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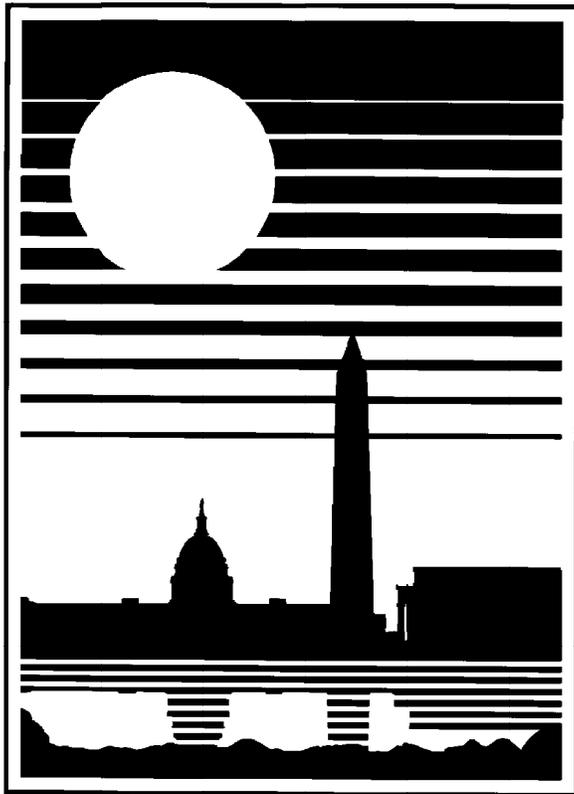
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Farmer's Tax Guide

For use in preparing
1996 Returns

Acknowledgement

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



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Introduction

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

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

of these free publications throughout this publication. See chapter 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.

Comments and recommendations. In compiling this *Farmer's Tax Guide*, we have adopted a number of suggestions that readers sent to us. We welcome your suggestions for future editions.



Please send your comments and recommendations to us at the following address:

Internal Revenue Service
Technical Publications Branch T:FP:P
1111 Constitution Avenue N.W.
Washington, DC 20224

We respond to many letters by telephone. It would be helpful if you include your area code and daytime phone number with your return address.

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.

Important Changes for 1996

The following items highlight a number of administrative and tax law changes for 1996.

Standard mileage rate. The standard mileage rate for the cost of operating your car, van, pickup, or panel truck in 1996 is 31 cents per mile for all business miles. See chapter 5.

Form 8645 obsolete. Form 8645, *Soil and Water Conservation Certification*, has been obsolete. You are no longer required to attach Form 8645 to Form 1040 when you deduct conservation expenses. See chapter 6.

Limits on depreciation of 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 1996 is \$3,060. Your depreciation cannot exceed \$4,900 for the second year of recovery, \$2,950 for the third year, and \$1,775 for each later tax year. See chapter 8.

Nonqualified section 179 property. The list of property you cannot treat as section 179 property includes additional items. See chapter 8.

Business property located in federal disaster area. Any business or income-producing property you acquire to replace destroyed business or income-producing property that was located in a federal disaster area is treated as property similar or related in service or use to the destroyed property. See chapter 13.

Tax rates and maximum net earnings for self-employment taxes. For 1996, the maximum amount of net earnings from self-employment subject to the social security part (12.4%) of the self-employment tax is \$62,700. There is no maximum limit on the amount subject to the Medicare part (2.9%).

For 1997, the maximum amount subject to the social security tax (12.4%) will be published in Publications 533 and 553. There is no maximum limit on the amount subject to the Medicare part (2.9%).

See chapter 15.

Wage limits for social security and Medicare taxes. The maximum amount of 1997 wages subject to the social security tax will be published in Circular A. There is no wage base limit for the amount subject to Medicare tax. See chapter 16.

Federal unemployment (FUTA) tax. For 1997, the gross FUTA tax rate remains 6.2% and the federal wage base remains \$7,000.

Alien farm workers. Wages paid to an alien who is admitted to the United States, performs contract farm labor for you, and then returns to his or her own country when the contract is completed, are exempt from the federal unemployment (FUTA) tax. This exemption, which expired after 1994, has been made permanent as of January 1, 1995. If you paid FUTA tax on these alien workers in 1995, you can file an amended Form 940, *Employer's Annual Federal Unemployment (FUTA) Tax Return*, for a refund. You must use the 1995 form. Amounts paid in 1996 can be adjusted on the 1996 Form 940. See the form instructions. Also see chapter 16 for information on the FUTA tax.

Credit for diesel-powered vehicle repealed. You cannot claim the credit for a diesel-powered vehicle purchased after August 20, 1996. See chapter 18.

Higher earned income credit. The maximum earned income credit has been increased to \$3,556 for 1996. To claim the credit, you must have earned income (including net earnings from self-employment) and modified adjusted gross income of less than \$28,495 and meet certain other requirements. For more information, including what counts as earned income, see Publication 596, *Earned Income Credit*.

Tax credits. The following credits have been changed or extended.

Work opportunity credit. This credit replaces the jobs credit, which expired January 1, 1995. The work opportunity credit applies to 35% of the qualified first-year wages you pay to certain individuals who begin working for you from October 1, 1996, through September 30, 1997. See Form 5884.

Research credit. This credit expired July 1, 1995. However, the credit is extended for qualified expenses paid or incurred from July 1, 1996, through May 31, 1997. You cannot take the credit for any expenses from July 1, 1995, through June 30, 1996. See Form 6765.

Orphan drug credit. This credit expired January 1, 1995. However, the credit is extended for qualified expenses paid or incurred from July 1, 1996, through May 31, 1997. You cannot carry back any part of an unused business credit attributable to the orphan drug credit to a year ending before July 1, 1996. See Form 6765.

Individual taxpayer identification number (ITIN). If you are a nonresident or resident alien who does not have and is not eligible for a social security number (SSN), the IRS will issue an ITIN you can use in place of an SSN. File Form W-7 with the IRS. It usually takes about 30 days to get the ITIN. Enter the ITIN wherever your SSN is requested on a tax return. If you must include another person's SSN on your return and that person does not have and is not eligible for an SSN, enter that person's ITIN.



An ITIN is for tax use only. It does not entitle you to social security benefits or change your employment or immigration status under U.S. law. See Form W-7.

Important Changes for 1997

The following items highlight a number of administrative and tax law changes for 1997.

Increased section 179 deduction. Beginning in 1997, the total cost of deductible section 179 property increases to \$18,000. It continues to increase annually until 2003. See chapter 8.

Voluntary withholding. Beginning in 1997, you can request income tax withholding at a rate of 7%, 15%, 28%, or 31% from the following payments:

- 1) Commodity Credit Corporation (CCC) loans included in income.
- 2) Certain disaster relief payments received under the Agricultural Act of 1949 or title II of the Disaster Assistance Act of 1988.
- 3) Unemployment compensation.
- 4) Certain other government payments.

You can request withholding from the payer on Form W4-V, *Voluntary Withholding Request*. It will be available in January 1997. See chapter 21 for information on ordering the

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

Electronic deposit of taxes. If your total deposits of social security, Medicare, and withheld income taxes were more than \$50,000 during 1995, you must begin making electronic deposits for *all* depository tax liabilities that occur after June 30, 1997. See Publication 51 (Circular A).

SIMPLE retirement plan. Beginning in 1997, you may be able to set up a savings incentive match plan for employees (SIMPLE). You can set up a SIMPLE plan if you have 100 or fewer employees and meet other requirements. See Publication 560, *Retirement Plans for the Self-Employed*.

Self-employed health insurance deduction. The deduction for health insurance costs of self-employed individuals is increased to 40% for tax years beginning in 1997. The deduction will increase to 45% for tax years beginning in 1998 through 2002, then rise gradually to 80% in 2006. See chapter 5.

Medical savings accounts. For tax years beginning after 1996, a self-employed individual may be able to take a deduction for contributions made to medical savings accounts (MSAs) to help cover medical expenses for the self-employed individual and his or her employees. See Publication 553, *Highlights of 1996 Tax Changes*.

Long-term care insurance. A qualified long-term care insurance contract issued after 1996 will generally be treated as an accident and health insurance contract. See Publication 553.

Important Reminders

The following reminders are included to help you file your tax return.

Direct deposit of refund. If you are due a refund on your 1996 tax return, you can have it deposited directly into your bank account. See your income tax package for details.

Club dues. Generally, you are not allowed any deduction for dues you pay or incur for membership in any club organized for business, pleasure, recreation, or other social purpose. However, you may be able to deduct dues you pay to a chamber of commerce or professional society. See chapter 5.

Depreciation of general asset account. You can elect to place assets subject to MACRS in one or more general asset accounts. After you have established the account, figure depreciation on the entire account by using the applicable depreciation method, recovery period, and convention for the assets in the account. See chapter 8.

Written tax questions. You can send written tax questions to your IRS District Director. If you do not have the address, call 1-800-829-

1040. The IRS is working to decrease the time it takes to respond to your correspondence. If you write, the IRS will usually reply within approximately 30 days.

Tele-Tax. The IRS has a telephone service called Tele-Tax. This service provides recorded tax information on approximately 140 topics such as filing requirements, employment taxes, taxpayer identification numbers, and tax credits. Recorded tax information is available 24 hours a day, 7 days a week, to taxpayers using push-button telephones, and during regular working hours to those using dial telephones. The topics covered and telephone numbers for your area are listed in the Form 1040 instructions.

Unresolved tax problems. IRS has a Problem Resolution Program for taxpayers who have been unable to resolve their problems with the IRS. If you have a tax problem you have been unable to resolve through normal channels, write to your local IRS District Director or call your local IRS office and ask for Problem Resolution assistance.

Although the Problem Resolution Office cannot change the tax law or technical decisions, it can frequently clear up misunderstandings that resulted from previous contacts. For more information, see Publication 1546, *How to Use the Problem Resolution Program of the IRS*.

Taxpayers who have access to TTY/TDD equipment can call 1-800-829-4059 to ask for help from Problem Resolution.

Overdue tax bill. If you receive a bill for overdue taxes, do not ignore the tax bill. 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, *Understanding the Collection Process*, for more information.

Payment voucher for Form 1040. To help process tax payments more accurately and efficiently, the IRS is sending Form 1040-V, *Payment Voucher*, to most Form 1040 filers this year.

If you have a balance due on Form 1040, send the voucher with your payment. Follow the instructions that come with the voucher. There is no penalty for not using the payment voucher, but the IRS strongly encourages you to use it.

Payment voucher for Forms 940 and 940-EZ. If you are required to make a payment of federal unemployment tax with Form 940 or 940-EZ, use the payment voucher at the bottom of the form. For more information, see the form instructions.

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. See chapter 21 for information on getting the publication.

Form W-4 for 1997. You should make new Forms W-4 available to your employees and encourage them to check their income tax withholding for 1997. Those employees who owed a large amount of tax or received a large refund for 1996 may need to file a new Form W-4. See chapter 16.

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.

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 taxes. See chapter 16.

Change of address. If you change your home or business address, you should use Form 8822, *Change of Address*, to notify IRS. Be sure to include your suite, room, or other unit number. Send the form to the Internal Revenue Service Center for your old address.

Form 1099-MISC. If you make total payments of \$600 or more during the year to another person, other than an employee or a corporation, in the course of your farm business, you must file information returns to report these payments. See chapter 2.

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 hand-harvest laborers. If you pay hand-harvest laborers 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 hand-harvest laborer must meet certain tests. See chapter 16.

Penalties. There are various penalties you should be aware of when preparing your return. You may be subject to a penalty if you:

- 1) Do not file your return by the due date. This penalty is 5% for each month or part of a month that your return is late, up to 25%.
- 2) Do not pay your tax on time. This penalty is 1/2 of 1% of your unpaid taxes for each month, or part of a month after the date the tax is due, up to 25%.
- 3) Substantially understate your tax. This penalty is 20% of the underpayment.
- 4) File a frivolous tax return. This penalty is \$500.
- 5) Fail to supply your social security number. This penalty is \$50 for each occurrence.

Tax shelter penalties. Tax shelters, their organizers, their sellers, or their investors may be subject to penalties for such actions as:

- 1) Failure to furnish tax shelter registration number. The penalty for the seller of the

tax shelter is \$100; the penalty for the investor in the tax shelter is \$250.

- 2) Failure to register a tax shelter. The penalty for the organizer of the tax shelter is the greater of 1% of the amount invested in the tax shelter, or \$500.
- 3) Not keeping lists of investors in potentially abusive tax shelters. The penalty for the tax shelter is \$50 for each person required to be on the list, up to a maximum of \$100,000.

Fraud penalty. The fraud penalty for underpayment of taxes is 75% of the part of the underpayment due to fraud.

Criminal penalties. You may be subject to criminal prosecution (brought to trial) for actions such as:

- 1) Tax evasion.
- 2) Willful failure to file a return, supply information, or pay any tax due.
- 3) Fraud and false statements.
- 4) Preparing and filing a fraudulent return.

Reminders—

Before you file your tax return, be sure to:

Use address label. Transfer the address label from the tax return package you received in the mail to your tax return, and make any necessary corrections.

Claim payments made. Be sure to include on the appropriate lines of your tax return any estimated tax payments and federal tax deposit payments you made during the tax year. Also, you must file a return to claim a refund of any payments you made, even if no tax is due.

Attach all forms in order. Attach all forms and schedules in sequence number order. The sequence number is just below the year in the upper right corner of the schedule or form. Attach all other statements or attachments last, but in the same order as the forms or schedules they relate to. Do not attach these other statements to the related form or schedule.

Complete Schedule SE. Fill out Schedule SE (Form 1040) if you had net earnings from self-employment of \$400 or more.

Use correct lines. List income, deductions, credits, and tax items on the correct lines.

Sign and date return. Make sure the tax return is signed and dated.

Submit payment. Enclose a check for any tax you owe. Write your social security number on the check. Also include the telephone number and area code where you can be reached during the day. If you receive a Form 1040-V, *Payment Voucher*, follow the instructions for completing and sending in the voucher.

Business codes for farmers. You must enter on line B of Schedule F (Form 1040) a code that identifies your principal business. 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 Activities Codes* on page 2 of Schedule F.

Rounding off dollars. You can round off cents to the nearest whole dollar on your return and schedules. To do so, drop amounts under 50 cents and increase amounts from 50 to 99 cents to the next dollar. For example, \$1.49 becomes \$1 and \$2.50 becomes \$3.

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.

Alternative ways of filing. IRS offers several alternatives to make filing your tax return easier. They are more convenient and accurate and will help us process your return faster.

TeleFile. Most taxpayers who filed a 1995 Form 1040EZ will receive a special TeleFile tax package that allows them to file their 1996 tax returns by phone. TeleFile is easy, fast, free, and available 24 hours a day.

On-line filing. You can file your tax return electronically using a computer and IRS-accepted software. This software is available at retail stores and from on-line filing companies. Using the software, you can file your return electronically, for a fee, through the software company or an on-line filing company.

1040PC format. You can print your return in 1040PC format with most tax software packages. The 1040PC is shorter than the regular tax return. There is less paper for your records and it is processed faster when you mail it to the IRS.

Electronic filing. Many paid tax return preparers can file your return electronically after they prepare it. If you prepare your own tax return, you generally must go through a tax return preparer or other company that provides, for a fee, IRS-accepted electronic filing services.

The free IRS Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE) programs may also be able to help you file your return electronically. See your income tax package for information on these programs.

You may be able to file your state tax return electronically with your federal return if you use one of the methods listed earlier.

More information. Call Tele-Tax and listen to topic 252 for more information. Check your income tax package for information about Tele-Tax.

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 local banking 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, but are explained in detail in Publication 509, *Tax Calendars for 1997*.

Fiscal year taxpayers. Generally, the due dates listed apply to all taxpayers, whether they use a calendar year or a fiscal year. However, fiscal year taxpayers should refer to Publication 509 for certain exceptions that apply to them.

1997—Calendar Year

During January

Employers. Give your agricultural employees their copies of Form W-2 for 1996 as soon as possible. The due date for giving Form W-2 to your employees is January 31, 1997. Copy A of Form W-2 must be filed by February 28, 1997.

January 15

Farmers. You can elect to pay your 1996 estimated income tax using Form 1040-ES. You have until April 15 to file your 1996 federal income tax return (Form 1040). If you do not pay your estimated tax by this date, you must file your 1996 return and pay any tax due by March 3, 1997.

January 31

Farm employers. File Form 943 to report social security and Medicare taxes and withheld income tax for 1996. Deposit any undeposited tax. If the total is less than \$500 and not a shortfall (see *Deposit Rules* and its discussion of *Safe harbors* under *Employer's Tax Calendar* in Publication 509), you can pay it with the return. If you have deposited the tax you owe for the year in full and on time, you have until February 10 to file the return. (Do not report wages for nonagricultural services on Form 943.)

All farm businesses. Give annual information statements to recipients of certain payments you made during 1996. You can use the appropriate version of Form 1099 or other information return. See chapter 2.

Federal unemployment (FUTA) tax. File Form 940 (or 940-EZ) for 1996. 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. See chapter 16. However, if you have deposited the tax you owe for the year in full and on time, you have until February 10 to file the return.

February 10

Farm employers. File Form 943 to report social security, Medicare, and withheld income tax for 1996. This due date applies only if you had deposited the tax for the year in full and on time. If not, you should have filed the return by January 31.

Federal unemployment (FUTA) tax. File Form 940 (or 940-EZ) for 1996. This due date applies only if you had deposited the tax for the year in full and on time. If not,

you should have filed the return by January 31.

February 28

All farm businesses. File information returns (Form 1099) for certain payments made during 1996 to a taxpayer other than a corporation. See chapter 2. There are different forms for different types of payments. Use a separate Form 1096 to summarize and transmit the form for each type of payment.

All employers. File Form W-3, *Transmittal of Wages and Tax Statements*, along with Copy A of all the Forms W-2 you issued for 1996. See chapter 2.

March 3

Farmers. File your 1996 income tax return (Form 1040) and pay any tax due. However, you have until April 15 to file if you paid your 1996 estimated tax by January 15, 1997.

March 17

Corporations. File a 1996 calendar year income tax return, (Form 1120 or 1120-A) and pay any tax due. See Publication 542, *Corporations*.

April 15

Individual farmers. File an income tax return (Form 1040) for 1996 and pay any tax due if you did not file by March 3. See chapter 2.

Partnerships. File a 1996 calendar year return (Form 1065). See Publication 541, *Partnerships*.

April 30

Federal unemployment (FUTA) tax. If you are liable for FUTA tax (see chapter 16), deposit the tax owed through March, if more than \$100, with a depository.

July 31

Federal unemployment (FUTA) tax. If you are liable for FUTA tax, deposit the tax owed through June with a depository. No deposit is necessary if the liability for the quarter, plus undeposited FUTA tax for the 1st quarter, does not exceed \$100.

October 31

Federal unemployment (FUTA) tax. If you are liable for FUTA tax, deposit the tax owed through September with a depository. No deposit is necessary if the liability for the quarter, plus undeposited FUTA tax for previous quarters, does not exceed \$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.

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

See chapter 21 for information about getting these 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 document 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 may choose any system suited to your farming business that clearly shows your income.

You should set up your books 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 books for each business.

Your books 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 books.

It is important to keep these documents because they support the entries in your books and on your tax return. You should keep them in an orderly fashion and in a safe place.

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 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, that you own and use in your business. You must keep records to verify certain information about your business assets. You need records to figure the annual depreciation and the gain or loss when you sell the assets. Your records should show:

- When and how you acquired the asset
- The purchase price
- The cost of any improvements

- Section 179 deduction taken
- Deductions taken for depreciation
- Deductions taken for casualty losses, such as fires or storms
- How you used the asset
- When and how you disposed of the asset
- The selling price
- The expenses of sale

Examples of records that may show this information include:

- Purchase 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. The following is a list of acceptable account statements.

- 1) An account statement showing a check clearing is accepted as proof if it shows the:
 - a) Check number,
 - b) Amount,
 - c) Payee's name, and
 - d) Date the check amount was posted to the account by the financial institution.
- 2) An account statement showing an electronic funds transfer is accepted as proof if it shows the:
 - a) Amount transferred,
 - b) Payee's name, and
 - c) Date the transfer was posted to the account by the financial institution.
- 3) An account statement showing a credit card charge (an increase to the cardholder's loan balance) is accepted as proof if it shows the:
 - a) Amount charged,
 - b) Payee's name, and
 - c) Date charged (transaction date).

These account statements must be highly legible and readable.

TIP *Proof of payment of an amount alone does not establish that 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 provision of the Internal Revenue Code. Generally, this means you must keep records that

support an item of income or deduction on a return until the period of limitations for that return runs out.

The period of limitations is the period of time in which you can amend your return to claim a credit or refund, or the IRS can assess additional tax. The period of time in which you can amend your return to claim a credit or refund is generally the later of:

- 1) 3 years after the date your return is due or filed, or
- 2) 2 years after the date the tax is paid.

Returns filed before the due date are treated as filed on the due date.

The IRS has 3 years from the date you file your return to assess any additional tax. If you file a fraudulent return or no return at all, the IRS has a longer period of time to assess additional tax.



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 received property in a nontaxable exchange, your basis in that property is the same as the basis of the property you gave up, increased by 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 Reminders

Form 1099–MISC. If you make total payments of \$600 or more during the year to another person, other than an employee or a corporation, in the course of your farming business, you must file Form 1099–MISC to report these payments.

Estimated tax. When you figure your estimated tax for 1997, you must include any alternative minimum tax you expect to owe. See chapter 14 and Publication 505, *Tax Withholding and Estimated Tax*.

Introduction

If you are a citizen or resident of the United States, single or married, and your gross income for the tax year is at least the amount shown later in the applicable category, you must file a 1996 federal income tax return, even if no tax is due. This also applies to minor children. If you do not meet the gross income requirement, you may still need to file a tax return if you have self-employment income, are entitled to a complete refund of tax withheld, or are entitled to a refund of the earned income credit. Gross income is explained later.

Topics

This chapter discusses:

- Filing requirements
- Identification number
- Estimated tax
- Main tax forms used by farmers
- Partnership return
- Corporation return
- S corporation return

Useful Items

You may want to see:

Publication

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

Form (and Instructions)

This chapter discusses various forms you may have to file with the IRS. We have not listed them separately here.

See chapter 21 for information about getting the publications and forms discussed.

Filing Requirements

When your income reaches a certain level, based on your filing status and age, you must file a tax return.

| Who Must File | |
|--|------------------|
| Filing Status Is: | Income At Least: |
| Single | |
| Under 65 | \$ 6,550 |
| 65 or older | 7,550 |
| Head of Household | |
| Under 65 | 8,450 |
| 65 or older | 9,450 |
| Married, Joint Return | |
| Both under 65 | 11,800 |
| One spouse 65 or older | 12,600 |
| Both 65 or older | 13,400 |
| Not living with spouse at end of year (or on date spouse died) | 2,550 |
| Married, Separate Return | |
| All (any age) | 2,550 |
| Qualifying Widow(er) with Dependent Child | |
| Under 65 | 9,250 |
| 65 or older | 10,050 |

Dependent's return. If you can claim someone as a dependent on your tax return (for example, your son or daughter), that person must generally also file his or her own tax return if he or she:

- 1) Had only earned income, such as salary or wages, and the total is more than \$4,000, or
- 2) Had only unearned income, such as interest and dividends, and the total is more than \$650, or
- 3) Had both earned and unearned income, and the total is more than \$650.

Self-employed. If you are self-employed, you must file an income tax return if you had net earnings of \$400 or more from self-employment, even though you may not be otherwise required to file a return. See chapter 15.

Earned income credit refund. You must also file a return to receive a refund of the earned income credit.

More information. See the Form 1040 instructions for more information on who must file a return for 1996.

Identification Number

You must show your taxpayer identification number (your social security or employer identification number) on all returns, statements,

or documents you are required to file. For example, it must be shown on your federal income tax return, your estimated tax payment voucher, and all information returns, such as Forms 1096 and 1099. A penalty of \$50 may be assessed for each failure to show the number.

Which number to use. If you file an excise, alcohol, tobacco, firearms, or employment tax return, you should have an employer identification number. Use that number on your farm business Schedule F (Form 1040). Otherwise, use your social security number. On your individual income tax return (Form 1040), computation of self-employment tax (Schedule SE), and estimated tax payment voucher (Form 1040-ES), you should use your social security number, regardless of the number used on your business returns.

If you are married, show social security numbers for both you and your spouse on your Form 1040, whether you file jointly or separately. If you are filing a joint return, list the social security numbers in the same order that you show your first names. Also show both social security numbers on your Form 1040-ES if you make joint estimated tax payments.

Application for identification number. To apply for a social security number (SSN), use Form SS-5. You can get the form from any social security office. If you are under 18 years of age, you must furnish evidence of age, identity, and U.S. citizenship 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 two weeks to get an SSN.



To apply for an employer identification number, use Form SS-4. You can get this form from any social security office or by calling IRS at 1-800-829-3676.

Estimated Tax and Return Due Dates

When you must pay estimated tax and file your return depends on whether you qualify as a farmer. To qualify as a farmer, you must receive at least two-thirds of your total gross income from farming in the current or prior year. **Gross income is not the same as total income** shown on line 22 of Form 1040.

Gross Income

Gross income is all income you receive in the form of money, property, and services that is not exempt from tax. It is the total income you receive before allowable deductions. For a business, gross income is total receipts minus cost of goods sold.

Your gross income is used to determine whether you must file an income tax return. It is also used to determine whether you qualify as a farmer. To see if you qualify as a farmer, first figure your total gross income and then determine the percentage of this total that comes from farming. On a joint return, you

must add your spouse's gross income to your own gross income to determine if at least two-thirds of the total is from farming.

Gross income includes:

- 1) Wages, salaries, tips, etc.
- 2) Taxable interest.
- 3) Dividends.
- 4) Taxable refunds of state and local taxes.
- 5) Alimony received.
- 6) Gross business income from line 7, Schedule C (Form 1040).
- 7) Gross receipts from line 1, Schedule C-EZ (Form 1040).
- 8) Capital gains from Schedule D (Form 1040). Use **only** column (g). Losses cannot be netted against gains. Add lines 7 and 16, column (g), and subtract the total of lines 5 and 13, column (g), and the gain from Form 4797 reported on line 12, column (g) of Schedule D.
- 9) Gains on sales of business property from Form 4797, column (h) of lines 7 and 19.
- 10) Taxable IRA distributions, pensions, annuities, and social security benefits.
- 11) Gross rental income from line 3, Schedule E (Form 1040).
- 12) Gross royalty income from line 4, Schedule E (Form 1040).
- 13) Your taxable net income from an estate or trust (line 36, Schedule E, Form 1040).
- 14) Income from a REMIC reported on line 38, Schedule E (Form 1040).
- 15) Gross farm rental income from line 7, Form 4835.
- 16) Farm income from line 11, Schedule F (Form 1040).
- 17) Your distributive share of gross income from a partnership or limited liability company treated as a partnership.
- 18) Your pro rata share of gross income from an S corporation.
- 19) Unemployment compensation.
- 20) Other income reported on line 21, Form 1040, not reported with any of the items listed above.

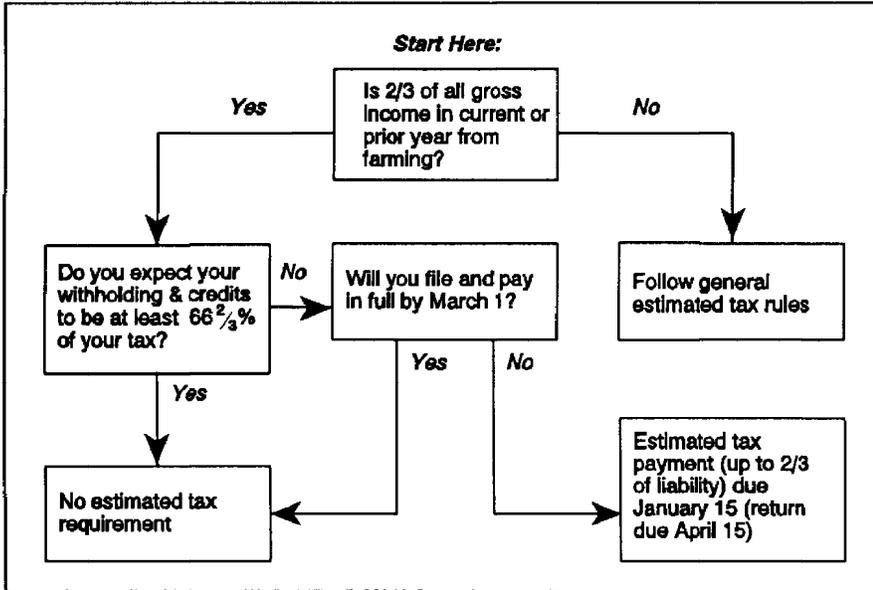
There are brief descriptions of forms and schedules used by farmers later.

Gross Income From Farming

Gross income from farming includes:

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

Figure 2-A. Estimated Tax for Farmers



reported on Schedule D (Form 1040) or Form 4797.



Wages you receive as a farm employee are not farm income. This includes wages you receive from a farm corporation even if you are a stockholder in the corporation. If all or most of your income is from wages as a farm employee, your employer is usually required to withhold income tax from your wages. You may also have to make estimated tax payments if you do not have enough tax withheld. For more information, see Publication 505.

Percentage From Farming

Total your gross income from all sources as shown earlier. Then total 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. James Smith had the following total gross income and farm gross income in 1996:

| | Gross Income | |
|-----------------------------|------------------|-----------------|
| | Total | Farm |
| Taxable interest | \$43,000 | |
| Dividends | 500 | |
| Rental income (Sch E) | 1,500 | |
| Farm income (Sch F) | 75,000 | \$75,000 |
| Schedule D | 5,000 | 5,000 |
| Total | \$125,000 | \$80,000 |

Schedule D showed gains from the sale of dairy cows carried over from Form 4797 (\$5,000) in addition to losses from the sale of corporate stock (\$2,000). Mr. Smith's gross farm income is 64% of his total gross income ($\$80,000 \div \$125,000 = .64$). Therefore, he

does not meet the farm gross income test in 1996. However, he can still qualify as a farmer if at least two-thirds of his gross income was from farming in 1995.

Example 2. The facts are the same as Example 1 except that Mr. Smith also received gross farm rental income (Form 4835) of \$15,000. This made his total gross income \$140,000 and his farm gross income \$95,000. He qualifies as a farmer in 1996 since at least two-thirds of his gross income is from farming [$\$95,000 \div \$140,000 = .679$ (67.9%)].

Qualified Farmer Due Dates for 1997

If at least two-thirds of your total gross income for 1996 or 1997 is from farming, you have only one payment due date for estimated tax—January 15, 1998.

For your 1997 tax, you may either:

- 1) Pay all your estimated tax by January 15, 1998, and file your Form 1040 by April 15, 1998, or
- 2) File your 1997 Form 1040 by March 2, 1998, and pay all the tax due. You are not required to make an estimated tax 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 1996 or 1997 is from farming, the required annual payment due January 15, 1998, is the smaller of:

- 1) 66 2/3% (.6667) of your total tax for 1997, or
- 2) 100% of the total tax shown on your 1996 return. (The return must cover all 12 months.)

Fiscal year. If you qualify as a farmer but your tax year does not start on January 1, you may file your return and pay the tax by the first day of the 3rd month after the close of your tax year. Or you may pay your required estimated tax 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.

Nonqualified Farmer Due Dates for 1997

If you did not qualify as a farmer in 1996 because less than two-thirds of your total gross income was from farming and you do not expect to qualify in 1997, you will not qualify for the special estimated tax payment and return due dates. In this case, you must generally make quarterly estimated tax payments on April 15, June 16, and September 15, 1997, and on January 15, 1998. You must file your return by April 15, 1998.

For more information on estimated taxes, see Publication 505.

Estimated Tax Penalty for 1996

If you do not pay all your required estimated tax for 1996 by January 15, 1997, or do not file your 1996 return and pay the tax by March 3, 1997, 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 10 days after the notice date, the IRS will not charge you interest.

Occasionally, you may get a penalty notice even though you filed your return on time, attached Form 2210-F, and met the gross income test. If you receive a penalty notice for underpaying estimated tax that you think 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, showing that you meet the gross income test. Do not ignore a penalty notice, even if you think it is in error.

Other Filing Information for 1996

Payment date on holiday or weekend. If the last day for filing your return or making a payment falls on a Saturday, Sunday, or legal holiday, your return or payment will be on time if it is filed or made on the next business day.

Automatic extension of time to file Form 1040. If you do not choose to file your 1996 return by March 3, 1997, the due date for your return will be April 15, 1997. However, you can get an automatic 4-month extension of time to file your return. Your Form 1040 would then be due by August 15, 1997. To get this extension,

file Form 4868, *Application for Automatic Extension of Time To File U.S. Individual Income Tax Return*, by April 15, 1997. Form 4868 does not extend the time to pay the tax. For more information, see the instructions for Form 4868.



This extension does not extend the March 3, 1997, filing date for farmers who did not make an estimated tax payment and want to avoid an estimated tax penalty. Therefore, if you did not make an estimated tax payment by January 15, 1997, and you file your tax return after March 3, 1997, you will be subject to a penalty for underpaying your estimated tax, even if you file Form 4868.

Return Forms

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 nonbusiness itemized deductions on this schedule.

Schedule B, Interest and Dividend Income. Report interest and dividend income of more than \$400 on this schedule.

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

Schedule C-EZ, Net Profit From Business. 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 sales 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 whether you file on the cash or an accrual method of accounting. List all farm income and deductions and determine the net farm profit or loss on this schedule.

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

Form 1040-ES. Use Form 1040-ES, *Estimated Tax for Individuals*, to figure and pay estimated tax. See Publication 505.

Form 2210-F. Use Form 2210-F, *Underpayment of Estimated Tax by Farmers and Fishermen*, to figure any underpayment of estimated tax and the penalty.

Form 3468. Form 3468, *Investment Credit*. The investment credit is generally repealed, but see chapter 9 for any exceptions that may apply.

Form 3800. Figure the general business credit on Form 3800, *General Business Credit*. See chapter 9 for information on the credits that comprise the general business credit.

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

Form 4255. Figure the tax from the recapture of investment credit on Form 4255, *Recapture of Investment Credit*.

Form 4562. Explain the deductions for depreciation and amortization on Form 4562, *Depreciation and Amortization*.

Form 4684. Report gains and losses from casualty and theft of business and personal-use property on Form 4684, *Casualties and Thefts*.

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 received as a share of crops or livestock produced by a tenant if you, the landlord, did not materially participate in the operation or management of the farm on Form 4835, *Farm Rental Income and Expenses*.

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*. It does not, however, extend the time to pay any tax due.

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

Other Forms

You may file the forms below in certain situations.

Form W-2. If you are in the trade or business of farming, prepare Form W-2, *Wage and Tax Statement*, for each employee you paid for services, including any payment that was not in cash. You must show, in the space marked *Wages, tips, other compensation*, the total paid to the employee. Give copies B and C of Form W-2 to the employee by the last day of January. Send Copy A of each Form W-2 to the Social Security Administration with a completed Form W-3, *Transmittal of Income and*

Tax Statements, by the last day of February. See chapter 16.

Form 940. File Form 940, *Employer's Annual Federal Unemployment (FUTA) Tax Return*, by January 31 of the following year if you were subject to FUTA tax. If all the tax due was deposited by January 31, you can file Form 940 as late as February 10.

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

Form 943. File Form 943, *Employer's Annual Tax Return for Agricultural Employees*, by January 31 of the following year if you were required to withhold and pay withheld income, social security, and Medicare taxes on farm labor wages you paid during the calendar year. If you deposited all the tax due by January 31, you can file Form 943 as late as February 10.

