. & JANE W. BROWN

Your social security number

543 00 2111

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

(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see page D-5 of the instructions)	(e) Cost or other basis (see page D-5 of the instructions)	(f) Gain or (loss) Subtract (e) from (d)	
1 25 shares HT Corp	12-3-00	3-6-01	400 -	450 -	( 50 - )	
2 Enter your short-term totals, if any, from Schedule D-1, line 2 . . . . .						
3 <b>Total short-term sales price amounts.</b> Add lines 1 and 2 in column (d) . . . . .			400 -			
4 Short-term gain from Form 6252 and short-term gain or (loss) from Forms 4684, 6781, and 8824 . . . . .						
5 Net short-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1 . . . . .						
6 Short-term capital loss carryover. Enter the amount, if any, from line 8 of your 2000 Capital Loss Carryover Worksheet . . . . .					( )	
7 <b>Net short-term capital gain or (loss).</b> Combine lines 1 through 6 in column (f).					( 50 - )	

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

(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see page D-5 of the instructions)	(e) Cost or other basis (see page D-5 of the instructions)	(f) Gain or (loss) Subtract (e) from (d)	(g) 28% rate gain or (loss) * (see instr. below)
8 40 shares Circle Corp	10-16-81	6-5-01	1,000 -	255 -	745 -	
9 Enter your long-term totals, if any, from Schedule D-1, line 9 . . . . .						
10 <b>Total long-term sales price amounts.</b> Add lines 8 and 9 in column (d) . . . . .			1,000 -			
11 Gain from Form 4797, Part I; long-term gain from Forms 2439 and 6252; and long-term gain or (loss) from Forms 4684, 6781, and 8824 . . . . .					14,770 -	
12 Net long-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1. . . . .						
13 Capital gain distributions. See page D-1 of the instructions . . . . .						
14 Long-term capital loss carryover. Enter in both columns (f) and (g) the amount, if any, from line 13 of your 2000 Capital Loss Carryover Worksheet . . . . .					( )	( )
15 Combine lines 8 through 14 in column (g) . . . . .						
16 <b>Net long-term capital gain or (loss).</b> Combine lines 8 through 14 in column (f) <b>Next:</b> Go to Part III on the back.					15,515 -	

\* **28% rate gain or loss** includes all "collectibles gains and losses" (as defined on page D-5 of the instructions) and up to 50% of the eligible gain on qualified small business stock (see page D-4 of the instructions).

**Part III Taxable Gain or Deductible Loss**

<b>17</b>	Combine lines 7 and 16 and enter the result. If a loss, go to line 18. If a gain, enter the gain on Form 1040, line 13, and complete Form 1040 through line 39 . . . . .	<b>17</b>	15,465	-
<p><b>Next:</b> • If both lines 16 and 17 are gains <b>and</b> Form 1040, line 39, is more than zero, complete Part IV below.</p> <p>• Otherwise, skip the rest of Schedule D and complete Form 1040.</p>				
<b>18</b>	If line 17 is a loss, enter the <b>smaller</b> of that loss or (\$3,000) (or, if married filing separately, (\$1,500)) here and on Form 1040, line 13. Then complete Form 1040 through line 37 . . . . .	<b>18</b>	(	)
<p><b>Next:</b> • If the loss on line 17 is more than the loss on line 18 <b>or</b> if Form 1040, line 37, is less than zero, skip <b>Part IV</b> below and complete the <b>Capital Loss Carryover Worksheet</b> on page D-6 of the instructions before completing the rest of Form 1040.</p> <p>• Otherwise, skip <b>Part IV</b> below and complete the rest of Form 1040.</p>				

**Part IV Tax Computation Using Maximum Capital Gains Rates**

<b>19</b>	Enter your unrecaptured section 1250 gain, if any, from line 17 of the worksheet on page D-7 of the instructions . . . . .	<b>19</b>	- 0 -	
<p><b>If line 15 or line 19 is more than zero, complete the worksheet on page D-9 of the instructions to figure the amount to enter on lines 22, 29, and 40 below, and skip all other lines below. Otherwise, go to line 20.</b></p>				
<b>20</b>	Enter your taxable income from Form 1040, line 39 . . . . .	<b>20</b>	48,766	-
<b>21</b>	Enter the <b>smaller</b> of line 16 or line 17 . . . . .	<b>21</b>	15,465	-
<b>22</b>	If you are deducting investment interest expense on Form 4952, enter the amount from Form 4952, line 4e. Otherwise, enter -0- . . . . .	<b>22</b>	- 0 -	
<b>23</b>	Subtract line 22 from line 21. If zero or less, enter -0- . . . . .	<b>23</b>	15,465	-
<b>24</b>	Subtract line 23 from line 20. If zero or less, enter -0- . . . . .	<b>24</b>	33,301	-
<b>25</b>	Figure the tax on the amount on line 24. Use the Tax Table or Tax Rate Schedules, whichever applies . . . . .	<b>25</b>	4,999	-
<b>26</b>	Enter the <b>smaller</b> of: <ul style="list-style-type: none"> <li>• The amount on line 20 <b>or</b></li> <li>• \$45,200 if married filing jointly or qualifying widow(er);</li> <li>  \$27,050 if single;</li> <li>  \$36,250 if head of household; or</li> <li>  \$22,600 if married filing separately</li> </ul>	<b>26</b>	45,200	-
<p><b>If line 26 is greater than line 24, go to line 27. Otherwise, skip lines 27 through 33 and go to line 34.</b></p>				
<b>27</b>	Enter the amount from line 24 . . . . .	<b>27</b>	33,301	-
<b>28</b>	Subtract line 27 from line 26. If zero or less, enter -0- and go to line 34 . . . . .	<b>28</b>	11,899	-
<b>29</b>	Enter your qualified 5-year gain, if any, from line 5 of the worksheet on page D-8 . . . . .	<b>29</b>	- 0 -	
<b>30</b>	Enter the <b>smaller</b> of line 28 or line 29 . . . . .	<b>30</b>	- 0 -	
<b>31</b>	Multiply line 30 by 8% (.08) . . . . .	<b>31</b>	- 0 -	
<b>32</b>	Subtract line 30 from line 28 . . . . .	<b>32</b>	11,899	-
<b>33</b>	Multiply line 32 by 10% (.10) . . . . .	<b>33</b>	1,190	-
<p><b>If the amounts on lines 23 and 28 are the same, skip lines 34 through 37 and go to line 38.</b></p>				
<b>34</b>	Enter the <b>smaller</b> of line 20 or line 23 . . . . .	<b>34</b>	15,465	-
<b>35</b>	Enter the amount from line 28 (if line 28 is blank, enter -0-) . . . . .	<b>35</b>	11,899	-
<b>36</b>	Subtract line 35 from line 34 . . . . .	<b>36</b>	3,566	-
<b>37</b>	Multiply line 36 by 20% (.20) . . . . .	<b>37</b>	713	-
<b>38</b>	Add lines 25, 31, 33, and 37 . . . . .	<b>38</b>	6,902	-
<b>39</b>	Figure the tax on the amount on line 20. Use the Tax Table or Tax Rate Schedules, whichever applies . . . . .	<b>39</b>	7,763	-
<b>40</b>	<b>Tax on all taxable income (including capital gains).</b> Enter the <b>smaller</b> of line 38 or line 39 here and on Form 1040, line 40 . . . . .	<b>40</b>	6,902	-



**SCHEDULE F  
(Form 1040)**

Department of the Treasury  
Internal Revenue Service

**Profit or Loss From Farming**

▶ Attach to Form 1040, Form 1041, Form 1065, or Form 1065-B.

▶ See Instructions for Schedule F (Form 1040).