Form 1065. A farm partnership files Form 1065, *U.S. Partnership Return of Income*. See *Partnership* later.

Form 1120. A corporation files Form 1120, *U.S. Corporation Income Tax Return*.

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

Form 1120S. An S corporation files Form 1120S, *U.S. Income Tax Return for an S Corporation*. See *S Corporation* later.

Form 2290. File Form 2290, *Heavy Vehicle Use Tax Return*, if a truck or truck tractor registered in your name is:

- 1) A highway motor vehicle.
- 2) Required to be registered for highway use.
- 3) Actually used at least once on a public highway.
- 4) Has a taxable gross weight of at least 55,000 pounds.

See the instructions for Form 2290.

Form 8109. Deposit employment taxes not deposited electronically 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 \$500 or more must be deposited. The IRS will send you a coupon book for making deposits when you apply for an employer identification number (EIN).



Beginning in July 1997, certain farmers must deposit taxes electronically. See chapter 16.

Form 8822. Notify IRS of a change in your home or business address with Form 8822, *Change of Address*. Include the suite, room, or other unit number if it is required in the address and send the form to the Internal Revenue Service Center for your old address.

Form 8824. Report the exchange of business or investment property for like-kind property on Form 8824, *Like-Kind Exchanges*. It is filed with Schedule D (Form 1040) or Form 4797. See chapter 10.

Ordering forms. To order any of the forms listed in this section, see chapter 21.

Information Returns

Information returns provide information the IRS requires, other than taxes due. There are many information returns, including Form W-2, discussed earlier. This discussion, however, is limited to Form 1099-INT, Form 1099-MISC, and Form 1096.

Form 1099-INT. You report interest payments, including interest paid on installment sale contracts, of \$600 or more 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. Payments of \$600 or more made for items such as custom harvesting, crop sprayers, services of a veterinarian, rents, commissions, fees, prizes, awards, services of an independent contractor, other payments and compensation, and services provided by nonemployees are reported on Form 1099-MISC, *Miscellaneous Income*. Payments of \$10 or more for royalties are also reported on Form 1099-MISC.

Do not report payments for merchandise, freight and similar charges on Form 1099-MISC. However, if you pay a contractor who is not a dealer in supplies for both supplies and services, include the payment for supplies used to perform the services as long as providing the supplies was incidental to providing the service.

You also use Form 1099-MISC to report to the payee and to the IRS payments you made that were subject to backup withholding and the amounts you withheld.

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

Preparation of returns. You must prepare separate copies of Form 1099-INT and Form 1099-MISC for each person. File one copy of the form with the IRS. Give each person you paid \$600 or more a statement (or copy of the form) by January 31 of the following year. Instructions for completing these forms are in 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 form. Because these forms are read by machine, there are very specific instructions for their preparation and submission. You may be subject to a penalty for each incorrectly filed document.

Penalties. If you file information returns late, without all 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-2* for information on Form 1099 penalties.

Partnership

A partnership is the relationship between two or more persons who join together to carry on a trade or business, including farming. Each partner contributes in some way—money, property, labor, or skill—and shares profits and losses in agreed proportions.

A syndicate, group, pool, joint venture, or other unincorporated organization that carries on any business, financial operation, or venture is also a partnership for tax purposes, unless it can be classified as a corporation, a trust, or an estate.

Family partnership. Members of the same family can, and often do, form valid partnerships. For instance, a husband and wife or parents and children can conduct a farming enterprise through a partnership. 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 on Form 1065. (See *Form 1065* later.)

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.

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 owner or tenants-in-common of farm property lease that property for cash rental or a share of the crops, a partnership is not necessarily created by the leasing. However, tenants-in-common may be partners if they actively carry on a farm or other business operation and share its profits and losses. A joint undertaking merely to share expenses is not 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.

Ending 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 end the partnership.

You may be able to avoid recognizing gain or loss when ending the partnership if you buy out your partners or change to a corporation status.

Form 1065. Partnerships file a return on Form 1065, *U.S. Partnership Return of 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. No tax is due on Form 1065.

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 the farm partnership profit or loss. This schedule should be filed with Form 1065. The profit or loss shown on Schedule F, adjusted for amounts to be reported on Schedule K-1 and Schedule K of Form 1065, is entered on line 5 of Form 1065.

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 other schedules on Form 1065 that apply to you.

Filing penalty. A penalty is assessed against the partnership if the partnership is required to file a partnership return and:

- 1) Fails to file the return on time, including extensions, or
- 2) Files a return that fails to show all the information required.

The penalty is \$50 multiplied by the number of partners per month (or part of a month), for a maximum of 5 months.

However, a partnership does not have to pay the penalty if it can show reasonable cause for failure to file a return. A family farm partnership with 10 or fewer partners is generally considered to meet this requirement if it can show that:

- 1) All partners have reported their entire share of all partnership items on timely filed income tax returns.
- 2) Each partner's proportionate share of each partnership item is the same.
- 3) The partnership has no foreign or corporate partners.

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

Limited Liability Company (LLC)

An LLC is an entity formed under state law by filing articles of organization as an LLC. Unlike a partnership, none of the members of an LLC are personally liable for its debts.

An LLC may be classified as a partnership or corporation for federal income tax purposes, depending on whether it has more than two of the corporate characteristics listed later. Depending on its classification, an LLC would file either Form 1065 or Form 1120. 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.

Corporation

A corporation, for federal income tax purposes, includes associations, joint stock companies, and insurance companies.

Unincorporated organizations having certain corporate characteristics are classified as associations and taxed as corporations. To be treated as a corporation for tax purposes the organization must have associates, be organized to carry on business, and divide any gains from the business. In addition, the organization must also have a **majority** of the following characteristics:

- 1) Continuity of life.
- 2) Centralization of management.
- 3) Limited liability.
- 4) Free transferability of interests.

Other factors may also be significant in classifying an organization as an association. Treat an organization as an association if its characteristics make it more nearly resemble a corporation than a partnership or trust. The facts in each case determine which characteristics are present.

Corporate tax. Corporate profits are normally taxed to the corporation. When 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). Corporations are also entitled to special deductions.

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 money is exchanged for stock, no gain or loss is realized by the shareholder or corporation. The stock received by the shareholder has a basis equal to the money transferred to the corporation by the shareholder.

If property is exchanged for stock, it may be either a taxable or nontaxable exchange.

Form 1120. Corporations file Form 1120 or Form 1120-A. A corporation must file an income tax return unless it has dissolved. This applies even if it ceased doing business and disposed of all its assets except for a small sum of cash retained to pay state taxes to keep its corporate charter.

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

S Corporation

A qualifying corporation can choose to be generally exempt from federal income tax. Its shareholders will then include in income their share of the corporation's nonseparately stated income or loss and separately stated items of income, deduction, loss, and credit. A corporation making this choice is known as an S corporation.

To make this election, a corporation, in addition to other requirements, must not have more than 75 shareholders. Each of its shareholders must also 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:
 - a) Excess passive investment income,
 - b) Certain capital gains, or
 - c) Built-in gains.
- 2) The tax from recomputing 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 its return on Form 1120S.

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

3.

Accounting Periods and Methods

Introduction

Each taxpayer (business or individual) must figure taxable income on the basis of an annual accounting period. Also, each taxpayer must consistently use an accounting method

that accurately accounts for income and expenses. For more detailed information, such as how to change an accounting period or method, see Publication 538.

Topics

This chapter discusses:

- Calendar tax year
- Fiscal tax year
- Cash method of accounting
- Accrual method of accounting

Useful Items

You may want to see:

Publication

- 538** Accounting Periods and Methods

Form (and Instructions)

- 3115** Application for Change in Accounting Method

See chapter 21 for information about getting this publication and form.

Accounting Periods

A "tax year" is an annual accounting period for keeping records and reporting income and expenses. The tax years you can use are:

- 1) Calendar year.
- 2) Fiscal year.

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

If you filed your first return using the calendar year, and you later begin business as a farmer or become a partner in a partnership or a shareholder in an S corporation, you must continue to use the calendar year unless you get IRS approval to change it. You must report your income from all sources, including your farm, salaries, partnership income, and dividends, using the same tax year.

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

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

Fiscal year. A fiscal year is 12 consecutive months ending on the last day of any month except December. A fiscal year also includes a 52-53 week annual accounting period. If you adopt a fiscal year, you must maintain your books and records and report your income and expenses using the same tax year.

Partnership or S corporation. Special restrictions apply to the tax year that a partnership or an S corporation can adopt. See *Partnerships, S Corporations, and Personal Service Corporations* in Publication 538.

Accounting Methods

An accounting method is a set of rules used to determine when and how income and expenses are reported. The term “accounting method” includes not only the overall method of accounting you use, but also the method of accounting you use for any item. You must file your return using the same method you use for your tax records.

You choose your accounting method when you file your first tax return. However, you cannot use the crop method for any return, including your first return, unless you get IRS approval. The crop method is discussed later. Getting IRS approval to change an accounting method is discussed in *Change in Accounting Method*.

You can use any of the following accounting methods.

- 1) Cash method.
- 2) An accrual method.
- 3) Special methods for certain items of income and expenses.
- 4) Combination (hybrid) method using elements of two or more of the above.

If you have more than one business, you can use a different accounting method for each business if you keep a complete and separate set of books and records for each business.

Cash Method

Most farmers use the cash method because they find it easier to keep cash method records. However, if you use an inventory to figure gross income, you must use an accrual method for your inventory purchases and sales. Certain farm corporations and partnerships, or any tax shelter, cannot use the cash method. See *Accrual Method*, later.

Income

With the cash method, you include in gross income all amounts you actually or constructively receive during the year. If you receive property or services, you must include their fair market value in income.

Constructive receipt. Constructive receipt of income occurs when an amount is credited to your account or made available to you without restriction. You need not have possession of it. The receipt of a check is constructive receipt of money, even if you do not deposit or cash it in the tax year you receive it. An amount credited to your account at a bank, store, grain elevator, etc., is constructively received in the year it is credited.

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 year. You sell grain in December 1996 under a bona fide arm’s-length contract that calls for payment in 1997. You include the sale proceeds in your 1997 gross income since that is the year payment is received. However, if under the terms of the contract 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 1996 income, regardless of when you actually receive payment.

Items to include in income. Your gross income for the tax year includes:

- 1) Cash and the value of merchandise or other property you receive during the tax year from the sale of livestock, poultry, vegetables, fruits, etc., that you raised.
- 2) Your profit from the sale of all other livestock or other items purchased for resale. To find your profit, deduct the cost or other basis of the property, plus selling expenses, from the sale proceeds. You generally cannot deduct the cost of items purchased for resale in the year paid unless the payment and sale occur in the same year. However, see chapter 5 for information on when to deduct the cost of chickens, seeds, and young plants.
- 3) Breeding fees, fees from the rent or lease of animals, machinery, or land, and other incidental farm income.
- 4) All subsidy and conservation payments you receive that are considered income.
- 5) Your gross income from other sources.

Crop insurance proceeds can be reported in income in the year following the year of loss under certain conditions. See *Crop Insurance and Disaster Payments* in chapter 4.

Expenses

You deduct farm business expenses only in the tax year you pay them. However, you cannot deduct certain prepaid expenses for supplies until they are actually used or consumed. You cannot use an inventory to figure income on the cash method or deduct certain prepayments of interest. For more information on prepaid supplies, interest, and other expenses, see chapter 5.

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 match income and expenses in the correct year.

Income

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

Items to include in income. If you use an accrual method of accounting, you must use an inventory to figure your gross income. You figure gross income using increases and decreases in inventory values of livestock, produce, feed, etc., between the beginning of the year and the end of the year. A complete inventory of these items is required for reporting income on an accrual method. For more information on an inventory, see *Farm Inventory*, later.

To figure gross income on an accrual method:

- 1) Add the following items:
 - a) Proceeds from the sale during the year of all livestock and livestock products, such as milk.
 - b) Inventory value of livestock and products not sold at the end of the year.
 - c) Miscellaneous items of income you earn during the year, such as breeding fees, fees from the rent or lease of animals, machinery, or land, or other incidental farm income.
 - d) Subsidy or conservation payments you receive that are considered income.
 - e) Your gross income from all other sources.
- 2) Then subtract the total of the following:
 - a) Inventory value of the livestock and products you had on hand at the beginning of the year.
 - b) Cost of any livestock or products you purchased during the year, including livestock held for draft, dairy, or breeding purposes if they are included in inventory. Do not subtract their cost unless they are included in inventory.

Expenses

You generally deduct or capitalize an expense in the tax year when all the following apply:

- 1) All events have occurred that fix the fact of liability.
- 2) The liability can be determined with reasonable accuracy.
- 3) Economic performance has occurred.

You generally cannot deduct or capitalize business expenses until economic performance occurs. If your expense is for property or services provided to you, or your use of property, economic performance occurs as the property or services are provided or 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. See Publication 538.

Example. Jane is a farmer who uses a calendar tax year and an accrual method of accounting. She enters into a turnkey contract with Waterworks in 1996. The contract states Jane must pay Waterworks \$200,000 in December 1996 and they will install a complete irrigation system, including a new well, by the close of 1998. She pays Waterworks

\$200,000 in December 1996, they start the installation in May 1998, and they complete the irrigation system in December 1998.

Economic performance for Jane's liability in the contract occurs as the services are provided. Jane incurs the \$200,000 cost in 1998.

Accrual Method Required

An accrual method is required for a tax shelter farm business unless it is excepted from the rule described later in *Accrual Method Not Required*.

Tax shelter. A farming business is a tax shelter if it is a partnership, noncorporate enterprise, or S corporation and:

- 1) Avoidance or evasion of federal income tax is the principal purpose of the entity, or
- 2) It is a farming syndicate. An entity is a farming syndicate if:
 - a) Interests in the activity have ever been offered for sale in any offering required to be registered with any federal or state agency with the authority to regulate the offering, or
 - b) More than 35% of the losses during the tax year are allocable to limited partners or limited entrepreneurs.

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

A "limited entrepreneur" is 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.

Accrual Method Not Required

The following entities are not required to use an accrual method of accounting:

- 1) An S corporation.
- 2) A corporation whose gross receipts for each tax year are \$1 million or less.
- 3) A corporation, or partnership with corporate partners, whose trade or business is operating a nursery or sod farm or raising or harvesting trees, other than fruit and nut trees.
- 4) Certain family farm corporations.

A **family farm corporation** can use the cash method of accounting if its annual gross receipts for each tax year beginning after 1985 are \$25 million or less and it qualifies as one of the following corporations in which:

- 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 own, 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 own, 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. Also, substantially all of the remaining stock must be owned by:
 - a) Corporate employees,
 - b) Their family members, or
 - c) A tax-exempt employees' trust for the benefit of the corporation's employees.



A corporation (other than an S corporation) also engaged in a nonfarming business activity cannot use the cash method for the nonfarming activity if its average annual gross receipts for the 3 prior tax years are more than \$5 million. For this purpose, "farming business" does not include processing commodities or products beyond those activities normally incident to the growing, raising, or harvesting of the product. For example, processing grain to produce bread and cereal to sell is not a farming business.

Farm Inventory

If you use an accrual method of accounting, you must use an inventory to figure 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 use as feed, seed, etc., whether raised or purchased, that are unsold at the end of the year.

Hatchery business. If you are in the hatchery business, 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. Do not include other supplies in inventory. Deduct the cost of the other supplies in the year used or consumed in operations. You can also 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. You can use any of the inventory and accounting methods discussed in this chapter.

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. You cannot take a current deduction for costs incurred during the preproductive period. See *Uniform Capitalization Rules* in chapter 7.

Required to use accrual method. If you are required to use an accrual method of accounting:

- 1) The uniform capitalization rules apply, even if the preproductive period of raising a plant is 2 years or less.
- 2) All animals are subject to the uniform capitalization rules, regardless of age or whether held primarily for slaughter.

Inventory valuation methods. You can generally use the following methods to value your inventory:

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

Farm-price method. Under this method, each item, whether raised or purchased, is valued at its market price less the estimated 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 commission, 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. Unit prices and classifications are subject to approval by the IRS on examination of your return. You cannot change them without IRS approval.

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

You must include in inventory all livestock purchased primarily for sale. You can include livestock purchased for draft, breeding, dairy,

or sporting purposes or treat them as depreciable assets. However, you must be consistent from year to year, regardless of the practice you have chosen. You cannot change your practice unless you get 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 six 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. You keep your books on the calendar year basis. You sell grain in December 1996, but you are not paid until January 1997. You must include both the sale proceeds and your costs incurred in producing the grain on your 1996 tax return. Under an accrual method of accounting, you report your profit or loss for the year in which all events occurred that fix your right to receive income from the transaction and you can determine your profit or loss with reasonable accuracy.

Example 2. Assume in Example 1 that you use the cash method and there was no constructive receipt of the sale proceeds in 1996. Under this method, you include the sale proceeds in income for 1997, the year you receive payment. You deduct the cost of producing the grain in the year you pay it.

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 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. Methods of accounting for depreciation, amortization, and depletion are explained in chapter 8. Accounting for an installment sale is explained in chapter 12.

Combination (Hybrid) Method

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

- 1) If an inventory is necessary to account for income, you must use an accrual method for purchases and sales. You can use the cash method for all other items of income and expense. See *Farm Inventory*, earlier.
- 2) If you use the cash method for figuring income, you must use the cash method for reporting your expenses.
- 3) If you use an accrual method for reporting expenses, you must use an accrual method for figuring your income.

Any combination that uses the cash method is treated as the cash method.

Change in Accounting Method

When you file your first return, you can choose any permitted accounting method except the crop method, discussed earlier, without IRS approval. The method must clearly show your income and be used from year to year. After that, if you want to change your accounting method, you must get IRS approval unless you qualify under one of the exceptions described next under *Approval not required*.

A change in your accounting method includes a change in:

- 1) Your overall method, such as from cash to an accrual method or vice versa, and
- 2) Your treatment of any material item, such as a change in your method of valuing inventory.

Approval not required. You do not need IRS approval to change your accounting method in the following situations.

- 1) You value livestock inventory at cost or the lower of cost or market and you change to the unit-livestock-price method.
- 2) You are a **family farm corporation**, described earlier under *Accrual Method Not Required*, and you must change to an accrual method because your annual gross receipts are more than \$25 million. However, you must establish a suspense account to reduce the section 481 adjustments you must include in income. See section 447(i) of the Internal Revenue Code for information about suspense accounts.

Approval required. You need IRS approval to change your accounting method before you can:

- 1) Change from cash to an accrual method or vice versa.

- 2) Change the method or basis used to value inventory.
- 3) Adopt any specialized method of computing net income, such as the crop method, or change the use of a specialized method.
- 4) Transfer draft, dairy, or breeding animals from inventory to a fixed asset account.
- 5) Change from reporting loan proceeds from the Commodity Credit Corporation (CCC) as income in the year received to reporting the proceeds as income in the year of sale.

Form 3115. Generally, you must file a current Form 3115 to get IRS approval to change your accounting method. You must send a user fee with the form.

In most cases, you must file Form 3115 within the first 180 days of the tax year for which you request the change. However, if you want to change your method of reporting CCC loans, you must request the application of Revenue Procedure 83-77 (C.B. 1983-2, p. 594). This procedure automatically extends the 90-day filing period for CCC loans to 180 days. See *Commodity Credit Corporation (CCC) Loans* in chapter 4 for information on these loans.

You must furnish all applicable information requested on the form. You may also be required to provide additional information.

Extension of time to file Form 3115. If you have good reason for filing Form 3115 after the due date, the IRS may grant you an extension. If you send Form 3115 within 90 days after the due date, you may qualify for an automatic extension if you provide evidence you acted reasonably and in good faith, and granting an extension will not damage the government's interest. However, if you file Form 3115 later than 9 months after the beginning of your tax year, the reasons for granting an extension must be unusual and compelling. See Revenue Procedures 92-20 (C.B. 1992-1, p. 685) and 92-85 (C.B. 1992-2, p. 490) for more information.

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. 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 include an item of income in gross income when you receive it. However, you may be considered to have received income not yet in your possession. See *Constructive receipt* under *Cash Method* in chapter 3.

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

Advance payments. If you receive advance payments (other than a Commodity Credit Corporation (CCC) loan) for property or services, you must include the payments in income in the year you receive them. If you receive an additional amount at a later date, include it in income in the year you receive it.

You may be required to include CCC loans in income in the year you receive them. See *Commodity Credit Corporation (CCC) Loans* later.

Topics

This chapter discusses:

- Schedule F
- Sales of livestock and produce
- Rents (including crop shares)
- Agricultural program payments
- Income from cooperatives
- Cancellation of debt
- Income from other sources

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
- 982** Reduction of Tax Attributes Due to Discharge of Indebtedness
- 1099–G** Certain Government Payments
- 1099–PATR** Taxable Distributions Received From Cooperatives
- 4797** Sales of Business Property
- 4835** Farm Rental Income and Expenses

See chapter 21 for information about getting these 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 the soil or raising or harvesting agricultural commodities. This includes income from operating a stock, dairy, poultry, fish and aquaculture products, bee, fruit, or truck farm, and income from operating a plantation, ranch, nursery, orchard, or oyster bed. It also includes income you receive in the form of crop shares if you materially participate in producing the crop. See *Landlord Participation in Farming* in chapter 15.

Income reported on Schedule F does **not** include gains from sales of:

- 1) Farm land or depreciable farm equipment.
- 2) Livestock held for draft, breeding, sport, or dairy purposes.

Gains and losses from the sale of farming assets, such as machinery or farm land, are discussed in chapters 10 and 11. Gains and losses from casualties, thefts, and condemnations are discussed in chapter 13.

Sales of Livestock and Produce

When you sell produce or livestock (including poultry) you raise for sale on your farm, the entire amount you receive is ordinary income. 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 produce and livestock on your tax return.

Schedule F. When you sell produce or livestock 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. Report these amounts on Schedule F for the year you receive payment.

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.** Animals you do not hold primarily for sale are considered business assets of your farm. See chapter 10.

Sale by agent. If your agent sells your produce or livestock, you must include the net proceeds from the sale in gross income for the year the agent receives payment. This applies even if you arrange for the agent to pay you in a later year. See *Constructive receipt* in chapter 3.

Sales Caused By Drought Conditions

If you sell more livestock, including poultry, than you normally would in one year because of drought conditions, you can choose to include the gain from selling the additional animals in the following year's income. You must meet all of the conditions below to qualify.

- 1) Your principal business is farming.
- 2) You use the cash method of accounting.
- 3) You can show that, under your usual business practices, you would not have sold the animals this year except for the drought.
- 4) The drought resulted in an area being designated as eligible for assistance by the federal government.

Sales made before the area became eligible for federal assistance qualify, as long as the drought 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 agencies.

TIP A drought 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. The number of animals you would have sold had you followed your usual business practice in the absence of drought will be determined by all the facts and circumstances. If you have not yet established a usual business practice, the usual business practices of similarly situated farmers in your general region will be relied on.

Drought sales in successive years. If you make this election in successive years, the following special rules prevent your first election from adversely affecting your second election:

- 1) Do not include the amount deferred from one year to the next as received from the sale or exchange of livestock in the later year when figuring the amount to be postponed. See *Amount to be postponed*, later, which describes the computation.
- 2) To determine your normal business practice for the later year, exclude any earlier year for which you made this election.

Connection with drought area. The livestock does not have to be raised in a drought area nor does the sale have to take place in a drought area to qualify for this postponement. However, the sale must occur solely because of drought conditions that affected the water, grazing, or other requirements of the livestock so that the sale became necessary.

Classes of livestock. You must make the election separately for each generic class of

Table 4-1. Where To Report Sales of Livestock and Produce

| Item Sold | Schedule F | Form 4797 |
|---|------------|-----------|
| Livestock and produce raised for sale | X | |
| Livestock and produce bought for resale | X | |
| Livestock held for draft, breeding, dairy, or sporting purposes (purchased or raised) | | X |
| Animals not held primarily for sale | | X |

animals — for example, hogs, sheep, cattle. You must also figure separately the amount to be postponed for each class of animals. Do not make a separate election solely because of an animal's 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 sold, and
- 2) Multiply the result in (1) by the excess number sold solely because of drought.

Example. You are a calendar year taxpayer and you normally sell 100 head of beef cattle a year. As a result of drought, you sell 135 head during 1996. You realize \$35,100 from the sale. On August 9, 1996, as a result of drought, the affected area was declared a disaster area eligible for federal assistance. The income you can elect to postpone until 1997 is \$9,100 $[(\$35,100 \div 135) \times 35]$.

How to make the election. To make the election, 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 the election is made:

- 1) A statement that you are making an election under section 451(e) of the Internal Revenue Code.
- 2) Evidence of the drought 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 drought conditions.
- 3) A statement explaining the relationship of the drought area to your early sale or exchange of the livestock.
- 4) The number of animals sold in each of the 3 preceding years.
- 5) The number of animals you would have sold in the tax year had you followed your normal business practice.
- 6) The total number of animals sold and the number sold because of drought during the tax year.
- 7) A computation, as described earlier, of the income to be postponed for each class of livestock.

The statement and the return must be filed by the due date of the return, including extensions. You can file the statement with an amended return, if you file it by this due date. However, once the election has been made, it may be changed 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 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 and must be entered as *Other income* on Schedule F. If you simply rent your pasture for a flat cash amount, the income is reported as rent in Part I of Schedule E (Form 1040).

Crop Shares

Rent you receive in crop shares must be included in income in the year the shares are reduced 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 subject to self-employment tax and should be reported on Schedule F. However, 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 subject to self-employment tax. See *Landlord Participation in Farming* in chapter 15.

Crop shares you use to feed livestock.

Crop shares you receive as a landlord and feed to your livestock are considered reduced to money when fed to the livestock. The fair market value of the crop shares must be included 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. Even though these two transactions would cancel each other for purposes of determining adjusted

gross income on Form 1040, they may be necessary to determine 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 reduced to money at the time 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. Part of your land was farmed by a tenant farmer under a crop share arrangement. The crop was harvested and delivered 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 payments are made directly to them by the elevator company.

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

Most government payments, such as those for approved conservation practices, must be included in income 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, as explained later.

Report the agricultural program payment on the appropriate line in Part I of Schedule F for the tax year you actually or constructively receive it. The full amount is reported 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 CCC loan. However, the amount you refund or return, or that reduces some other payment or loan to you, is deductible on Schedule F for the year of repayment or reduction.

Reporting Refunds of Agricultural Program Expenses

Refunds of malting barley assessments. A farmer who participates in the malting barley production program of the Commodity Credit Corporation (CCC) receives a barley subsidy benefit and pays a malting barley assessment. The barley subsidy benefit is reported to the

farmer and to the IRS on Form CCC-1099-G, *Certain Government Payments*. If the farmer does not sell the barley for malting purposes, the farmer is eligible to receive a refund of the malting barley assessment. If the farmer receives the refund in a year after the assessment was paid, how the farmer reports the refund depends on whether the farmer claimed the assessment as an expense in the year it was paid. The following example shows the proper reporting of refunds of malting barley assessments.

Example. Lee White is a farmer. He uses the cash method of accounting and files his tax return on a calendar year basis. He participated in the malting barley production program and received a \$2,850 payment from the CCC in 1996. The payment is Lee's \$3,000 barley subsidy benefit less the malting barley assessment (\$150) he was required to pay for the barley produced. Lee received a Form CCC-1099-G for 1996 showing the \$3,000 barley subsidy benefit. In 1997, Lee proved that he did not sell the barley for malting purposes and received a refund of the \$150 malting barley assessment. He receives a 1997 Form CCC-1099-G for the refund showing a *Barley Assessment Deficiency* of \$150.

Assessment claimed as an expense. For 1996, Lee reported \$3,000 farm income from the barley subsidy benefit and an expense of \$150 from the malting barley assessment. He claimed the \$150 assessment as a farm expense in Part II of his 1996 Schedule F (Form 1040). Lee received a tax benefit from the deduction because it reduced his 1996 tax liability. Lee includes the \$150 refund (barley assessment deficiency) as income in Part I of his 1997 Schedule F (Form 1040).

Assessment not claimed as an expense. For 1996, Lee reported the \$3,000 barley subsidy benefit as income, but did not claim the \$150 assessment as an expense. Because Lee received no tax benefit from the payment of the assessment in 1996, he does not include the refund (barley assessment deficiency) as income on his 1997 Schedule F (Form 1040).

Payments made under the Dairy Refund Payment Program (DRPP). DRPP, administered by the CCC, refunds the reductions in price received by eligible producers during a calendar year. Milk processors, milk handlers, and others responsible for the marketing of milk withhold the reductions in price from their payments to the producers and send the withheld amounts to the CCC. If the producer can prove that milk marketing for the current year did not exceed milk marketing for the prior year, the producer is eligible for a refund of the reductions in price. Typically, an eligible producer receives a refund of the reductions in price in a year after the reductions occurred. Proper reporting of the refund depends on whether the producer claimed the reductions in price as an expense in the year they occurred. The following example shows the proper reporting of refunds of reductions in price.

Example. Sam Brown is a milk producer. He uses the cash method of accounting and files his tax return on a calendar year basis. The marketing of Sam's milk is subject to reductions in price. In 1996, Sam had gross receipts of \$200,000 from milk sales and had \$3,000 withheld as reductions in price. Sam proved that his 1996 milk marketing did not exceed his 1995 marketing. In 1997, Sam received a \$3,000 refund from the CCC of the 1996 reductions in price. Sam receives a 1997 Form CCC-1099-G for the refund showing a *Milk Marketing Fee* of \$3,000.

Reductions claimed as an expense. For 1996, Sam reported \$200,000 farm income from milk sales. He claimed the \$3,000 reductions in price as a farm expense in Part II of his 1996 Schedule F (Form 1040). Sam received a tax benefit from the deduction because it reduced his 1996 tax liability. Sam includes the \$3,000 refund (milk marketing fee) as income in Part I of his 1997 Schedule F (Form 1040).

Reductions not claimed as an expense. For 1996, Sam reported milk sales income of \$200,000, but did not claim the reductions in price for his milk as an expense. Because Sam received no tax benefit from the reductions in price in 1996, he does not include the refund (milk marketing fee) on his 1997 Schedule F (Form 1040).

Commodity Credit Corporation (CCC) Loans

Normally, 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 elect to report the loan proceeds as income for the year you receive them, rather than for the year of sale. You do not need permission 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 the crop was sold.

Once you report a CCC loan as income for the year received, you must report all succeeding loans in the same way, unless you obtain permission from the IRS to change to a different method. See *Change in Accounting Method* in chapter 3.

To make this election, include the amount of 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.

When you make this election, the amount you report as income becomes your basis in the commodity. If you later sell the commodity either by forfeiting it to the CCC instead of repaying the loan or by repaying the loan, redeeming the commodity, and selling it to someone else, you report as income at the time of sale only the amount of the loan forgiveness or sale proceeds that are greater than 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.



TIP You can request income tax withholding on CCC loan payments made to you after 1996. Use Form W-4V, Voluntary Withholding Request. See chapter 21 for information about ordering the form.

Reporting Market Gain

If you have a CCC loan which is secured by the pledge of an eligible commodity you produced and you elected to report the loan proceeds as income in the year received, reporting the market gain shown on Form CCC-1099-G, *Certain Government Payments*, may result in duplicate reporting of this income. Eligible commodities include cotton, wheat, feed grains, rice, and oilseeds. The following examples illustrate the proper reporting of market gain.

Example 1. Mike Green is a cotton farmer. He uses the cash method of accounting and files federal income tax returns on a calendar year basis. He has currently deducted all expenses incurred in producing the cotton and has a basis of \$0 in the commodity. In 1996, Mike pledges 1,000 pounds of cotton as collateral for a CCC price support loan at \$.50 per pound. In 1997, Mike decides to redeem the cotton when the prevailing world market price for cotton is \$.42 per pound. Under CCC program provisions, the repayment rate is the lesser of the loan amount or the prevailing world price of the commodity on the date of repayment. Mike later sells the cotton for \$.60 per pound.

As a result of the redemption of the cotton, Mike will receive a Form CCC-1099-G from the CCC showing a market gain in 1997 of \$80, which is the difference between the original loan rate (\$.50 per pound) and the repayment rate (\$.42 per pound) multiplied by the pounds of cotton redeemed (\$.08 per pound \times 1,000 pounds of cotton). The proper reporting of the \$80 market gain on Mike's 1997 tax return will depend upon whether he has made an election to include CCC loans in income in the year received.

With election. Mike has income of \$500 in 1996 from the CCC loan. The cotton is treated as sold for \$500 when it is pledged as collateral for the CCC loan and it is treated as being repurchased by Mike for \$420 (\$.42 repayment rate \times 1,000 pounds of cotton) when it is redeemed by repayment of the CCC loan. No gain or loss is recognized on this repurchase. Mike has income of \$180 in 1997 from the sale of the cotton (\$600 sale price - basis of \$420). He reports the \$500 CCC loan as income in 1996 and the \$180 from the sale as income in 1997. Because Mike has already included the \$500 CCC loan in income, including the \$80 market gain shown on the 1997 Form CCC-1099-G in income would result in an overstatement of his income in the amount of \$80. Therefore, for 1996, Mike reports the \$500 CCC loan on line 7a of Part 1 of Schedule F (Form 1040). For 1997, he reports the \$80 market gain as an "Agricultural program payment" on line 6a of Part I of Schedule F, but does not include the \$80 as a "Taxable amount" on line 6b of Part I of Schedule F.

Note. The line numbers may change in the 1997 version of Schedule F. Check the 1997 instructions.

Without election. Mike has income of \$80 from market gain in 1997. Because he has not made the election, the cotton is not treated as sold when it is pledged as collateral for the CCC loan. Therefore, the sale of the cotton in 1997 generates income of \$600 (\$600 sale price – \$0 basis) to Mike. He reports as income in 1997 both the \$600 from the sale and the \$80 market gain. The \$80 is reported on both lines 6a and 6b of Part I of Schedule F. See *Note*, earlier.

Example 2. Assume the same facts as Example 1, but Mike enters into an “option to purchase” contract with Tom Merchant in 1996. Tom pays Mike \$.05 per pound for the option to purchase the 1,000 pounds of cotton. Mike also gives Tom a power of attorney giving him the authority to repay the loan on Mike’s behalf. In 1997, Tom repays the loan at \$.42 per pound and immediately exercises his option to purchase Mike’s cotton at the price of \$.42 per pound.

Mike will receive a Form CCC-1099-G for 1997 from the CCC showing a market gain of \$80. The proper reporting of the market gain will again depend upon whether Mike has made the election to include CCC loans in income the year received.

With election. Mike has income of \$500 in 1996 from the CCC loan. He also has income of \$50 in 1996 from granting the option to Tom. Because Mike is treated as having repurchased the cotton for \$.42 per pound upon repayment of the CCC loan, he recognized no income upon the sale of the cotton to Tom for \$.42 per pound. Mike reports both the \$500 CCC loan and the \$50 from the option as income in 1996. Because he has already included the \$500 CCC loan in income, including the \$80 market gain shown on the 1997 Form CCC-1099-G in income would result in an overstatement of his income in the amount of \$80. Therefore, for 1996, Mike reports the \$500 CCC loan on line 7a of Part I of Schedule F. For 1997, Mike reports the \$80 market gain as an “Agricultural program payment” on line 6a of Part I of Schedule F, but does not include the \$80 as a “Taxable amount” on line 6b of Part I of Schedule F. See *Note*, earlier.

Without election. Mike has income of \$50 in 1996 from granting the option to Tom. Because Mike has not made the election, the cotton is not treated as sold when it is pledged as collateral for the CCC loan. Therefore, the sale of the cotton to Tom in 1997 generates income of \$420 (\$420 sale price – \$0 basis) to Mike. He reports the \$50 from the option as income in 1996 and the \$420 from the sale of the commodity and the \$80 market gain shown on Form CCC-1099-G as income in 1997. The \$80 is reported on both lines 6a and 6b of Part I of Schedule F. See *Note*, earlier.

Conservation Reserve Program (CRP)

Under the Conservation Reserve Program (CRP), the Secretary of Agriculture and you,

as the owner or operator of highly erodible or other specified cropland, may enter into a long-term contract providing for conversion to a less intensive use of that cropland. Under the program, you are compensated for this conversion in the form of an “annualized rental payment.” The payment may be in the form of cash, commodity certificates, or a combination of cash and certificates.

The annual CRP payment is farm income, which you report in Part I of Schedule F. However, if you do not materially participate in farming operations on the land, the annual payment is rental income, which you report on Form 4835. See *Rents (Including Crop Shares)*, earlier. Also see *Landlord Participation in Farming* in chapter 15.

Crop Insurance and Disaster Payments

You must include in income any crop insurance proceeds you receive as the result of crop damage. They are generally included in the year you receive them. 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 are treated as crop insurance proceeds.



TIP Beginning in 1997, 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.

Election to include in income in following year. If you use the cash method of accounting, you can elect to include crop insurance proceeds in income for the tax year following tax year in which the crops were damaged. You can make this election if you can show you would have included the income from the damaged crops in any tax year following the year the damage occurred. This election applies only if you receive the proceeds in the year the crops were damaged. If you receive the insurance proceeds in the following tax year, you include the proceeds in gross income for the year you receive them.

To make the election to postpone reporting crop insurance proceeds, attach a statement to your tax return, or amended return, for the year the damage took place. Merely indicating on your return that insurance proceeds were deferred does not constitute this election. The statement must include your name and address and contain the following information:

- 1) A statement that you are making an election under section 451 (d) of the Internal Revenue Code and section 1.451-6 of the Income Tax Regulations.
- 2) The specific crop or crops destroyed or damaged.
- 3) 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.

- 4) The cause of the destruction or damage and the date or dates it occurred.
- 5) The total amount of payments you received from insurance carriers, itemized for each specific crop, and the date each payment was received.
- 6) The name of each insurance carrier from whom you received payments.

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

An election is binding for the year. If you want to change your election, write to your IRS District Director giving your name, address, identification number, the year you made the election, and your reasons for wanting to change it.

Feed Assistance and Payments

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

These payments are not proceeds from the sale of livestock, or received for the destruction or damage to crops raised for sale, or for the inability to raise the crops. Therefore, you include these benefits in income in the year you receive them.

You must 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.

Other Payments

Other government program payments must be included in income as explained below.

Fertilizer and Lime

Include in income the value of fertilizer or lime received under a government program. The manner of claiming 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, they are still included in income. The full cost of the improvement is capitalized. Since the payments have been included in income, they do not reduce your basis.

Payment to More Than One Person

A program payment intended for more than one person is reported by the USDA to the IRS 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 actually 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 let the IRS know the identity of the actual recipient of the payment. You should also furnish this information to the recipient. You may avoid the inconvenience of unnecessary inquiries about the identity of the recipient if you file this form.

See chapter 21 for information about ordering Form 1099-G and chapter 2 for information about preparing the form.

Cost-Sharing Exclusion

Part or all of the payments you receive under certain federal or state cost-sharing conservation, reclamation, and restoration programs can be excluded from your income. However, this exclusion applies only if the payment (or part of a payment) meets all three of the following tests:

- 1) The cost-sharing payment must be for a capital expense.
 - a) You cannot exclude any part of a payment for an expense you are allowed to deduct in the current tax year. You must include the payment in income and take any offsetting deduction. (See chapter 6 for information on deducting soil and water conservation expenses.)
 - b) You cannot exclude a payment that is rent for the use of your property or compensation for your services.
- 2) The IRS must determine that 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 exceeds the greater of 10% of the average annual income derived from the affected property before receiving the improvement or an amount equal to \$2.50 times the number of affected acres.
- 3) The Secretary of Agriculture must certify the payment was made primarily for conserving soil and water resources, protecting or restoring the environment, improving forests, or providing a habitat for wildlife.

If the three tests above are met, you can exclude payments from the following programs:

- 1) The rural clean water program authorized by the Federal Water Pollution Control Act.
- 2) The rural abandoned mine program authorized by the Surface Mining Control and Reclamation Act of 1977.
- 3) The water bank program authorized by the Water Bank Act.
- 4) The emergency conservation measures program authorized by title IV of the Agricultural Credit Act of 1978.
- 5) The agricultural conservation program authorized by the Soil Conservation and Domestic Allotment Act.
- 6) The great plains conservation program authorized by the Soil Conservation and Domestic Policy Act.
- 7) The resource conservation and development program authorized by the Bankhead-Jones Farm Tenant Act and by the Soil Conservation and Domestic Allotment Act.
- 8) The forestry incentives program authorized by the Cooperative Forestry Assistance Act of 1978.
- 9) Any small watershed program administered by the Secretary of Agriculture that is determined by the IRS Commissioner to be substantially similar to the types of programs for which an exclusion is allowed.
- 10) Any program of a state, possession of the United States, a political subdivision of any of the foregoing, or the District of Columbia under which payments are made to individuals primarily for the purpose of 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 Consolidated Farmers Service Agency (CFSA) and the Natural Resources and Conservation Service (NRCS).

Income realized. The gross income you realize upon payment under these cost-sharing programs is the value of the improvement, reduced by 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.

- 1) The numerator of the fraction is the total cost of the improvement (including all amounts paid either by you or by the government), reduced by the sum of:
 - a) Any government payments under a program not listed earlier.
 - b) Any portion of a government payment under a program listed earlier that the Secretary of Agriculture has not certified as primarily for purposes of conservation.

- c) Any government payment for rent or your services.
- 2) 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 the greater of:

- 1) 10% of the prior average annual income from the affected acreage, or
- 2) \$2.50 times the number of affected acres.

The “prior average annual income” is the average gross receipts from the affected acreage for the last 3 tax years before the tax year in which installation of the improvement was started.



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

Example. 100 acres of your land was reclaimed under a contract with the Natural Resources Conservation Service of the USDA. The total cost of the improvement was \$500,000. USDA paid \$490,000. You paid \$10,000. It is determined that the value of the cost-sharing improvement is \$15,000.

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

The amount to be included in gross income is figured as follows:

| | | | |
|-----------------------------------|-------|-----------|-----------------|
| Value of cost-sharing improvement | | \$ 15,000 | |
| Minus: Your share | | \$ 10,000 | |
| Excludable portion | | 1,550 | 11,550 |
| Amount included in income | | | <u>\$ 3,450</u> |

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 dollar amount of the cost funded by the government payment, the value of the improvement, and the amount you are excluding.

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

Recapture. Part or all of the cost-sharing payments you exclude may be treated as ordinary income if you dispose of the property within 20

years after the date the payments are received. You must report the recapture on Form 4797. See *Section 1255 property* in chapter 11.

Electing out. You can elect *not* to exclude all or part of any payments you receive under these programs. The election must be made not later than the due date, including extensions, for filing your return. If you elect not to exclude these payments, none of the above restrictions and rules apply.

Income From Cooperatives

If you purchase farm supplies through a cooperative, you may receive income from the cooperative in the form of patronage dividends (distributions). If you market your farm products through a cooperative, you may receive 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 also 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*.

Patronage Dividends (Distributions)

Patronage dividends you receive are generally reported as income on lines 5a and 5b of Schedule F for the tax year you receive them. They include:

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

Nonqualified notices of allocation, explained later, are not included in income when you receive them. See also *Purchase of depreciable and capital assets* and *Personal purchases*, later, for a discussion of amounts not to include in income on line 5b.

Qualified written notice of allocation. A qualified written notice of allocation is taxable at its stated dollar value in the year received. To be qualified, it must be paid as part of a patronage dividend, or a payment by a cooperative, in which 20% or more of the dividend or payment is paid in money or a qualified check. It must also meet one of the following conditions:

- 1) It 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, or
- 2) You must have agreed to include the stated dollar value in income in the year the notice is received by doing one of the following:

- a) Signing and giving a written agreement to the cooperative.
- b) Obtaining or retaining membership in the cooperative after it adopted a bylaw providing that membership constitutes agreement. The cooperative must notify you of this bylaw and provide you with a copy.
- c) Endorsing and cashing a qualified check, paid as part of the notice of allocation, by the 90th day after the close of the payment period for the tax year of the cooperative.

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 receive in the ordinary course of your farming business. The loss is the difference between the stated dollar amount you included in income and the amount you received when you redeemed it.

Nonqualified notices of allocation. All other written notices of allocation are not qualified and are not included in income when received. A nonqualified notice of allocation has a zero basis in your hands. Any amount you receive from the sale, redemption, or other disposition of a nonqualified written notice of allocation must be included in income. It is ordinary income up to the stated dollar value and is reported in Part I of Schedule F for the tax year of disposition. Any amount greater than the stated dollar value must be included on your return according to the type of income it represents. For example, if the excess represents interest income, include it as interest on your return for the year of disposition.

Purchase of depreciable property or capital assets. Do not include in income 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. If the dividends are more than your unrecovered cost, include the excess 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.

Example. On July 1, 1995, Mr. Brown, a patron of a cooperative association, purchased 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 Publication 946). Mr. Brown files his return on a calendar year basis. For 1995, he claimed a 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, 1996, 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 1996 (and later years) as follows:

| | |
|---|----------------|
| Cost of machine on July 1, 1995 | \$2,900 |
| Minus: 1995 depreciation | \$311 |
| 1996 cash dividend | 300 |
| | 611 |
| Adjusted basis for depreciation for 1996: | <u>\$2,289</u> |

Depreciation rate: $1 + 6\% \div (\text{remaining recovery period as of } 1/1/96) = 15.38\% \times 1.5 = 23.08\%$

Depreciation deduction for 1996
 $(\$2,289 \times 23.08\%) \dots \dots \dots$ \$ 528

Exceptions. If the dividends come from the marketing or purchasing of capital assets or depreciable property used in your business and you did not own the property at any time during the year you received them, you must include the dividends in income unless either of the following exceptions applies:

- 1) If the dividends relate to a capital asset you held for more than one year for which a loss was or would have been deductible, they are treated as gain from the sale or exchange of a capital asset held for more than one year.
- 2) If the dividends relate to a capital asset for which a loss was not or would not have been deductible, they are not reported as income (ordinary or capital gain).

If you receive a dividend from the marketing of a capital asset or depreciable property used in your business in the same year the asset was marketed, treat it as an additional amount received on the sale or other disposition of the asset.

If you cannot determine from which item the dividend comes, include the dividend in income as ordinary income.

Personal purchases. Do not include in income dividends from the purchase of personal, living, or family items, such as supplies, equipment, or services not used in your business. This rule also applies to amounts from the sale, redemption, or other disposition of a nonqualified written notice of allocation resulting from these purchases. If the dividend or nonqualified allocation cannot be traced to these purchases, include it in income as ordinary income.

Per-Unit Retain Certificates

A per-unit retain certificate is any written notice that discloses 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 marketed 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 consented in writing, or in effect

have given their consent by obtaining or retaining membership in a cooperative whose bylaws or charter state that membership constitutes consent, to include the stated dollar amount of these certificates in income in the year of receipt. 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. All other per-unit retain certificates are not qualified and are not included in income when received. However, any amount you receive from the redemption, sale, or other disposition of a nonqualified certificate, to the extent the state dollar amount exceeds its basis, is ordinary income reported in Part I of Schedule F for the tax year of disposition.

Cancellation of Debt

Any debt you owe over \$600 that is canceled by the federal government, a financial institution, or a credit union will be reported to you on Form 1099-C, *Cancellation of Debt*.

General Rule

Generally, if a debt you owe 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. A debt includes any debt for which you are liable or which attaches to property you hold.

Exceptions

The following discussion covers exceptions to the general rule for canceled debt.

Price reduced after purchase. If you owe a debt to the seller for property you purchased, and the seller reduces the amount you owe, generally you do not have income from the reduction. The part of the debt reduced is treated as a purchase price adjustment and reduces your basis in the property.

Deductible debt. You do not realize income from debt cancellation to the extent the payment of the debt would have given rise to a deduction.

Example. You own a business and obtain accounting services on credit. Later, you have trouble paying your business 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 cancellation of debt depends on your method of accounting:

- 1) Cash method – You do not include the debt cancellation in income because payment for the services would have been deductible as a business expense.
- 2) An accrual method – Your accountant's cancellation of the debt must be included in income. Under an accrual method of accounting, the expense is deductible when the liability is incurred, not when the debt is paid.

Student loan. A student loan is a loan to assist you in attending an educational institution. Do not include in income any student loan canceled because you worked for a certain period of time in certain professions for one of a broad class of employers.

To qualify, the loan must have been made by one of the following:

- 1) The government — federal, state, or local, or their agencies or subdivisions.
- 2) A tax-exempt public benefit corporation that has assumed control of a state, county, or municipal hospital, and whose employees are considered public employees under state law.
- 3) An educational institution under an agreement with an entity described in (1) or (2) that provided the funds to the institution to make the loan.

Exclusions

Debt canceled in the following situations is not included in income. However, you may be required to file Form 982. See *Form 982*, later.

- 1) The cancellation takes place in a bankruptcy case.
- 2) The cancellation takes place when you are insolvent.
- 3) The canceled debt is a qualified farm debt.
- 4) The canceled debt is qualified real property business debt. For more information on this type of canceled debt, see chapter 5 in Publication 334.

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

Bankruptcy and Insolvency

You can exclude the cancellation or discharge of 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 United States Code, provided you are under the jurisdiction of the court and the discharge of the debt is granted by the court or is the result of a plan approved by the court.

Debt canceled in a bankruptcy case is not included in your gross income in the year it is canceled. Instead, the amount canceled must be used to reduce your tax benefits, explained later under *Reduction of tax benefits*.

Insolvency. You are insolvent to the extent your liabilities exceed the fair market value of your assets immediately before the discharge of debt.

You can exclude canceled debt from gross income up to the amount by which you are insolvent. If the canceled debt exceeds the amount by which you are insolvent and you qualify, you can apply the rules for qualified

farm debt to the excess. Otherwise, you include the excess 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.

Example. You had a \$10,000 debt canceled outside of bankruptcy. Immediately before the cancellation, your liabilities totaled \$80,000 and your assets totaled \$75,000. Since your liabilities exceeded 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 (\$5,000) may be subject to the qualified farm debt rules. If not, it must be included 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. This prevents an excessive tax benefit from the cancellation.

Order of reduction. The excluded canceled debt must be used to reduce the following tax benefits in the order listed, unless you choose to reduce the basis of depreciable property first, explained later.

- 1) **Net operating loss (NOL).** Reduce any NOL for the tax year the debt cancellation takes place, and then any NOL carryover to that tax year. Reduce the NOL 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 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 one dollar for each dollar of excluded canceled debt.
- 5) **Basis.** Reduce the basis of your property by one dollar for each dollar of excluded canceled debt. This reduction is made to both depreciable and nondepreciable property you hold at the beginning of the tax year following the tax year of debt cancellation. The reduction cannot be more than the excess of the total bases of property you hold immediately after the debt cancellation over your total liabilities immediately after the cancellation. See *Reduction of basis of depreciable property*, later.
- 6) **Passive activity loss and credit carryovers.** Reduce the passive activity loss and credit carryovers available from the tax year of the debt cancellation. Reduce the carryover of the deduction one dollar

for each dollar of excluded canceled debt. Reduce the credit carryover 33 ⅓ 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 these credits 33 ⅓ cents for each dollar of excluded canceled debt.

How to make tax benefit reductions. In all cases, make the required reductions in tax benefits after figuring your tax for the year of the debt cancellation. In reducing net operating losses and capital losses, 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. Make your reductions of the general business credit and the foreign tax credit carryovers in the order in which they are taken into account for the tax year of the debt cancellation.

Reduction of basis of depreciable property. You can choose to apply any portion of the excluded canceled debt to reduce the basis of your depreciable property before reducing other tax benefits. The amount you apply cannot exceed the total adjusted bases of all depreciable property you held at the beginning of the tax year following the tax year of your debt cancellation.

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.

When to make basis reductions. The reduction in basis is made to the property you hold at the beginning of the tax year following the tax year of the debt cancellation.

Recapture of basis reductions. If the basis of property is reduced under these provisions and later sold or otherwise disposed of at a gain, the part of the gain due to this basis reduction is taxable as ordinary income under the depreciation recapture provisions. Any property that is not section 1245 or section 1250 property is treated 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.

Qualified Farm Debt

You can exclude from income the cancellation or discharge of qualified farm debt by a qualified person. Your debt is qualified farm debt if:

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

To see if you meet this requirement, divide your total gross receipts from farming for the 3-year period by your total gross

receipts from all sources, including farming, for that period. See chapter 2 for information about gross farm income and total gross income.

Qualified person. The person who cancels or forgives your qualified farm debt must be a qualified person — one 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. Therefore, these rules apply to debts discharged by the USDA.

A qualified person does not include:

- 1) A person related to you.
- 2) A person from whom you acquired the property (or a person related to this person).
- 3) 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.

Limit. If your canceled debt is qualified farm debt, you cannot exclude from income more than the sum of your adjusted tax benefits and the total adjusted bases of your qualified property, defined later. If the discharged debt is more than this limit, you must include the excess in gross income.

Adjusted tax benefits. Adjusted tax benefits means the sum of the following:

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

You multiply the credits by 3 to make them comparable with the deduction benefits.

Example. You have a \$200 general business credit carryover in the year of debt cancellation. You apply \$300 of the cancellation as follows:

- 1) Multiply the credit by 3 for a result of \$600.
- 2) Subtract the \$300 canceled debt from \$600.

- 3) Divide the remaining \$300 by 3 to determine the amount of credit left — \$100.

The general business credit is reduced to \$100 and may be applied to the tax shown on the return for the year of debt cancellation or carried to another tax year if there is no tax liability for the year of cancellation.

Order of reduction. The rules for reducing tax benefits for qualified farm debt are not the same as the rules for bankruptcy or insolvency. You must reduce adjusted tax benefits (1), (2), (3), and (4), in that order, by the excluded amount (to the extent not used under *Reduction of basis of depreciable property*, earlier). Then, before reducing adjusted tax benefit (5), apply any remaining excluded amount to reduce your basis in **qualified property**. This is any property you use or hold for use in your business or for the production of income.

You must reduce the basis of qualified property in the following order:

- 1) Depreciable property.
- 2) Land you use in your farming business.
- 3) Other qualified property.

Form 982

Use Form 982 to show the amounts excluded from income and the reduction of tax benefits in the order listed on the form.

When to file. You must file Form 982 with your income tax return for the tax year in which the cancellation of debt occurred. If you do not file this form with your original return, you must file it with an amended return or claim for credit or refund if the cancellation occurred in bankruptcy or insolvency or involved qualified farm debt or qualified real property business debt.

If you do not make the elections on your original return, you must establish reasonable cause with IRS before you can make them on an amended return or claim for credit. The elections may be revoked only with IRS consent.

More information. For information on debt cancellation, other than qualified farm debt, see Publication 908.

Income From Other Sources

This section discusses other types of income you may receive.

Barter income. If you do work for someone and are paid in products, property, or in work done for you, 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 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 the stated interest you receive from the borrower. See Publication 550 for more information on below-market loans.

Commodity futures and options. See chapter 10 for information on gains and losses from commodity futures transactions.

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 \$1,000. 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. The payment for the right-of-way is treated 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, the basis is reduced by \$1,000.
- 2) If the payment is more than the basis of the affected part of your land, the basis is reduced to zero and the excess is gain from the sale of section 1231 property. See chapter 11.

If growing crops were damaged during construction of the line and you later receive a settlement of \$250 for this damage, the \$250 is income. It has no effect on the basis of your land.

Fuel tax credit and refund. Include as income any credit or refund of federal excise tax you paid as part of any fuel cost claimed as an expense deduction that reduced your income tax. See chapter 18 for more information.

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 over the amount 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 excess of full cost over the amount you paid is an illegal subsidy and you must include it in income. Report the illegal subsidy on line

10 of Schedule F. You cannot take a deduction for the amount you are required to include in income.

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

Machine work (custom hire). Pay you receive for work you or your hired help perform off your farm for contract work or custom work done for others, or for the use of your property or machines, is income to you whether or not income tax was withheld at the source. This rule applies whether you receive the pay in cash, services, or merchandise.

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

See Publication 525 for information about 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, the tax on the gain may be postponed to a later year. See chapters 11 and 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 predominantly 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.

Similarly, 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. A reimbursement, refund, or recovery of an item for which you took a deduction in an earlier year should be included in income 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 in income.

Example. A tenant farmer purchased fertilizer for \$1,000 in April 1995. He deducted \$1,000 on his 1995 Schedule F and the entire deduction reduced his tax. The landowner reimbursed him \$500 of the cost of the fertilizer in February 1996. The tenant farmer must include \$500 in income on his 1996 tax return because the entire deduction decreased his 1995 tax.

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.

Depletion. A reasonable allowance for depletion of the natural deposit sold may be claimed as a deduction. See *Depletion* in chapter 8.

Sod. Proceeds from the sale of sod are reported on Schedule F. A deduction for cost depletion is allowed, but only for the amount of 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, the income 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, lumber, and pulpwood, are discussed in chapter 10.

5.

Farm Business Expenses

Important Change for 1996

Standard mileage rate. The standard mileage rate for the cost of operating your car, van, pickup, or panel truck in 1996 is 31 cents per mile for all business miles. For more information, see *Truck and Car Expenses*, later.

Important Changes for 1997

Self-employed health insurance deduction. The deduction for health insurance costs of self-employed individuals is increased to 40% for tax years beginning in 1997. The deduction will increase to 45% for tax years beginning in

1998 through 2002, then rise gradually to 80% in 2006. For more information on the self-employed health insurance deduction, see *Insurance*, later.

Medical savings accounts. For tax years beginning after 1996, a self-employed individual may be able to take a deduction for contributions made to medical savings accounts (MSAs) to help cover medical expenses for the self-employed individual and his or her employees. For more information, see Publication 553, *Highlights of 1996 Tax Changes*.

Long-term care insurance. A qualified long-term care insurance contract issued after 1996 will generally be treated as an accident and health insurance contract. For more information, see Publication 553.

Important Reminder

Club dues. Generally, you are not allowed any deduction for dues you pay or incur for membership in any club organized for business, pleasure, recreation, or other social purpose. However, you may be able to deduct dues you pay to chambers of commerce and to professional societies. For more information, see *Dues and subscriptions*, later.

Introduction

You generally deduct farm business expenses in the tax year you pay or incur them. Determine the tax year you can deduct a farm business expense based on your accounting method. For more information, see *Accounting Methods* in chapter 3.

The uniform capitalization rules require you to capitalize certain expenses. These rules do not apply to plants with a preproductive period of 2 years or less or to animals, unless you are a corporation, partnership, or tax shelter required to use an accrual method of accounting. For more information, see *Uniform Capitalization Rules* in chapter 7.

Under certain circumstances, you can deduct expenses for soil or water conservation, or for the prevention of erosion, if they are consistent with a plan approved by the Natural Resources Conservation Service of the USDA. For more information, see chapter 6.

Topics

This chapter discusses:

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

Useful Items

You may want to see:

Publication

- 463** Travel, Entertainment, Gift, and Car Expenses
- 535** Business Expenses
- 536** Net Operating Losses
- 538** Accounting Periods and Methods
- 587** Business Use of Your Home
- 925** Passive Activity and At-Risk Rules
- 936** Home Mortgage Interest Deduction

Form (and Instructions)

- 1040** U.S. Individual Income Tax Return
- 1040X** Amended U.S. Individual Income Tax Return
- Sch A (Form 1040)** Itemized Deductions
- Sch F (Form 1040)** Profit or Loss From Farming
- 1045** Application for Tentative Refund
- 2290** Heavy Vehicle Use Tax Return
- 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 these 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.

Economic performance. Generally, you cannot deduct or capitalize farm business expenses until economic performance occurs. If your expense is for property or services provided to you, or for use of property by you, economic performance occurs as the property or services are provided, or as the property is used. If your expense is for property or services that you provide to others, economic performance occurs as you provide the property or services. For more information about economic performance, see Publication 538.

Reimbursed expenses. If you are reimbursed, either reduce the amount of the expense or report the amount you receive as income, depending on when you receive the reimbursement. See *Refunds and reimbursements* in chapter 4.

Contested liabilities. If you use the cash method of accounting and contest an asserted liability for any of your farm business expenses, you may claim the deduction only in the year you pay the liability. If you are an accrual method taxpayer, however, you can deduct the expense either in the year you pay the

contested liability (or transfer money or other property in satisfaction of it) or in the year you finally settle the contest. However, to be able to take the deduction in the year of payment or transfer, you must meet certain rules. For more information, see *Contested Liabilities* under *Accrual Method* in Publication 538.

Prepaid Farm Supplies

There may be a limit on your deduction for prepaid farm supplies if you use the cash method of accounting to report your income and expenses. This limit will not apply, however, if you meet one of the exceptions described later.

Defined. Prepaid farm supplies are amounts you paid during the tax year for:

- 1) Feed, seed, fertilizer, and similar farm supplies not used or consumed during the year,
- 2) Poultry (including egg-laying hens and baby chicks) bought for use (or use and sale) in your farm business that would be deductible in the following year if you had capitalized the cost and deducted it ratably (for example, on a monthly basis) over the lesser of 12 months or the useful life of the poultry, and
- 3) Poultry bought for resale and not resold during the year.

Prepaid farm supplies do not include any amount paid for farm supplies on hand at the end of the tax year that would have been consumed if not for a fire, storm, flood, other casualty, disease, or drought.

Deduction limit. You can deduct prepaid farm supplies that do not exceed 50% of your other deductible farm expenses in the year of payment. You can deduct any excess prepaid farm supplies only for the tax year you use or consume the supplies.

The cost of poultry bought for use in your farm business and not allowed in the year of payment is deductible in the following year. The cost of poultry bought for resale is deductible in the year you sell or otherwise dispose of that poultry.

Other deductible farm expenses. Other deductible farm expenses are any amounts allowable as deductions on Schedule F (Form 1040), including depreciation or amortization, but not including prepaid farm supplies.

Example. During 1996, 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 for 1996 are \$5,500. Your other deductible farm expenses totaled \$10,000 for 1996. Therefore, your deduction for prepaid farm supplies may not exceed \$5,000 (50% of \$10,000) for 1996. The excess prepaid farm supplies of \$500 (\$5,500 – \$5,000) are deductible in the later tax year the supplies are used or consumed.

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

- 1) Your prepaid farm supplies are more than 50% of your other deductible farm expenses because of a change in business operations caused by extraordinary circumstances, or
- 2) Your total prepaid farm supplies for the preceding 3 tax years are 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 apply:

- 1) Your principal 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, aunts, uncles, and their children.

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

Livestock Feed

If you report your income under the cash method, you can deduct in the year paid the cost of feed your livestock consumed in that year. However, the cost of feed not consumed in that year is subject to the advance payment for feed rules, discussed next, and the limit on prepaid farm supplies, discussed earlier.

Advance payments for feed. If you meet *all* three of the following tests, you can deduct in the year of payment (subject to the limit on prepaid farm supplies), the cost of feed your livestock will consume in a later tax year. This rule does not apply to the purchase of commodity futures contracts.

- 1) The expense is a payment for the purchase of feed, not a deposit. Whether an expense is a deposit or payment depends on the facts and circumstances in each case. The expense is a payment 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, under contract provision or business custom, to a refund or repurchase.

Factors that show an expense is a deposit rather than a payment include:

- a) The absence of specific quantity terms.
- b) The right to a refund of any unapplied payment credit at the end of the contract.
- c) The treatment as a deposit by the seller.
- d) 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 current diet requirements of the livestock for which you bought the feed will not indicate a deposit. Further, adjustment to the contract price to reflect market value at the date of delivery is not, by itself, proof of a deposit.

- 2) The prepayment has a business purpose and is not merely for tax avoidance. You should have a reasonable expectation of receiving some business benefit from the prepayment. Some examples of business benefits are:

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

Whether the prepayment was a condition imposed by the seller and whether the condition was meaningful will also be considered in determining the existence of a business purpose for the prepayment.

- 3) The deduction of these costs does not result in a material distortion of your income. Even if you meet the first two tests, this does not automatically mean the expense is deductible in the year paid. A deferral of the deduction may be necessary to clearly reflect your income. Some factors to consider in determining whether the deduction results in a material distortion of income are:

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

If you fail any of these tests, you cannot deduct in the year paid the cost of feed your livestock will consume in a later tax year. You deduct it in the tax years your livestock consume the feed.

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 may pay wages in cash or non-cash items such as inventory items, 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. See *Taxes* later.

Deductible Pay

The kinds of pay you can deduct include the fair market value of property you transfer to your employees and wages you pay to members of your family, as discussed next.

Property for services. If you transfer property to one of your employees 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, you can deduct as wages the fair market value of the property minus the amount paid by the employee for the property. Treat the amount you deduct on your return as the 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 children for doing farm work if a *true employer-employee relationship* exists between you and your children. 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 Members* 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 Members* 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 items. These wages are part of the cost of the building or other improvement. Capitalize them.

Maintaining your home. If your farm employee spends time maintaining or repairing your home, the wages and social security and Medicare 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 social security and Medicare taxes you pay for that employee.

Employment Credits

Reduce your deduction for wages by any employment credits allowed for the tax year. The following are employment credits and their related forms:

- 1) Work Opportunity Tax Credit, Form 5884
- 2) Empowerment Zone Employment Credit, Form 8844
- 3) Indian Employment Credit, Form 8845

For more information, see the forms and their instructions.

Personal and Business Expenses

Some of the 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.

Allocation. Allocate these mixed expenses because the personal part is not deductible as a business expense.

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. No rule can be prescribed for all cases, but the allocation must be reasonable. What is reasonable depends on the circumstances in each case.

Telephone expense. You cannot deduct the cost of basic local telephone service (including taxes) for the first telephone line you have in your home. However, you can deduct the cost of additional telephone service in your home if you use it for your farm business.

Tax preparation fees. You can deduct as a farm business expense on Schedule F (Form 1040) the cost of preparing that part of your tax return relating to your farm business. You can 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.

Repairs and Maintenance

You can deduct most expenses for the repair and maintenance of your farm property. However, repairs to depreciable property that substantially prolong the life of the property, increase its value, or adapt it to a different use

are capital expenses. If you repair the barn roof the cost is deductible. But if you replace the roof it is a capital expense. Common items of repair and maintenance are repainting, replacing shingles and supports on farm buildings, and minor overhauls of cars, tractors, and other farm machinery. You must, however, capitalize major overhauls that prolong the life of the property.

Interest

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

If you use the cash method of accounting, you can deduct interest paid during the 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.

If you use an accrual method of accounting, deduct interest as it accrues. 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 chapter 8 in Publication 535.

Allocation of interest. If you use the proceeds of a loan for more than one purpose (for example, personal and business), allocate the interest on that loan to each use.

The best way to allocate interest is to keep the proceeds of a particular loan separate from any other funds. You can treat a payment made from any account (or in cash) within 30 days before or after the debt proceeds are deposited (or received in cash) as being made from those debt proceeds.

In general, you allocate interest on a loan the same way you allocate the loan. This is true even if the funds are paid directly to a third party. You allocate loans by tracing disbursements to specific uses. If you must allocate your interest expense, use the following categories:

- 1) Trade or business interest.
- 2) Passive activity interest.
- 3) Investment interest.
- 4) Personal interest.
- 5) Portfolio expenditure interest.

Allocation based on use of loan's proceeds. Loan proceeds and the related interest are allocated by the use of the proceeds. The allocation is not affected by the use of property that secures the loan.

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

Allocation period. The period a loan is allocated to a particular use begins on the date the proceeds are used and ends on the earlier of the date the loan is:

- 1) Repaid, or
- 2) Reallocated to another use.

For more information, see chapter 8 in Publication 535.

Prepaid interest. Under the cash method, you cannot generally deduct any interest paid before the year it is due. Interest you pay that is properly allocable to a later tax year must be charged to a capital account. Treat an advance payment as paid in the period covered by the prepaid interest.

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.

Breeding Fees

You can deduct breeding fees as a farm business expense. However, if you must 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 chapter 3.

Fertilizer and Lime

You can deduct in the year paid or incurred the cost of fertilizer, lime, and other materials applied to farm land to enrich, neutralize, or condition it. You can deduct the cost of applying these materials in the year you pay or incur it. If the benefits of the fertilizer, lime, or other materials last substantially more than a year, you can choose to deduct the expenses in the year paid or incurred, or you can capitalize them and deduct a part each year the benefits last. However, see *Prepaid Farm Supplies*, earlier, for a rule that may limit your deduction for these materials.

Farm land is land used for producing crops, fruits, or other agricultural products or for sustaining livestock. Farm land for the choice described in the preceding paragraph does not include land you have never used for producing crops or sustaining livestock. You cannot deduct initial land preparation costs (see *Capital Expenses*, later).

If you choose to deduct the expenses in the year paid or incurred, you can change the choice for that year only with IRS consent. Include government payments you receive for lime or fertilizer in income. For more information, see *Fertilizer and Lime* 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.

The taxes on the part of your farm you use as your home, and its furnishings, are nonbusiness taxes. To determine the nonbusiness part, prorate the taxes between the farm assets and nonbusiness assets. The proration can be done on the basis of the assessed valuations. If your tax statement does not show the assessed valuations, you can usually get them from the tax assessor.

State or local general sales taxes. State or local general sales taxes on nondepreciable farm business expense items are part of the cost of the item. Include state or local general sales taxes imposed on the purchase of capital assets for use in your farm business as part of the cost that you depreciate. If state or local general sales taxes on the purchase of farm business capital assets are imposed on the seller and passed on to you, treat them as part of the cost of the capital assets.

State and federal income taxes. You cannot deduct state and federal income taxes as farm business expenses. You can deduct state income tax if you itemize your deductions on Schedule A. You cannot deduct federal income tax.

Federal 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 more information on the tax, see the instructions for Form 2290.

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. You can generally deduct premiums you pay for the following types of insurance related to your farm business on Schedule F:

- 1) Fire, storm, crop, theft, liability, and other insurance on farm business assets,
- 2) Premiums for health and accident insurance on your employees, and
- 3) Payments for workers' compensation insurance and state unemployment insurance.

Self-employed health insurance deduction. If you are a self-employed individual, you can deduct, as an adjustment to income on your 1996 Form 1040, 30% of the amount you paid 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.

If you are 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. This also applies if you are eligible

to participate in a health plan maintained by your spouse's employer.

Use the worksheet in the Form 1040 instructions to figure your deduction. Include the remaining part of the insurance payment in your medical expenses on Schedule A, if you itemize your deductions.

Advance premiums. If you pay insurance premiums in advance, you can deduct each year only the premium that applies to that tax year. You can deduct the balance in each later year to which it applies. This is true whether you use the cash or accrual method of accounting.

Example. On June 28, 1996, 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, 1996. Only the cost for the 6 months in 1996 is deductible as an insurance expense on your 1996 tax return. You can deduct \$500, which is the premium for 6 months of the 36-month premium period, or $\frac{6}{36}$ of \$3,000. In 1997 and 1998, \$1,000 ($\frac{12}{36}$ of \$3,000) is deductible. The remaining \$500 is deductible in 1999. Had the policy been effective on January 1, 1996, the deductible expense would have been \$1,000 for each of the years 1996, 1997, and 1998, based on one-third of the premium used each year.

Business interruption insurance. Business interruption insurance premiums are deductible. This insurance pays for lost profits if your business is shut down due to a fire or other cause. You report any proceeds in full as ordinary income.