OMB No. 1545-0074

**2001**

Attachment  
Sequence No. **14**

Name of proprietor: **WALTER A. BROWN** Social security number (SSN): **543 : 00 : 2111**

A Principal product. Describe in one or two words your principal crop or activity for the current tax year. **MILK** B Enter code from Part IV: **1 | 1 | 2 | 1 | 2 | 0**

C Accounting method: (1)  Cash (2)  Accrual D Employer ID number (EIN), if any: **1 | 0 : 9 | 8 | 7 | 6 | 5 | 4 | 3**

E Did you "materially participate" in the operation of this business during 2001? If "No," see page F-2 for limit on passive losses.  Yes  No

**Part I Farm Income—Cash Method. Complete Parts I and II (Accrual method taxpayers complete Parts II and III, and line 11 of Part I.) Do not include sales of livestock held for draft, breeding, sport, or dairy purposes; report these sales on Form 4797.**

1	Sales of livestock and other items you bought for resale . . . . .	1	26,584	-			
2	Cost or other basis of livestock and other items reported on line 1 . . . . .	2	6,523	-			
3	Subtract line 2 from line 1 . . . . .	3			20,061	-	
4	Sales of livestock, produce, grains, and other products you raised . . . . .	4			163,018	-	
5a	Total cooperative distributions (Form(s) 1099-PATR) . . . . .	5a	33	-	5b	Taxable amount	33 -
6a	Agricultural program payments (see page F-2) . . . . .	6a	438	-	6b	Taxable amount	438 -
7	Commodity Credit Corporation (CCC) loans (see page F-3):						
a	CCC loans reported under election . . . . .	7a			665	-	
b	CCC loans forfeited . . . . .	7b			7c	Taxable amount	
8	Crop insurance proceeds and certain disaster payments (see page F-3):						
a	Amount received in 2001 . . . . .	8a			8b	Taxable amount	
c	If election to defer to 2002 is attached, check here ▶ <input type="checkbox"/> . . . . .	8d			8d		
9	Custom hire (machine work) income . . . . .	9			1,258	-	
10	Other income, including Federal and state gasoline or fuel tax credit or refund (see page F-3) . . . . .	10			567	-	
11	<b>Gross income.</b> Add amounts in the right column for lines 3 through 10. If accrual method taxpayer, enter the amount from page 2, line 51 . . . . . ▶	11			186,040	-	

**Part II Farm Expenses—Cash and Accrual Method. Do not include personal or living expenses such as taxes, insurance, repairs, etc., on your home.**

12	Car and truck expenses (see page F-4—also attach Form 4562) . . . . .	12	4,043	-	25	Pension and profit-sharing plans . . . . .	25		
13	Chemicals . . . . .	13	2,701	-	26	Rent or lease (see page F-5):			
14	Conservation expenses (see page F-4). . . . .	14	1,040	-	a	Vehicles, machinery, and equipment . . . . .	26a		
15	Custom hire (machine work) . . . . .	15	1,575	-	b	Other (land, animals, etc.) . . . . .	26b	2,400	-
16	Depreciation and section 179 expense deduction not claimed elsewhere (see page F-4) . . . . .	16	42,681	-	27	Repairs and maintenance . . . . .	27	5,424	-
17	Employee benefit programs other than on line 25 . . . . .	17			28	Seeds and plants purchased . . . . .	28	2,132	-
18	Feed purchased . . . . .	18	18,019	-	29	Storage and warehousing . . . . .	29		
19	Fertilizers and lime . . . . .	19	6,544	-	30	Supplies purchased . . . . .	30	2,807	-
20	Freight and trucking . . . . .	20	5,105	-	31	Taxes . . . . .	31	3,201	-
21	Gasoline, fuel, and oil . . . . .	21	3,521	-	32	Utilities . . . . .	32	3,997	-
22	Insurance (other than health) . . . . .	22	1,070	-	33	Veterinary, breeding, and medicine . . . . .	33	3,217	-
23	Interest:				34	Other expenses (specify):			
a	Mortgage (paid to banks, etc.) . . . . .	23a	3,175	-	a	Milk assessment . . . . .	34a	807	-
b	Other . . . . .	23b	1,043	-	b	Commissions, dues & fees . . . . .	34b	347	-
24	Labor hired (less employment credits) . . . . .	24	16,416	-	c	Records/Office supplies . . . . .	34c	287	-
					d	Travel & meals . . . . .	34d	534	-
					e	. . . . .	34e		
					f	. . . . .	34f		
35	<b>Total expenses.</b> Add lines 12 through 34f . . . . . ▶	35					35	132,086	-
36	<b>Net farm profit or (loss).</b> Subtract line 35 from line 11. If a profit, enter on Form 1040, line 18, and also on Schedule SE, line 1. If a loss, you must go on to line 37 (estates, trusts, and partnerships, see page F-6) . . . . .	36					36	53,954	-
37	If you have a loss, you must check the box that describes your investment in this activity (see page F-6). • If you checked 37a, enter the loss on Form 1040, line 18, and also on Schedule SE, line 1. • If you checked 37b, you must attach Form 6198.						37a	<input type="checkbox"/> All investment is at risk.	
							37b	<input type="checkbox"/> Some investment is not at risk.	

**SCHEDULE SE  
(Form 1040)**

**Self-Employment Tax**

OMB No. 1545-0074

**2001**

Attachment  
Sequence No. **17**

Department of the Treasury  
Internal Revenue Service

▶ See Instructions for Schedule SE (Form 1040).

▶ Attach to Form 1040.

Name of person with **self-employment** income (as shown on Form 1040)  
WALTER A. BROWN

Social security number of person  
with **self-employment** income ▶

543 : 00 : 211

**Who Must File Schedule SE**

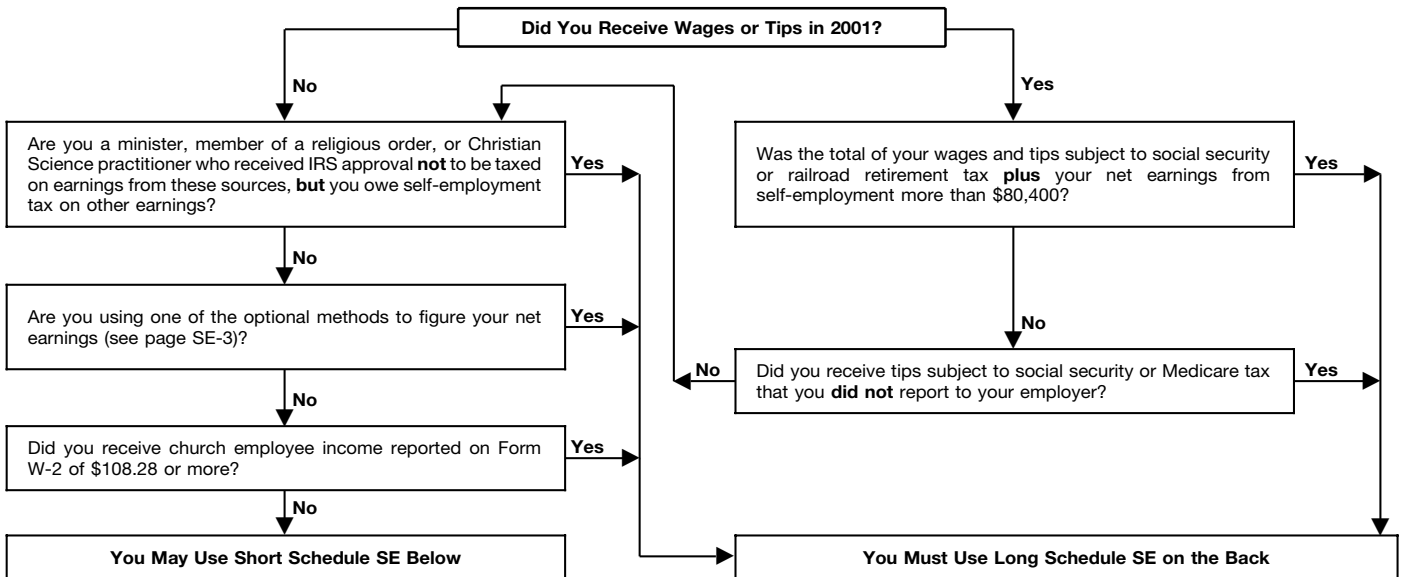
You must file Schedule SE if:

- You had net earnings from self-employment from **other than** church employee income (line 4 of Short Schedule SE or line 4c of Long Schedule SE) of \$400 or more **or**
- You had church employee income of \$108.28 or more. Income from services you performed as a minister or a member of a religious order **is not** church employee income. See page SE-1.

**Note.** Even if you had a loss or a small amount of income from self-employment, it may be to your benefit to file Schedule SE and use either "optional method" in Part II of Long Schedule SE. See page SE-3.

**Exception.** If your only self-employment income was from earnings as a minister, member of a religious order, or Christian Science practitioner **and** you filed Form 4361 and received IRS approval not to be taxed on those earnings, **do not** file Schedule SE. Instead, write "Exempt-Form 4361" on Form 1040, line 53.