Rent and Leasing

If you lease property for use in your business, you can generally deduct the rent you pay.

Rent

You can deduct on Schedule F rent you pay in cash. However, you cannot deduct rent you pay in crop shares because you deduct the cost of raising the crops as farm expenses.

Advance payments. You can 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, you cannot 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 equipment rather than buy it, determine whether the agreement is a lease or, in reality, a conditional sales contract. If the agreement is a lease, you can deduct rental payments for the use of the equipment in your trade or business. If the agreement is a conditional sales contract and you have acquired, or will acquire, title to or equity in the equipment, the payments under the agreement, so far as they do not represent interest or other charges, are payments for the purchase of the equipment. You cannot deduct these payments as rent, but must capitalize the cost of

the equipment and recover this cost through depreciation.

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

Intent. Whether the agreement, which in form is a lease, is in substance a conditional sales contract depends on the intent of the parties. This intent is shown by the agreement, read in the light of the facts and circumstances existing at the time you made the agreement. In determining the intent, no single test, or special combination of tests, is absolutely definitive. However, in the absence of compelling and persuasive factors to the contrary, treat an agreement as 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 receive title to the property after you pay a stated amount of required payments.
- 3) You must pay, over a short period of time, an amount that represents a large part of the price you would pay to buy 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 small price compared to the value of the property at the time you can exercise the option. Determine this value at the time of entering into the original agreement.
- 6) You have an option to buy the property at a small price compared to the total amount you must pay under the lease.
- 7) The lease designates some part of the payments as interest, or part of the payments are easy to recognize as interest.

Leveraged leases. Special rules apply to leveraged leases of equipment (property financed by a nonrecourse loan from a third party). For more information, see the following revenue procedures.

- 1) 75-21, 1975-1 CB 715,
- 2) 75-28, 1975-1 CB 752,
- 3) 76-30, 1976-2 CB 647, and
- 4) 79-48, 1979-2 CB 529.

Motor vehicle leases. Special rules apply to lease agreements that have a terminal rental adjustment clause. The clause will generally provide for a rental adjustment on termination of the lease. If your rental agreement contains

a terminal rental adjustment clause, treat the agreement as a lease. For more information, see section 7701(h) of the Internal Revenue Code.

Depreciation

If you acquire property for use in your farm business and that property has a useful life of more than one year, you generally cannot deduct its entire cost in one year. Instead, spread the cost over more than one year and deduct part of it each year. For most property, this deduction is depreciation. However, you may be able to deduct part or all of the cost of this property as a business expense in the year you place it in service. This is the section 179 deduction.

Depreciation 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.

The principal place of business of a farm is the entire farm. If your home office is on your farm, the office and the surrounding farm land are considered one place of business. For more information on how to determine your principal place of business if you have more than one place of business, see Publication 587.

If you use part of your home for business, you must divide the expenses of operating your home between personal and business use. For more information, see Publication 587.

Deduction limit. If the gross income from the business use of your home is less than your total business expenses, your deduction for certain expenses for the business use of your home is limited. Total deductions for otherwise nondeductible expenses, such as utilities, insurance, and depreciation (with depreciation taken last), cannot be more than the gross income from the business use of your home minus the sum of:

- 1) The business percentage of the otherwise deductible mortgage interest, real estate taxes, and casualty and theft losses, and
- 2) The business expenses that are attributable to the business activity in the home, but not to the use of the home itself (for example, salaries or supplies).

You can carry forward to your next tax year deductions over the current year's limit. These

deductions are subject to the gross income limit from the business use of your home for the next tax year.

See Publication 587 for information on how to figure this limit and where to deduct the expenses on your return.

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.

Instead of using actual costs, under certain conditions you can use a standard mileage rate of 31 cents a mile for all miles of business use in 1996. You can use the standard mileage rate only for cars and light trucks, such as vans, pickups, and panel trucks, that you own. The standard mileage rate cannot be used if you operate two or more cars or light trucks at the same time in your farm business.

For more information, see Publication 463.

Travel Expenses

You can deduct ordinary and necessary expenses you incur while traveling away from home for your farm business. However, you cannot deduct lavish or extravagant expenses. Your home, for tax purposes, is usually the location of your farm business. 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 reasonable and necessary expenses for travel, meals, and lodging. You can ordinarily deduct only 50% of your business-related meal expenses.

Travel expenses include:

- 1) Air, rail, bus, and car transportation.
- 2) Meals and lodging.
- 3) Cleaning and laundry.
- 4) Telephone and fax.
- 5) Transportation between your hotel and your temporary work assignment.
- 6) Similar expenses related to ordinary and necessary travel.
- 7) Tips for any of the above expenses.

Meals. You can deduct 50% of the cost of meals 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. If you pay for a business meal when you are not traveling, you can deduct 50% of the cost only if you meet the

rules for business entertainment. For more 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 use either the actual cost or a standard amount. For more information on using a standard amount, see *Standard Meal Allowance* in chapter 1 of Publication 463.

Recordkeeping requirements.



You must be able to prove your deductions for travel by adequate records or sufficient 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, that together supports each element of an expense.

Instead of deducting the actual cost of meals and incidental expenses while traveling away from home for business, you can generally choose to deduct a standard meal allowance. If you choose this option, you do not have to keep records to prove amounts spent for meals and incidental expenses. However, you must still prove the actual cost of other travel expenses, as well as the time, place, and business purpose of your travel.

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

Reimbursements to employees. You can generally deduct as business expenses reimbursements you pay to your employees for travel and transportation expenses they incur in the conduct of your business. If you reimburse these expenses under an accountable plan, deduct them as travel, meal, and entertainment expenses. If you reimburse these 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 6 of Publication 463.

Marketing Quota Penalties

You can deduct 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 amount paid 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 can deduct the cost of livestock and other items purchased for resale in Part I of Schedule F in the year of sale. This cost includes freight charges for transporting the livestock to the farm. Ordinarily, this is the only time you can deduct the purchase price. However, see *Cost of chickens, seeds, and young plants—cash method*, later.

Example. You report on the cash method. In 1996, you buy 50 steers you will sell in 1997. You deduct the purchase price, plus any freight cost, in 1997 when you sell the steers.

Cost of chickens, seeds, and young plants—cash method. Cash method farmers can deduct the cost of hens and baby chicks bought for commercial egg production or for raising and resale as an expense in the year they pay the costs, if they do it consistently and it clearly reflects income. You can deduct the purchase price of seeds and young plants bought for further development and cultivation before sale as an expense when paid if it is done consistently and you do not figure your income on the crop method. However, this rule does not apply to the cost of seeds and young plants for Christmas trees, orchards, and timber.

If you deduct the purchase price of chickens and young plants as an expense, report their entire selling price as income. You cannot also deduct the purchase price from the selling price.

See *Prepaid Farm Supplies*, earlier, for a rule that may limit your deduction for the items discussed here.

Capitalize the cost of plants with a preproductive period of more than 2 years, unless you can elect out of the uniform capitalization rules, which are discussed in chapter 7.

Example. You use the cash method of accounting. In 1996, you buy 500 baby chicks to raise for resale in 1997. You also buy 50 bushels of winter seed wheat in 1996 that you sow in the fall. You can deduct the cost of both the baby chicks and the seed wheat in 1996, unless you previously adopted the method of deducting these costs in the year you sell the chickens or the harvested crops.

Delaying deduction—crop method. You can delay deducting the purchase price of seeds and young plants until you sell them if you get IRS permission. If you follow this method, deduct the purchase price from the selling price to determine your profit. Do this in Part I of Schedule F. For more information, see *Crop method* under *Special Methods* in chapter 3.

Choosing the method. You can adopt either of these methods for deducting the purchase price in the first year you buy egg-laying hens, pullets, chicks, or seeds and young plants. If you choose the crop method, however, you need IRS permission.

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 permission to change your method. For more information, see *Change in Accounting Method* in chapter 3.

You cannot deduct the purchase price of seeds and young plants for Christmas trees and timber as an expense. You deduct the cost of these seeds and plants through depletion allowances. For more information, see *Depletion* in chapter 8.

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

Other Expenses

The following list, while not all-inclusive, shows some of the 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, or (2) incurred, if you use an accrual method.

- Accounting fees
- Advertising
- Chemicals
- Custom hire (machine work)
- Educational expenses (to maintain and improve farming skills)
- Farm 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 having a useful life of one year or less
- Stamps and stationery
- Storage and warehousing
- Tying material and containers
- Veterinary fees and medicine

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. 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 casualty or theft loss that was more than your income.

You can use an NOL to reduce your income (and tax) in other years by carrying it to those years and deducting it from income. However, the at-risk limits, discussed later,

may limit how much of your NOL you can carry to other years.

Net Operating Losses

It is important for you to determine whether you have an NOL. If you have an NOL this year, you may be able to get all or part of the income tax you paid for the past 3 tax years refunded, or you may be able to 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 35 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 more than zero, you do not have an NOL.

There are rules that limit what you can deduct 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:

- 1) Exemptions,
- 2) Net capital losses,
- 3) Nonbusiness losses,
- 4) Nonbusiness deductions, and
- 5) Net operating loss deductions.

Example. Glenn Johnson is a dairy farmer. He is single and has the following income and deductions on his Form 1040 for 1996.

| | |
|--|------------------------|
| INCOME | |
| Wages from part-time job | \$ 1,225 |
| Interest on savings | 425 |
| Net long-term capital gain on sale of farm acreage | 2,000 |
| Glenn's total income | <u>\$ 3,650</u> |
| DEDUCTIONS | |
| 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 |
| Personal exemption | 2,550 |
| Standard deduction | 4,000 |
| Loss on small business investment company stock | 1,000 |
| Glenn's total deductions | <u>\$13,550</u> |

Glenn's deductions exceed his income by \$9,900 (\$13,550 – \$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:

| | |
|---|-----------------------|
| Nonbusiness net short-term capital loss ... | \$1,000 |
| Personal exemption | 2,550 |
| Nonbusiness deductions (standard deduction, \$4,000) minus nonbusiness income (interest, \$425) | 3,575 |
| Total adjustments to net loss | <u>\$7,125</u> |

When these items are eliminated, Glenn's net loss is reduced to \$2,775 (\$9,900 – \$7,125). This amount is his NOL for 1996.

Carrybacks. You generally carry an NOL back to the 3 tax years before the NOL year and deduct it from income you had in those years. 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 forgo 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 3 carryback years to which you carried an NOL. If your refigured tax is less than the tax you originally paid, you can apply for a refund by filing Form 1040X for each year affected, or by filing Form 1045. You will usually get a refund faster by filing Form 1045, and you can use one Form 1045 to apply an NOL to all 3 carryback years.

Carryovers. If you do not use up the NOL in the 3 carryback years, carry forward what remains of it to the 15 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 15-year carryforward period.

Forgoing the carryback period. You can choose not to carry back your NOL. If you make this choice, you use your NOL only in the 15-year carryforward period. (This choice means you also choose to not carry back any alternative tax NOL.) To make this choice, attach a statement to your tax return for the NOL year. This statement must show that you are choosing to forgo the carryback period. For more information about making the choice, see *Forgoing the carryback period* under *When To Use an NOL* in Publication 536.

Partnerships and S corporations. Partnerships and S corporations 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.

At-Risk Limits

Rules that limit your deduction for losses apply to most business or income-producing activities. Farming is one of the activities covered. The at-risk rules limit the loss you can deduct when figuring your taxable income or an NOL. The deductible loss from an activity is limited to the amount you have at risk in the activity.

You are generally at risk for:

- 1) The amount of money and property you contribute to an activity.
- 2) The amounts borrowed for use in the activity if:

- a) You are personally liable for repayment of the amounts borrowed, or
- b) Your property not used in the activity secures the amounts borrowed.

You are not at risk, however, for amounts borrowed for use in a farming activity from a person who has an interest in the activity or a person related to someone (other than you) having such an interest. For more information, see Publication 925.

Passive Activity Limits

If you have a passive activity, special rules limit the amount of loss you can deduct in the tax year. You generally cannot deduct losses from passive activities in the tax year that these losses exceed income from passive activities. Credits are similarly limited.

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. For more information, see Publication 925.

Capital Expenses

A capital expense is an amount paid, or a debt incurred, for the acquisition, improvement, or restoration of an asset having a useful life of more than one year. Capital expenses are generally not deductible, but they may be depreciable. Uniform capitalization rules also require you to capitalize or include in inventory certain expenses. See chapters 3 and 7. However, you can elect to deduct certain capital expenses such as:

- 1) Soil and water conservation expenses. For more information, see chapter 6.
- 2) Property that qualifies for a deduction under section 179. For more information, see chapter 8.
- 3) The cost of qualifying clean-fuel vehicle property and clean-fuel vehicle refueling property. For more information, see chapter 15 in Publication 535.

The costs of the following items are capital expenses you must capitalize. The costs of material, hired labor, and installation of these items are also capital expenses you must capitalize:

- 1) Land and buildings.
- 2) Additions, alterations, and improvements to buildings, etc.
- 3) Automobiles and trucks.
- 4) Equipment and machinery.
- 5) Fences.
- 6) Breeding, dairy, and draft livestock.
- 7) Reforestation costs.
- 8) Repairs to machinery, equipment, cars, and trucks that prolong their useful life, increase their value, or adapt them to different use.
- 9) Water wells, including drilling and equipping costs.

10) Preparatory costs as follows:

- 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.
- i) Building roads.

Production expenses. The uniform capitalization rules generally require you to capitalize production expenses incurred in producing long-term crops. 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:

- 1) Site preparation costs such as:
 - a) Girdling,
 - b) Applying herbicide,
 - c) Baiting rodents, and
 - d) Clearing and controlling brush.
- 2) 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 costs. These capitalized amounts are your basis for the timber. You 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 reforestation 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 \$10 each and are available from the U.S. Government Printing Office. Place your order using Stock #001-000-04621-7 at the following address:

Superintendent of Documents
U.S. Government Printing Office
Mail Stop: SSOP
Washington, DC 20402-9328

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. You recover these expenses as part of your adjusted basis when you sell the standing trees or you take depletion allowances when you cut the trees. For more information, see *Timber 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.

Not-for-Profit Farming

A farmer who operates a farm for profit can deduct all the ordinary and necessary expenses of carrying on the business of farming. However, if you do not carry on your farming activity, or other activity you engage or invest in, to make a profit, there is a limit on the deductions you can take. You cannot use a loss from that activity to offset other income. Activities you do as a hobby, or mainly for sport or recreation, come under this limit. 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 be considered are whether:

- 1) You operate your farm in a businesslike manner.
- 2) The time and effort you spend on farming indicates 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 make a profit from farming in some years and how much profit you make.
- 7) You, or your advisors, have the knowledge needed to carry on the farming activity as a successful business.

8) You made a profit in similar activities in the past.

9) You are carrying on the farming activity for personal pleasure or recreation.

Limit on deductions and losses. If your activity is not carried on for profit, take deductions only in the following order, only as far as stated in the three categories, and, if you are an individual, only if you itemize them on Schedule A (Form 1040). You do not have to go through the following computations (Categories 1, 2, or 3) if the gross income from the activity is more than your deductions. But you must still 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 mortgage interest, taxes, and casualty losses (see chapter 13), belong in this category. For the limits that apply to mortgage interest, see Publication 936.

Category 2. Deductions that do not result in an adjustment to the basis of property are allowed next, but only to the extent your gross income from the activity is more than the deductions you take (or could take) for it 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) for it 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.

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 stockholder's or partner's distributive shares.

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 the same for each year within this period. You have a profit when gross income from an activity is more than the deductions from that activity.

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, 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 under *Not-for-Profit Farming*.

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 generally must be filed within 3 years after the due date of your return for the year you first started farming. If you receive a notice from a District Director 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 you had a loss.

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

Nondeductible Expenses

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

Personal, Living, and Family Expenses

The law specifically prohibits the deduction of 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 automobiles 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 crops.

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 parties. You cannot deduct losses from sales or exchanges of property between you and certain related parties, 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 chapter 10.

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 gifts of agricultural products or property held for sale in the ordinary course of business. For example, you cannot deduct as a farm business expense, in the year of the gift or any later year, the cost of raising cattle given as a gift to your child or the cost of planting and raising unharvested wheat on parcels of land given as a gift to your children.

Dues and subscriptions. 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 business, social, athletic, luncheon, sporting, airline, and hotel clubs.

Exception. 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, the following organizations will not be treated as clubs organized for business, pleasure, recreation, or other social purpose:

- 1) Boards of trade,
- 2) Business leagues,
- 3) Chambers of commerce,
- 4) Civic or public service organizations,
- 5) Professional associations, and

- 6) Trade associations.

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

6.

Soil and Water Conservation Expenses

Important Change for 1996

Form 8645 obsolete. Form 8645, *Soil and Water Conservation Plan Certification*, has been obsolete. You are no longer required to attach Form 8645 to Form 1040 when you deduct conservation expenses.

Introduction

If you are in the business of farming, you can choose to deduct your capital expenses for soil or water conservation or for the prevention of erosion of land used in farming. Otherwise, these expenses must be added to the basis (cost) of the land. 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 the cost of primarily producing an agricultural crop that also conserves 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

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 also not farming if you are engaged only in forestry or the growing of timber, such as growing Christmas trees or producing maple syrup.

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 participate materially in operating or managing the farm. See *Landlord Participation in Farming* in chapter 15.

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

Plan Certification

You can deduct your expenses for soil and water conservation 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 to be deductible.

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:

- 1) **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.
- 2) **NRCS county plans.** These plans include a listing of farm conservation practices that are approved for the county where the farm land is located. Expenses for conservation practices not included on the NRCS county plans are deductible only if the practice is a part of an individual site plan.
- 3) **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.

Conservation Expenses

Deductible conservation expenses are those made for land that you or your tenant are using, or have used in the past, for farming. They include, but are not limited to:

- 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 exclude from gross income any cost-sharing payments you receive for soil and water conservation expenses you deduct. See chapter 4 for information about 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 make on it will be treated as made on land you previously used in farming. 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, the expenses will qualify.

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

Wetlands. Expenses to drain or fill wetlands are **not** deductible as soil and water conservation expenses. These expenses are added to the basis of the land.

Center pivot irrigation. Expenses to prepare land for center pivot irrigation systems are **not** deductible as soil and water conservation expenses. These expenses are added to the basis of the land.

Depreciable conservation assets. You cannot deduct your expenses for depreciable conservation assets. There is, however, an exception 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 items 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, conduits, canals, dams, wells, or pumps composed of masonry, concrete, tile, metal, or wood. You recover your capital investment through annual allowances for depreciation.

However, soil and water conservation expenses for nondepreciable earthen items such as earthen terraces and dams are deductible.

Water well. The cost of drilling a water well for irrigation and other agricultural purposes is a capital expense and **not** deductible as a soil and water conservation 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.

Assessment by Conservation District

In some localities, a soil or water conservation or drainage district incurs the expenses for soil or water conservation and levies an assessment against the farmers who benefit from the expenses. You can include as a deductible conservation expense the part of an assessment that you would have included if you had paid it directly. You include the amount in the year you pay or incur the assessment, depending on your method of accounting, not the year the expenses are paid or incurred by the district.

Assessment for Depreciable Property

You can include as a deductible conservation expense part of an assessment levied against you by a soil and water conservation or drainage district to pay 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. Special limits, discussed next, apply to these assessments.

Amount to include. The amount you can include for any conservation district assessment for depreciable property is subject to the following limits.

- 1) The total amount you can include for the assessment (whether one payment or paid in installments) cannot exceed 10% of the total assessment against all members of the district for the property.
- 2) The maximum amount you can include each year is 10% of your deductible share of the cost + \$500.

The amount you can include is added to your other conservation expenses for the year. The total for these expenses is then subject to the limit on deduction discussed later. See *Table 6-1* for information on the limits.

Total limit. You cannot include more than 10% of the total amount assessed to all members of the conservation 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 assessment:

- 1) The amount over 10% is a capital expense and is added to the basis of your land.
- 2) If the assessment is paid in installments, each payment must be prorated between the deductible amount and the capital expense.

Yearly limit. The maximum amount you can include in one year is the total of 10% of your deductible share of the cost as explained earlier, plus \$500. If the assessment is equal to or less than the maximum amount, you can include the entire assessment in the year it is paid. If the assessment is more, the maximum amount you can include in one year is 10% of your deductible share of the cost. The remainder of the assessment is included in equal amounts over the next 9 tax years.

Example 1. This year, the soil conservation district levies an assessment of \$2,400 against your farm. Of the assessment, \$1,500 is for digging drainage ditches. It is includable 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 include for the depreciable equipment is limited to 10% of the

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 |
|--|--|---|
| 10% of: | (10% of: | 25% of: |
| Total assessment against all members of the district for the property. | Your deductible share of the cost to the district for the property) + \$500. | Your gross income from farming. |
| <ul style="list-style-type: none"> No one taxpayer can deduct more than 10% of the total assessment. Any amount over 10% is a capital expense and is added to the basis of your land. If an assessment is over 10% and payable in installments, each payment must be pro-rated between the deductible amount and the capital expense. | <ul style="list-style-type: none"> The maximum amount each year is (10% of your deductible share of the cost) + \$500. If the assessment is greater than that amount paid, the limit for that year is 10% of your deductible share of the cost. The remainder is included in equal amounts over the next 9 tax years. | <ul style="list-style-type: none"> Limit for all conservation expenses, including assessments for depreciable property. Amounts in excess of 25% may be carried to the following year and added to that year's expenses. The total is then subject to the limit of 25% of gross income from farming in that year. |

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 to include for this year, multiply your deductible share of the total assessment (\$700) by 10%. Add \$500 to the result for a total of \$570. The deductible assessment, \$700, is greater than the maximum amount deductible in one year so you can include only \$70 of the assessment for depreciable property this year (10% of \$700). The balance is included 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 include \$1,570 of the \$2,400 assessment as a soil and water conservation expense this year, subject to the limit on deduction discussed later.

Example 2. Assume that \$1,850 of the \$2,400 assessment in *Example 1* 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. Your total deductible assessment for the depreciable equipment is limited to 10% of this amount, or \$550.

The maximum amount deductible this year for the depreciable equipment is \$555 (10% of the total assessment, \$55, plus \$500). Since the assessment for depreciable property is less than the maximum amount deductible, you can include the entire \$550. The entire assessment, \$2,400, is deductible as a soil and water conservation expense this year, subject to the limit on 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, any remaining assessment not yet included is 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 assessment not yet included is included in the year of death.

Limit on Deduction

The total deduction for deductible 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, dairy, or sport are included. Gains from sales of assets such as farm machinery, or from the disposition of land, are not included.

Carryover of deduction. You can carry over any unused deduction to later years if your deductible conservation expenses in any year are more than 25% of your gross income from farming for that year. However, the amount deducted in any later year cannot be more than 25% of the gross income from farming for the year the deduction is taken.

Example. In 1996, you have gross income of \$16,000 from two farms. During the year, you made \$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 (\$5,300 – \$4,000) is carried over to 1997 and added to deductible soil and water conservation expenses made in that year. The total of the 1996 carryover plus 1997 expenses is deductible in 1997, subject to the limit of 25% of your gross income from farming in 1997. Any excess expenses over the limit in that year are carried to 1998 and later years.

Net operating loss. The deduction for soil and water conservation expenses is included when computing 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 the 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 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 consent of your IRS District Director. To get this consent, 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:

- 1) Your name and address.
- 2) The first tax year the method or change of method is to apply.
- 3) 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.
- 4) The total expenses you paid or incurred in the first tax year the method or change of method is to apply.
- 5) 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 and discontinue farming, you cannot adjust the basis of the land at the time of the sale for any unused carryover of soil and water conservation expenses. You

can, however, pick up the unused balance and start taking deductions again if you return to the business of farming in a later year.

Gain on disposition of farm land. If you held the land 5 years or less before you sold or disposed of it, gain on the sale or other disposition 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 *Farm land (under section 1252)* in chapter 11.

7.

Basis of Assets

Introduction

Basis is the amount of your investment in property for tax purposes. Use the adjusted basis of property to figure the amount of gain or loss on the sale, exchange, or other disposition of property. Also use it to figure the deduction for depreciation, amortization, depletion, and casualty losses. You must keep accurate records of all items that affect the original basis of property so you can make these computations.

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.

The basis for inventories is discussed in chapter 3.

Topics

This chapter discusses:

- Cost basis
- Uniform capitalization rules
- Adjusted basis
- Other basis

Useful Items

You may want to see:

Publication

- 378** Fuel Tax Credits and Refunds
- 504** Divorced or Separated Individuals
- 535** Business Expenses
- 537** Installment Sales
- 544** Sales and Other Dispositions of Assets
- 551** Basis of Assets
- 559** Survivors, Executors, and Administrators

Form (and Instructions)

- Sch E (Form 1040)** Supplemental Income and Loss
- Sch F (Form 1040)** Profit or Loss From Farming
- 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. The cost is the amount you pay in cash, notes, other property, or services. Your cost also includes amounts you pay for sales tax, freight, installation, and testing. In addition, the basis of real estate and business assets will include other items.

Low- or no-interest loans. If you buy property on any 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.

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.

Real estate taxes. If you buy real property and agree to pay certain taxes the seller owed on it, treat the taxes you pay as part of your basis. You cannot deduct them as taxes.

If you reimburse the seller for taxes the seller paid for you, you usually can deduct them as an expense in the year of purchase. Do not include them in the property cost.

Settlement costs. You can include in the basis of property you buy the settlement fees and closing costs that are for buying it. You cannot include the fees and costs that are for getting a loan on the property. (A fee is for buying property if you would have had to pay it even if you bought the property for cash.)

Some of the settlement fees or closing costs that you can include in the basis of your property are:

- 1) Abstract fees (sometimes called abstract of title fees),
- 2) Charges for installing utility services,
- 3) Legal fees (including title search and preparing the sales contract and deed),
- 4) Recording fees,
- 5) Surveys,
- 6) Transfer taxes,
- 7) Title insurance,
- 8) Owner's title insurance, and

- 9) 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.

You must reasonably allocate these fees or costs between land and improvements, such as buildings, to figure the basis for depreciation of the improvements. Allocate the fees according to the fair market values of the land and improvements at the time of purchase.

Settlement costs **do not include** amounts placed in escrow for the future payment of items such as taxes and insurance.

Some settlement fees and closing costs you **cannot** include in the basis of the property are:

- 1) Fire insurance premiums.
- 2) Rent for occupancy of the property before closing.
- 3) Charges for utilities or other services relating to occupancy of the property before closing.
- 4) Fees for refinancing a mortgage.
- 5) Charges connected with getting a loan, such as:
 - a) Points (discount points, loan origination fees),
 - b) Mortgage insurance premiums,
 - c) Loan assumption fees,
 - d) Cost of a credit report, and
 - e) Fees for an appraisal required by a lender.

Points. If you pay points to get a loan (including a mortgage, second mortgage, line-of-credit, or a home equity loan) you generally must capitalize and amortize them ratably over the term of the loan. Do not add the cost to the basis of the related property.

Points on home mortgage. Special rules may apply to the amounts you and the seller pay as points when you get a mortgage to buy your main home. If these amounts meet certain requirements, you can deduct them in full as points for the year in which they are paid. If you deduct seller-paid points, reduce your basis by that amount. For more information, see *Points* in Publication 936, *Home Mortgage Interest Deduction*.

Assumption of a mortgage. If you buy property and assume an existing mortgage on the property, your basis includes the amount you pay for the property plus the amount to be paid on the mortgage you assume.

Example. If you buy a building for \$20,000 cash and assume a mortgage of \$80,000 on it, your basis is \$100,000.

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:

- 1) Land,

- 2) Materials and supplies,
- 3) Architect's fees,
- 4) Building permits,
- 5) Payments to contractors,
- 6) Payments for rental equipment, and
- 7) Inspection fees.

In addition, if you use your employees or farm materials and equipment to build an asset, your basis would also include:

- 1) Employee wages paid for the construction work,
- 2) Depreciation on equipment you own while it is used in the construction,
- 3) Operating and maintenance costs for equipment used in the construction, and
- 4) The cost of business supplies and materials used in the construction.

Do not deduct these expenses, which you must capitalize (i.e., include in the asset's basis) on Schedule F. Also, reduce your basis by any jobs credit, Indian employment credit, or empowerment zone employment credit allowable on the wages you pay in (1). 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 you receive. Make 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 to a specific allocation of the purchase price among the assets in the sales contract. If this allocation is based on the value of each asset and you and the seller have adverse legal interests, the allocation generally will be accepted.

Example. You bought farm property in March for the lump-sum price of \$275,000. You use the cash method of accounting. An inventory of the property at its FMV on the date of purchase is as follows:

| | <u>FMV</u> |
|---|------------------|
| Growing wheat crop..... | \$ 1,400 |
| Timber | 5,600 |
| Minerals (such as gravel, coal, sand, etc.) | 8,000 |
| Farmland | 170,000 |
| House | 30,000 |
| Depreciable assets used in farming | <u>60,000</u> |
| Total purchase price | <u>\$275,000</u> |

The FMV of each asset is the basis assigned to that asset.

You harvested and sold the wheat in July. You deduct its cost of \$1,400 on Schedule F, line 2, to figure the net farm profit.

Also, you sold the timber in July. Accordingly, you use its cost of \$5,600 to figure the gain realized or the loss sustained.

You will recover the cost of the minerals bought when you sell or otherwise dispose of the mineral interest in a taxable exchange. If you produce minerals, you will recover the cost through depletion allowances. (See chapter 8.)

Allocate (based on FMV) the cost basis assigned to the depreciable assets used in the farming business, \$60,000, among the various assets involved. Each asset's share of the cost basis is its basis for figuring depreciation and gain or loss on its sale.

Embryo transplants. If you get an embryo transplant by buying a recipient cow pregnant with the 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 basis allocated to the calf is currently deductible as a business expense.

Quotas and allotments. Certain areas of the country have quotas or allotments for commodities such as milk and tobacco. 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.

Adjusted Basis

Before figuring any 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 to the basis is the adjusted basis.

Increases to Basis

Increase the basis of any property by all items properly added to a capital account. This includes the cost of any improvements having a useful life of more than one year and amounts spent after a casualty to restore the damaged property.

Some additional items added to the basis are:

- 1) The cost of extending utility service lines to property,
- 2) Legal fees, such as the cost of defending and perfecting title, and
- 3) 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. Also, depreciate the basis of each according to the depreciation rules in effect when you placed the addition or improvement in service. See chapter 8.

Assessments for local improvements. Add assessments for items such as paving roads and building ditches, which increase the value of the property assessed, to the basis of the

property. Do not deduct them as taxes. However, you can deduct assessments for maintenance and repair and for meeting interest charges on the improvements as taxes.

Deducting vs. capitalizing costs. Do not add costs you can deduct as current expenses to your basis. However, you can choose either to deduct or to capitalize certain other costs. If you capitalize these costs, include them in your basis. If you deduct them, do not include them in your basis. See chapter 11 in Publication 535.

Decreases to Basis

Some items that reduce the basis of your property are:

- 1) The section 179 deduction,
- 2) The deduction for clean-fuel vehicles and clean-fuel refueling property,
- 3) Investment credit (part or all of credit) taken,
- 4) Casualty and theft losses,
- 5) Easements granted,
- 6) Deductions previously allowed or allowable for amortization, depreciation, and depletion,
- 7) Exclusion from income of subsidies for energy conservation measures,
- 8) Credit for qualified electric vehicles,
- 9) Gain on the sale of your old home on which tax was postponed,
- 10) Certain canceled debt excluded from income,
- 11) Rebates received from the manufacturer or seller,
- 12) Patronage dividends received as a result of a purchase of property (See *Patronage Dividends (Distributions)* in chapter 4.),
- 13) Residential energy credit,
- 14) Gas-guzzler tax, and
- 15) Tax credit or refund for buying a diesel-powered highway vehicle.

Some of these decreases to basis are discussed next.

Section 179 deduction. If you choose to take the section 179 deduction for all or part of the cost of 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 either the deduction for clean-fuel vehicles or clean-fuel vehicle refueling property, or both, decrease the basis of the property by the amount of the deduction. For more information about these deductions, see chapter 15 in Publication 535.

Casualties and thefts. If you have a casualty or theft loss, decrease the basis of your property by the amount of any insurance or other amount you get. Also, decrease it by any deductible loss not covered by insurance. However, increase your basis for amounts you

spend after a casualty to restore the damaged property. See chapter 13.

Easements. The amount you get for granting an easement is usually considered to be from the sale of an interest in your 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 to zero and treat the excess as a recognized gain. See *Easements and rights-of-way* in chapter 4.

Depreciation. Decrease the basis of your property by the depreciation you could have deducted on your tax returns under the method of depreciation you chose. If you took less depreciation than you could have under the method you chose, decrease the basis by the amount you could have taken under that method. If you did not take a depreciation deduction, figure the amount of depreciation you could have taken. If you deducted more depreciation than you should have, decrease your basis as follows. Decrease it 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.

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. If you got a subsidy from a utility company for the purchase or installation of any energy conservation measure, you can exclude it from income. Reduce the basis of the property on which you got the subsidy by the excluded amount. For more information about this subsidy, see Publication 525, *Taxable and Nontaxable Income*.

Credit for qualified electric vehicle. If you claim the credit for qualified electric vehicles, you must reduce the basis of the vehicle on which you claimed the credit. For more information about this credit, see chapter 15 in Publication 535.

Canceled debt excluded from income. If a debt is canceled or forgiven, other than as a gift or bequest, you generally must include the canceled amount in gross income for tax purposes. A debt includes 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:

- 1) Canceled in a title 11 case or when you are insolvent,
- 2) Qualified farm debt, or
- 3) Qualified real property business indebtedness (provided you are not a C corporation).

If you exclude canceled debt from income, you may have to reduce the basis of your property.

For more information about canceled debt in a bankruptcy case, see Publication 908. For more information about insolvency and canceled debt that is qualified farm debt, see chapter 4.

Diesel-powered vehicle. If you got an income tax credit or refund for buying a diesel-powered highway vehicle, reduce your basis in that vehicle by the credit or refund allowable. For more information about this credit or refund, see Publication 378.

Other Basis

There are many times when you cannot use cost as basis. In these cases, the fair market value of the property or the adjusted basis of certain property may be used. Adjusted basis is 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 buyer and a 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 to figure the FMV of the property.

Property changed to business use. When you hold property for personal use and change it to business use or use it to produce rent, you must figure the basis for depreciation. An example of this would be renting out your former main home.

Basis for depreciation. The basis for depreciation equals the lesser of:

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

Property received for services. If you get 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. If you get property in exchange for other property in a taxable exchange, the basis of the property you get is usually its FMV at the time of the exchange. A taxable exchange occurs when you get cash or get property that is not similar or related in use to the property exchanged.

Example. You trade a tract of farmland with an adjusted basis of \$3,000 for a tractor that has a fair market value 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. If you got property in a nontaxable exchange, its basis is usually the same as the basis of the property you exchanged. A nontaxable gain or loss also is known as an **unrecognized** gain or loss.

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 exchange and the property you get. There must be an exchange of like-kind property (depreciable tangible personal property may be like-class property). For other requirements, see *Nontaxable Like-Kind Exchanges*, in chapter 10.

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

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

Property plus cash. If you trade property in a nontaxable exchange and pay money, the basis of the property you get is the basis of the property you exchanged 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 paid).

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 does not qualify for like-kind 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 in the property gotten in the original exchange will be its fair market value.

This rule generally does not apply to dispositions due to:

- 1) The death of either related person,
- 2) Involuntary conversions, or
- 3) Exchanges whose main purpose is not the avoidance of federal income tax.

Related persons. Generally, related persons are ancestors, lineal descendants, brothers and sisters (whole or half), and a spouse.

For other related persons (two or more corporations, an individual and a corporation, a grantor and fiduciary, etc.), see the rules relating to losses under *Nondeductible Loss* in chapter 2 of Publication 544.

Exchange of business. Exchanging the assets of one business for the assets of another business is a multiple asset exchange. For information on figuring basis in a multiple asset exchange, see *Multiple Property Exchanges* in chapter 1 of Publication 544.

Partially Nontaxable Exchange

A partially nontaxable exchange is an exchange in which you get unlike property or money and like property. The basis of the property you get is the same as the basis of the old property with the following adjustments:

- 1) Decrease the basis by:
 - a) Any money you get, and
 - b) Any loss recognized on the exchange.
- 2) Increase the basis by:
 - a) Any additional costs incurred, and
 - b) Any gain recognized on the exchange.

The other party to the transaction who assumes your liabilities (including a nonrecourse obligation), treats them as money transferred to you in the exchange.

Example 1. You traded farmland (basis \$10,000) for another tract of farmland (FMV \$11,000). You also got \$3,000. Your gain is \$4,000 (\$11,000 + \$3,000 – \$10,000). Include your gain in income only to the extent of the cash you got. Your basis in the land you got is:

| | |
|-------------------------------|-----------------|
| Basis of land traded | \$10,000 |
| Minus: Cash received | 3,000 |
| | \$ 7,000 |
| Plus: Gain recognized | 3,000 |
| Basis of land received | \$10,000 |

Example 2. You traded a truck (adjusted basis \$22,750) for another truck (FMV \$22,000). You also got \$10,000. Your gain is \$7,250 (\$20,000 + \$10,000 – \$22,750). Your basis in the truck you got is:

| | |
|--------------------------------------|-----------------|
| Adjusted basis of truck traded | \$22,750 |
| Minus: Cash received | 10,000 |
| | \$12,750 |
| Plus: Gain recognized | 7,250 |
| Basis of truck received | \$20,000 |

Allocation of basis. Allocate the basis among the properties, other than money, you got in the exchange. In making this allocation, the basis of the unlike property is 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 got \$1,000 in cash and a truck that had an FMV of \$3,000. You have a gain of \$1,500 (\$16,500 – \$15,000) recognized on the exchange. Your basis in the properties you received is:

| | |
|---|-----------------|
| Adjusted basis of old tractor | \$15,000 |
| Minus: Cash received | 1,000 |
| | \$14,000 |
| Plus: Gain recognized | 1,500 |
| Total basis of properties received | \$15,500 |

Allocate the total basis of \$15,500 between the tractor and the truck. The basis of the truck is its FMV, \$3,000, and the basis of the tractor is the rest, \$12,500.

Trade-In or Sale and Purchase

If a sale and purchase are a single transaction, you cannot increase the basis of property by selling your old property outright to a dealer and then buying new property from the same dealer. If the sale of your old property to the dealer and the purchase of the new property from that dealer are dependent on each other, you are considered to have traded your old property. Treat the transaction as an exchange no matter how you carry it out. You cannot avoid the trade-in rule by using a subsidiary in the transaction.

Example. Assume that 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 with a listed retail price of \$16,000 that regularly sells for \$15,500. If you trade your old tractor for the new one and pay \$11,500, your basis for depreciation for the new tractor is \$13,500 (\$11,500 plus the \$2,000 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 if you exchanged your old tractor for the new one. Your basis for the new tractor is \$13,500, the same as if you traded the old tractor and did not pay \$15,500.

Involuntary Exchanges

If you get property as a result of an involuntary exchange, such as a casualty, theft, or condemnation, you may figure the basis of the replacement property you get using the basis of the property you exchanged.

Similar or related property. If you get property similar or related in service or use to the property exchanged, the new property's basis is the same as the old property's basis on the date of the exchange. However, make the following adjustments.

- 1) Decrease the basis by:
 - a) Any loss recognized on the exchange, and
 - b) Any money received that was not spent on similar property.
- 2) Increase the basis by:

- a) Any gain recognized on the exchange, and
- b) Any cost of getting replacement property.

Not similar or related property. If you get money or other property not similar or related in service or use to the old property and you buy new property similar or related in service or use to the old property, the basis of the new property is the cost of the new property decreased by the gain not recognized on the exchange.

For more information about involuntary exchanges, see chapter 13.

Property Received as a Gift

To figure the basis of property you get 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 was equal to or more than the donor's adjusted basis, your basis is the donor's adjusted basis when you got the gift. Increase your basis by all or part of the 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 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 got a gift before 1977, increase your basis in the gift by the gift tax paid on it. (Your basis in the gift is the donor's adjusted basis.) 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 amount of 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 got the gift.

Gift received after 1976. If you got a gift after 1976, increase your basis in the gift by the part of the gift tax paid that is due to the net increase in value of the gift. (Your basis in the gift is the donor's adjusted basis.) Figure the increase by multiplying the gift tax paid on the gift by a fraction. The numerator (top part) of the fraction is the net increase in value of the gift and the denominator (bottom part) is the amount of the gift. The net increase in value of the gift is the FMV of the gift minus the donor's adjusted basis.

Example. Last year you got a gift of property from your mother that had an FMV of \$50,000. Her adjusted basis was \$20,000. She paid a gift tax of \$9,000. Your basis is \$25,400, figured as follows:

| | |
|---|------------------------|
| Fair market value | \$50,000 |
| Minus: Adjusted basis | 20,000 |
| Net increase in value | <u>\$30,000</u> |
| Gift tax paid | \$ 9,000 |
| Multiplied by (\$30,000 ÷ \$50,000) | .60 |
| Gift tax due to net increase in value | \$ 5,400 |
| Adjusted basis of property to your mother | <u>20,000</u> |
| Your basis in the property | <u><u>\$25,400</u></u> |

FMV less than donor's adjusted basis. If the FMV of the property was less than the donor's adjusted basis, your basis for gain on its sale or other disposition is the donor's adjusted basis plus or minus any required adjustment to basis while you held the property (see *Adjusted Basis*, earlier). Your basis for loss on its sale or other disposition is its FMV when you got 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 use the FMV for figuring a loss and get a gain, you have neither gain nor loss on the sale or other disposition.

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 the transferor'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 the transferor on property transferred in trust. This rule applies only to a property transfer 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 Publication 551 and Publication 504.

Inherited Property

Your basis in property you inherit is usually its FMV at the date of the decedent's death. If a federal estate tax return has to be filed, your basis in property you inherit can be its FMV at the alternate valuation date if the estate qualifies and chooses to use alternate valuation. If a federal estate tax return does not have to be filed, your basis in the property is its appraised

value at the date of death for state inheritance or transmission taxes.

Your basis in inherited property also may be figured under the special farm or closely held business real property valuation method, if chosen for estate tax purposes. This method is discussed next.

Special farm real property 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 on other than its FMV. If so, the executor or personal representative values the qualified real property based on its use as a farm. 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 got special-use valuation property, your basis in the property is the estate's or trust's basis in that property immediately before the distribution. If there is a gain recognized by the estate or trust because of post-death appreciation, increase the basis by this amount. Post-death appreciation is the difference between the property's FMV on the date of distribution and 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 have to increase your basis in special-use valuation property if it becomes subject to the additional estate tax. This tax is assessed if, within 10 years after the death of the decedent (15 years if decedent died before 1982), you transfer the property to a person who is not a member of your family 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.

To increase your basis in the property, you must make an irrevocable choice and pay the 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 fair market value 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 results in the additional estate tax.

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

- 1) Contains your name, address, and taxpayer identification number,
- 2) Identifies the choice as a choice under section 1016(c) of the Internal Revenue Code,
- 3) Specifies the property for which you are making the choice, and
- 4) 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 generally becomes the basis of the entire property, even the part belonging to the surviving spouse. For this to apply, at least half of the community property interest must be includible in the decedent's gross estate, whether the estate must file a return.

For example, if at least half the FMV of the community interest is includible in the decedent's estate and the FMV of the community interest is \$100,000, the basis of the surviving spouse's half of the property is \$50,000. The basis of the other half to the decedent's heirs also is \$50,000.

For more information about community property, see Publication 555.

Uniform Capitalization Rules

The uniform capitalization rules do not apply to any animal or plant that has a preproductive period of 2 years or less that you produce in your farming business. This exception does not apply to a corporation, partnership, or tax shelter required to use the accrual method of accounting (see chapter 3).

You are subject to the uniform capitalization rules if you:

- 1) Produce real property or tangible personal property for use in a trade or business or an activity engaged in for profit,
- 2) Produce real property or tangible personal property for sale to customers, or
- 3) Acquire property for resale.

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

Real property is land and generally anything that is erected on, growing on, or attached to land. Examples of real property you might produce (build) for use in your farming business are barns, chicken houses, and storage sheds.

Tangible property is any property that can be seen or touched. Personal property is generally any property that is not real property (for example, equipment or animals). Examples of tangible personal property you might produce for use in your farming business or for sale to customers include crops raised for sale or as animal feed. Other examples are animals raised for sale (beef cattle, hogs, etc.) or animals used in your farming business for breeding or production purposes (dairy cows).

Under the uniform capitalization rules, you must capitalize direct costs and an allocable part of most indirect costs you incur 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 deduct them as

current expenses. You can recover these costs through depreciation, amortization, or costs of goods sold, when you use, sell, or otherwise dispose of the property.

Costs that are allocable to property being produced include variable costs, such as: feed and labor, and fixed costs, such as: depreciation on machinery and buildings.

For more information about these rules, see the regulations under section 263A of the Internal Revenue Code.

Direct costs are your direct material costs and direct labor costs incurred for production or resale activities.

Indirect costs include all costs other than direct material and labor costs. Indirect costs include amounts incurred for:

- 1) Repair and maintenance of equipment or facilities.
- 2) Utilities (heat, light, power, etc.) relating to equipment or facilities.
- 3) Rent of equipment, facilities, or land.
- 4) Depreciation, amortization, and cost recovery allowance on equipment and facilities to the extent deductible.

Exceptions. The uniform capitalization rules do not apply to:

- 1) Property you produce that you use for personal or nonbusiness purposes, such as your home, and
- 2) Costs of raising, growing, or harvesting trees other than ornamental trees or trees bearing fruit, nuts, or other crops.

See Publication 551 for information about other property not subject to these rules.

Farming Business

Under the uniform capitalization rules, a farming business means a trade or business involving the cultivation of land or the raising or harvesting of any agricultural or horticultural commodity. Examples include the business of:

- 1) Operating a nursery or sod farm,
- 2) Raising or harvesting crops,
- 3) Raising or harvesting trees bearing fruit, nuts, or other crops,
- 4) Raising ornamental trees, and
- 5) Raising, shearing, feeding, caring for, training, and management of animals.

You cannot treat an evergreen tree over 6 years old when severed from its roots as an ornamental tree regardless of the purpose for which it is sold. The processing of commodities or products beyond activities normally incident to the growing, raising, or harvesting of these products is not a farming business. For nonfarming businesses, see Publication 551.

Example 1. C, an individual, is in the business of growing and harvesting apples and other fruits. C also processes the fruits, which he harvests to produce applesauce and similar food products that he sells to customers in the course of his business. Although C is in the farming business for the growing and harvesting of apples and other fruits, C is not in the

farming business for processing the fruit products he sells.

Example 2. Bob, an individual, is in the business of raising livestock. He uses the livestock in a meat processing operation in which the livestock are slaughtered, processed, and packaged for sale to customers. Although Bob is in the farming business for the raising of livestock, he is not in the farming business for the meat processing operation.

Preproductive Period for Plants

If your preproductive period for a plant is more than 2 years, you must capitalize the direct and indirect costs incurred during the preproductive period. Add these costs to the basis of your growing plant or include them in your inventory costs if you have an inventory. You can recover these costs through depreciation or cost of goods sold. When the plant becomes productive, current expenses allocable to the plant are deductible.

The preproductive period is:

- 1) The period before a plant's first marketable crop or yield if the plant has more than one crop or yield, or
- 2) The period before you reasonably expect to dispose of the plant.

The preproductive period of a plant begins when you first plant or acquire the seed or plant. The preproductive period ends when the plant becomes productive in marketable quantities or is reasonably expected to be disposed of or sold.

Damaged Crops

The uniform capitalization rules do not apply to the costs incurred for replacing plants damaged or destroyed by freezing temperatures, disease, drought, pests, or casualty. These are the costs you incur for the replacing, cultivation, maintenance, and development of any plants bearing an edible crop for human consumption that were lost or damaged while in your hands. This includes, but is not limited to, plants that make up a grove, orchard, or vineyard.

The replacing or maintenance costs may be incurred on property other than the property that was damaged or lost. This is allowed if the undamaged acreage is not more than the acreage of the property on which the damage or loss occurred.

Ownership. Generally, the person owning the property at the time the plants were lost or damaged must incur the costs. However, costs will qualify if they are incurred by a person other than the majority owner of the plants at the time of damage or loss if:

- 1) The person who owned the plants at the time the damage or loss occurred owns an equity interest of more than 50% in the plants or crops, and
- 2) The other person owns any part of the remaining equity interest and materially participates in the replanting, cultivation, maintenance, or development of the plants or crops.

Choosing Not To Use Uniform Capitalization Rules

You can choose not to use the uniform capitalization rules for any plant produced in a farming business that you conduct if you are not a corporation, partnership, or tax shelter required to use an accrual method of accounting. This choice 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 that the trees were planted. If you plant a citrus or almond grove over a period of years, the part of the grove planted in any one tax year is treated as a separate grove for determining the year of planting.

Making the choice. Unless you obtain consent from the IRS, you can only make this election for your **first** tax year in which you are in a farming business that includes the production of property subject to the uniform capitalization rules.

Make the choice on Schedule E, Schedule F, or any other schedule that you have to use for the first tax year that the election is effective. For a partnership or S corporation, the partner or shareholder must make the choice.

If you are eligible, you are treated as having made the choice if you do not capitalize the costs of producing your farm business property under the uniform capitalization rules.

Example. Brian Dey, a sole proprietor farmer, uses the calendar tax year. From 1977 until last year, Brian grew only wheat and corn. Because the preproductive period for these crops is less than 2 years, Brian was not subject to the uniform capitalization rules on the wheat and corn.

Starting last tax year, Brian began growing grapes. Brian is subject to the uniform capitalization rules on the grapes unless he chooses not to use the rules beginning with his last tax year.

Changing the choice. Once you have chosen not to use the uniform capitalization rules, you can change your choice only with consent from the IRS.

Disposition of plants. If you made the choice not to use the uniform capitalization rules, you must treat the plants you produce as section 1245 property. Further, you must "recapture" the preproductive expenses that you would have capitalized by treating these expenses as ordinary income. If the income from the sale of these plants is subject to self-employment tax, the recapture amounts treated as ordinary income also are subject to self-employment tax. Recapture these preproductive expenses when you figure your gain on selling or disposing of the property.

Depreciation under choice. If you or a related person chooses not to use the rules, you must use ADS (alternate depreciation system) to depreciate all property used predominantly in any farming business owned by you or the related person. This applies to all property placed in service in any tax year the choice is

in effect. This will not prevent you from taking the section 179 deduction to expense certain depreciable business assets.

For more information about depreciation and the section 179 deduction, see chapter 8.

Related person. For this election, a related person is:

- 1) You and members of your family, which include your spouse and any of your children who have not reached the age of 18 as of the last day of the tax year,
- 2) Any corporation (including an S corporation) if 50% or more of the stock (in value) is owned directly or indirectly by you or members of your family,
- 3) A corporation and any other corporation that is a member of the same controlled group, and
- 4) Any partnership if 50% or more (in value) of the interests in the partnership is owned directly or indirectly by you or members of your family.

Example 1. Peter Smith, a sole proprietor, planted an apple orchard. In addition, Peter grows and harvests wheat and other grains. The preproductive period of Peter's new orchard is more than 2 years. Peter chooses not to use the uniform capitalization rules for the costs of growing new apple trees. Peter must use ADS to depreciate all property used predominantly in his farming business (including the growing and harvesting of wheat) if the property is placed in service in a year the choice is in effect.

This means that Peter must depreciate all assets and equipment, including equipment used to grow and harvest wheat, that is placed in service in a year that the choice is in effect using the straight-line method over the required number of years as provided by ADS.

Example 2. Assume the same facts as in Example 1, except that Peter and members of his family also own 51% (in value) of the interests in Partnership K. Partnership K is engaged in the business of growing and harvesting corn. Partnership K must use ADS for any property used predominantly in its farming business that is placed in service in a year that the choice made by Peter is in effect.

Animals

Your costs incurred after 1988 for raising animals are exempt from the uniform capitalization rules if you are not a corporation, partnership, or tax shelter required to use an accrual method of accounting. However, for 1987 and 1988, you were subject to the uniform capitalization rules for animals that had a preproductive period of more than 2 years.

Choosing not to use uniform capitalization rules. If you did not have to use the accrual method of accounting, you could have elected not to use the uniform capitalization rules. This election allowed you to currently deduct the costs of raising animals. However, if you made this choice, you had to use ADS to depreciate property placed in service while the election was in effect. You must treat the disposition of

any qualifying animal as section 1245 property and "recapture" the preproductive expenses you would have capitalized.

Choice changed. If you changed your choice for your first tax year starting after 1988, you must continue to use ADS for any property placed in service in any tax year the election was in effect.

You can use any permissible depreciation method for property placed in service after 1988. Upon disposition of any animals raised or bought while the election was in effect, you must recapture the preproductive expenses deducted while the election was in effect.

Example. You raise beef cattle and use the calendar tax year. In 1987 you chose not to use the uniform capitalization rules for the costs of raising heifers. While the election was in effect, you bought a new tractor and began depreciating it under ADS. You figured the costs of raising heifers at \$90 in the year a calf was born and \$150 in the first tax year after birth.

In 1989 you changed your choice. You must continue to depreciate the tractor under ADS. You must keep preproductive cost records for all heifers born while the election was in effect (1987 and 1988). These heifers are section 1245 property, and you must recapture the preproductive costs when you dispose of them (\$240 for heifers born in 1987 and \$90 for heifers born in 1988).

8.

Depreciation, Depletion, and Amortization

Important Changes

Limits on depreciation for business cars. The total section 179 deduction and depreciation you can take on a car that you use in your business and first place in service in 1996 is \$3,060. Your depreciation cannot exceed \$4,900 for the second year of recovery, \$2,950 for the third year of recovery, and \$1,775 for each later tax year. See *Special Rules for Passenger Automobiles*, later.

Property not qualifying for the section 179 deduction. Effective for property placed in service after 1990, the following are among the types of property that do not qualify for the section 179 deduction:

- 1) Property used predominately outside the U.S.,
- 2) Property used predominately to furnish lodging or in connection with furnishing lodging,

- 3) Property used by foreign persons or entities, and
- 4) Air conditioning or heating units.

For more information, see *Nonqualifying Property*, later.

Important Reminder

General asset accounts. You can elect to place assets subject to MACRS in one or more general asset accounts. After you have established a general asset account, figure depreciation on the entire account by using the applicable depreciation method, recovery period, and convention for the assets in the account.

For more information, see *General Asset Accounts*, later.

Introduction

If you buy farm property, such as machinery, equipment, or structures, that has 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 a part of it each year. For most types of property, this is called "depreciation."

The discussion in this chapter gives you general information on depreciation, the section 179 deduction, and the modified accelerated cost recovery system (MACRS) that applies to property placed in service after 1986. If you depreciate property used in a farming business, you must use the 150% declining balance method.

For more information on depreciating property placed in service after 1986, see Publication 946.

For information on depreciating property placed in service before 1987, see Publication 534.

This chapter also discusses general information on depletion. It gives information on how to figure both cost depletion (including timber depletion) and percentage depletion.

Finally, this chapter discusses the amortization deduction. It discusses how you amortize section 197 intangibles, reforestation expenses, pollution control facilities, and costs of going into business.



It is important to keep good records for property you depreciate. You do not need to file this record with your return. Instead, you should keep it as a permanent record. You claim depreciation, including the section 179 deduction, on Form 4562. Keep your own records to verify the accuracy of the information on Form 4562.

Filled-in Form 4562. A filled-in Form 4562 is shown in chapter 20 to help you understand how to complete it.

Alternative minimum tax. If you use accelerated depreciation, you may need to figure alternative minimum tax. Accelerated depreciation is any method, including MACRS, that allows recovery at a faster rate in the earlier

years than the straight line method. For more information on alternative minimum tax, see chapter 14.

Topics

This chapter discusses:

- General information on depreciation
- The section 179 deduction
- The Modified Accelerated Cost Recovery System (MACRS)
- Listed property rules
- Basic information on depletion and amortization

Useful Items

You may want to see:

Publication

- 448** Federal Estate and Gift Taxes
- 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
- 4562** Depreciation and Amortization
- 4797** Sales of Business Property

See chapter 21 for information about getting these publications and forms.

General Information on Depreciation

The first part of the discussion on depreciation gives you basic information on what property can and cannot be depreciated, when to begin and end depreciation, and how to claim depreciation.

What Can Be Depreciated

You can depreciate property only if it meets all of the following basic requirements:

- 1) The property must be used in business or held for the production of income (for example, to earn rent or royalty income),
- 2) The property must have a determinable useful life longer than one year, and
- 3) The property must be something that wears out, decays, gets used up, becomes obsolete, or loses value from natural causes.

Depreciable property may be tangible or intangible.

Tangible Property

Tangible property can be seen or touched and includes both real and personal property. Tangible personal property includes machinery or equipment, and anything else that is tangible except real property. Real property is land and buildings, and generally anything built on or constructed on or anything growing on, or attached to land. However, land itself is never depreciable.

Livestock. Livestock purchased for work, breeding, or dairy purposes that is not kept in an inventory account may be depreciated.

Raised livestock. Livestock that you raise usually has no depreciable basis because the costs of raising it are deducted and are not added to the basis. However, if you purchase immature livestock for draft, dairy, or breeding purposes, you can depreciate your initial cost. See *Immature livestock* in *Placed in Service Date* later, for a discussion of when to begin depreciation.

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

Irrigation systems and water wells. You can depreciate irrigation systems and wells composed of masonry, concrete, tile, metal, or wood. In addition, you can depreciate such costs as dirt moving to make irrigation systems and water wells composed of these materials.

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

If you use your car for farm business, you can depreciate the car for the percentage of time you use it in farming. If you also use it for investment purposes, i.e., for the production of income, you can depreciate the portion used for investment.

If you use part of your home for business, you may be able to take a depreciation deduction for this use.

Intangible Property

Intangible property is generally any property that has value but that you cannot see or touch. It includes items, such as copyrights, patents, franchises, trademarks, and trade names.

Computer software. Computer software includes all programs used to cause a computer to perform a desired function. Computer software also includes any data base or similar item that is in the public domain and is incidental to the operation of qualifying software.

Software purchased before August 11, 1993. If you purchased software before August 11, 1993 (before July 26, 1991, if

electd), your recovery of costs depends on how you were billed. If the cost of the software was included in the price of computer hardware and the software cost was not separately stated, you treat the entire amount as the cost of the hardware. Depreciate the entire amount as explained in *MACRS Defined*, later. If the cost of the software was separately stated, you can depreciate the cost using the straight line method over 5 years (or any shorter life you can establish).

Software acquired after August 10, 1993. If you acquire software after August 10, 1993 (after July 25, 1991, if electd), you must amortize it over 15 years (rather than depreciate it) unless it meets all three requirements discussed later in *Computer software*, under *Section 197 Intangibles*, later. Also, it must have been acquired in connection with the acquisition of a substantial portion of a business.

For information on amortization, see *Amortization*, later.

Software leased. If you lease software, you can treat the rental payments in the same manner that you treat any other rental payments.

What Cannot Be Depreciated

To determine if you are entitled to depreciation, you must know not only what you can depreciate but what you cannot depreciate.

Property placed in service and disposed of in the same year. You cannot depreciate property placed in service and disposed of in the same tax year. When property is placed in service is explained later.

Land. You can never depreciate the cost of land because land does not wear out or become obsolete and it cannot be 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. You may be able to depreciate some land preparation costs. For information on these costs, see chapter 1 of Publication 946.

Property held for sale. You can never depreciate property held primarily for sale to customers in the ordinary course of business.

Equipment used to build capital improvements. You cannot deduct depreciation on equipment you are using to build your own capital improvements. You must add depreciation on equipment used during the period of construction to the basis of your improvements. See *Uniform Capitalization Rules* in chapter 7.

Rented property. Generally, a person who uses depreciable property in a trade or business or holds it for producing income is entitled to the depreciation deduction for the property. This is usually the owner of the property. For rented property, this is usually the lessor. An owner or lessor is the person who generally bears the burden of exhaustion of capital

investment in the property. This means the person who retains the incidents of ownership for the property. Incidents of ownership include:

- 1) The legal title,
- 2) The legal obligation to pay for it,
- 3) The responsibility to pay its maintenance and operating expenses,
- 4) The duty to pay any taxes, and
- 5) The person who would have the risk of loss if the property is destroyed, condemned, or diminished in value through obsolescence or exhaustion.

Intangible property. You can never depreciate some types of intangible property.

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 chapter 12 in Publication 535.

Trademark and trade name. In general, you must capitalize trademark and trade name expenses. This means that you cannot deduct the full amount in the current year. You can neither depreciate nor amortize the costs for trademarks and trade names you acquired before August 11, 1993 (before July 26, 1991, if elected). You may be able to amortize over 15 years the costs of trademarks and trade names acquired after August 10, 1993 (after July 25, 1991, if elected). For more information, see chapter 12 in Publication 535.

For more information on trademarks and trade names in general, see *Franchise, Trademark, or Trade Name* in Publication 544.

When Depreciation Begins and Ends

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 your property either when you have fully recovered your cost or other basis or when you retire it from service. (See *Retired From Service*, later.) You have fully recovered your cost or other basis when you have taken section 179 and depreciation deductions that are equal to your cost or investment in the property.

Placed in Service

For depreciation purposes, property is considered placed in service when it is ready and available for a specific use, whether in trade or business, the production of income, a tax-exempt activity, or a personal activity. Even if the property is not being used, it is in service when it is ready and available for its specific use. However, you can begin depreciating property only when it is ready and available for a specific use in a trade or business or for the production of income.

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. However, you can claim a depreciation deduction 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 for your farm business late in the year after harvest was over. You take a depreciation deduction for the planter for that year because it was ready and available for its specific use.

Retired From Service

You retire property from service when you permanently withdraw it from use in a trade or business or in the production of income. You stop depreciating property when you retire it from service.

You can retire property from service by selling or exchanging it, abandoning it, or destroying it.

Correct Depreciation Not Deducted

You cannot deduct unclaimed depreciation on your tax return for any later tax year. However, you can claim the depreciation on a timely filed amended return for the year for which it should have been claimed. You must file an amended return within 3 years from the date you filed your original return, or within 2 years from the time you paid your tax, whichever is later. A return filed early is considered filed on the due date.

Basis adjustment for unclaimed depreciation. If you do not claim depreciation you are entitled to deduct, you must still reduce your property's basis by the amount of depreciation you were entitled to deduct. If you deduct more depreciation than you should, you must decrease your basis by any amount deducted from which you received a tax benefit.

Changing your accounting method to deduct unclaimed depreciation.



If you claimed less depreciation than allowable, you can change your accounting method to claim the proper depreciation allowed. You will then be able to take into account your unclaimed depreciation from years before the year of change.

You must have the consent of the Commissioner of the Internal Revenue to change your method of accounting. You can follow the instructions in Revenue Procedure 92-20 to request permission to make the change or, in some instances, you can receive automatic consent. Revenue Procedure 92-20 is in Cumulative Bulletin 1992-1. Cumulative Bulletins are available at some libraries and IRS offices.

The situations in which you can receive automatic consent are explained next.

Automatic consent to change accounting method. You can receive an automatic consent from the Commissioner of the Internal Revenue to change your accounting method. This will enable you to claim previously unclaimed allowable depreciation. To do so, you must file Form 3115 requesting a change to a permissible method of accounting for depreciation. You generally can use this procedure for any depreciable property that meets the following two conditions.

- 1) Under your present accounting method, you claimed less than the depreciation allowable on the property.
- 2) You held the property at the beginning of the year of change in accounting method.

Exceptions. You generally cannot use the automatic consent procedure for:

- 1) Any property held by a tax-exempt organization,
- 2) Any depreciable intangible property other than certain property that cannot be amortized,
- 3) Any property for which you are attempting to either revoke a timely election or make a late election under certain depreciation or amortization provisions,
- 4) Any depreciable property (other than certain property that cannot be amortized), for which you are changing only the estimated useful life,
- 5) Any depreciable property the use (but not ownership) of which changes,
- 6) Any property for which the depreciation that has been claimed is more than the amount allowable,
- 7) Any change in your accounting method that involves a change from deducting the cost (or other basis) of any property as an expense to capitalizing and depreciating the cost (or other basis),
- 8) Any change in your accounting method involving a change from one permissible accounting method for the property to another permissible accounting method for the property,
- 9) Any change in your accounting method for an item of income or deduction other than depreciation.

Other restrictions. You cannot use the automatic consent procedure if a criminal investigation or proceeding is pending concerning either of the following.

- 1) Any issue related to your federal tax liability for any year.
- 2) The possibility that you made false or fraudulent statements about any issue related to your federal tax liability for any year.

More information. For more information on how to get this automatic consent to change your method of accounting in order to claim previously unclaimed allowable depreciation, see Revenue Procedure 96-31, Internal Revenue Bulletin 1996-20.

How To Claim Depreciation

Use Form 4562 to claim depreciation and amortization deductions and to elect the section 179 deduction. Amortization and section 179 are discussed later. For more information on completing the form, you should refer to the instructions for Form 4562.

Section 179 Deduction

This part of the chapter explains the rules for the section 179 deduction. It explains what the deduction is, what property qualifies for the deduction, what limits may apply, and how to claim a deduction. You can recover through depreciation certain costs that you do not recover through the section 179 deduction.

What Costs Can and Cannot Be Deducted

You can claim the section 179 deduction only on qualifying property acquired for use in your trade or business. You cannot claim the deduction on property you hold only for the production of income.

For information on property held for the production of income, see *Production of income*, later.

Acquired by Purchase

Only the cost of property you acquire for use in your business qualifies for the section 179 deduction. The cost of property acquired from a related person or group may not qualify. See *Nonqualifying Property*, later.

Acquired by Trade

If you purchase an asset with cash and a trade-in, part of the basis of the asset you buy is the basis of the trade-in. You cannot claim the section 179 deduction on this part of the basis of the purchased asset. 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 tractor you trade for the new vehicle. See *Adjusted Basis* in chapter 7.

Example. J-Bar Farms traded two tiller machines having a total adjusted basis of \$680 for a new tiller machine costing \$1,320. J-Bar also traded a used van with an adjusted basis of \$4,500 for a new van costing \$9,000. J-Bar Farms places the new items in service this year. J-Bar was given an \$800 trade-in for the old tiller machines and paid \$520 cash for the new tiller machine. J-Bar was given a \$4,800 trade-in and paid \$4,200 cash for the new van.

J-Bar Farms' basis in the new property includes both the adjusted basis of the property traded and the cash paid. However, only the portion of the basis of the new property paid by cash qualifies for the section 179 deduction. J-Bar has business costs that qualify for a section 179 deduction of \$4,720 (\$520 and \$4,200), the part of the cost of the new property not determined by the property traded.

Qualifying Property

Property qualifying for the section 179 deduction is depreciable property and includes:

- 1) Tangible personal property,
- 2) Other tangible property (except most 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, or
 - b) A research facility in any of the activities in (a) for the bulk storage of the fungible commodities, or
 - c) A facility in any of the activities in (a) for the bulk storage of fungible commodities (including commodities in a liquid or gaseous state).
- 3) Single purpose agricultural (livestock) or horticultural structures (defined later), and
- 4) Storage facilities (excluding buildings and their structural components) used in distributing petroleum or any primary product of petroleum.

Tangible personal property. Tangible personal property is any tangible property that is not real property. Machinery and equipment are examples of tangible personal property.

Land and land improvements, such as buildings and other permanent structures and their components, are real property. Swimming pools, paved parking areas, wharfs, docks, bridges, and fences are examples of land improvements. They are not tangible personal property.

Business property. All business property, other than structural components, that is contained in or attached to a building is tangible personal property. Under certain local laws, some tangible personal property cannot be tangible personal property for purposes of section 179, and some real property under local law, such as fixtures, can be tangible personal property for section 179 purposes. Property, such as milk tanks, automatic feeders, barn cleaners, and office equipment, are tangible personal property.

Livestock. Livestock is qualifying property. For this purpose, livestock includes horses, cattle, hogs, sheep, goats, and mink and other furbearing animals.

Single purpose agricultural (livestock) or horticultural structures. For purposes of determining whether a structure is a single purpose agricultural structure, poultry is considered to be livestock.

Agricultural structure. A single purpose agricultural (livestock) structure is any building or enclosure specifically designed, constructed, and used to:

- 1) House, raise, and feed a particular type of livestock and its produce, and

- 2) House the equipment, including any replacements, needed to house, raise, or feed the livestock.

Because the full range of livestock production is included, special purpose structures are qualifying property if used 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:

- 1) A greenhouse specifically designed, constructed, and used for the commercial production of plants, or
- 2) 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 which qualified it. For example, a hog barn will not be eligible property if you use it to house poultry. Similarly, using part of your greenhouse to sell plants will make the greenhouse ineligible.

If a structure includes work space, that structure is not a single purpose agricultural or horticultural structure unless the work space is used only for:

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

Business and nonbusiness use. When you use property for business and nonbusiness purposes, you can elect the section 179 deduction only if more than 50% of the property's use in the tax year you place it in service is for trade or business purposes. You must figure the part of the cost of your property that reflects only its business use. You do this by multiplying the cost of the property by the percentage of business use. This is your business cost. Use it to figure your section 179 deduction.

Nonqualifying Property

Generally, the section 179 deduction cannot be claimed on:

- 1) Property you hold only for the production of income,
- 2) Real property, including buildings and their structural components,
- 3) Property you acquired from certain groups or persons,
- 4) Air conditioning or heating units,
- 5) Certain property used outside the U.S.,
- 6) Property used predominately to furnish lodging or in connection with the furnishing of lodging, and

- Property used by foreign persons or entities.

For more information on nonqualifying property, see *Nonqualifying Property* in Publication 946.

For the kind of property you lease on which you can claim the section 179 deduction, see *Qualifying Property* in Publication 946.

Production of income. You hold property only for the production of income if it is investment property, rental property (if renting property is not your trade or business), or property that produces royalties. If you use property in the active conduct of a trade or business, you do not hold it **only** for the production of income.

Acquired from certain groups or persons. Property does not qualify for the section 179 deduction if:

- The property is acquired by one member of a controlled group from a member of the same group, or
- The property's basis is either:
 - Determined in whole or in part by its adjusted basis in the hands of the person from whom it was acquired, or
 - Determined under stepped-up basis rules for property acquired from a decedent as discussed in Publication 448, or
- The property is acquired from a related person.

For the preceding rules, a "related person" generally means a member of your immediate family (including your spouse, an ancestor, and a lineal descendant).

For more information on related parties, see Publication 946.

How To Make the Election

You make the election by taking your deduction on Form 4562. You attach and file Form 4562 with:

- The original tax return filed for the tax year the property was placed in service (whether or not you file your return on time), or
- An amended return filed by the due date (including extensions) for your return for the tax 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).

How To Figure the Deduction

The total business cost you can elect to deduct under section 179 for 1996 cannot be more than \$17,500. This \$17,500 maximum dollar limit applies to each taxpayer, not to each business. You do not have to claim the full \$17,500. You can decide how much of the

business cost of your qualifying property you want to deduct under section 179. You may be able to depreciate any cost you do not deduct under section 179. To figure depreciation, see *MACRS Defined*, later.