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



**Section A—Short Schedule SE. Caution.** Read above to see if you can use Short Schedule SE.

<b>1</b>	Net farm profit or (loss) from Schedule F, line 36, and farm partnerships, Schedule K-1 (Form 1065), line 15a	<b>1</b>	53,954	—
<b>2</b>	Net profit or (loss) from Schedule C, line 31; Schedule C-EZ, line 3; Schedule K-1 (Form 1065), line 15a (other than farming); and Schedule K-1 (Form 1065-B), box 9. Ministers and members of religious orders, see page SE-1 for amounts to report on this line. See page SE-2 for other income to report	<b>2</b>		
<b>3</b>	Combine lines 1 and 2	<b>3</b>	53,954	—
<b>4</b>	<b>Net earnings from self-employment.</b> Multiply line 3 by 92.35% (.9235). If less than \$400, <b>do not</b> file this schedule; you do not owe self-employment tax	<b>4</b>	49,827	—
<b>5</b>	<b>Self-employment tax.</b> If the amount on line 4 is: <ul style="list-style-type: none"> <li>• \$80,400 or less, multiply line 4 by 15.3% (.153). Enter the result here and on <b>Form 1040, line 53.</b></li> <li>• More than \$80,400, multiply line 4 by 2.9% (.029). Then, add \$9,969.60 to the result. Enter the total here and on <b>Form 1040, line 53.</b></li> </ul>	<b>5</b>	7,624	—
<b>6</b>	<b>Deduction for one-half of self-employment tax.</b> Multiply line 5 by 50% (.5). Enter the result here and on <b>Form 1040, line 27</b>	<b>6</b>	3,812	—

For Paperwork Reduction Act Notice, see Form 1040 instructions.

Cat. No. 11358Z

Schedule SE (Form 1040) 2001

**SCHEDULE J  
(Form 1040)**

**Farm Income Averaging**

OMB No. 1545-0074

**2001**

Attachment  
Sequence No. **20**

Department of the Treasury  
Internal Revenue Service

▶ Attach to Form 1040.

▶ See Instructions for Schedule J (Form 1040).

Name(s) shown on Form 1040

Social security number (SSN)

WALTER A. & JANE W. BROWN

543 : 00 : 2111

<b>1</b>	Enter the taxable income from your 2001 Form 1040, line 39 . . . . .		<b>1</b>	48,766	-
<b>2</b>	Enter your <b>elected farm income</b> (see page J-1). <b>Do not</b> enter more than the amount on line 1		<b>2</b>	29,766	-
<b>3</b>	Subtract line 2 from line 1 . . . . .		<b>3</b>	19,000	-
<b>4</b>	Figure the tax on the amount on line 3. Use the <b>2001</b> Tax Table, Tax Rate Schedules, Capital Gain Tax Worksheet, or Schedule D, whichever applies . . . . .		<b>4</b>	2,076	-
<b>5</b>	If you used Schedule J to figure your tax for 2000, enter the amount from line 11 of your 2000 Schedule J. If you used Schedule J for 1999 but not 2000, enter the amount from line 15 of your 1999 Schedule J. If you used Schedule J for 1998 but not 1999 or 2000, enter the amount from line 3 of your 1998 Schedule J. Otherwise, enter the taxable income from your <b>1998</b> Form 1040, line 39; Form 1040A, line 24; or Form 1040EZ, line 6. If zero or less, see page J-2	<b>5</b>	700	-	
<b>6</b>	Divide the amount on <b>line 2</b> by 3.0 . . . . .	<b>6</b>	9,922	-	
<b>7</b>	Combine lines 5 and 6. If zero or less, enter -0- . . . . .	<b>7</b>	10,622	-	
<b>8</b>	Figure the tax on the amount on line 7 using <b>1998</b> tax rates. See page J-3 . . . . .		<b>8</b>	1,594	-
<b>9</b>	If you used Schedule J to figure your tax for 2000, enter the amount from line 15 of your 2000 Schedule J. If you used Schedule J for 1999 but not 2000, enter the amount from line 3 of your 1999 Schedule J. Otherwise, enter the taxable income from your <b>1999</b> Form 1040, line 39; Form 1040A, line 24; or Form 1040EZ, line 6. If zero or less, see page J-4 . . . . .	<b>9</b>	1,050	-	
<b>10</b>	Enter the amount from line 6 . . . . .	<b>10</b>	9,922	-	
<b>11</b>	Combine lines 9 and 10. If less than zero, enter as a negative amount . . . . .	<b>11</b>	10,972	-	
<b>12</b>	Figure the tax on the amount on line 11 using <b>1999</b> tax rates. See page J-5 . . . . .		<b>12</b>	1,646	-
<b>13</b>	If you used Schedule J to figure your tax for 2000, enter the amount from line 3 of your 2000 Schedule J. Otherwise, enter the taxable income from your <b>2000</b> Form 1040, line 39; Form 1040A, line 25; or Form 1040EZ, line 6. If zero or less, see page J-6 . . . . .	<b>13</b>	2,500	-	
<b>14</b>	Enter the amount from line 6 . . . . .	<b>14</b>	9,922	-	
<b>15</b>	Combine lines 13 and 14. If less than zero, enter as a negative amount . . . . .	<b>15</b>	12,422	-	
<b>16</b>	Figure the tax on the amount on line 15 using <b>2000</b> tax rates. See page J-7 . . . . .		<b>16</b>	1,864	-
<b>17</b>	Add lines 4, 8, 12, and 16 . . . . .		<b>17</b>	7,180	-
<b>18</b>	If you used Schedule J to figure your tax for 2000, enter the amount from line 12 of your 2000 Schedule J. If you used Schedule J for 1999 but not 2000, enter the amount from line 16 of your 1999 Schedule J. If you used Schedule J for 1998 but not 1999 or 2000, enter the amount from line 4 of your 1998 Schedule J. Otherwise, enter the tax from your <b>1998</b> Form 1040, line 40*; Form 1040A, line 25; or Form 1040EZ, line 10 . . . . .	<b>18</b>	107	-	
<b>19</b>	If you used Schedule J to figure your tax for 2000, enter the amount from line 16 of your 2000 Schedule J. If you used Schedule J for 1999 but not 2000, enter the amount from line 4 of your 1999 Schedule J. Otherwise, enter the tax from your <b>1999</b> Form 1040, line 40*; Form 1040A, line 25; or Form 1040EZ, line 10 . . . . .	<b>19</b>	159	-	
<b>20</b>	If you used Schedule J to figure your tax for 2000, enter the amount from line 4 of your 2000 Schedule J. Otherwise, enter the tax from your <b>2000</b> Form 1040, line 40*; Form 1040A, line 26; or Form 1040EZ, line 10 . . . . .	<b>20</b>	377	-	
<b>21</b>	<b>*Caution.</b> Do not include any amount from Form 4972 or 8814. Add lines 18 through 20. . . . .		<b>21</b>	643	-
<b>22</b>	Subtract line 21 from line 17. Also include this amount on Form 1040, line 40. . . . .		<b>22</b>	6,537	-

For Paperwork Reduction Act Notice, see Form 1040 instructions.

Cat. No. 25513Y

Schedule J (Form 1040) 2001



Name(s) shown on tax return. Do not enter name and identifying number if shown on other side.

Identifying number

WALTER A. & JANE W. BROWN

543-00-2111

**SECTION B—Business and Income-Producing Property**

**Part I Casualty or Theft Gain or Loss** (Use a separate Part I for each casualty or theft.)

19 Description of properties (show type, location, and date acquired for each):  
 Property A DAIRY COW #42 HOMETOWN, VA 6-22-97  
 Property B \_\_\_\_\_  
 Property C \_\_\_\_\_  
 Property D \_\_\_\_\_

		Properties (Use a separate column for each property lost or damaged from the same casualty or theft.)			
		A	B	C	D
20	Cost or adjusted basis of each property . . . . .	257 -			
21	Insurance or other reimbursement (whether or not you filed a claim). See the instructions for line 3 <b>Note:</b> If line 20 is more than line 21, skip line 22.	109 -			
22	Gain from casualty or theft. If line 21 is more than line 20, enter the difference here and on line 29 or line 34, column (c), except as provided in the instructions for line 33. Also, skip lines 23 through 27 for that column. See the instructions for line 4 if line 21 includes insurance or other reimbursement you did not claim, or you received payment for your loss in a later tax year				
23	Fair market value before casualty or theft . . . . .	500 -			
24	Fair market value after casualty or theft . . . . .	- 0 -			
25	Subtract line 24 from line 23 . . . . .	500 -			
26	Enter the smaller of line 20 or line 25 . . . . . <b>Note:</b> If the property was totally destroyed by casualty or lost from theft, enter on line 26 the amount from line 20.	257 -			
27	Subtract line 21 from line 26. If zero or less, enter -0-	148 -			
28	Casualty or theft loss. Add the amounts on line 27. Enter the total here and on line 29 or line 34 (see instructions)				148 -

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

(a) Identify casualty or theft	(b) Losses from casualties or thefts		(c) Gains from casualties or thefts includible in income
	(i) Trade, business, rental or royalty property	(ii) Income-producing and employee property	

Casualty or Theft of Property Held One Year or Less			
29		( )	( )
30	Totals. Add the amounts on line 29 . . . . .	30 ( )	( )
31	Combine line 30, columns (b)(i) and (c). Enter the net gain or (loss) here and on Form 4797, line 14. If Form 4797 is not otherwise required, see instructions . . . . .	31	
32	Enter the amount from line 30, column (b)(ii) here. Individuals, enter the amount from income-producing property on Schedule A (Form 1040), line 27, and enter the amount from property used as an employee on Schedule A (Form 1040), line 22. Estates and trusts, partnerships, and S corporations, see instructions. . . . .	32	