If you acquire and place in service more than one item of qualifying property during the year, you can divide the deduction between the items in any way, as long as the total deduction is not more than the limits. If you have only one item of qualifying property and it does not cost more than \$17,500, your deduction is limited to the lesser of:

- Your taxable income from your trade or business (the taxable income limit is discussed later), or
- The cost of the item.

You must figure your section 179 deduction before figuring your depreciation deduction.

You must subtract the amount you elect to deduct under section 179 from the business/ investment cost of the qualifying property. This result is called your unadjusted basis and is the amount you use to figure any depreciation deduction.

Deduction Limits

Your section 179 deduction cannot be more than the business cost of the qualifying property. In addition, in figuring your section 179 deduction, you must apply the following limits:

- Maximum dollar limit,
- Investment limit, and
- Taxable income limit.

Maximum dollar limit. The total cost that you can elect to deduct for 1996 cannot be more than \$17,500. This maximum dollar limit is reduced if you go over the investment limit (discussed later) in any tax year.



Increases to the section 179 deduction.

The total cost of section 179 property that you can deduct increases as shown below:

| Tax Year | Maximum Amount Deductible |
|-------------|---------------------------|
| 1997 | \$18,000 |
| 1998 | 18,500 |
| 1999 | 19,000 |
| 2000 | 20,000 |
| 2001 – 2002 | 24,000 |
| After 2002 | 25,000 |

Joint returns. A husband and wife who file a joint return are treated as one taxpayer in determining any reduction to the maximum dollar limit, regardless of which spouse acquired the property or placed it in service.

Married taxpayers filing separate returns. A husband and wife filing separate returns for a tax year are treated as one taxpayer for the maximum dollar limit and for the \$200,000 investment limit. Unless they elect otherwise, 50% of the maximum dollar limit

(after applying the investment limit) will be allocated to each spouse. If the percentages elected by each spouse do not total 100%, 50% will be allocated to each spouse.

Joint return after filing separate returns. If you filed a separate return and after the due date choose to file a joint return, the maximum dollar limit on the joint return is the lesser of:

- The maximum dollar limit (after the investment limit), or
- The total cost of section 179 property you both elected to expense on your separate returns.

Investment limit. For each dollar of business cost over \$200,000 for section 179 property placed in service in a tax year reduce the maximum dollar limit by one dollar (but not below zero). If your business cost of section 179 property placed in service during a tax year is \$217,500 or more, you cannot take a section 179 deduction and you are not allowed to carry over the cost that is more than \$217,500.

Example. In 1996, James Smith placed in service machinery costing \$207,000. Because this cost is \$7,000 more than \$200,000, he must reduce the maximum dollar limit of \$17,500 by \$7,000. If his taxable income is at least \$10,500, James is entitled to a section 179 deduction for 1996 of \$10,500.

Taxable income limit. The total cost that you can deduct in each year is limited to the taxable income from the active conduct of any trade or business during the tax 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.

Figure taxable income for this purpose by totaling the net income (or loss) from all trades and businesses you actively conducted during the tax year. Items of income derived from a trade or business actively conducted by you include section 1231 gains (or losses) as discussed in chapter 11 and interest from working capital of your trade or business. Also include in total taxable income any wages, salaries, tips, or other pay earned as an employee. When figuring taxable income, do not take into account any unreimbursed employee business expenses you may have as an employee.

In addition, figure taxable income without regard to:

- The section 179 deduction,
- The self-employment tax deduction, and
- Any net operating loss carryback or carryforward.

Any cost that is not deductible in one tax year under section 179 because of this limit can be carried to the next tax year. The amount you carry over will be taken into account in determining your section 179 deduction in the next year; however, it is subject to the limits in that year. You may select the

properties for which costs will be carried forward and you may allocate the portion of the costs to these properties.

Example. Last year, Joyce Jones placed in service a machine that cost \$8,000. The taxable income from her business last year (determined without a section 179 deduction for the cost of the machine and without the self-employment tax deduction) was \$6,000. Her section 179 deduction is limited to \$6,000. The \$2,000 cost that is not allowed as a current section 179 deduction because of the taxable income limit that was carried to this year.

This year, Joyce placed another machine in service that cost \$9,000. Her taxable income from business (determined without a section 179 deduction for the cost of the machine and without 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 limits. However, she can carry the balance of \$1,000 as carryover to next year.

More information. See *Carryover of disallowed deduction* in Publication 946 for information on figuring the carryover, or use the *Section 179 Worksheet* in chapter 2 of Publication 946 to figure your carryover.

Two different taxable income limits. The section 179 deduction is subject to a taxable income limit. You also may have to figure another deduction that has a limit based on taxable income. You may have to figure the limit for this other deduction taking into account the section 179 deduction. If so, complete the steps discussed next.

Step 1. Figure taxable income without either a section 179 deduction or the other deduction.

Step 2. Figure a hypothetical section 179 deduction using the taxable income figured in Step 1.

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

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

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

Step 6. Now figure your actual section 179 deduction using the taxable income figured in Step 5.

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

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

Example. XYZ is a farm corporation. During the tax year, the 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 tax 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 taxable income limit for the section 179 deduction is figured after subtracting any allowable charitable contributions. XYZ's taxable income figured without taking into account either any section 179 deduction or any deduction for the 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, a hypothetical section 179 deduction of \$10,000 would be allowable.

Step 3—\$12,000 (from Step 1) minus \$10,000 (from Step 2) equals \$2,000.

Step 4—Using \$2,000 (from Step 3) as taxable income, a hypothetical charitable contribution (limited to 10% of taxable income) of \$200 is figured.

Step 5—\$12,000 (from Step 1) minus \$200 (from Step 5) equals \$11,800.

Step 6—Using \$11,800 (from Step 5) as taxable income, the actual section 179 deduction is figured. Because the taxable income is at least \$10,000, XYZ can take a \$10,000 section 179 deduction.

Step 7—\$12,000 (from Step 1) minus \$10,000 (from Step 6) equals \$2,000.

Step 8—Using \$2,000 (from Step 7) as taxable income, the actual charitable contribution (limited to 10% of taxable income) of \$200 is figured.

Passenger automobiles. For passenger automobiles placed in service in 1996, your total section 179 deduction and depreciation cannot be more than \$3,060 for 1996. For more information, see *Maximum deduction for 1996* under *Special Rules for Passenger Automobiles*, later.

How to figure the deduction. You must figure your section 179 deduction before figuring your depreciation deduction. You must subtract the amount you elect to deduct under section 179 from the business and investment cost of the qualifying property. This result is called your unadjusted basis and is the amount you use to figure any depreciation deduction.



You cannot take depreciation on the cost of property you deduct under section 179.

Example. This year, you bought a tractor for \$16,000 and a mower for \$6,200 for use in your farming business. You placed both items in service this year. You elect to deduct the entire \$6,200 for the mower and \$11,300 for the tractor, a total of \$17,500. This is the most you can deduct. Your \$6,200 deduction for the mower completely recovered its cost. The cost of your tractor is adjusted by \$11,300. Its unadjusted basis for depreciation is \$4,700.

You figure this by subtracting the amount of your section 179 deduction, \$11,300, from the cost of the tractor, \$16,000.

When To Recapture the Deduction

If you claim a section 179 deduction for the cost of property and, in a year after you place it in service, you do not use it more than 50% for business, you may have to recapture part of the deduction. This can occur in any tax year during the recovery period for the property. Recovery periods for property are discussed later.

If you elect the section 179 deduction, treat the amount deducted as depreciation for purposes of the recapture rules. You may have to treat any gain you realize from a sale, exchange, or other disposition of property as ordinary income up to the section 179 and depreciation deductions you claimed. Ordinary income is income that is all taxable.

Where to report recapture. Report any recapture of the section 179 deduction on Form 4797 and Schedule F.

How To Figure the Recapture

To figure the amount to include in income subtract the depreciation that would have been allowable on the section 179 amount for prior tax years and the tax year of recapture from your section 179 deduction.

Example. Paul Lamb, a calendar year taxpayer, bought and placed in service on August 1, 1994, an item of 3-year property costing \$10,000. The property is not listed property. He used the property only for business in 1994 and 1995. He elected a section 179 deduction of \$5,000. During 1996, he used the property 40% for business and 60% for personal use. He figures his recapture amount as follows:

| | | |
|---|------------|-------------------|
| Section 179 deduction claimed (1994) | \$5,000.00 | |
| Allowable depreciation (instead of section 179): | | |
| 1994 — | | |
| \$5,000 × 25.00%* | \$1,250.00 | |
| 1995 — | | |
| \$5,000 × 37.50%* | 1,875.00 | |
| 1996 — | | |
| \$5,000 × 25.00%* | | |
| × 40% (business) | 500.00 | 3,625.00 |
| 1996 — | | |
| Recapture amount | | <u>\$1,375.00</u> |

*Rates from the 150% table, later.

Paul reports the \$1,375 on Form 4797 and Schedule F.

Dispositions. If you dispose of property, the amount you deducted under section 179 is subject to recapture as ordinary income. For more information, see chapter 11.

MACRS Defined

MACRS consists of two systems that determine how you depreciate your property. The main system is called the **General Depreciation System (GDS)**. The second system is called the **Alternative Depreciation System (ADS)**. Unless you are specifically required by law to use ADS or you elect it, you generally use GDS to figure your depreciation deduction. Property for which you are required by law to use ADS and how to elect ADS are discussed in *What Can Be Depreciated Under MACRS*, next. The main **difference between the two systems** is that ADS generally provides for a longer recovery period and uses only the straight line method of depreciation to figure a deduction.

What Can Be Depreciated Under MACRS

MACRS applies to most tangible depreciable property placed in service after 1986. Property that you cannot use MACRS for is discussed later in *What Cannot Be Depreciated Under MACRS*.

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

When To Use GDS

Most tangible depreciable property falls within the general rule of MACRS, also called the General Depreciation System (GDS). As discussed earlier in *MACRS Defined*, the major differences between GDS and ADS are the recovery period and method of depreciation you use to figure the deduction. Because GDS permits use of the declining balance method over a shorter recovery period, the deduction is greater in the earlier years.

However, the law requires you to use ADS for certain property as discussed under *When To Use ADS*, later.

Although your property may qualify for GDS, you can elect on a property-by-property or class of assets basis to use ADS. If you make this election, however, you can never revoke it. How to make this election is discussed in *Election*, under *ADS method*, later.

When To Use ADS

Under ADS, you determine your deduction by using the straight line method over a recovery period that generally is longer than the recovery period under GDS. The ADS system is required for:

- 1) Any property used predominantly in a farming business and placed in service during any tax year in which you make an election not to apply the uniform capitalization rules to certain farming costs,
- 2) Any tax-exempt use property,
- 3) Any tax-exempt bond-financed property,

- 4) Any imported property covered by an executive order of the President of the United States, and
- 5) Any tangible property used predominantly outside the United States during the year.

What Cannot Be Depreciated Under MACRS

You cannot use MACRS for certain property placed in service because of special rules that exclude it from MACRS. You can elect to exclude certain other property from being depreciated under MACRS.

Property that you cannot depreciate using MACRS includes:

- 1) Intangible property,
- 2) Any motion picture film or video tape,
- 3) Any sound recording,
- 4) Certain real and personal property placed in service before 1987, and
- 5) Property you elect to exclude from MACRS that is properly depreciated under a method of depreciation that is not based on a term of years.

Election To Exclude Certain Property

If you properly depreciate any of your property under a method not based on a term of years, such as the unit-of-production method (discussed later), you can elect to exclude that property from MACRS.

You must make this election by the return due date (including extensions) for the tax year you place your property in service. You make it by reporting your depreciation for the property on line 18 of Part III of Form 4562 and attaching a separate sheet as described in the Instructions for Form 4562.

Standard mileage rate. If you use the standard mileage rate for an automobile you buy and use for business, you are considered to have elected to exclude the automobile from MACRS. See Publication 463 for a discussion of the standard mileage rate.

Property Placed in Service Before 1987

There are special rules that may prevent you from using MACRS for property placed in service by you or anyone (for any purpose) before 1987 (before August 1, 1986, if MACRS was elected). These rules apply to both personal and real property. However, the rules for personal property are more restrictive.



For these rules, do not treat either real or personal property as owned before you placed it in service. If you owned property in 1986 but did not place it in service until 1987, you do not treat it as owned in 1986.

Personal property. You cannot use MACRS for most personal property (section 1245 property) that you acquired after 1986 (after July 31, 1986, if MACRS was elected) if:

- 1) You or someone related to you owned or used the property in 1986,
- 2) The property was acquired from a person who owned it in 1986 and as part of the transaction the property user did not change,
- 3) You leased the property to a person (or someone related to this person) who owned or used the property in 1986, or
- 4) The property was acquired in a transaction in which:

- 1) The property user did not change, and
- 2) The property was not MACRS property in the hands of the person from whom it was acquired because of 2) or 3).

Real property. You cannot use MACRS for certain real property. This includes acquired after 1986 (after July 31, 1986, if MACRS was elected), if:

- 1) You or someone related to you owned the property in 1986,
- 2) You leased the property back to the person (or someone related to this person) who owned the property in 1986, or
- 3) You acquired the property in a transaction in which some of your gain or loss was not recognized. MACRS applies only to that part of your basis in the acquired property that represents cash paid or unlike property given up. It does not apply to the substituted portion of the basis.



This rule does not apply to nonresidential real property or residential rental property.

Special rule. The excluded property rules discussed above do not apply to any property if the allowable deduction for the property for the first tax year it was placed in service using ACRS was greater than the deduction under MACRS applying the half-year convention.

For more information on other special rules, see Publication 946.

Related Parties

For the preceding rules, a related party includes members of your immediate family (including your spouse, ancestors, and lineal descendants).

For more information on related parties, see Publication 946.

How To Figure the Deduction Using Percentage Tables

Once you determine that your property can be depreciated under MACRS and whether it falls under GDS or ADS, you are ready to figure

your deduction. To figure your MACRS deduction each year, you need to know the following information about your property:

- 1) Its basis,
- 2) Its placed-in-service date,
- 3) Its property class and recovery period,
- 4) Which convention to use, and
- 5) Which depreciation method to use.

Basis

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. If you bought the property, your basis is the amount you paid for the property plus any sales tax, freight charges, and installation and testing fees. Other basis refers to basis that is determined by the way you received the property. For example, you may have received the property through a taxable or nontaxable exchange, for services you performed, as a gift, or as an inheritance. If you received property in this or some other way, see chapter 7 to determine your basis.

Basis of property changed from personal use. If you held property for personal use and later change it to business use or use in the production of income, your basis is the lesser of:

- 1) The fair market value (FMV) of the property on the date you change it from personal use, or
- 2) Your original cost or other basis adjusted as follows:
 - a) Increased by the cost of any permanent improvements or additions and other additions to basis, and
 - b) Decreased by any tax deductions you claimed for casualty losses and other charges to basis claimed on earlier years' income tax returns.

Placed in Service Date

For depreciation purposes, property is considered placed in service when it is ready and available for a specific use, whether in a trade or business, the production of income, a tax-exempt activity, or a personal activity. Even if the property is not being used, it is in service when it is ready and available for its specific use. However, you can begin depreciating property only when it is ready and available for a specific use in a trade or business or for the production of income.

Example 1. A corn planter that is delivered to the farm ready to be used in December 1996 is considered placed in service in the 1996 calendar year even though it will not be used until the spring of 1997.

Example 2. If the planter comes unassembled in December 1996 and is put together in February 1997, it is not considered placed in service until the 1997 calendar year.

Example 3. If the planter was delivered and assembled in February 1996 but not used until April 1996, its placed-in-service date is February 1996, since this is when the planter was in a condition of readiness for its specified use.

Fruit or nut trees and vines. If you acquire an orchard, grove, or vineyard and the trees or vines have not yet reached the income-producing stage, your depreciation will begin when they reach the income-producing stage.

Immature livestock. If you acquire immature livestock for draft, dairy, or breeding purposes, your depreciation will begin when it reaches maturity. This means depreciation begins when it reaches the age when it can be worked, milked, or bred. When this occurs, your basis for depreciation is your initial cost for the immature livestock.

Property Classes and Recovery Periods

Each item of property depreciated under MACRS is assigned to a property class. The property class establishes the number of years over which you recover the basis of your property. This period of time is called a recovery period.

Property classes. Under MACRS, tangible property that you place in service after 1986, or after July 31, 1986, if elected, falls into one of the following classes:

- 1) 3-year property,
- 2) 5-year property,
- 3) 7-year property,
- 4) 10-year property,
- 5) 15-year property,
- 6) 20-year property,
- 7) Residential rental property, and
- 8) Nonresidential real property.

Recovery periods. See *Table 8-1* for recovery periods under both GDS and ADS for some commonly used assets. For a more complete listing of the class lives and recovery periods for most assets, see the *Table of Class Lives and Recovery Periods* in Appendix B of Publication 946.

Water wells. Depreciable water wells used to provide water for raising poultry and livestock are land improvements and have a 15-year recovery period under GDS and a 20-year recovery period under ADS.

The types of water wells that can be depreciated are discussed earlier in *Irrigation systems and water wells*.

Conventions

To figure your depreciation deduction for both GDS and ADS, use one of three conventions:

- 1) The half-year convention,
- 2) The mid-month convention, or
- 3) The mid-quarter convention.

Half-year convention. Generally, you use this convention for property other than non-residential real and residential rental property. Under the half-year 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 that tax year. This means that no matter when in the year you begin or end the use of the property, you treat it as if you began or ended its use in the middle of the year.

Mid-quarter convention. You must apply this convention to your property (other than non-residential real property and residential rental property) in certain circumstances.

These circumstances occur during any tax year when the total depreciable bases of MACRS property you placed in service during the last 3 months of that year are more than 40% of the total depreciable bases of all MACRS property you placed in service during the entire year. When that happens, you must use this convention for all MACRS property you placed in service during the year. To determine the total bases of property, do not include the basis of either:

- 1) Residential rental property,
- 2) Nonresidential real property, or
- 3) Property you placed in service and disposed of in the same tax year.

To determine whether you must use the mid-quarter convention, the depreciable basis of property is your basis multiplied by the percentage of business/investment use and then reduced by:

- 1) The amortization taken on the property,
- 2) Any section 179 deduction claimed on the property, and
- 3) Any deduction claimed for clean-fuel vehicles or for clean-fuel vehicle refueling property.

Under the mid-quarter convention, you treat all property placed in service or disposed of during a tax year as placed in service in the middle of the quarter.

To figure your MACRS deduction using the mid-quarter convention, you must first figure your depreciation for the full tax year. Then multiply that amount by the following percentages for the quarter of the tax year the property is placed in service.

| Quarter of Tax Year | Percentage |
|---------------------|------------|
| First | 87.5% |
| Second | 62.5% |
| Third | 37.5% |
| Fourth | 12.5% |

For more information, including percentage tables based on the mid-quarter convention, see Publication 946.

Mid-month convention. This convention is used for:

- 1) Nonresidential real property, and
- 2) Residential rental property.

Table 8-1. Farm Property Recovery Periods

| Assets | Recovery Period in Years for: | |
|---|-------------------------------|-----|
| | GDS | ADS |
| Agricultural structures (single purpose) | 10 | 15 |
| Airplanes (including helicopters) ¹ | 5 | 6 |
| Automobiles | 5 | 5 |
| Calculators and copiers | 5 | 6 |
| Cattle (dairy or breeding) | 5 | 7 |
| Communication equipment ² | 7 | 10 |
| Computers and peripheral equipment | 5 | 5 |
| Cotton ginning assets | 7 | 12 |
| Drainage facilities | 15 | 20 |
| Farm buildings ³ | 20 | 25 |
| Farm machinery and equipment | 7 | 10 |
| Fences (agricultural) | 7 | 10 |
| Goats and sheep (breeding) | 5 | 5 |
| Grain bin | 7 | 10 |
| Hogs (breeding) | 3 | 3 |
| Horses (age when placed in service) | | |
| Breeding and working (12 years or less) | 7 | 10 |
| Breeding and working (more than 12 years) | 3 | 10 |
| Racing horses (more than 2 years) | 3 | 12 |
| Horticultural structures (single purpose) | 10 | 15 |
| Logging machinery and equipment ⁴ | 5 | 6 |
| Nonresidential real property | 39 ⁵ | 40 |
| Office equipment (not calculators, copiers, or typewriters) | 7 | 10 |
| Office furniture or fixtures | 7 | 10 |
| Residential rental property | 27.5 | 40 |
| Tractor units (over-the-road) | 3 | 4 |
| Trees or vines bearing fruit or nuts | 10 | 20 |
| Truck (heavy duty, unloaded weight 13,000 lbs. or more) | 5 | 6 |
| Truck (weight less than 13,000 lbs.) | 5 | 5 |
| Typewriter | 5 | 6 |

¹ Not including airplanes used in commercial or contract carrying of passengers.

² Not including communication equipment listed in other classes.

³ Not including single purpose agricultural or horticultural structures.

⁴ Used by logging and sawmill operators for cutting of timber.

⁵ For property placed in service after May 12, 1993; for property placed in service before May 13, 1993, the recovery period is 31.5 years.

raising or harvesting any agricultural or horticultural commodity. A farming business includes:

- 1) Operating a nursery or sod farm,
- 2) Raising or harvesting crops,
- 3) Raising or harvesting trees bearing fruit, nuts, or other crops,
- 4) Raising ornamental trees, and
- 5) Raising, shearing, feeding, caring for, training, and managing animals.

An evergreen tree is not considered an ornamental tree if it is more than 6 years old when it is severed from its roots.

Farming does not include processing commodities or products if the processing is not normally part of growing, raising, or harvesting these products. It does include processing activities which are normally part of growing, raising, or harvesting agricultural products.

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. You must use ADS for all property you place in service in any tax year the election is in effect. See chapter 7 for a discussion of the application of the uniform capitalization rules to farm property.

Declining balance method. To figure your MACRS deduction using the declining balance method, you can use the percentage tables or, if you want to figure your own percentage, see *How To Figure the Deduction Without Using the Tables* in chapter 3 of Publication 946.

Straight line election. Instead of using the declining balance method, you can elect to use the straight line method over the GDS recovery period.

 *The election to use the straight line method for one item in a property class applies to all property in that class placed in service in the tax year of the election. Once you make the election, you cannot change it.*

ADS method. Although your property may come under GDS, you can elect to use ADS. 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.

Election. Make the election by completing line 16, Part II of Form 4562. File Form 4562 with your tax return by the due date (including extensions) for the year you placed the property in service.

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 regardless of when during a month you place property in service or dispose of it, you treat it as being placed in service or disposed of in the middle of that month.

Depreciation Methods

You depreciate property placed in service after 1988 in a farming business using:

- 1) The 150% declining balance method over the GDS recovery period, which switches to the straight line method when that method provides a greater deduction,
- 2) The straight line method over the GDS recovery period,
- 3) The 150% declining balance method over fixed ADS recovery periods, which switches to the straight line method when that method provides a greater deduction, or

- 4) The straight line method over fixed ADS recovery periods.



If you use the MACRS percentage tables (discussed in MACRS Percentage Tables later), you do not need to determine in what year your deduction is greater using the straight line method. The tables have the switch to the straight line method built into their rates.

For the specific method to use for a property class, see the *Depreciation Methods Chart*, later.

For farm property placed in service before 1989 in the 3-, 5-, 7-, or 10-year class, you use the double (200%) declining balance method over 3, 5, 7, or 10 years. For 15- or 20-year property, you must use the 150% declining balance method over 15 or 20 years.

Farming business. A farming business is any trade or business involving cultivating land or



The election of the ADS method for one item of property in a property class applies to all property in that class placed in service during the tax year of the election. However, the election applies on a property-by-property basis for residential rental and nonresidential real property. Once you make the election to use ADS, you cannot change it.

Depreciation Methods Chart

The following depreciation methods chart will help you determine the proper method to use for a specific property class. The declining balance method is shown as DB and the straight line method as SL.

Depreciation Methods Chart

| Property Class | Method - Recovery Period |
|---|---|
| 3, 5, 7, 10-Year (Farm) | 150% DB-GDS 150% DB-ADS* SL-GDS* SL-ADS* |
| 15, 20-Year (Farm) | 150% DB-GDS SL-GDS* SL-ADS* |
| 3, 5, 7, 10-Year (Nonfarm) | 200% DB-GDS 150% DB-ADS* SL-GDS* SL-ADS* |
| 15, 20-Year (Nonfarm) | 150% DB-GDS SL-GDS* SL-ADS* |
| Nonresidential Real Property | SL-GDS SL-ADS* |
| Residential Rental Property | |
| Trees, Vines, or Bushes Bearing Fruit or Nuts | |
| Tax-Exempt Use Property | SL-ADS |
| Tax-Exempt Bond Financed Property | |
| Imported Property | |
| Foreign Use Property (Used Outside U.S.) | |

*Elective Method

Figuring MACRS Deductions

You can determine your MACRS depreciation deduction in one of two ways. You can use the percentage tables or you can actually figure the deduction using the applicable depreciation method and convention over the recovery period.



Figuring MACRS deductions without using the tables will generally result in a slightly different amount than using the tables.

MACRS percentage tables. Before using the percentage tables, you should know the special rules that govern their use:

- 1) You must apply the rates in the percentage tables to your property's **unadjusted basis**,
- 2) You cannot use the percentage tables for a short tax year, and
- 3) When using the percentage tables to figure your depreciation, you must continue to use them for the entire recovery period unless there are adjustments to the basis of your property for reasons other than:
 - a) Depreciation allowed or allowable, or
 - b) An addition or improvement to that property that is depreciated as a separate item of property.
- 4) You cannot continue to use the tables if there is an adjustment to the basis of your property other than for a reason listed in (3) above.

Figuring unadjusted basis. You must apply the table rates to your property's unadjusted basis each year of the recovery period. **Unadjusted basis** is the same amount you would use to figure gain on a sale but you figure it without taking into account any depreciation taken in earlier years. However, you do reduce your original basis by:

- 1) The amount of amortization taken on the property,
- 2) Any section 179 deduction claimed on the property,
- 3) Any deduction claimed for clean-fuel vehicle or clean-fuel vehicle refueling property, and
- 4) Any qualified electric vehicle credit.

For business property you purchase during the tax year, the unadjusted basis is its cost minus any amortization, any section 179 deduction, any deduction claimed for clean-fuel vehicles or for clean-fuel vehicle refueling property, and any electric vehicle credit claimed for the property.

If you trade property, your unadjusted basis in the property received is the cash paid plus the adjusted basis of the property traded minus any amortization, any section 179 deduction, any deduction claimed for clean-fuel vehicles or for clean-fuel vehicle refueling property, and any electric vehicle credit claimed for the property.

The clean-fuel vehicle and clean-fuel vehicle refueling property deductions and the credit for electric vehicles are discussed in chapter 15 of Publication 535.

Short tax year. You cannot use the tables if you have a short tax year. If this occurs, see *MACRS Deduction in Short Tax Year* in chapter 3 of Publication 946.

Adjustment due to casualty loss. If you reduce the basis of your property because of a casualty, it is an adjustment to basis other than those listed in (3). You cannot continue to use the tables. For the year of adjustment and the remaining recovery period, figure the depreciation using the property's adjusted basis at the end of the year of adjustment and for the remaining recovery period.

150% table applying the half-year convention. The following table 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 applies for only the half-year convention and only covers 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.

Example 1. This year, you buy and place in service an item of 7-year property for \$10,000. You do not elect a section 179 deduction for this property. The unadjusted basis of the property is \$10,000. You use the percentage tables to figure your deduction.

Since this is 7-year property, you multiply \$10,000 by 10.71% to get your depreciation this year of \$1,071. For next year, you figure your depreciation deduction by multiplying \$10,000 by 19.13% to get \$1,913.

Example 2. You have a barn constructed on your farm at a cost of \$20,000. This year, you place the barn in service. The barn is 20-year property and you use the table percentages to figure your deduction. You use the calendar year as your tax year. You figure the depreciation for it by multiplying \$20,000 (unadjusted basis) by 3.75% to get \$750. For next year, your depreciation will be \$20,000 multiplied by 7.219%, or \$1,443.80.

Straight line table applying the half-year convention. The following table has the percentages for 3-, 5-, 7-, and 20-year property. The percentages are based on the straight line method and apply for only the half-year convention. The table only covers 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.

| Year | 3-Year | 5-Year | 7-Year | 20-Year |
|------|--------|--------|--------|---------|
| 1 | 16.67% | 10% | 7.14% | 2.5% |
| 2 | 33.33% | 20% | 14.29% | 5% |
| 3 | 33.33% | 20% | 14.29% | 5% |
| 4 | 16.67% | 20% | 14.28% | 5% |
| 5 | | 20% | 14.29% | 5% |
| 6 | | 10% | 14.28% | 5% |
| 7 | | | 14.29% | 5% |
| 8 | | | 7.14% | 5% |

Figuring MACRS deductions without the tables. If you are required or would prefer to figure your own depreciation without using the tables, see *How To Figure the Deduction Without Using the Tables* in chapter 3 of Publication 946.

Dispositions

If you dispose of depreciable property at a profit, you may have to report, as ordinary income, all or part of the profit. See chapter 11.

General Asset Accounts

You can choose to group certain depreciable property subject to MACRS in one or more general asset accounts. After you have set up a general asset account, you generally figure

Table 8-2. 150% Declining Balance Method

| Year | 3-Year | 5-Year | 7-Year | 20-Year |
|------|--------|--------|--------|---------|
| 1 | 25% | 15% | 10.71% | 3.75% |
| 2 | 37.5 | 25.5 | 19.13 | 7.219 |
| 3 | 25 | 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 |

the amount of depreciation for each general asset account by using the depreciation method, recovery period, and convention that applies to the property in the account. For each general asset account, record the depreciation allowance in a separate depreciation reserve account.

Property you cannot include. You cannot include property in a general asset account if you use it in both a trade or business (or for the production of income) and in a personal activity in the tax year in which you first place it in service.

How To Group Property in General Asset Accounts

Each general asset account must include only property that:

- 1) Has the same asset class,
- 2) Has the same recovery period,
- 3) Has the same depreciation method,
- 4) Has the same convention, and
- 5) You placed in service in the same tax year.

The following rules also apply when you establish a general asset account.

- 1) Property without an asset class, but with the same depreciation method, recovery period, and convention, that you place in service in the same tax year, can be grouped into the same general asset account.
- 2) Property subject to the mid-quarter convention can only be grouped into a general asset account with property that is placed in service in the same quarter of the taxable year.
- 3) Property subject to the mid-month convention can only be grouped into a general asset account with property that is placed in service in the same month of the taxable year.
- 4) Passenger automobiles subject to the limits on passenger automobile depreciation must be grouped into a separate general asset account.

Dispositions and Conversions

When you transfer ownership of property in a general asset account or you permanently withdraw it from use in your trade or business

or from the production of income, it is considered disposed of. You also dispose of property when you transfer it to a supplies, scrap, or similar account. You can dispose of property through sale, exchange, retirement, physical abandonment, or destruction of property. The retirement of a structural component of real property is not a disposal.

The unadjusted depreciable basis and the depreciation reserve of the general asset account are not affected by your disposition of property from the general asset account.

You must remove from the general asset account property you change to personal use.

Unadjusted depreciable basis. The unadjusted depreciable basis of an item of property in a general asset account is the same amount you would use to figure gain on the sale of the property, but it is figured without taking into account any depreciation taken in earlier years.

The unadjusted depreciable basis of a general asset account is the total of the unadjusted depreciable bases of all of the property in the account.

For more information on general asset accounts, see chapter 3 in Publication 946.

Listed Property

If listed property is not used predominantly (more than 50%) in a qualified business use, as discussed in *Predominant Use Test* later, the section 179 deduction is not allowable and the property must be depreciated using ADS (straight line method) over the ADS recovery period. For more information on listed property that is leased, see chapter 4 in Publication 946.

A rule that pertains only to passenger automobiles limits the amount of your section 179 and depreciation deductions. See *Special Rules for Passenger Automobiles*, later.

Listed Property Defined

Listed property is any of the following.

- 1) Any passenger automobile (defined later).
- 2) Any other vehicle used for transportation.
- 3) Any property of a type generally used for entertainment, recreation, or amusement.
- 4) 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.

- 5) Any cellular telephone (or similar telecommunication equipment) placed in service or leased in a tax year beginning after 1989.

Other property used for transportation.

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

Listed property does not include certain types of special-purpose farm vehicles. For example, tractors and combines are excluded from the application of the limits because they are suited only for use in the business of farming.

Predominant Use Test

Listed property meets the predominant use test for any tax year if its business use is more than 50% of its total use. You must allocate the use of any item of listed property used for more than one purpose during the tax year among its various uses. You cannot use the percentage of investment use of listed property as part of the percentage of qualified business use to meet the predominant use test. However, you do use the combined total of business and investment use to figure your depreciation deduction for the property.



Property does not stop being predominantly used in a qualified business use because of a transfer at death.

Special Rules for Passenger Automobiles

In addition to the rules for all listed property, a passenger automobile is also subject to other special limits. For passenger automobiles, the total depreciation deduction (including the section 179 deduction) that you can claim is limited.

Maximum deduction for 1996. Determine the maximum depreciation deduction (including section 179) that you can claim for a passenger automobile by the date you place it in service. The maximum deductions for 1996 are:

Maximum Depreciation Deduction

| Year Placed In Service | 1st Year | 2nd Year | 3rd Year | 4th Year and Later |
|------------------------|----------|----------|----------|--------------------|
| 1996 | \$3,060 | \$4,900 | \$2,950 | \$1,775 |
| 1995 | | \$4,900 | \$2,950 | \$1,775 |
| 1994 | | | 2,850 | 1,675 |
| 1993 | | | | 1,675 |
| 1992 | | | | 1,575 |
| 1991 | | | | 1,575 |

For automobiles placed in service during 1996, the depreciation deduction, including the section 179 deduction, cannot be more than \$3,060 for 1996 (the first tax year of the recovery period). For 1997 and 1998 (second

and third tax years), the depreciation deduction will be limited to \$4,900 and \$2,950, respectively. The maximum will be \$1,775 in each succeeding tax year. You must reduce these limits further if your business/investment use is less than 100%.

Fully depreciated automobile. If you have fully depreciated a car that you are still using in your business, you can continue to claim your other operating expenses for the business use of your car. Continue to keep records, as explained later.

Passenger automobile defined. 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. For more information on passenger automobiles, see Publication 463.

What Records Must Be Kept



You cannot take any depreciation or section 179 deduction for the use of listed property (including passenger automobiles) 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 ADS recovery period.

For more information on records, see chapter 4 in Publication 946.

Depletion

If you have an economic interest in mineral property or standing timber, you can take a deduction for depletion. There are two ways of figuring depletion: cost depletion or percentage depletion. You must use cost depletion to figure your deduction for standing timber.

You have an economic interest if both of the following apply.

- 1) You have acquired by investment a legal interest in mineral deposits or standing timber.

- 2) You have the 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.

More than one party can have an economic interest in a mineral deposit or timber.

You must have a capital interest in a mineral deposit or standing timber to have an economic interest in the property. A contractual relationship you have that allows you an economic or a monetary advantage from products of the mineral deposit or standing timber is not, in itself, an economic interest.

Figuring the Deduction

You can generally figure the deduction for depletion by either cost depletion or percentage depletion. You cannot use the percentage method to figure the depletion deduction for standing timber.

Cost depletion. You can use cost depletion to figure the deduction for mines; for oil, gas, and geothermal wells; and for other natural resources, including timber.

To figure the deduction, first determine the total number of units that can be recovered. This number of recoverable units can be measured in tons, barrels, board feet, etc., and is determined using the existing methods for the particular industry.