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

33	Casualty or theft gains from Form 4797, line 32 . . . . .	33	
34	Cow killed by lightning . . . . .	( 148 - )	( )
35	Total losses. Add amounts on line 34, columns (b)(i) and (b)(ii) . . . . .	35 ( 148 - )	( )
36	Total gains. Add lines 33 and 34, column (c) . . . . .	36	- 0 -
37	Add amounts on line 35, columns (b)(i) and (b)(ii) . . . . .	37	(148 -)
38	If the loss on line 37 is more than the gain on line 36: <b>a</b> Combine line 35, column (b)(i) and line 36, and enter the net gain or (loss) here. Partnerships (except electing large partnerships) and S corporations, see the note below. All others, enter this amount on Form 4797, line 14. If Form 4797 is not otherwise required, see instructions . . . . . <b>b</b> Enter the amount from line 35, column (b)(ii) here. Individuals, enter the amount from income-producing property on Schedule A (Form 1040), line 27, and enter the amount from property used as an employee on Schedule A (Form 1040), line 22. Estates and trusts, enter on the "Other deductions" line of your tax return. Partnerships (except electing large partnerships) and S corporations, see the note below. Electing large partnerships, enter on Form 1065-B, Part II, line 11	38a	(148 -)
39	If the loss on line 37 is less than or equal to the gain on line 36, combine lines 36 and 37 and enter here. Partnerships (except electing large partnerships), see the note below. All others, enter this amount on Form 4797, line 3 . . . . .	39	

**Note:** Partnerships, enter the amount from line 38a, 38b, or line 39 on Form 1065, Schedule K, line 7. S corporations, enter the amount from line 38a or 38b on Form 1120S, Schedule K, line 6.

**Sales of Business Property**  
**(Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2))**

Department of the Treasury  
Internal Revenue Service

▶ **Attach to your tax return.** ▶ **See separate instructions.**

Name(s) shown on return WALTER A. & JANE W. BROWN	Identifying number 543-00-2111
--	-----------------------------------

1 Enter the gross proceeds from sales or exchanges reported to you for 2001 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20 (see instructions) . . . . .	1
--	---

**Part I Sales or Exchanges of Property Used in a Trade or Business and Involuntary Conversions From Other Than Casualty or Theft—Most Property Held More Than 1 Year (See instructions.)**

(a) Description of property	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Gross sales price	(e) Depreciation allowed or allowable since acquisition	(f) Cost or other basis, plus improvements and expense of sale	(g) Gain or (loss) Subtract (f) from the sum of (d) and (e)
2 <i>Raised cows</i>	<i>before 1993</i>	<i>2001</i>	14,110. –	– 0 –	325. –	13,785. –
<i>Dairy cow #52</i>	<i>7-15-97</i>	<i>2-3-01</i>	303. –	514. –	912. –	(95. –)
<i>Raised heifer</i>	<i>6-2-99</i>	<i>8-3-01</i>	1,100. –	– 0 –	20. –	1,080. –

3 Gain, if any, from Form 4684, line 39 . . . . .	3
4 Section 1231 gain from installment sales from Form 6252, line 26 or 37 . . . . .	4
5 Section 1231 gain or (loss) from like-kind exchanges from Form 8824 . . . . .	5
6 Gain, if any, from line 32, from other than casualty or theft . . . . .	6
7 Combine lines 2 through 6. Enter the gain or (loss) here and on the appropriate line as follows: . . . . . <b>Partnerships (except electing large partnerships).</b> Report the gain or (loss) following the instructions for Form 1065, Schedule K, line 6. Skip lines 8, 9, 11, and 12 below. <b>S corporations.</b> Report the gain or (loss) following the instructions for Form 1120S, Schedule K, lines 5 and 6. Skip lines 8, 9, 11, and 12 below, unless line 7 is a gain and the S corporation is subject to the capital gains tax. <b>All others.</b> If line 7 is zero or a loss, enter the amount from line 7 on line 11 below and skip lines 8 and 9. If line 7 is a gain and you did not have any prior year section 1231 losses, or they were recaptured in an earlier year, enter the gain from line 7 as a long-term capital gain on Schedule D and skip lines 8, 9, 11, and 12 below.	7 14,770. –
8 Nonrecaptured net section 1231 losses from prior years (see instructions) . . . . .	8
9 Subtract line 8 from line 7. If zero or less, enter -0-. Also enter on the appropriate line as follows (see instructions): <b>S corporations.</b> Enter any gain from line 9 on Schedule D (Form 1120S), line 15, and skip lines 11 and 12 below. <b>All others.</b> If line 9 is zero, enter the gain from line 7 on line 12 below. If line 9 is more than zero, enter the amount from line 8 on line 12 below, and enter the gain from line 9 as a long-term capital gain on Schedule D.	9

**Part II Ordinary Gains and Losses**

10 Ordinary gains and losses not included on lines 11 through 17 (include property held 1 year or less):						
Raised dairy heifer	10-2-00	3-3-01	255. –	– 0 –	5. –	250. –

11 Loss, if any, from line 7 . . . . .	11 ( )
12 Gain, if any, from line 7 or amount from line 8, if applicable . . . . .	12
13 Gain, if any, from line 31 . . . . .	13 852. –
14 Net gain or (loss) from Form 4684, lines 31 and 38a . . . . .	14 (148. –)
15 Ordinary gain from installment sales from Form 6252, line 25 or 36 . . . . .	15
16 Ordinary gain or (loss) from like-kind exchanges from Form 8824 . . . . .	16
17 Recapture of section 179 expense deduction for partners and S corporation shareholders from property dispositions by partnerships and S corporations (see instructions) . . . . .	17
18 Combine lines 10 through 17. Enter the gain or (loss) here and on the appropriate line as follows: . . . . . <b>a For all except individual returns.</b> Enter the gain or (loss) from line 18 on the return being filed. <b>b For individual returns:</b> (1) If the loss on line 11 includes a loss from Form 4684, line 35, column (b)(ii), enter that part of the loss here. Enter the part of the loss from income-producing property on Schedule A (Form 1040), line 27, and the part of the loss from property used as an employee on Schedule A (Form 1040), line 22. Identify as from "Form 4797, line 18b(1)." See instructions . . . . . (2) Redetermine the gain or (loss) on line 18 excluding the loss, if any, on line 18b(1). Enter here and on Form 1040, line 14. . . . .	18 954. –
	18b(1)
	18b(2) 954. –

**Part III Gain From Disposition of Property Under Sections 1245, 1250, 1252, 1254, and 1255**

19 (a) Description of section 1245, 1250, 1252, 1254, or 1255 property:	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)
<b>A</b> TRUCK	6-22-92	7-9-01
<b>B</b> MOWER	4-21-91	8-12-01
<b>C</b> PURCHASED DAIRY COW #60	2-21-98	10-28-01
<b>D</b>		

These columns relate to the properties on lines 19A through 19D. ▶		Property A	Property B	Property C	Property D
<b>20</b> Gross sales price (Note: See line 1 before completing.)	<b>20</b>	700. -	70. -	670. -	
<b>21</b> Cost or other basis plus expense of sale	<b>21</b>	4,390. -	1,200. -	1,200. -	
<b>22</b> Depreciation (or depletion) allowed or allowable	<b>22</b>	4,390. -	1,200. -	612. -	
<b>23</b> Adjusted basis. Subtract line 22 from line 21	<b>23</b>	- 0 -	- 0 -	588. -	
<b>24</b> Total gain. Subtract line 23 from line 20	<b>24</b>	700. -	70. -	82. -	
<b>25 If section 1245 property:</b>					
<b>a</b> Depreciation allowed or allowable from line 22	<b>25a</b>	4,390. -	1,200. -	612. -	
<b>b</b> Enter the smaller of line 24 or 25a	<b>25b</b>	700. -	70. -	82. -	
<b>26 If section 1250 property:</b> If straight line depreciation was used, enter -0- on line 26g, except for a corporation subject to section 291.					
<b>a</b> Additional depreciation after 1975 (see instructions)	<b>26a</b>				
<b>b</b> Applicable percentage multiplied by the smaller of line 24 or line 26a (see instructions)	<b>26b</b>				
<b>c</b> Subtract line 26a from line 24. If residential rental property or line 24 is not more than line 26a, skip lines 26d and 26e	<b>26c</b>				
<b>d</b> Additional depreciation after 1969 and before 1976	<b>26d</b>				
<b>e</b> Enter the smaller of line 26c or 26d	<b>26e</b>				
<b>f</b> Section 291 amount (corporations only)	<b>26f</b>				
<b>g</b> Add lines 26b, 26e, and 26f	<b>26g</b>				
<b>27 If section 1252 property:</b> Skip this section if you did not dispose of farmland or if this form is being completed for a partnership (other than an electing large partnership).					
<b>a</b> Soil, water, and land clearing expenses	<b>27a</b>				
<b>b</b> Line 27a multiplied by applicable percentage (see instructions)	<b>27b</b>				
<b>c</b> Enter the smaller of line 24 or 27b	<b>27c</b>				
<b>28 If section 1254 property:</b>					
<b>a</b> Intangible drilling and development costs, expenditures for development of mines and other natural deposits, and mining exploration costs (see instructions)	<b>28a</b>				
<b>b</b> Enter the smaller of line 24 or 28a	<b>28b</b>				
<b>29 If section 1255 property:</b>					
<b>a</b> Applicable percentage of payments excluded from income under section 126 (see instructions)	<b>29a</b>				
<b>b</b> Enter the smaller of line 24 or 29a (see instructions)	<b>29b</b>				

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

<b>30</b> Total gains for all properties. Add property columns A through D, line 24	<b>30</b>	852. -
<b>31</b> Add property columns A through D, lines 25b, 26g, 27c, 28b, and 29b. Enter here and on line 13	<b>31</b>	852. -
<b>32</b> Subtract line 31 from line 30. Enter the portion from casualty or theft on Form 4684, line 33. Enter the portion from other than casualty or theft on Form 4797, line 6.	<b>32</b>	- 0 -

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

	(a) Section 179	(b) Section 280F(b)(2)
<b>33</b> Section 179 expense deduction or depreciation allowable in prior years	<b>33</b>	
<b>34</b> Recomputed depreciation. See instructions	<b>34</b>	
<b>35</b> Recapture amount. Subtract line 34 from line 33. See the instructions for where to report	<b>35</b>	



**Depreciation and Amortization**  
**(Including Information on Listed Property)**

Department of the Treasury  
Internal Revenue Service

▶ See separate instructions. ▶ Attach this form to your return.

Name(s) shown on return

Business or activity to which this form relates

Identifying number

WALTER A. & JANE W. BROWN

FARMING

543-00-2111

**Part I Election To Expense Certain Tangible Property Under Section 179**

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

<b>1</b>	Maximum dollar limitation. If an enterprise zone business, see page 2 of the instructions . . . . .	<b>1</b>	\$24,000
<b>2</b>	Total cost of section 179 property placed in service (see page 2 of the instructions). . . . .	<b>2</b>	162,229. -
<b>3</b>	Threshold cost of section 179 property before reduction in limitation . . . . .	<b>3</b>	\$200,000
<b>4</b>	Reduction in limitation. Subtract line 3 from line 2. If zero or less, enter -0- . . . . .	<b>4</b>	- 0 -
<b>5</b>	Dollar limitation for tax year. Subtract line 4 from line 1. If zero or less, enter -0-. If married filing separately, see page 2 of the instructions . . . . .	<b>5</b>	24,000. -
<b>6</b>	(a) Description of property	(b) Cost (business use only)	(c) Elected cost
	TRACTOR	33,729. -	24,000. -
<b>7</b>	Listed property. Enter amount from line 27 . . . . .	<b>7</b>	
<b>8</b>	Total elected cost of section 179 property. Add amounts in column (c), lines 6 and 7 . . . . .	<b>8</b>	24,000. -
<b>9</b>	Tentative deduction. Enter the smaller of line 5 or line 8 . . . . .	<b>9</b>	24,000. -
<b>10</b>	Carryover of disallowed deduction from 2000 (see page 3 of the instructions). . . . .	<b>10</b>	- 0 -
<b>11</b>	Business income limitation. Enter the smaller of business income (not less than zero) or line 5 (see instructions)	<b>11</b>	24,000. -
<b>12</b>	Section 179 expense deduction. Add lines 9 and 10, but do not enter more than line 11 . . . . .	<b>12</b>	24,000. -
<b>13</b>	Carryover of disallowed deduction to 2002. Add lines 9 and 10, less line 12 ▶	<b>13</b>	- 0 -

**Note:** Do not use Part II or Part III below for listed property (automobiles, certain other vehicles, cellular telephones, certain computers, or property used for entertainment, recreation, or amusement). Instead, use Part V for listed property.

**Part II MACRS Depreciation for Assets Placed in Service Only During Your 2001 Tax Year (Do not include listed property.)**

**Section A—General Asset Account Election**

**14** If you are making the election under section 168(i)(4) to group any assets placed in service during the tax year into one or more general asset accounts, check this box. See page 3 of the instructions . . . . .

**Section B—General Depreciation System (GDS) (See page 3 of the instructions.)**

(a) Classification of property	(b) Month and year placed in service	(c) Basis for depreciation (business/investment use only—see instructions)	(d) Recovery period	(e) Convention	(f) Method	(g) Depreciation deduction
<b>15a</b> 3-year property						
<b>b</b> 5-year property						
<b>c</b> 7-year property		81,729. -	7	HY	150DB	8,753. -
<b>d</b> 10-year property		56,500. -	10	HY	150DB	4,238. -
<b>e</b> 15-year property						
<b>f</b> 20-year property		1,300. -	20	HY	150DB	49. -
<b>g</b> 25-year property			25 yrs.		S/L	
<b>h</b> Residential rental property			27.5 yrs.	MM	S/L	
			27.5 yrs.	MM	S/L	
<b>i</b> Nonresidential real property			39 yrs.	MM	S/L	
				MM	S/L	

**Section C—Alternative Depreciation System (ADS) (See page 5 of the instructions.)**

<b>16a</b> Class life					S/L	
<b>b</b> 12-year			12 yrs.		S/L	
<b>c</b> 40-year			40 yrs.	MM	S/L	

**Part III Other Depreciation (Do not include listed property.) (See page 5 of the instructions.)**

<b>17</b>	GDS and ADS deductions for assets placed in service in tax years beginning before 2001 . . . . .	<b>17</b>	2,823. -
<b>18</b>	Property subject to section 168(f)(1) election . . . . .	<b>18</b>	
<b>19</b>	ACRS and other depreciation . . . . .	<b>19</b>	574. -

**Part IV Summary (See page 6 of the instructions.)**

<b>20</b>	Listed property. Enter amount from line 26 . . . . .	<b>20</b>	2,244. -
<b>21</b>	<b>Total.</b> Add deductions from line 12, lines 15 and 16 in column (g), and lines 17 through 20. Enter here and on the appropriate lines of your return. Partnerships and S corporations—see instructions	<b>21</b>	42,681. -
<b>22</b>	For assets shown above and placed in service during the current year, enter the portion of the basis attributable to section 263A costs . . . . .	<b>22</b>	

**Part V Listed Property** (Include automobiles, certain other vehicles, cellular telephones, certain computers, and property used for entertainment, recreation, or amusement.)

**Note:** For any vehicle for which you are using the standard mileage rate or deducting lease expense, complete **only** 23a, 23b, columns (a) through (c) of Section A, all of Section B, and Section C if applicable.

**Section A—Depreciation and Other Information (Caution: See page 7 of the instructions for limits for passenger automobiles.)**

**23a** Do you have evidence to support the business/investment use claimed?  **Yes**  **No** **23b** If "Yes," is the evidence written?  **Yes**  **No**

(a) Type of property (list vehicles first)	(b) Date placed in service	(c) Business/investment use percentage	(d) Cost or other basis	(e) Basis for depreciation (business/investment use only)	(f) Recovery period	(g) Method/Convention	(h) Depreciation deduction	(i) Elected section 179 cost
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**24** Property used more than 50% in a qualified business use (see page 6 of the instructions):

CAR	1-6-98	60 %	12,350. -	7,410. -	5	150DB/HY	1,065. - *	- 0 -
PICKUP TRUCK	5-18-98	100 %	7,076. -	7,076. -	5	150DB/HY	1,179. -	- 0 -
PICKUP TRUCK	6-22-92	100 %						

**25** Property used 50% or less in a qualified business use (see page 6 of the instructions):

		%				S/L -		
		%				S/L -		
		%				S/L -		

**26** Add amounts in column (h). Enter the total here and on line 20, page 1 . . . . . **26** 2,244. -

**27** Add amounts in column (i). Enter the total here and on line 7, page 1 . . . . . **27** - 0 -

**Section B—Information on Use of Vehicles**

Complete this section for vehicles used by a sole proprietor, partner, or other "more than 5% owner," or related person. If you provided vehicles to your employees, first answer the questions in Section C to see if you meet an exception to completing this section for those vehicles.