Figure cost depletion by dividing the adjusted basis of your mineral property by the total recoverable units in the property's natural deposit. The result is the rate per unit. Multiply the rate for each unit by:

- 1) The units sold based on your inventories, during the tax year, if you use the accrual method of accounting, or
- 2) The units sold for which you receive payment, during the year (regardless of the year of sale), if you use the cash method of accounting.

Units sold does not include any with respect to which depletion deductions were allowed or allowable in earlier years.

Cost depletion on ground water of 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 that the ground water is being depleted and that the rate of recharge is so low that, once extracted, the water is lost to the taxpayer and immediately succeeding generations.

For tax years ending prior to December 13, 1982, those extracting ground water for irrigation farming from areas in the Ogallala Formation outside the Southern High Plains were not required to reduce their basis in ground water by cost depletion that was allowable but not claimed.

Timber depletion. You can take depletion on timber (including Christmas trees) only if you cut it yourself or have it cut for you. To figure timber depletion, you multiply the number

of units of standing timber cut by your depletion unit.

Figure your depletion unit as follows:

- 1) Determine your cost or 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 number of units acquired during the year to the number of units on hand in the account at the beginning of the year and then adding (or subtracting) any correction to the estimate of the number of units remaining in the account.
- 4) Divide the result of 2) by the result of 3). This is your depletion unit.

Generally, you can deduct depletion only in the tax year that the products (such as logs, cordwood, and lumber) from the timber are sold. The number of units sold will depend on your accounting method, discussed in chapter 3. You should include the depletion that you cannot deduct for that year in the closing inventory on those products.

Form T. Attach Form T to your income tax return if you are claiming a deduction for timber depletion.

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 \$1,800. 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 \$.006 ($\$1,800 \div 300,000$). His deduction for depletion is \$162 ($27,000 \times \$.006$). 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 \$.006. However, his depletion deduction would have been \$120 for this year and he would have included the balance of \$42 ($7,000 \times \$.006$) 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.

Figure percentage depletion, by multiplying a certain percentage, specified for each mineral by your gross income from the property during the tax year. The depletion deduction under this method cannot be more than **50%** (100% for oil and gas property) of your taxable income from the property figured without the depletion deduction.

Taxable income. In figuring the taxable income limit, do not take a net operating loss deduction from the gross income of the property.

For more information, see chapter 13 in Publication 535.

Amortization

You may be able to deduct each year, as amortization, a part of certain capital expenses. Amortization is a method to recover these expenses that is like straight line depreciation. See chapter 12 in Publication 535 for more information.

Section 197 Intangibles

You must amortize over 15 years the capitalized costs of certain intangibles that you acquire after August 10, 1993. These intangibles are called "section 197 intangibles" and are defined later. You must amortize them if you hold them in connection with your trade or business or in an activity engaged in for the production of income. Your deduction each year is the adjusted basis (for purposes of determining gain) of the intangible amortized ratably over a 15-year period beginning with the month acquired. You are not allowed any other depreciation or amortization deduction for any section 197 intangibles that you can amortize over 15 years.

Effective date elections. This amortization provision generally applies only to property acquired after August 10, 1993. However, under **two elections**, you can choose to have it apply differently. See chapter 12 of Publication 535 for information on the elections.

Section 197 Intangibles Defined

The following assets are section 197 intangibles:

- 1) Goodwill,
- 2) Going concern value,
- 3) Workforce in place including its composition, and terms and conditions (contractual or otherwise) of its employment,
- 4) Business books and records, operating systems, and 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 other item similar to those in items 3) through 7).
- 9) A license, permit, or other right granted by a governmental unit or agency (including renewals),
- 10) A covenant not to compete entered into in connection with an acquisition of an interest in a trade or business, and
- 11) A franchise, trademark, or trade name (including renewals).

You cannot amortize any of the intangibles listed in items 1) through 8) that you created, unless you created it in connection with the acquisition of assets constituting a trade or business or a substantial portion of a trade or business.

For more information on these section 197 intangibles, see chapter 12 of Publication 535.

Other 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 an existing lease or sublease of tangible property, and
- 4) An interest under a debt that was in existence when the interest was acquired.

For a complete list of nonsection 197 intangibles, see chapter 12 of Publication 535.

Computer software. Section 197 intangibles do not include computer software that is:

- 1) Readily available for purchase by the general public,
- 2) Subject to a nonexclusive license, and
- 3) Not substantially changed.

Also, computer software you did not acquire in the acquisition of a substantial part of a business is not section 197 property.

If you are allowed to depreciate any computer software that is not a section 197 intangible, use the straight line method with a useful life of 36 months.

For more information on depreciation of computer software, see Publication 946.

Additional costs associated with nonsection 197 intangibles. Additional costs you take into account in determining the basis of property that is not a section 197 intangible are not themselves section 197 intangibles. For example, none of the cost of acquiring real property held for the production of rental income (including goodwill, going concern value, etc.) is an amortizable section 197 intangible. Instead, add these costs to the basis of the real property.

Dispositions

Treat a section 197 intangible as depreciable property used in your trade or business. If you dispose of a section 197 intangible that you held for more than one year, the property qualifies as section 1231 property. Treat any gain on the disposition as ordinary income to the extent of the allowable amortization. Report the gain or loss on the sale of property held for one year or less as an ordinary gain or loss. See chapter 2 in Publication 544, *Sales and Other Dispositions of Assets*, for more information.

If you acquire more than one section 197 intangible in a transaction (or series of related transactions) and later dispose of one of them or one of them becomes worthless, you cannot recognize any loss on the intangible. Increase the adjusted basis of each remaining amortizable section 197 intangible that you did not dispose of by a certain amount.

For more information on dispositions of amortizable section 197 property, see chapter 12 in Publication 535.

Anti-Churning Rules

You cannot amortize certain section 197 intangibles over 15 years. You cannot use 15-year amortization for goodwill, going concern value, or any intangible for which you cannot claim a depreciation or amortization deduction that would not have been allowable before August 10, 1993, to amortizable property.

For more information, see chapter 12 in Publication 535.

Anti-Abuse Rule

You cannot amortize any section 197 intangible you acquired in a transaction one of the principal purposes of which is to:

- 1) Avoid the requirement that the intangible be acquired after August 10, 1993, or
- 2) Avoid any of the anti-churning rules.

For more information on amortizable section 197 intangibles, see chapter 12 in Publication 535.

Reforestation Expenses

You can elect to amortize a limited amount of your reforestation of qualified timber property expenses. Qualifying expenses that you have during the tax year are set up as an amortizable basis for the tax year and amortized over an 84-month period.

Annual limit. Each year you can elect to amortize up to \$10,000 (\$5,000 if you are married filing separate returns) of qualified expenses you incur during the tax year. You cannot carry over or carry back qualifying expenses that are in excess of the annual limit. If your reforestation costs exceed these limits in a tax year, the amount in excess of the limit must be capitalized — that is, added to the basis of your property.

Qualified timber property. Your qualified timber property must be located in the United States. You must hold it for the growing and cutting of timber that you will either use in or sell in the commercial production of timber products. Your property can be a woodlot or other site but it must consist of at least one acre that is planted with tree seedlings in a manner normally used in forestation or reforestation.

You do not have to own the property. You can elect to amortize qualifying reforestation expenses you incur on qualified leased property.

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

Qualified expenses. Reforestation expenses are the direct costs incurred to plant or seed for forestation or reforestation.

Your reforestation expenses do not include any expenses for which you have been reimbursed under any governmental reforestation cost-sharing program, unless you included this reimbursement in your gross income. Qualifying expenses include amounts

spent for site preparation, seeds or seedlings, labor, tools, and depreciation on equipment used in planting or seeding. Include in these costs depreciation on equipment, such as tractors, trucks, tree planters, and similar machines used in planting and seeding. Qualifying expenses include only those costs that you must capitalize and include in the adjusted basis of the property. Costs you can deduct currently are not qualifying expenses.

Maximum annual amortization. The maximum annual amortization you are allowed for expenses incurred in any tax year is \$1,428.57 (\$10,000÷7). The maximum you are allowed to deduct in the first and eighth taxable years of the amortization period is (1/2) one half of \$1,428.57 or \$714.29.

Estates. The reforestation deduction is available to estates in the same manner as to individuals. The deduction is allocated between the income beneficiaries and the fiduciary. A beneficiary will include any amount so allocated as part of his or her limit.

Trusts. Trusts are not allowed the reforestation deduction.

Investment credit. Reforestation expenses that are eligible to be amortized qualify for an investment credit, whether or not they are amortized. See chapter 9.

Election to amortize. To make this election, attach Form 4562 to your income tax return and enter the deduction in Part VI of that form. Also, attach a statement to Form 4562 that describes the expenses and provides the dates you incurred the expenses. Show 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 expenses. You can make the election only on a timely filed return (including extensions) for the tax year in which you incurred the expenses.

Recapture. If you dispose of qualified timber property within 10 years after the tax year you elect to amortize reforestation expenses for it, report any gain as ordinary income up to the amount of the amortization taken.

Pollution Control Facilities

You can elect to amortize the cost of a certified pollution control facility over 60 months. You must the facility for a plant (or other property) that was in operation before 1976.

Certified pollution control facility. A certified pollution control facility is a new identifiable treatment facility used to abate or control water or atmospheric pollution or contamination. The abatement or control must be done by removing, changing, disposing, storing, or preventing the creation or emission of pollutants, contaminants, wastes, or heat. It must be certified by the state and federal certifying authorities. Examples of such a facility include septic tanks and manure-control facilities.

For information regarding certification procedures, see section 1.169-2(c) of the income tax regulations.

If it appears that all or part of the cost of a facility will be recovered from its operation, such as through sales of recovered wastes, the federal certifying authority will certify to that effect. The federal certifying authority will describe the nature of the potential cost recovery. The amortizable cost of the facility must be reduced accordingly. For more information, see section 169 of the Internal Revenue Code and the related regulations.

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 choose to amortize its cost over 60 months. Otherwise, you can capitalize the cost and depreciate the facility.

Going Into Business

When you go into business treat all the costs you incur to get your business started as capital expenses and a part of your basis in the business. Generally, you recover any costs that are for particular assets through depreciation deductions. Generally, you cannot recover other costs until you sell or otherwise go out of business.

Business Start-Up Costs

Start-up costs are those you have in setting up an active trade or business or investigating the possibility of creating or acquiring an active trade or business. Start-up costs include any amounts paid or incurred in connection with an activity engaged in for profit and the production of income in anticipation of the activity becoming an active trade or business.

For more information, see *Going Into Business* in chapter 12 of Publication 535.

9.

General Business Credit

Important Changes for 1996

Work opportunity credit. The work opportunity credit replaces the jobs credit, which expired for wages paid after December 1994. The credit applies to 35% of the qualified first-year wages you pay to certain individuals who

begin work for you after September 1996, and before October 1997. For more information, see Form 5884.

Research credit. The research credit, which expired for certain expenses paid or incurred after June 30, 1995, is extended for the period of July 1, 1996 through May 31, 1997. For more information, see Form 6765.

Orphan drug credit. The orphan drug credit, which expired December 31, 1994, is extended for qualified expenses paid or incurred during the period of July 1, 1996, through May 31, 1997. No part of an unused business credit attributable to the orphan drug credit may be carried back to a year ending before July 1, 1996. For more information, see Form 8820.

Introduction

Your general business credit consists of your carryover of business credits from prior years plus your total current year business credits. Current year business credits include the:

- 1) Investment credit (Form 3468),
- 2) Work opportunity credit (Form 5884), from fiscal year 1995-96 flow-through entities only. (The jobs credit expired for employees' wages paid after December 31, 1994.)
- 3) Alcohol fuels credit (Form 6478),
- 4) Research credit (Form 6765), from fiscal year 1995-96 flow-through entities only. (The research credit expired for qualified expenditures made after June 30, 1995.)
- 5) Low-income housing credit (Form 8586),
- 6) Orphan drug credit (Form 8820),
- 7) Disabled access credit (Form 8826),
- 8) Enhanced oil recovery credit (Form 8830),
- 9) Renewable electricity production credit (Form 8835),
- 10) Empowerment zone employment credit (Form 8844),
- 11) Indian employment credit (Form 8845),
- 12) Credit for employer social security and Medicare taxes paid on certain employee tips (Form 8846), and
- 13) Credit for contributions to selected community development corporations (Form 8847).

In addition, your general business credit for the current year may be increased later by the carryback of business credits from later years.

If you need more information about these credits than you find in this chapter, get the credit forms listed above.

Topics

This chapter discusses:

- Claiming the general business credit
- Carrybacks and carryovers
- 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

See chapter 21 for information about getting these publications and forms.

Claiming the General Business Credit

Disregarding any empowerment zone employment credit, if you have only one current year business credit, no carryback or carryover, and the credit (other than the low-income housing credit) is not from a passive activity, use only the applicable credit form listed under *Introduction*, earlier, to claim the general business credit. For information about passive activity credits, get Form 8582—CR.

If you have more than one credit, a carryback or carryover, or a credit (other than the low-income housing credit) from a passive activity, you must use Form 3800 to figure your general business credit.

Claiming the empowerment zone employment credit. The empowerment zone employment credit is subject to special 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.

Carrybacks and Carryovers

Note: The following discussion does not apply to the empowerment zone employment credit.

There is a limit on how much general business credit you can take in any one tax year. If your credit is more than this limit, you can generally carry the excess to another tax year and subtract it from your income tax for that year. See *Rule for carrybacks and carryovers*, later.

Tax limit. Your general business credit is limited to your net income tax minus the larger of:

- 1) Your tentative minimum tax, or
- 2) 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 minus certain credits. Your **net regular tax liability** is your regular tax liability minus certain credits. For more information, see Form 3800 or any of the credit forms listed under *Introduction*, earlier.

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.

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 (\$27,500 minus \$18,487). This is your net income tax, \$27,500, minus the **larger of** your tentative minimum tax, \$18,487, or 25% of your net regular tax liability that is more than \$25,000 (25% of \$2,500 = \$625).

Married persons filing separate returns.

If you are married and file a separate return, you and your spouse must each figure your tax 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 carryovers or carrybacks of any credit to that year, the other spouse can use the full \$25,000 instead of \$12,500 in figuring the limit based on the separate tax.

Rule for carrybacks and carryovers. In general, you can carry the unused portion of your credit back to your last 3 tax years and then forward to your next 15 tax years to reduce your tax in those years. First, carry the unused portion to the earliest of your last 3 years. Then, if you cannot use it all in that year, carry the remaining unused portion to the second earliest year and so on. Any unused credit that you could not take in these 3 earlier years can be carried forward in the same way to the next 15 tax years until it is used up.

There are generally 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.

Credits must be used in the order in which they are earned.

- 1) First, for any tax year, use your credit carryover (earliest year first).
- 2) Next, use the current year's credit.
- 3) Finally, use your credit carrybacks (earliest year first).

Unused carryover. If you have any unused credit carryover in the year following the end of the 15-year carryover period, you can generally deduct the unused amount. 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.

Claiming carryovers. Use Form 3800 to claim a carryover of an unused credit from a previous tax year. The carryover becomes part of your general business credit for the tax year to which it is carried.

Claiming carrybacks. You can make a claim for 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. Use Form 1120X if your original return was a Form 1120 or 1120—A. 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 refunds. 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 adjustment of tax from a general business credit carryback. The application should be filed on or after the date of filing the tax return for the carryback year, but 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:

- 1) Reforestation credit,
- 2) Rehabilitation credit, and
- 3) Energy credit.

Reforestation credit. The 10% reforestation credit applies to up to \$10,000 of the 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. These costs must qualify for amortization. You can take the investment credit for reforestation costs whether you choose to amortize them or add them to the basis of your property. For more information about these costs, see *Amortization* in chapter 8.

Example. Gerald elected to amortize qualified reforestation costs of \$9,000 he incurred during the year. He may take a reforestation credit of \$900 (10% of \$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, or reconstruction. It does not include enlargement or new construction. 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 must generally reduce the depreciable 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 for more information.

How to take the investment credit. Use Form 3468 to figure your credit. You may also need to file Form 3800. See *Claiming the General Business Credit*, earlier.

Carrybacks and carryovers. Even if you cannot take an investment credit for 1996, you may have unused credits from earlier years that may reduce your 1996 tax. These unused credits from earlier years are carried to your current tax year as general business credit carryovers and the rules for the general business credit, discussed earlier, apply.

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. If you dispose of property before the end of the recapture period, you must recapture a percentage of the credit by adding it to your tax. See *Recapture Rule*, later, for a discussion of recapture period.

Use Form 4255 to figure the recapture tax or 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 carryover.

Dispositions

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 disposal for investment credit recapture purposes.

Certain transactions result in dispositions for investment credit recapture purposes. The following illustrate those that are and those that are not dispositions.

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. 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 amount of 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 it or otherwise retire it from use. Normal retirements are also dispositions.

Transfer by reason of death. There is no disposition of investment credit property if the property is transferred because the owner-taxpayer died.

Gifts. You are considered to have disposed of property that you transferred by gift.

Transfers 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 or theft loss. You are considered to have disposed of property that was destroyed by casualty or lost by theft.

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.

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 Income Tax Regulations.

Sale and leaseback. There is no disposition when investment credit property is sold by the taxpayer who claimed the credit and then is leased back to that taxpayer as part of the same transaction.

At-risk reduction. If the amount of your investment for which you are at risk is reduced, you are subject to the recapture rules (discussed next). See the instructions for Form 3468 for more information.

Recapture Rule

If you dispose of investment credit property before the end of the recapture period (defined in the next paragraph), 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.

The amount of credit you must recapture depends on when during the recapture period you dispose of, or change the use of, the property. The **recapture period** is the length of time the property must be used to get the full investment credit.

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 on Form 4255. The result of this computation is the amount of the recapture. 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.

Net operating loss carrybacks. 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 Income Tax Regulations.

10. Gains and Losses

Introduction

During the year, you may have sold or exchanged property. This chapter explains how to figure your gain or loss on the sale or exchange and determine the effect it has on your taxes.

Topics

This chapter discusses:

- Sales and exchanges
- Nontaxable exchanges
- Capital and noncapital assets
- Hedging (commodity futures)
- Livestock
- Converted wetland and erodible cropland
- Timber
- Sale of a farm
- Foreclosures, repossessions, and abandonments

Useful Items

You may want to see:

Publication

- 504** Divorced or Separated Individuals
- 523** Selling Your Home
- 544** Sales and Other Dispositions of Assets
- 547** Casualties, Disasters, and Thefts (Business and Nonbusiness)
- 550** Investment Income and Expenses
- 551** Basis of Assets

Form (and Instructions)

- 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
- 8824** Like-Kind Exchanges

See chapter 21 for information about getting these 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 some of the 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 excess of the amount you realize from a sale or exchange of property over its adjusted basis. A **loss** is the excess of the adjusted basis of the property over the amount you realize.

See chapter 7 for the definitions 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 that were 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 *Multiple Property Exchanges*, and its discussion *Treatment of liabilities*, 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 that you must include in gross income. A recognized loss is a loss that 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 certain exchanges of property is not recognized for tax purposes. See *Nontaxable Like-Kind Exchanges* next. Also, a loss from the disposition of property held for personal use is not deductible.

Nontaxable Like-Kind Exchanges

Certain exchanges are not taxable. This means that any gain from the exchange is not taxed, and any loss cannot be deducted. In other words, even though you may **realize** a gain or loss on the exchange, it will not be **recognized** until you sell or otherwise dispose of the property you receive.

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

- 1) Involve qualifying property, and
- 2) Involve like property.

These two requirements are discussed later. If the like-kind exchange includes the receipt of money or unlike property, you may have a taxable gain. (See *Partially nontaxable exchange*, 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 exchanges*, 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 of the conditions described in this section.

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

Basis of property received. If you acquire property in a like-kind exchange, the basis of that property is the same as the basis of the property you transferred. See chapter 7 for more information about basis.

Money paid. If, in addition to giving up like property, you pay money in a like-kind exchange, you still have no taxable gain or deductible 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 for a new one. The new tractor costs \$10,800. He is allowed \$2,000 for the old tractor, and pays \$8,800 cash. He has no taxable gain or deductible loss on the transaction, regardless of the adjusted basis of his old tractor. If Bill sold the old tractor to a third party for \$2,000 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 on Form 8824. The instructions for the form explain how to report the details of the exchange. Report the exchange even though no gain or loss is recognized.

If you have any taxable 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 taxable gain as ordinary income because of depreciation on Form 4797. See chapter 11 for more information.

Qualifying property. The property must be business or investment property. Both the property you trade and the property you receive must be held by you for business or investment purposes. Neither may be property used for personal purposes, such as your home or family car. For example, a farm truck traded for another farm truck qualifies under this provision, but a farm truck traded for a family car that is not used in the farm business does not qualify.

Property held primarily for sale. The nontaxable exchange rules do not apply to exchanges of property held primarily for sale. Exchanges of this property, such as crops or produce, result in taxable gains or losses.

Exchanges of stocks, bonds, or other securities. The rules for like-kind exchanges generally do not apply to exchanges of stocks, bonds, or other securities. Therefore, security exchanges are generally taxable.

Like property. There must be an exchange of like property. An exchange of a truck for a tractor is an exchange of like-kind property, and so is an exchange of timberland 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. See *Personal property*, next.

Personal property. Depreciable tangible personal property can be either “like kind” or “like class” to qualify for nonrecognition treatment. Like-class properties are depreciable tangible personal properties within the same General Asset Class or Product Class.

General Asset Classes describe the types of property frequently used in many businesses. **Product Classes** include property listed in a 4-digit product class 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). For more information, see chapter 1 in Publication 544.

Example. Gerald Maroon transfers a greenhouse to Lloyd Moore for grain bins. The farmers are not related to each other. Since both the greenhouse and the grain bins are in the same asset class (01.1) the exchange is considered a like-kind nontaxable exchange.

Partially nontaxable exchange. If you exchange your property for like-kind property and also receive money or unlike property in the exchange, 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 received. A loss is not deductible.

Example 1. You trade farm land that cost you \$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 gain of \$30,000, but only \$10,000, the cash received, is taxable. If, instead of money, you received a tractor with a fair market value of \$10,000, your taxable gain is still limited to \$10,000, the value of the tractor.

Example 2. 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 you trade property for like-kind property and also give up unlike property in the exchange, you have a taxable gain or deductible loss only on the unlike property you give up. This gain or loss is the difference between the fair market value and the adjusted basis of the unlike property.

Like-kind exchanges between related parties. Special rules apply to like-kind exchanges made between related parties. These rules affect both direct and indirect exchanges. Under these rules, if either party disposes of the property within 2 years after the exchange, then the exchange is disqualified from nonrecognition treatment. The gain or loss on the original exchange must be recognized as of the date of that 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 parties. Under these rules, a related party generally includes: a member of your family (spouse, brother, sister, parent,

child, etc.), a corporation in which you have more than 50% ownership, a partnership in which you directly or indirectly own more than 50% interest of the capital or profits, and two partnerships in which you directly or indirectly own more than 50% of the capital interests or profits interests.

For the list of related parties, see *Non-deductible Loss*, under *Sales and Exchanges Between Related Parties* in chapter 2 of Publication 544.

Exceptions to the related-party rules. The following kinds of property dispositions are excluded from these rules:

- 1) Dispositions due to the death of either related person,
- 2) Involuntary conversions, or
- 3) Exchanges or dispositions if it is established to the satisfaction of the IRS that their main purpose is not the avoidance of federal income tax.

Transfers between spouses. No gain or loss is recognized (included in income) 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 transferee spouse is a nonresident alien. Nor does this rule apply to a transfer in trust to the extent the adjusted basis of the property is less than the amount of the liabilities assumed and the liabilities on the property.

For more information, see *Property Settlements* in Publication 504.

Exchanges of multiple properties. 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:

- 1) Transfer and receive properties in two or more exchange groups, or
- 2) 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 exchanges. A deferred exchange is one in which you transfer property you use in business or hold for investment and, at a later time, you 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 that is used to purchase replacement property.

For more information, see *Deferred Exchanges* in chapter 1 of Publication 544.

Foreclosures and Repossessions

If the borrower (buyer) does not make payments due on a loan secured by property, the lender (mortgagee or creditor) may foreclose on the mortgage or repossess the property. The foreclosure or repossession is treated as a sale or exchange from which the borrower may realize gain or loss. This is true even if the property is voluntarily returned to the lender. The borrower may also realize ordinary income from cancellation of debt if the loan balance is more than the property's fair market value.

Gain or loss on foreclosure or repossession. The borrower's gain or loss from the foreclosure or repossession described earlier is generally figured and reported in the same way as gain or loss from sales or exchanges. The gain or loss is the difference between the borrower's adjusted basis in the transferred property and the amount realized. See *Determining Gain or Loss*, earlier.



You can use Table 10–1 to figure your gain or loss from a foreclosure or repossession.

Amount realized on a nonrecourse debt. If the borrower is not personally liable for repaying the debt (nonrecourse debt) secured by the transferred property, the amount realized by the borrower includes the full amount of the debt canceled by the transfer. The full amount of the canceled debt is included even if the property's fair market value is less than the canceled debt.

Example. In 1991, Ann paid \$200,000 for farm land. She paid \$15,000 down and borrowed the remaining \$185,000 from a bank. Ann is not personally liable on the loan (nonrecourse debt), but pledges the land as security. In 1996, the bank foreclosed on the loan because Ann stopped making payments. When the bank foreclosed on the loan, the balance due was \$180,000 and the fair market value of the land was \$170,000. The amount Ann realized on the foreclosure is \$180,000, the debt canceled by the foreclosure. She figures her gain or loss by comparing the amount realized (\$180,000) with her adjusted basis (\$200,000). She has a \$20,000 deductible loss.

Amount realized on a recourse debt. If the borrower is personally liable for the debt (recourse debt), the amount realized on the foreclosure or repossession does not include the amount of the canceled debt that is income to the borrower from cancellation of debt. However, if the fair market value of the transferred property is less than the canceled debt, the amount realized by the borrower includes the canceled debt up to the fair market value of the property. The borrower is treated as receiving ordinary income from the canceled debt for that part of the debt not included in the amount realized. See *Cancellation of debt*, later.

Example. Assume the same facts as in the example above except that Ann is personally liable for the loan (recourse debt). In this case,

Table 10-1. Worksheet for Foreclosures and Repossessions
(Keep for your records)



| | |
|---|-------|
| <p>Step 1. 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 Step 1 and go to Step 2.</i>)</p> | |
| 1. Enter the amount of debt canceled by the transfer of property | _____ |
| 2. Enter the fair market value of the transferred property | _____ |
| 3. Income from cancellation of debt.* Subtract line 2 from line 1. If less than zero, enter zero | _____ |
| <p>Step 2. Figure your gain or loss from foreclosure or repossession.</p> | |
| 4. Enter the smaller of line 1 or line 2. (If you are not personally liable for the debt, enter the amount of debt cancelled by the transfer of property.) | _____ |
| 5. Enter the adjusted basis of the transferred property | _____ |
| 6. Gain or loss from foreclosure or repossession. Subtract line 5 from line 4. | _____ |

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

the amount she realizes is \$170,000. This is the amount of the canceled debt (\$180,000) up to the farm land's fair market value (\$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. 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.

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 exceeds 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.

However, income from cancellation of debt is not taxed if:

- 1) The cancellation is intended as a gift,
- 2) The debt is qualified farm debt (see chapter 4),
- 3) The debt is qualified real property debt (see chapter 5 of Publication 334, *Tax Guide for Small Business*), or

- 4) You are insolvent or bankrupt (see Publication 908, *Bankruptcy Tax Guide*).



You can use Table 10-1 to figure your income from cancellation of debt.

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 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, or federal government agency. For foreclosures or repossessions occurring in 1996, these forms should be sent to you by January 31, 1997.

Ordinary or Capital Gain or Loss

If you have a taxable gain or a deductible loss from a sale or exchange of property, it may be either an ordinary gain or loss, or a capital gain or loss, or a combination of both. Usually, the full amount of an ordinary gain is taxable, and the full amount of an ordinary loss is deductible. The tax treatment of a capital gain or loss depends upon whether the gain or loss is short or long term and whether the taxpayer is an individual or a corporation.

Your net capital gains may be taxed at a lower tax rate than ordinary income. See *Maximum Tax Rate on Capital Gains*, later. Your

deduction for net capital losses may be limited. See *Treatment of Capital Losses*, later.

Generally, you will have a capital gain or loss if you sell or exchange a capital asset (defined next). You may also have a capital gain or loss if you sell or exchange a noncapital asset that is section 1231 property, described in chapter 11.

Capital Assets

For income tax purposes, all property you own and use for personal purposes or investment is a capital asset.

Some **examples of capital assets** include:

- 1) A home owned and occupied by you and your family.
- 2) Household furnishings.
- 3) 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 noncapital asset, defined later.
- 4) Stocks and bonds. Losses on certain small business stock, however, may be treated as losses on property that is not a capital asset. For more information on this subject, see *Losses on Small Business Investment Company Stock* in chapter 4, 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.

Personal casualty gains and losses. To figure your personal casualty (or theft) gain, subtract your adjusted basis in the property from any insurance or other reimbursements. To figure your personal casualty (or theft) loss, reduce each loss by any reimbursements and by \$100. If your personal casualty gains for the tax year exceed your personal casualty losses, all your personal casualty gains and losses are treated as sales or exchanges of capital assets. If your personal casualty losses for the tax year exceed your personal casualty gains, the excess is deductible on Schedule A (Form 1040) to the extent it exceeds 10% of your adjusted gross income. Use Section A of Form 4684 to report all personal casualty gains and losses. For more information, see *Figuring the Deduction and How To Report Gains and Losses* in Publication 547.

Long and Short Term

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

If you hold a capital asset 1 year or less, the gain or loss resulting from its disposition is short term. If you hold a capital asset for more than 1 year, the gain or loss resulting from its disposition is long term.

Holding period. To figure if you held property more than 1 year, start counting on the day after the day you acquire the property. This same date of each following month is the beginning of a new month regardless of the number of days in the preceding month. The day you dispose of the property is part of your holding period.

Example. If you bought an asset on June 18, 1996, you should start counting on June 19, 1996. If you sell the asset on June 18, 1997, your holding period is not more than 1 year, but if you sell it on June 19, 1997, your holding period is more than 1 year.

Inherited property. If you inherit property, you are considered to have held the property for more than 1 year even if you dispose of it within 1 year after the decedent's death.

Bad debt. A nonbusiness bad debt is always treated as a short-term capital loss. See the example on the filled-in Schedule D (Form 1040) in chapter 20.

Nontaxable exchanges. If you acquire an asset in exchange for another asset and your basis for the new asset is determined, in whole or in part, by 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.

Gifts. If you receive a gift of property and your basis 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 all of 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. Merge 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 one 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 merge 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 excess is taxable. This net gain is generally taxed at the same rate as your ordinary income. However, the part that is not more than your net long-term capital gain is taxed at a

rate no higher than 28%. See *Maximum Tax Rate on Capital Gains*, later.

Net loss. If the total of your capital losses is more than the total of your capital gains, the excess 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 deduct the excess even if you do not have ordinary income to offset it. The yearly limit on the amount of the capital loss you can deduct is \$3,000 (\$1,500 if you are married and file a separate return).

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

- 1) Your excess capital loss is more than the yearly limit, or
- 2) The amount shown on line 35, Form 1040 (your taxable income without your deduction for exemptions), is less than zero.

If either of these situations applies to you in 1996, complete the *Capital Loss Carryover Worksheet*, provided in the instructions to Schedule D (Form 1040), to figure the amount of your loss that you can carry over to 1997.

Maximum Tax Rate on Capital Gains

The 31%, 36%, and 39.6% income tax rates for individuals do not apply to net capital gains. The maximum tax rate on a net capital gain (the smaller of line 17 or 18 of Schedule D (Form 1040)) is 28%. Net capital gain is the excess of net long-term capital gain for the year over the net short-term capital loss for the year.

However, if you elect 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 28% rate by the same amount. You make this election on Form 4952, line 4e. For information on making this election, see the instructions to Form 4952. For information on the investment interest deduction, see chapter 3 in Publication 550.

Figuring tax on net capital gains. If you file Schedule D and both lines 17 and 18 of Schedule D are gains, or if you reported capital gain distributions on line 13, Form 1040, you may need to use the *Capital Gain Tax Worksheet*, provided in the instructions for line 38 of Form 1040, to figure your tax. See the Form 1040 instructions for more information.

Noncapital Assets

Noncapital assets include properties 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, are noncapital assets. Gain or loss from sales or other dispositions of this property is reported on Schedule F (not on Schedule D or Form 4797).

Land and depreciable properties. Noncapital assets include land and depreciable properties you use in farming. They also include livestock held for draft, breeding, dairy, or sporting purposes. However, as explained in chapter 11 under *Section 1231 Property*, 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.

Hedging (Commodity Futures)

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:

- 1) Transactions that are entered in the normal course of business primarily to reduce the risk of interest rate or price changes or currency fluctuations with respect to borrowings, ordinary property, or ordinary obligations (hedging transactions). (Ordinary property or obligations are those that cannot produce capital gain or loss under any circumstances.)
OR
- 2) Transactions that are not hedging transactions.

Futures transactions that are not hedging transactions generally result in capital gain or loss. There is a limit on the amount of capital losses you can deduct each year.

If, as a farmer-producer, to protect yourself from the risk of unfavorable price fluctuations, you trade in commodity forward contracts, futures contracts, or options on futures contracts **and** the contracts are 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 hedge on line 10 of Schedule F.

Moreover, the gain or loss on transactions that hedge the purchase of a noninventory supply (for example, animal feed) may be ordinary. If a business sells only a negligible amount of a noninventory supply, a transaction to hedge the purchase of that supply is treated as a hedging transaction if it occurred after July 17, 1994. Ordinary gain or loss treatment is also available for certain hedges of the purchase of noninventory supplies that occurred in a tax year that ended before July 18, 1994, and that, as of September 1, 1994, was still open for assessment of tax.



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. The identification of the hedged item, items, or risk must be made no more than 35 days after entering into the hedging transaction. These rules apply to hedging transactions entered into after 1993, or hedging transactions entered into before 1994 and remaining in existence on March 31, 1994.

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.

Example of a hedging transaction. You file your income tax returns on the cash method. On July 2, 1996, 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, 1996—Sold Dec. corn futures 50,000 bu. @ \$2.75 | \$137,500 |
| Nov. 6, 1996—Bought Dec. corn futures 50,000 bu. @ \$3 (plus broker's commission) | 150,700 |
| Futures loss | <u>(\$13,200)</u> |

This is an ordinary loss 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 |
| | <u>\$2.75</u> |

The gain on your futures transactions would have been \$11,800, figured as follows:

| | |
|--|------------------|
| July 2, 1996—Sold Dec. corn futures 50,000 bu. @ \$2.75 | \$137,500 |
| Nov. 6, 1996—Bought Dec. corn futures 50,000 bu. @ \$2.50 (plus broker's commission) | 125,700 |
| Futures gain | <u>\$ 11,800</u> |

The \$11,800 is ordinary income 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

The sale of livestock held primarily for sale to customers is reported on Schedule F as ordinary income. However, the sale of livestock used in your trade or business may qualify as section 1231 property (discussed in chapter 11) and result in a capital gain or loss.

Holding period. To qualify as section 1231 property, livestock used in your trade or business for draft, breeding, dairy, or sporting purposes, must be held for 12 months or more (24 months or more for horses and cattle).