	(a) Vehicle 1		(b) Vehicle 2		(c) Vehicle 3		(d) Vehicle 4		(e) Vehicle 5		(f) Vehicle 6	
	Yes	No	Yes	No	Yes	No	Yes	No	Yes	No	Yes	No
<b>28</b> Total business/investment miles driven during the year (do not include commuting miles—see page 1 of the instructions) . . . . .	6,270		11,350		2,350							
<b>29</b> Total commuting miles driven during the year . . . . .	- 0 -		- 0 -		- 0 -							
<b>30</b> Total other personal (noncommuting) miles driven. . . . .	4,180		- 0 -		- 0 -							
<b>31</b> Total miles driven during the year. Add lines 28 through 30. . . . .	10,450		11,350		2,350							
<b>32</b> Was the vehicle available for personal use during off-duty hours? . . . . .	✓		✓		✓							
<b>33</b> Was the vehicle used primarily by a more than 5% owner or related person? . . . . .	✓		✓		✓							
<b>34</b> Is another vehicle available for personal use? . . . . .	✓		✓		✓							

**Section C—Questions for Employers Who Provide Vehicles for Use by Their Employees**

Answer these questions to determine if you meet an exception to completing Section B for vehicles used by employees who are not more than 5% owners or related persons (see page 8 of the instructions).

	Yes	No
<b>35</b> Do you maintain a written policy statement that prohibits all personal use of vehicles, including commuting, by your employees? . . . . .		
<b>36</b> Do you maintain a written policy statement that prohibits personal use of vehicles, except commuting, by your employees? See page 8 of the instructions for vehicles used by corporate officers, directors, or 1% or more owners . . . . .		
<b>37</b> Do you treat all use of vehicles by employees as personal use? . . . . .		
<b>38</b> Do you provide more than five vehicles to your employees, obtain information from your employees about the use of the vehicles, and retain the information received? . . . . .		
<b>39</b> Do you meet the requirements concerning qualified automobile demonstration use? (See page 8 of the instructions.) . . . . .		

**Note:** If your answer to 35, 36, 37, 38, or 39 is "Yes," do not complete Section B for the covered vehicles.

**Part VI Amortization**

(a) Description of costs	(b) Date amortization begins	(c) Amortizable amount	(d) Code section	(e) Amortization period or percentage	(f) Amortization for this year
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**40** Amortization of costs that begins during your 2001 tax year (see page 8 of the instructions):

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**41** Amortization of costs that began before your 2001 tax year . . . . . **41**

**42** **Total.** Add amounts in column (f). See page 9 of the instructions for where to report . . . . . **42**

\* Limited deduction for passenger automobile



## Depreciation Worksheet

Description of Property	Date Placed in Service	Cost or Other Basis	Business/Investment Use %	Section 179 Deduction	Depreciation Prior Years	Basis for Depreciation	Method/Convention	Recovery Period	Rate or Table %	Depreciation Deduction
STRAIGHT LINE										
BARN	1-8-78	6,400	100%		5,888	512 <sup>5</sup>	SL	25		256
SILLO	1-2-80	16,000	"		16,000	0 <sup>5</sup>	SL	20		0
ALTERNATE ACKS										
MACHINE SHED	1-2-86	6,000	100%		4,740	6,000	Mod SL	19	5.3	318
MACRS										
TRACTOR #2 (traded 7/01)	1-8-97	7,297	100%	5,000	804	2,297	SL/HY	10	10.0	229.70 <sup>1</sup>
DAIRY COW #42 (killed 7/01)	6-22-97	600	"		300	600	SL/HY	7	14.29	42.87 <sup>2</sup>
DAIRY COW #52 (sold 2/01)	7-15-97	900	"		450	900	SL/HY	7	14.29	64.31 <sup>2</sup>
DAIRY COW #54	9-9-97	1,200	"		600	1,200	SL/HY	7	14.29	171.48
CAR (listed property)	1-6-98	12,350	60%		4,334	7,410	150DB/HY	5	16.66	1,065.- <sup>3</sup>
DAIRY COW #60 (sold 10/01)	2-21-98	1,200	100%		538	1,200	150DB/HY	7	12.25	73.50 <sup>2</sup>
PLOW	4-6-98	4,821	100%		1,599	4,821	150DB/HY	10	10.02	483.06
PICKUP TRUCK (listed property)	5-18-98	7,076	"		4,129	7,076	150DB/HY	5	16.66	1,178.86
DAIRY COW #61	9-1-98	1,400	"		628	1,400	150DB/HY	7	12.25	171.50
TRACTOR #4	10-12-98	13,483	"	5,000	2,814	8,483	150DB/HY	10	10.02	849.99
MILK TANK	1-4-99	11,500	100%	10,000	448	1,500	150DB/HY	7	15.03	225.45
MANURE SPREADER	5-3-99	3,400	"		1,015	3,400	150DB/HY	7	15.03	511.02
DAIRY FACILITY BUILDING	1-9-01	56,500	100%		- 0 -	56,500	150DB/HY	10	7.50	4,237.50
DAIRY FACILITY EQUIPMENT	1-9-01	72,000	"		- 0 -	72,000	150DB/HY	7	10.71	7,711.20
MACHINE SHED IMPROVEMENT	2-20-01	1,300	"		- 0 -	1,300	150DB/HY	20	3.75	48.75
TRACTOR #5	7-8-01	33,729	"	24,000	- 0 -	9,729	150DB/HY	7	10.71	1,041.98 <sup>4</sup>
TOTAL										18,680.17

<sup>1</sup> Full year depreciation for tractor #2

<sup>2</sup> Depreciation limited to half-year

<sup>3</sup> Limited deduction for passenger automobile

<sup>4</sup> Half-year depreciation for tractor #5

<sup>5</sup> Adjusted basis



## 21.

# How To Get Tax Help

You can get help with unresolved tax issues, order free publications and forms, ask tax questions, and get more information from the IRS in several ways. By selecting the method that is best for you, you will have quick and easy access to tax help.

**Contacting your Taxpayer Advocate.** If you have attempted to deal with an IRS problem unsuccessfully, you should contact your Taxpayer Advocate.

The Taxpayer Advocate represents your interests and concerns within the IRS by protecting your rights and resolving problems that have not been fixed through normal channels. While Taxpayer Advocates cannot change the tax law or make a technical tax decision, they can clear up problems that resulted from previous contacts and ensure that your case is given a complete and impartial review.

To contact your Taxpayer Advocate:

- Call the Taxpayer Advocate at **1-877-777-4778**.
- Call the IRS at **1-800-829-1040**.
- Call, write, or fax the Taxpayer Advocate office in your area.
- Call **1-800-829-4059** if you are a TTY/TDD user.

For more information, see Publication 1546, *The Taxpayer Advocate Service of the IRS*.

**Free tax services.** To find out what services are available, get Publication 910, *Guide to Free Tax Services*. It contains a list of free tax publications and an index of tax topics. It also describes other free tax information services, including tax education and assistance programs and a list of TeleTax topics.



**Personal computer.** With your personal computer and modem, you can access the IRS on the Internet at [www.irs.gov](http://www.irs.gov). While visiting our web site, you can:

- Find answers to questions you may have.
- Download forms and publications or search for forms and publications by topic or keyword.
- View forms that may be filled in electronically, print the completed form, and then save the form for recordkeeping.

- View Internal Revenue Bulletins published in the last few years.
- Search regulations and the Internal Revenue Code.
- Receive our electronic newsletters on hot tax issues and news.
- Get information on starting and operating a small business.

You can also reach us with your computer using File Transfer Protocol at [ftp.irs.gov](http://ftp.irs.gov).



**TaxFax Service.** Using the phone attached to your fax machine, you can receive forms and instructions by calling **703-368-9694**. Follow the directions from the prompts. When you order forms, enter the catalog number for the form you need. The items you request will be faxed to you.

For help with transmission problems, call the FedWorld Help Desk at **703-487-4608**.



**Phone.** Many services are available by phone.

- *Ordering forms, instructions, and publications.* Call **1-800-829-3676** to order current and prior year forms, instructions, and publications.
- *Asking tax questions.* Call the IRS with your tax questions at **1-800-829-1040**.
- *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.

**Evaluating the quality of our telephone services.** To ensure that IRS representatives give accurate, courteous, and professional answers, we evaluate the quality of our telephone services in several ways.

- A second IRS representative sometimes monitors live telephone calls. That person only evaluates the IRS assistor and does not keep a record of any taxpayer's name or tax identification number.
- We sometimes record telephone calls to evaluate IRS assistors objectively. We hold these recordings no longer than one week and use them only to measure the quality of assistance.
- We value our customers' opinions. Throughout this year, we will be surveying our customers for their opinions on our service.



**Walk-in.** 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 governments, credit unions, and office supply stores have an extensive collection of products available to print from a CD-ROM or photocopy from reproducible proofs. Also, some IRS offices and libraries have the Internal Revenue Code, regulations, Internal Revenue Bulletins, and Cumulative Bulletins available for research purposes.



**Mail.** You can send your order for forms, instructions, and publications to the Distribution Center nearest to you and receive a response within 10 workdays after your request is received. Find the address that applies to your part of the country.

- **Western part of U.S.:**  
Western Area Distribution Center  
Rancho Cordova, CA 95743-0001
- **Central part of U.S.:**  
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P.O. Box 8903  
Bloomington, IL 61702-8903
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Eastern Area Distribution Center  
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Richmond, VA 23261-5074



**CD-ROM.** You can order IRS Publication 1796, *Federal Tax Products on CD-ROM*, and obtain:

- Current tax forms, instructions, and publications.
- Prior-year tax forms and instructions.
- Popular tax forms that may be filled in electronically, printed out for submission, and saved for recordkeeping.
- Internal Revenue Bulletins.

The CD-ROM can be purchased from National Technical Information Service (NTIS) by calling **1-877-233-6767** or on the Internet at [www.irs.gov](http://www.irs.gov). The first release is available in mid-December and the final release is available in late January.

IRS Publication 3207, *Small Business Resource Guide*, is an interactive CD-ROM that contains information important to small businesses. It is available in mid-February. You can get one free copy by calling **1-800-829-3676** or visiting the IRS web site at [www.irs.gov](http://www.irs.gov).

# Index

<b>A</b>					
Abandonment	66	Calendar year defined	11	Shares	15
Accounting method:		Canceled debt	20	Unharvested	30, 67, 84
Accrual	12	Capital assets	59	Cropland, highly erodible	63
Cash	12	Capital expenses	29		
Change in	14	Car expenses	27	<b>D</b>	
Crop	14	Cash method of accounting	12	Damage:	
Farm inventory	13	Casualties and thefts:		Casualties and thefts	75
Accounting periods	11	Adjustments to basis	77	Crop insurance	17
Accrual method of		Casualty, defined	75	Tree seedlings	78
accounting	12	Disaster area losses	80	Debt:	
Adjusted basis of assets	37	Leased property	77	Bad	60
Agricultural activity codes,		Livestock	75-76	Canceled	20, 37, 66,
Schedule F	2	Reimbursement	77	Nonrecourse	82
Agricultural program		Reporting gains and		Qualified farm	21
payments	16	losses	80	Recourse	66
Agricultural structure,		Theft, defined	75	Depletion	52
defined	44	Change in accounting		Depreciation:	
Alternative Depreciation		method	14	ADS election	49
System (ADS)	47, 49	Chickens, purchased	28	Clean-fuel vehicles	51
Alternative minimum tax	80	Christmas trees	29, 63	Conservation assets	33
Amortization:		Claim for refund	101	Deduction	41
Going into business	53	Clean-fuel vehicles	51	Incorrect amount	
Pollution control facilities	54	Club dues	30	deducted	43
Reforestation expenses	53	Collection of tax	101	Limit for automobiles	45
Section 197 intangibles	54	Comments	2	Listed property	51
Appeal rights	101	Commodity Credit Corporation:		Raised livestock	41
Assessments:		Loans	16	Recapture	50, 68-69
By conservation district	33	Market gain	16	When to file	43
Depreciable property	33	Commodity:		Disaster area losses	80
Sale, disposal of land	34	Futures	61	Disaster payments	17
Assistance (See Tax help)		Wages	88	Dispositions	34-35,
Audits	101	Compensation	93	55-56, 66, 71	
Automobiles, depreciation	45	Computer software	42, 54		
		Condemnation	75, 78	<b>E</b>	
<b>B</b>		Conservation:		Easement	22, 37
Bankruptcy	20	District assessments	33	Election:	
Barter income	22	Expenses	32	ADS depreciation	47, 49
Basis of assets:		Plans	33	Amortization:	
Adjusted basis	37	Reserve Program (CRP)	17	Business start-up costs	53
Allocating to several		Constructing assets	36	Pollution control	
assets	36	Constructive receipt of		facilities	54
Changed to business use	38	income	12	Reforestation costs	53
Constructing assets	36	Contamination	79	Crop method	28
Cost	35	Converted wetland	63	Cutting of timber	63
Decreases	37	Cooperatives, income from	19	Deducting conservation	
Depreciation	47	Corporation	10	expenses	34
Exchanges:		Cost-sharing exclusion	17	Farming loss	31
Like-kind	38	Credits:		MACRS exclusion	43
Nontaxable	38	Child tax	2	Not excluding	
Partially nontaxable	38	Earned income (EIC)	2, 89	cost-sharing payments	18
Taxable	38	Employment	25	Out of installment	
Gifts	39	Fuel tax	22, 98-99	method	2, 71
Increases	37	General business	55	Postponing casualty gain	78
Inherited	40	Investment	56	Postponing reporting crop	
Real property	35	Prior year minimum tax	82	insurance proceeds	17
Received for services	38	Qualified electric vehicle	37	Recognizing gain on	
Transfer from spouse	40	Social security and		certain assets	61
Uniform capitalization		Medicare	82	S corporation status	11
rules	36	Social security coverage	82	Section 179 deduction	46
Below-market loans	22	State unemployment tax	89	SIMPLE IRA period	93
Books and records	4	Crew leaders	88	Special valuation, estate	40
Breeding fees	26	Crop:		Electronic:	
Business income limit,		Destroyed	79	Deposit of taxes	3, 86
section 179 deduction	46	Insurance proceeds	17	Filing	3
Business use of home	27	Method of accounting	14	Embryo transplants	36
				Employer identification	
				number	3, 7, 87
				Environmental	
				contamination	79
				Estimated tax:	
				Farm gross income	7
				Farmer due dates	8
				Fiscal year farmer	8
				Gross income	7
				Penalties	8
				Examinations (audits)	101
				Exchanges:	
				Basis:	
				Like-kind	38
				Nontaxable	38
				Partially nontaxable	38
				Taxable	38
				Like-kind	57
				Nontaxable	57
				Excise taxes:	
				Credit	99
				Diesel fuel	97
				Farming purposes	96
				Home use of fuels	98
				Off-highway uses	98
				Refund	100
				<b>F</b>	
				Fair market value	
				defined	38, 73
				Family member:	
				Business expenses	13
				Installment sale	72
				Like-kind exchange	58
				Loss on sale or exchange	
				of property	30
				Personal-use property	76
				Section 179 property	45
				Social security coverage	87
				Third party designee	2
				Farm:	
				Business expenses	24
				Business, defined	32
				Defined	32, 49, 96
				Income averaging	23
				Rental	32
				Sale of	64
				Special use	
				valuation	40
				Federal unemployment tax	
				(FUTA)	89
				Fertilizer	18, 26
				Filing requirements	6
				Fiscal tax year defined	11
				Foreclosure	65
				Form:	
				1040	8
				1040-ES	9
				1040X	31
				1045	31, 56
				1065	9-10
				1096	9
				1099-A	66
				1099-C	20, 66
				1099-G	16, 19
				1099-INT	9
				1099-MISC	3, 6, 9, 89
				1099-PATR	19
				1120	9-10
				1120S	9, 11

1128	11	Holding period	60	Limits:	Market gain, reporting	16
1139	56	Horticultural structure	44	At-risk	Marketing quota penalties	28
2210	8			Business use of home	Material participation	84
2210-F	8			Capital losses	Meals	28
2290	9			Conservation	Membership fees	30
3115	14, 44			expenses	Methods of accounting	11
3468	8, 56	<b>I</b>		Depreciation on business	Minimum tax credit	82
3800	8, 55	Identification number,		cars	Modified ACRS (MACRS):	
4136	8, 99	taxpayer	6	Depreciation:	ADS election	49
4255	9, 56	Illegal irrigation subsidy	22	Business-use	Conventions	48
4562	9, 43	Improvements	43	Employees	Depreciation methods	48
4684	9	Income averaging (See Farm:		Excluded farm debt	Exchange	50
4797	9, 15, 18,	Income averaging)		Farm losses	Figuring the deduction	49
	58	Income:		General business credit	Involuntary conversion	50
4835	9, 15	Accounting for	11	Loss of personal-use	Nontaxable transfer	50
4868	8-9	Accrual method of		property	Percentage tables	49
4952	81	accounting	12	Not-for-profit farming	Property classes	47
5213	32	Canceled debt excluded	20	Passive activity	Recovery periods	47
5304-SIMPLE	93	Community	86	Percentage depletion	Money purchase pension	
5305-S	93	From farming	7, 14, 34	Prepaid farm supplies	plan	95
5305-SA	93	Gross	7	Reforestation costs	More information (See Tax help)	
5305-SEP	91	Not-for-profit farming	31	Section 179 deduction:		
5305-SIMPLE	93	Partner's distributive		Automobile	<b>N</b>	
6251	9, 80	share	10	Business income	Net operating loss	30
6252	71	Pasture	16	Dollar	Noncapital asset	61
8109	9	Schedule F	14	Self-employment earnings	Nontaxable exchanges	57
8594	9	Tax forms used by farmers	8	subject to SE tax	Nontaxable transfer of	
8801	82	Withholding of tax	88	SSA posting	MACRS property	50
8822	3, 9	Incorrect amount of		self-employment	Not-for-profit farming	31
8824	9, 58	depreciation deducted	43	income	Notification requirement:	
8832	10	Individual retirement		exchange	Earned income credit	89
8849	100	arrangements (IRAs)	96	Time for deferred	SIMPLE IRA	93
940	9	Individual taxpayer		exchange		
943	9, 89	identification number		Time to keep records		
982	22	(ITIN)	83	Listed property:		
I-9	87	Information returns	9	Defined	<b>O</b>	
SS-4	3, 7, 87	Innocent spouse relief	101	Limit on deduction for	Overdue tax bill	3
SS-5	6, 83	Insolvency	20	employees		
T	52	Installment sales:		Passenger automobile	<b>P</b>	
W-2	9, 88, 94	Electing out	71	Recordkeeping	Partner, limited	83
W-4	3, 89	Farm, sale of	73	Rules	Partnership	10, 83
W-4V	3, 16-17	Figuring income	71	Livestock:	Passenger automobile	51
W-5	89	Payments received	72	Casualty and theft losses	Pasture income	16
W-7	83	Reporting income	71	Crop shares	Patronage dividends	19
Free tax services	120	Unstated interest	73	Depreciation	Penalties:	
Fuel tax credit or refund	22, 98	Insurance	26	Diseased	Estimated tax	8
		Intangible property	54	Feed assistance	Information returns	9
		Interest:		Immature	Trust fund recovery	89
<b>G</b>		Expense	25	Losses	Per-unit retain certificates	20
Gains and losses:		Unstated	73	Purchased	Personal expenses	30
Basis of assets	35	Inventory:		Raised	Placed in service	42, 47
Capital assets, defined	59	Items included	13	Sale of	Pollution control facilities	54
Casualty	76-77	Methods of valuation	13	Unit-livestock-price,	Postponing casualty gain	78
Installment sales	70	Investment credit	56	inventory valuation	Prepaid expense:	
Livestock	62	Involuntary		Used in a farm business	Advance premiums	26
Long- or short-term	59	conversions	39, 50, 75	Weather-related sales	Extends useful life	12
Ordinary or capital	59	IRA	96	Loans	Farm supplies	24
Sale of farm	64	Irrigation:		Losses:	Livestock feed	24
Section 1231	67	Illegal subsidy	22	At-risk limits	Prizes	22
Theft	76-77	Project	78	Casualty	Produce	15
Timber	63			Disaster areas	Production flexibility	
General asset accounts	50			Farming	contract payments	12, 18
General business credit	55	<b>K</b>		Growing crops	Profit-sharing plans	95
Gifts	16, 30, 39,	Keogh plan (See Qualified		Hobby farming	Property:	
	57, 60	retirement plan)		Livestock	Changed to business use	38
Going into business	53			Nondeductible	Improvements	43
Goodwill	41			Theft	Received for services	38
				Lost property	Section 1245	68
<b>H</b>					Section 1252	70
Health insurance deduction	26			<b>M</b>	Section 1255	70
Hedging	61			MACRS property:	Section 1255	70
Help (See Tax help)				Involuntary conversion	Tangible personal	44
Highway use tax	26			Like-kind exchange	Publications (See Tax help)	
				Nontaxable transfer		



<hr/>		
<b>Q</b>		
Qualified farm debt . . . . .	21	
Qualified farmer, defined . . . . .	8	
Qualified retirement plan . . . . .	94	
Questions sent to IRS . . . . .	3	
Quotas and allotments . . . . .	36	
<hr/>		
<b>R</b>		
Recapture:		
Amortization . . . . .	68	
Basis reductions . . . . .	21	
Certain depreciation . . . . .	22	
Cost-sharing payments . . . . .	18	
Depreciation . . . . .	50, 68, 71, 74	
Investment credit . . . . .	56	
Reforestation expenses . . . . .	53	
Section 1245 property . . . . .	68	
Section 1250 property . . . . .	69	
Section 179 deduction . . . . .	47	
Recordkeeping . . . . .	4, 28, 82	
Reforestation expenses . . . . .	53	
Refund:		
Claim for . . . . .	101	
Deduction taken . . . . .	22	
Fuel tax . . . . .	22, 100	
Reimbursements:		
Casualties and thefts . . . . .	37, 75, 77	
Deduction taken . . . . .	22	
Expenses . . . . .	24	
Feed assistance . . . . .	17	
Real estate taxes . . . . .	35	
Reforestation expenses . . . . .	53	
To employees . . . . .	28	
Related persons . . . . .	13, 30, 38, 45, 58, 72, 78-79	
Rental income . . . . .	15	
Rented property, improvements . . . . .	43	
Repairs . . . . .	25, 43	
Repayment of income . . . . .	12	
Replacement:		
Period . . . . .	79	
Property . . . . .	79	
Repossessions . . . . .	65	
Residual method, sale of business . . . . .	64	
Retirement plans:		
Defined benefit . . . . .	95	
Defined contribution . . . . .	94	
IRA . . . . .	96	
Money purchase . . . . .	95	
Profit-sharing . . . . .	95	
Qualified . . . . .	94	
Salary reduction . . . . .	92	
SEP . . . . .	91	
SIMPLE . . . . .	92	
Returns:		
Corporation . . . . .	10	
Dependent's . . . . .	6	
Forms used by farmers . . . . .	8	
Information . . . . .	9	
Partnership . . . . .	10	
Penalties . . . . .	8-9	
Qualified farmer due dates . . . . .	8	
Sample . . . . .	101	
Self-employed . . . . .	6	
Right-of-way income . . . . .	22	
<hr/>		
<b>S</b>		
S corporation . . . . .	11	
Sale of home . . . . .	65	
Section 179 deduction:		
How to elect . . . . .	46	
Listed property . . . . .	51	
Qualifying property . . . . .	44	
Recapture . . . . .	47	
Section 197 intangibles . . . . .	42	
Self-employed health insurance . . . . .	26	
Self-employment tax:		
Community income . . . . .	86	
How to pay . . . . .	82	
Landlord participation . . . . .	84	
Material participation . . . . .	84	
Optional method . . . . .	85	
Regular method . . . . .	85	
Rental income . . . . .	84	
Share farming . . . . .	83	
SEP plans . . . . .	91	
Settlement costs (fees) . . . . .	35	
SIMPLE plans . . . . .	93-94	
Social security and Medicare:		
Credits of coverage . . . . .	82	
Withholding of tax . . . . .	88	
Withholding statement . . . . .	9	
Social security number . . . . .	6, 83	
Software, computer . . . . .	42	
Soil:		
Conservation . . . . .	33	
Contamination . . . . .	79	
Spouse, property transferred from . . . . .	40	
Standard mileage rate . . . . .	27	
Start-up costs for businesses . . . . .	53	
Suggestions . . . . .	2	
<hr/>		
<b>T</b>		
Tangible personal property . . . . .	44	
Tax help . . . . .	120	
Tax preparation fees . . . . .	29	
Tax shelter:		
At-risk limits . . . . .	30	
Defined . . . . .	12	
Tax-free exchanges . . . . .	57	
Taxes:		
Excise . . . . .	96	
Federal use . . . . .	26	
General . . . . .	26	
Self-employment . . . . .	82	
State and federal . . . . .	26	
State and local general sales . . . . .	26	
Withholding . . . . .	3, 9, 88	
Taxpayer Advocate . . . . .	101, 120	
Taxpayer rights . . . . .	100	
Telephone expense . . . . .	27	
Tenant house expenses . . . . .	28	
Term interests . . . . .	42	
Theft losses . . . . .	75	
Timber . . . . .	29, 52, 63	
Trade-in . . . . .	39	
Travel expenses . . . . .	28	
Truck expenses . . . . .	27	
Trust fund recovery penalty . . . . .	89	
TTY/TDD information . . . . .	120	
<hr/>		
<b>U</b>		
Uniform capitalization rules:		
Basis of assets . . . . .	36	
Inventory . . . . .	13	
Unstated interest . . . . .	73	
<hr/>		
<b>W</b>		
Water conservation . . . . .	33	
Water well . . . . .	33, 48	
Weather-related sales, livestock . . . . .	15, 78	
Withholding:		
Income tax . . . . .	88	
Social security and Medicare tax . . . . .	88	
<hr/>		