Livestock. For purposes of section 1231, livestock includes cattle, hogs, horses, mules, donkeys, sheep, goats, fur-bearing animals (such as mink), and other mammals (see chapter 11). Livestock does not include chickens, turkeys, pigeons, geese, emus, ostriches, rheas, or other birds, fish, frogs, reptiles, etc. For purposes of section 1245, livestock includes horses, cattle, hogs, sheep, goats, mink, and other fur-bearing animals (see *Depreciation Recapture on Personal Property* in chapter 11).

Livestock used in trade or business. If livestock is held primarily for draft, breeding, dairy, or sporting purposes, it is used in your trade or 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.

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, for example, 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. It is the business practice 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 held by you as additions or replacements to your own breeding herd to produce calves that you add to your herd 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 some horses from your racing stable. In 1996, you decided that to prevent your racing stable from getting too large to be effectively operated, you must cull six horses from it. All six of these horses had been raced at public tracks in 1995. These horses are all considered held for sporting purposes.

Figuring gain or loss on the cash method. Farmers or ranchers who file their income tax returns on the cash method figure their gain or loss on the sale of livestock qualifying as section 1231 property as follows.

Raised livestock. The gross sales price reduced by any expenses of the sale is gain. 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 less your adjusted basis and any expenses of sale is the gain or loss.

Example. A farmer sold a breeding cow on January 6, 1996, for \$1,250. Expenses of sale were \$125. The cow was bought July 2, 1993, for \$1,300. Depreciation (not less than the amount allowable) was \$759.

| | | |
|--|---------|---------------|
| Gross sales price | | \$1,250 |
| Cost (basis) | \$1,300 | |
| Less: Depreciation deduction | 759 | |
| Unrecovered cost (adjusted basis) | \$ 541 | |
| Expense of sale | 125 | 666 |
| Gain realized | | \$ 584 |

Converted Wetland and Highly Erodible Cropland

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

Converted wetland. This is generally land that must have been drained or filled to make the production of agricultural commodities possible. It includes land held by the person who originally converted the wetland or held by any other person who used the land at any time after conversion for farming purposes.

A wetland (before conversion) is land that meets all of the following conditions:

- 1) 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.
- 2) 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.
- 3) It supports under normal circumstances mostly plants that grow in saturated soil.

Highly erodible cropland. This is cropland that is subject to erosion that you used at any time for farming purposes other than for the grazing of animals. Generally, highly erodible cropland is land that is 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.

Successors. 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 in the gross receipts/sales and cost of goods sold lines 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. In these cases, amounts realized from such sales, and the expenses incurred in cutting, hauling, etc., are ordinary farm income and expenses on Schedule F (Form 1040).

Special rules apply if you owned the timber more than 1 year and choose to either treat timber cutting as a sale or exchange, or enter into a cutting contract discussed below. Depletion on timber is discussed under *Depletion* 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 special rules, discussed next.

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 may elect to treat the cutting of timber as a sale or exchange of section 1231 property 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 it in your trade or business.

Making the election. You make your 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 may choose to make it in any year to which the election would apply. If the timber is partnership property, the election is made on the partnership return. This election cannot be made on an amended return.

Once you have made the election, it remains in effect for all later years unless you revoke it.

Revoking a post-1986 election. You can revoke an election you made for a tax year beginning after 1986 only if you can show undue hardship and get the consent of the Internal Revenue Service (IRS). Thereafter, you may not make any new election unless you have the consent of the IRS.

Revoking a pre-1987 election. You can revoke an election you made for a tax year beginning before 1987 without the consent of the IRS. You can revoke the election by attaching a statement to your tax return for the year the election is to be effective. If you make this special revocation, which can be made only once, you can make a new election without the consent of IRS. Any further revocation will require the consent of IRS.

The statement must provide:

- 1) Your name, address, and identification number,
- 2) The year the revocation is effective and the timber to which it applies,
- 3) That the revocation 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,
- 4) That the revocation is being made under section 311(d) of Public Law 99-514, and
- 5) That you are entitled to make the revocation 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 Income Tax Regulation 1.611-3.

Example. In April 1996, you have owned 4,000 MBF (1,000 board feet) of standing timber for more than 12 months. It had an adjusted basis for depletion of \$40 per MBF. You are a calendar year taxpayer. On January 1, 1996, the timber had a fair market value (FMV) of \$120 per MBF. It was cut in April for sale. On your 1996 tax return, you elect to treat the cutting of the timber as a sale or exchange. You report the difference between the FMV and

your adjusted basis for depletion 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 long-term capital gain or as ordinary gain. You figure your gain as follows:

| | |
|---|------------------|
| FMV of timber January 1, 1996 | \$480,000 |
| Minus: Adjusted basis for depletion | 160,000 |
| Section 1231 gain | <u>\$320,000</u> |

The FMV becomes your basis in the timber cut, and a later sale of the timber cut, 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 sale or exchange of section 1231 property if:

- 1) You are the owner of the timber,
- 2) You held the timber for more than 1 year before its disposal, and
- 3) You retained 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 of the timber is the date the timber is cut. However, if you receive payment under the contract before the timber is cut, you may elect to treat the date of payment as the date of disposal. This election is effective only to figure the holding period of the timber. It has no effect on the time for reporting gain or loss. To make this election, attach a statement to the tax return filed by the due date (including extensions) for the year payment is received. The statement must identify the advance payments subject to the election and the contract under which they were made.

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

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, either 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 usually will 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 postpone paying tax on 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 party is deducted as an ordinary loss. Losses, other than casualty, theft, etc., from nonbusiness property are not deductible. If payments for your farm are received in installments, you may be permitted to pay the tax on your gain over the period of years that the payments are received. See chapter 12.

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. All of the assets sold must be classified as:

- 1) Capital asset held 1 year or less,
- 2) Capital asset held more than 1 year,
- 3) Property (including real estate) used in your business and held 1 year or less (include draft, breeding, dairy, and sporting animals if held less than the holding periods discussed earlier under *Livestock*),
- 4) Property (including real estate) used in your business and held more than 1 year (include draft, breeding, dairy, and sporting animals only if held for the holding periods discussed earlier), or
- 5) Property held primarily for sale or which is of the kind that would be included in inventory if on hand at the close 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 the like-kind exchange rules (discussed earlier), 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.

Residual method. The residual method provides for the consideration to be reduced first by the amount of cash, demand deposits, and similar accounts transferred by the seller. The amount of consideration remaining after this reduction must be allocated among the various business assets in a specified order.

The allocation must be made among the following assets in proportion to (but not in excess of) their fair market value on the purchase date in the following order:

- 1) Certificates of deposit, U.S. government securities, readily marketable stock or securities, and foreign currency,
- 2) All other assets except section 197 intangibles, and

- 3) Section 197 intangibles (discussed in chapter 8).

For more information about the residual method and how to report the allocation of the sales price on Form 1040, see chapter 2 in Publication 544.

Property used in farm operation. The rules for postponing tax on the gain on a voluntary sale, described later under *Sale of your home*, do not apply to the part of your farm used for business. Taxable gains and deductible losses on this property must be reported on your return for the year of the sale. If the property was held for more than 1 year, it may qualify as section 1231 property (see chapter 11) and be reported as ordinary income or loss or as capital gain or loss.

Example. You sell your farm, including your home, which you have owned since December 1992, and realize gain as follows:

| | Farm With Home | Home Only | Farm Without Home |
|--------------------------------|-------------------|-----------------|-------------------------|
| Selling price | \$182,000 | \$58,000 | \$124,000 |
| Cost (or other basis) | <u>40,000</u> | <u>10,000</u> | <u>30,000</u> |
| Gain | <u>\$142,000</u> | <u>\$48,000</u> | <u>\$ 94,000</u> |

You may not postpone tax on the \$94,000 gain from the sale of the property used in your farm business, even though you invest all of the selling price in another farm. All or a part of that gain may have to be reported as ordinary income from the recapture of depreciation or soil and water conservation expenses. Treat the balance as section 1231 gain.

The \$48,000 gain from the sale of your home is a capital gain. This gain is taxable unless you purchase or build another home for at least \$58,000 within the required period of time or can exclude the gain as explained later under *Gain on sale of your main home*.

Partial sale. If you sell a part of your farm, you must report any taxable gain or deductible loss on that part on your tax return for the year of the sale. You may not 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.

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 (60/600 or 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.

Assessing values for local property taxes. If you paid a flat sum for the entire farm

and no other facts are available for properly allocating a part of your original cost or other basis to the part sold, you may use assessed value for local property taxes for the year of purchase as evidence of value to allocate the costs to basis.

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 $\frac{3}{4}$ of the total assessed valuation. You may apply the fraction $\frac{3}{4}$ to the \$700,000 total purchase price to arrive at a basis of \$525,000 for the 600 acres of land. The unadjusted basis of the 60 acres you sold would then be \$52,500 ($60/600$ or $1/10$ of \$525,000). If your home is on the farm, you must properly adjust the basis to exclude those costs from your farm asset costs, as discussed next.

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 that are allocable to your home. Your home includes the immediate surroundings and outbuildings relating to it.

If you use a 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 *Allocating the Basis* in chapter 7.

Gain on sale of your main home. When you have a gain on the sale of your main home, you must postpone the tax on the gain if, within the period beginning 2 years before and ending 2 years after the sale, you buy and occupy another home that you purchase at a cost equal to or more than the adjusted sale price of your old home.

Gain from condemnation. If you have a gain from a condemnation or sale under threat of condemnation, you may use the preceding rule regarding time for replacing your old home to postpone tax on the gain, rather than the rules discussed under *Postponing Gain* in chapter 13. To use the preceding rule, you must choose to treat the involuntary exchange as a voluntary sale or exchange.

Age 55 or older. If you are 55 or older and sell your main home, you may not have to pay tax on all or part of the gain up to \$125,000 (\$62,500, if married filing separately) even though you do not invest in another home.

A loss on your home. You cannot deduct a loss on your home from a voluntary sale, condemnation, or a sale under threat of condemnation.

For more information on selling your home, see Publication 523.

Abandonments

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 amount of the property's adjusted basis when abandoned. Report the loss on Form 4797, Part II, line 11. This rule also applies to leasehold improvements the lessor made for the lessee that were abandoned after June 12, 1996. However, if the property is later foreclosed on or repossessed, gain or loss is figured as discussed earlier under *Foreclosures and Repossessions*. The abandonment loss is taken in the tax year in which the loss is sustained.

You may not deduct any loss from abandonment of your home or other property held for personal use.

Example. Ann abandoned her 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 (the 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 *Foreclosures and Repossessions*.

Cancellation of 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 amount of 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 if:

- 1) The cancellation is intended as a gift,
- 2) The debt is qualified farm debt (see chapter 4),
- 3) The debt is qualified real property debt (see chapter 5 of Publication 334, *Tax Guide for Small Business*), or
- 4) You are insolvent or bankrupt (see Publication 908, *Bankruptcy Tax Guide*).

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 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 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, or federal government agency. For abandonments of property and debt cancellations occurring in 1996, these forms should be sent to you by January 31, 1997.

11.

Dispositions of Property Used in Farming

Introduction

Certain farm property such as land, structures, certain cattle, horses, and other livestock, and equipment used in farming, is section 1231 property. This kind of property is also called **property used in farming**. When sold, it is reported differently from farm products. In addition, depreciation that you have taken on property used in farming may cause a gain on the disposition of that property to be treated as ordinary income. The gain on section 1231 property may first be treated as gain on section 1245 or 1250 property before being treated as gain on section 1231 property. See *Depreciation Recapture on Personal Property and Depreciation Recapture on Real Property*, later. These types of gains or losses from property used in farming are reported on Form 4797. Table 11-1 shows examples of items reported on Form 4797 and refers to the part of that form on which they first should be reported.

Topics

This chapter discusses:

- Section 1231 property
- Depreciation recapture on personal property
- Depreciation recapture on real property
- Recapture on installment sales
- Section 1252 and Section 1255 property
- How to use Form 4797

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 these publications and forms.

Section 1231 Property

Real property and depreciable or amortizable personal property used in your farming business or held for the production of rents or royalties and held more than 1 year is section 1231 property. Gain or loss recognized on its sale, exchange, or involuntary conversion is

Table 11-1. Where to Report Items on Form 4797

| Type of property | Held one year or less | Held more than one year |
|--|-------------------------------|-------------------------------------|
| 1 Depreciable trade or business property: a Sold or exchanged at a gain b Sold or exchanged at a loss | Part II Part II | Part III (1245, 1250) Part I |
| 2 Depreciable residential rental property: a Sold or exchanged at a gain b Sold or exchanged at a loss | Part II Part II | Part III (1250) Part I |
| 3 Farmland, held less than 10 years upon which soil, water, or land clearing expenses were deducted: a Sold at a gain b Sold at a loss | Part II Part II | Part III (1252) Part I |
| 4 Disposition of cost-sharing payment property described in section 126 | Part II | Part III (1255) |
| 5 Cattle and horses used in a trade or business for draft, breeding, dairy, or sporting purposes: | Held less than 24 mos. | Held 24 mos. or more |
| a Sold at a gain b Sold at a loss c Raised livestock sold at a gain | Part II Part II Part II | Part III (1245) Part I Part I |
| 6 Livestock other than cattle and horses used in a trade or business for draft, breeding, dairy, or sporting purposes: | Held less than 12 mos. | Held 12 mos. or more |
| a Sold at a gain b Sold at a loss c Raised livestock sold at a gain | Part II Part II Part II | Part III (1245) Part I Part I |

subject to section 1231 treatment (explained later under *Treatment of gains and losses*). Capital assets held in connection with a trade or business or a transaction entered into for profit and subjected to an involuntary conversion are also section 1231 property if held more than 1 year. Involuntary conversions are discussed in chapter 13.

Before you apply section 1231 treatment to a gain on a disposition of depreciable section 1231 property, first figure any ordinary gain from the deduction of depreciation. See the rules discussed later under *Depreciation Recapture on Personal Property or Depreciation Recapture on Real Property*. Any remaining gain is subject to section 1231 treatment.

Qualifying transactions. Transactions that may result in gain or loss subject to section 1231 treatment are—

Sales or exchanges of cattle and horses held for draft, breeding, dairy, or sporting purposes and held 24 months or longer from the date you acquired them.

Sales or exchanges of livestock held for draft, breeding, dairy, or sporting purposes and held 12 months or longer from the date you acquired them. For purposes of this rule, livestock includes hogs, mules, sheep, and goats, but does not include cattle, horses, or poultry.

Sales or exchanges of depreciable personal property used in your business, such as farm machinery, trucks, and livestock, except for gain from depreciation as explained later. This also includes amortizable section 197 intangibles.

Sales or exchanges of real estate used in your business, such as your farm or ranch (including barns and sheds), except for gain from depreciation, or from soil and water conservation expenses, explained later. It also includes property held for the production of rents or royalties.

Sales or exchanges of unharvested crops on land used in farming is section 1231 property if the crop and land are sold, exchanged, or involuntarily converted at the same time and to the same person and the land was held for more than 1 year. Growing crops sold with a lease on the land, though sold to the same person in a single transaction, are not included. Also not included is a sale, exchange, or involuntary conversion of an unharvested crop with land if the taxpayer retains any right or option to reacquire the land directly or indirectly (other than a right customarily incident to a mortgage or other security transaction).

Your distributive share of partnership gains and losses from the sale or exchange of property listed above held more than 1 year, or for the required period for certain livestock, except for gain attributable to depreciation as explained later.

Timber. Gain or loss from the cutting of timber and the disposal of timber with a retained economic interest, as described in chapter 10 under *Timber*, is subject to section 1231 treatment.

Condemnations. The gain or loss on condemnations (described in chapter 13) is

treated as section 1231 gain or loss if the property was held for more than 1 year. This includes business property and capital assets held in connection with a trade or business or transaction entered into for profit, such as investment property. Property held for personal use is not included.

Casualty and theft gains and losses. For casualty and theft gains and losses to receive section 1231 treatment, the property must be held for more than 1 year. These include a casualty to or theft of business property, property held for the production of rents and royalties, and investment property (such as notes and bonds). Insurance payments or any other reimbursement must be taken into account in arriving at the net gain or loss. However, if your casualty or theft losses exceed your casualty or theft gains, neither the gains nor losses are taken into account in the section 1231 computation. The excess net loss is deductible from ordinary income. Section 1231 does not apply to personal casualty gains and losses.

See *Personal casualty gains and losses*, under *Capital Assets* in chapter 10. Also, see chapter 13.

Treatment of gains and losses. Combine all gains and losses from the sale or other disposition of section 1231 property for the tax year. If your section 1231 gains exceed your section 1231 losses, you have a net section 1231 gain. These gains and losses are treated as long-term capital gains or long-term capital losses, unless you have nonrecaptured section 1231 losses. (See the next discussion.) If your section 1231 losses exceed your section 1231 gains, you have a net section 1231 loss. If you have a net section 1231 loss or your section 1231 gains and losses are equal, treat each item as ordinary gain or loss.

Recapture of net ordinary losses. A net section 1231 gain is treated as ordinary income to the extent it does not exceed your nonrecaptured net section 1231 losses taken in prior years. **Nonrecaptured losses** are the total of your net section 1231 losses for your five most recent preceding tax years that have not yet been applied (recaptured) against any net section 1231 gains in those years. Your losses are recaptured beginning with the earliest year subject to recapture.

Example. In 1993, you had a net section 1231 loss of \$2,500. For tax years 1995 and 1996, you had net section 1231 gains of \$1,800 and \$2,000, respectively. In 1991, 1992, and 1994, you had no section 1231 gains or losses. In figuring taxable income for 1995, you treated your net section 1231 gain of \$1,800 as ordinary income by recapturing \$1,800 of your \$2,500 net section 1231 loss. For 1996, you apply your remaining \$700 net section 1231 loss (\$2,500 – \$1,800) against your net section 1231 gain of \$2,000. For 1996, you report \$700 as ordinary income and \$1,300 (\$2,000 – \$700) as long-term capital gain.

Depreciation Recapture on Personal Property

A gain on the disposition of section 1245 property is treated as ordinary income to the extent of depreciation allowed or allowable. See *Treatment of gain*, later.

Section 1245 property. This includes any property that is or has been subject to an allowance for depreciation or amortization and that is:

- 1) Personal property (either tangible or intangible),
- 2) Other tangible property (except buildings and their structural components) used as:
 - a) An integral part of manufacturing, production, or extraction or of furnishing transportation, communications, electricity, gas, water, or sewage disposal services,
 - b) A research facility in any of the activities in (a) above, or
 - 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)) having an adjusted basis that was 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 expenditures), or a section 179 deduction,
- 4) Single purpose agricultural (livestock) or horticultural structures, or
- 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.

A structure that is essentially machinery or equipment is not considered a building or structural component. Also, a structure that houses property used as an integral part of an activity is not considered a building or structural component if the structure's use is so closely related to the use of the property 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 the fact that the structure cannot be used economically for other purposes indicate that it is closely related to the use of the property it houses. Thus, 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. To be fungible, a commodity must be such that one part may be used in place of another. Bulk storage means storage of a commodity in a large mass before it is used. Thus, if a facility is used to store oranges that have been sorted and boxed, it is not used for bulk storage.

Treatment of gain. The amount of gain treated as ordinary income on the sale, exchange, or involuntary conversion of section 1245 property, including a sale and leaseback transaction, is limited to the **lower** of:

- 1) The depreciation and amortization allowed or allowable on the property (the recomputed basis of the property minus the adjusted basis of the property), or
- 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 lower of (1) above or the amount by which its fair market value exceeds its adjusted basis. See *Other Dispositions*, in chapter 4 of Publication 544.

Recomputed basis. The recomputed basis of your section 1245 property is the total of its adjusted basis plus depreciation and amortization adjustments (allowed or allowable) reflected in the adjusted basis. These include adjustments:

- 1) On property you exchanged for, or converted to, your section 1245 property in a like-kind exchange or involuntary conversion, and
- 2) Allowed or allowable to a previous owner, if your basis is determined with reference to that person's adjusted basis.

Property received in an exchange or conversion. If you received property in a like-kind exchange or involuntary conversion, the recomputed basis of that property includes a depreciation or amortization adjustment allowed or allowable on the old property you exchanged or converted. This adjustment is reduced by any gain you recognized on the exchange or conversion of the old property.

Property received as a gift. If you received property as a gift, the recomputed basis includes any depreciation or amortization adjustments allowed or allowable to the donor for that property.

Depreciation and amortization. Depreciation and amortization that must be recaptured as ordinary income include (but are not limited to) the following items:

- 1) Ordinary depreciation deductions;
- 2) Amortization deductions for—
 - a) The cost of acquiring a lease,
 - b) The cost of lessee improvements,

- c) Pollution control facilities,
 - d) Reforestation expenses,
 - e) Section 197 intangibles,
 - f) Child care facility expenditures made before 1982, and
 - g) Franchises, trademarks, and trade names acquired before August 10, 1993;
- 3) The section 179 expense deduction;
 - 4) Deductions for—
 - a) The cost of removing barriers to the disabled and the elderly,
 - b) Tertiary injectant expenses, and
 - c) Depreciable clean-fuel vehicles and refueling property (less the amount of any recaptured deduction);
 - 5) The amount of any basis reduction for the investment credit (less the amount of any basis increase for any credit recapture); and
 - 6) The amount of any basis reduction for qualified electric vehicle credit (less the amount of any basis increase for credit recapture).

Example. You file your returns on a calendar year basis. In February 1994, you purchased 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 1994 and \$2,550 in 1995. You did not take the section 179 deduction on it. You sold the truck in May 1996 for \$7,000. The MACRS deduction in 1996, the year of sale, is \$893 (1/2 of \$1,785). Your adjusted basis is \$5,057 (\$10,000 minus \$4,943). Your recomputed basis is \$10,000 (\$5,057 plus \$4,943). The amount you treat as ordinary income is the **lower** of the following:

- 1) Recomputed basis (\$10,000) minus the adjusted basis (\$5,057), or \$4,943, **or**
- 2) Amount realized (\$7,000) minus the adjusted basis (\$5,057), or \$1,943.

The lower of these two amounts, \$1,943, is the amount of gain treated as ordinary income. Figure this amount in Part III, Form 4797.

Depreciation allowed or allowable. The greater of the depreciation allowed or allowable is generally the amount to use in 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 gain is treated as ordinary income under the rules for section 1245 depreciation recapture.

Section 1231 gain. Any gain recognized that is more than the part that is ordinary income because of depreciation is a section 1231 gain. See *Treatment of gains and losses* under *Section 1231 Property*, earlier.

Disposition of plants and animals. If you made the election not to apply the uniform capitalization rules, you must treat any plant or animal (if the animals were produced in 1987 or 1988) that you produce as section 1245 property. Further, you must “**recapture**” the **preproductive expenses** that you would have capitalized if you had not made the election by treating these expenses as ordinary income when you determine your gain on selling or disposing of the property. For plants that are section 1231 property, show these expenses as depreciation on line 24, Part III, of Form 4797. For plant sales that are reported on Schedule F (Form 1040), this recapture rule does not change the reporting of income because the gain is already ordinary income. To figure the amount of these expenses, you may use the farm-price method or the unit-livestock-price method discussed in chapter 3.

Example. Janet Maple sold her apple orchard in 1996 for \$80,000. Her adjusted basis at the time of sale was \$60,000. She purchased the orchard in 1989, but the trees did not produce a crop until 1992. Her preproductive expenses were \$6,000. She elected not to apply the uniform capitalization rules. Janet must treat the \$6,000 preproductive expenses as ordinary income when figuring the gain on the sale.

Livestock costs incurred before 1989. For livestock costs incurred before 1989, the IRS provided two safe-harbor elections. These safe-harbor elections were not available to corporations, partnerships, or tax shelters that were required to use an accrual method of accounting. For information on these elections, see Notice 88–24 in the Internal Revenue Cumulative Bulletin 1988–1 on page 491 and Notice 88–113 modifying Notice 88–24 in Cumulative Bulletin 1988–2 on page 448.

For information on the uniform capitalization rules, see chapter 7.

Tax-free exchange or involuntary conversions. Special rules apply to property received as a gift or by transfer at death, and to property received in certain distributions and tax-free exchanges. Additional information on these subjects may be found under *Other Dispositions* in chapter 4 of Publication 544.

Use **Part III of Form 4797**, to report gain from the sale, exchange, or involuntary conversion of section 1245 property.

Depreciation Recapture on Real Property

A 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.

Section 1250 property. This includes all real property that is subject to an allowance for depreciation and that is not and never has been section 1245 property. It includes a leasehold of land or section 1250 property that is subject to an allowance for depreciation. A fee simple interest in land is not section 1250 property because it is not depreciable.

The ordinary income rules for dispositions of section 1250 property do not apply if:

- 1) You figured depreciation for the property using the straight line method or any other method that does not result in depreciation that is more than the amount figured by the straight line method, and you have held the property more than a year,
- 2) You realize a loss on the sale, exchange, or involuntary conversion of the property,
- 3) 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, or
- 4) You dispose of residential rental property or nonresidential real property placed in service after 1986 (or after July 31, 1986, if the election 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 is treated as ordinary income, follow these steps:

- 1) In a sale, exchange, or involuntary conversion of the property, figure the excess of the amount realized over the adjusted basis of the property (in any other disposition of the property, figure the excess of fair market value over adjusted basis).
- 2) Figure the additional depreciation for the periods after 1975.
- 3) Multiply the smaller 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 that is 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 smaller of (4) or (5) to the result in (3). This is the gain that is treated as ordinary income because of additional depreciation.

Use Part III, Form 4797, to figure the ordinary income part of section 1250 gain.

Additional depreciation. If you hold section 1250 property longer than 1 year, the additional depreciation is the excess of actual depreciation adjustments over the depreciation figured using the straight line method. For a list of items treated as depreciation adjustments,

(see *Depreciation and amortization* under *Depreciation Recapture on Personal Property*, earlier).

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.

If you hold section 1250 property for 1 year or less, all of the depreciation is additional depreciation.

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 elect 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 carry-over basis property).

Depreciation allowed or allowable. 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) is generally the amount to use in figuring the part of the gain to be reported as ordinary income. If you can show that the deduction allowed for any tax year was less than the amount allowable, the smaller figure will be the depreciation adjustment for figuring additional depreciation.

Applicable percentage. The applicable percentage used to figure the amount taxable as 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 4 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 applicable percentage is zero and no ordinary income will result on its disposition because of additional depreciation 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 applicable percentage for periods after 1975 is 100%. For residential rental property, the applicable percentage for periods before 1976 is zero. Therefore, no ordinary income will result from a disposition of residential rental property because of additional depreciation before 1976.

Like-kind exchange or involuntary conversion. Even though your disposition may not otherwise be taxable, you may be subject to tax on a like-kind exchange or an involuntary conversion of your property. For example,

even though you postpone paying tax, a limited amount of the gain from additional depreciation may be taxed. For information on these limits, see *Like-Kind Exchanges and Involuntary Conversions* in chapter 4 of Publication 544.

More information. For more information about depreciation recapture on section 1250 property, see chapter 4 of Publication 544.

Recapture on Installment Sales

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. Any depreciation recapture income must be reported in the year of sale before using the installment method for any remaining gain.

For a detailed discussion of installment sales, get Publication 537.

Other Farm Property

This section discusses gain on the disposition of farm land for which you were allowed deductions for:

- 1) Soil and water conservation expenditures (section 1252 property), and
- 2) Property for which you were allowed to exclude from income certain cost sharing payments (section 1255 property).

Farm land (under section 1252). 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 expenditures discussed in chapter 6, you must treat part of the gain as ordinary income and treat the balance as section 1231 gain.

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

- 1) The total amount of deductions allowed for soil and water conservation expenditures multiplied by the applicable percentage, discussed below, or
- 2) Your gain (the result of subtracting the adjusted basis from the amount realized from a sale, exchange, or involuntary conversion, or the fair market value for all other dispositions).

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 applicable percentage is 100%. If you dispose of the land within 6 to 9 years after you got it, the applicable percentage is reduced by 20% a year for each year you hold the land after the 5th year. If you dispose of the land 10 years or more after you got it, the applicable percentage is zero (0), and the entire amount of the gain is a section 1231 gain.

Example. You acquired farm land on January 19, 1989. On October 3, 1996, you sold the land at a \$30,000 gain. Between January 1 and October 3, 1996, you make soil and water conservation expenditures of \$15,000 that are fully deductible in 1996. The applicable percentage is 40% since you sold the land within the 8th year after you got it. Thus, 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 that you exclude from income (discussed in chapter 4) and you have a gain on the disposition of the property, you may have to treat part of the gain as ordinary income and treat the balance as a section 1231 gain. If you elected 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:

- 1) The applicable percentage of the total excluded cost-sharing payments, or
- 2) 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 Code section.

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 portion of a gain from the sale, exchange, or involuntary conversion of section 1252 property and section 1255 property.

12.

Installment Sales

Introduction

Certain sales are made under an arrangement that provides for part or all of the selling price to be paid in a later year. These sales are called "installment sales."

The buyer's "installment obligation" to make future payments to you can be in the form of a contract for deed, deed of trust, note, land contract, mortgage, or other evidence of the buyer's debt to you. The rules discussed in this chapter apply regardless of the form of the installment obligation.

Topics

This chapter discusses:

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

Useful Items

You may want to see:

Publication

- 523** Selling Your Home
- 537** Installment Sales

Form (and Instructions)

- 6252** Installment Sale Income

See chapter 21 for information about getting these publications and the form.

Installment Method

An installment sale is a sale of property, except for inventory, where one or more payments are received after the close of the tax year of the sale. However, a cash basis 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, 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.*

You generally report your gain on an installment sale as you actually receive payment. Each payment consists of three parts:

- 1) Interest.
- 2) Return of adjusted basis.
- 3) Gain on the sale.

You are taxed only on the part of each payment that represents interest and your gain on the sale. In this way, the installment method of reporting income relieves you of paying tax on income you have not yet collected. However, when reporting a sale of depreciable property, you must include any depreciation or amortization recapture income (up to the amount of gain) in income for the year of the sale. Any remaining gain can be reported 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, you can 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, you generally have a gain or loss to report. The gain or loss is considered to be gain or loss on the sale of the property for which you received the installment obligation. If this takes place during the year of sale, report your entire gain on your return for that year. You do not have an installment sale. If it 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 other than 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 it is canceled. (A reduction in the selling price changes the gross profit and gross profit percentage.)

Transfer due to death. The transfer of an installment obligation (other than to the buyer) as a result of the death of the seller (or other holder of the obligation) 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. This means 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 if the seller had lived to receive the payments.

However, if the installment obligation is canceled, becomes unenforceable, or is transferred to the buyer, it is treated as a disposition of the obligation. 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, even if you are paid in later years. However, if you are a cash basis farmer and 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 a definition of farm inventory, see *Farm Inventory* in chapter 3.

If inventory items are included in an installment sale, you may have an agreement with the buyer concerning 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. You are required to use the installment method to report an installment sale unless you elect not to use that method. If you make the election, you generally report the entire gain in the year of sale, even though you will not be paid all of the selling price in that year. You then do not report any gain from the payments you receive in later years.

If you make this choice, do not report your sale on Form 6252. Instead, report it on Schedule D (Form 1040) or Form 4797, whichever applies.

When to elect out. Generally, you must 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.

You may qualify for an automatic extension of six months from the due date of the return, **excluding extensions**, to make this election. See Revenue Procedure 92-85 for more information. You can read the full text of this revenue procedure at some IRS offices and public libraries.

More information. See *Electing Out of Installment Method* in Publication 537 for more information on electing out of the installment method.



You must continue to report the interest income on payments you receive for subsequent years.

Figuring Installment Income

Each year you receive a payment, you 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 in the property. 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. The following worksheet shows how 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) Gross profit percentage (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 the property subject to. The debt could be a note, mortgage, or any other liability, such as a lien, accrued interest, or taxes you owe on the property. If the buyer pays any of your selling expenses for you, that amount is also included in the selling price. The selling price does not include interest, whether stated or unstated.

Installment sale basis. The adjusted basis plus selling expenses and depreciation recapture income is referred to in this chapter as the installment sale basis.

Adjusted basis. Basis is a way of measuring your investment in the property you are selling. It is defined and discussed in chapter 7. The way you figure basis depends on how you first acquired the property. The basis of property purchased is often its cost to you. The basis of property you inherited, received as a gift, built yourself, or received in a tax-free exchange is figured differently.

While you own personal-use property, various events may change your original basis in the property. Some events, such as adding rooms or making permanent improvements, increase basis. Others, such as damage from deductible casualty losses or depreciation allowed or allowable, decrease basis. The result is adjusted basis.

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

Depreciation recapture. If you took depreciation deductions on the asset, part of the gain on the sale of the asset may be recaptured as ordinary income. See *Sale of depreciable property* later.

Gross profit. For an installment sale, 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 postpone or exclude.

Contract price. The contract price is the total of all principal payments you are to receive on the installment sale. It includes payments you are considered to receive, even though you are not paid anything directly. 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 equals the selling price.

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 from the sale 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. The property has an adjusted basis of \$150,000. Your gross profit is \$50,000. Your gross profit percentage is 25% ($\$50,000 \div \$200,000$). Therefore, 25% of each principal payment, including the down payment, is reported as your gain from the sale for the tax year the payment is received.

Amount to include in income. Each year you receive a payment on the installment sale, multiply the payment (less interest) by the gross profit percentage to determine the amount you must include in income for the tax year.

Sale of depreciable property. You cannot use the installment method to report any depreciation recapture income up to the gain on the sale. Any remaining gain can be reported on the installment method.

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.

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 15 in Publication 535. For more information on depreciation recapture, see *Depreciation Recapture on Personal Property and Depreciation Recapture on Real Property* 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 your gross profit percentage for the remaining payments. Refigure your gross profit using the reduced sale price. Then subtract gain already reported and spread the remaining gain evenly over the remaining installments. You cannot go back and refigure the gain you reported in earlier years.

Example. In 1994, 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 1995. Your gross profit percentage is 60%. You reported a gain of \$12,000 on each payment received in 1994 and 1995. In 1996, you and the buyer agreed to reduce the purchase price to \$85,000 and the payments for 1996, 1997, and 1998 are reduced to \$15,000 for each year.

The new gross profit percentage, 46.67%, is figured as follows. You will report a gain of \$7,000 on each of the \$15,000 installments due in 1996, 1997, and 1998.

| | | |
|--|----------|----------|
| 1) Reduced selling price | \$85,000 | |
| 2) Minus: Basis | 40,000 | |
| 3) Adjusted gross profit | \$45,000 | |
| 4) Minus: Gain reported in 1994 & 1995 | 24,000 | |
| 5) Gain to be reported..... | \$21,000 | |
| 6) Selling price to be received: | | |
| Reduced selling price | \$85,000 | |
| Minus: Payments | | |
| received in 1994 and | | |
| 1995 | 40,000 | \$45,000 |
| 7) New gross profit percentage | | |
| (line 5 ÷ line 6) | | 46.67% |

Sale to related person. Special rules apply to an installment sale between related persons. 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 *Sale to Related Person* in Publication 537.

Trading for like-kind property. If you trade business or investment property for the same kind of property, you can postpone reporting part of the gain. See *Nontaxable 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 fair market value 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.

Payments Received

You must figure your gain each year on the payments you receive, or are treated as receiving, from an installment sale. These payments 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 arise if the buyer assumes or pays any of

your debts, such as a loan, or pays any of your expenses, such as a sales commission.

Buyer assumes expenses. If the buyer assumes and pays any of your expenses related to the sale 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.

Mortgage assumed. 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 in the property, it is not considered a payment to you. The contract price equals the selling price minus the mortgage. This difference is all 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 in the property, you recover your entire basis. You are also relieved of the obligation to repay the amount borrowed. The part of the mortgage greater than your basis is treated as a payment received in the year of sale. This is in addition to the buyer's other payments.

To figure the contract price, subtract the mortgage from the selling price. This is the total you will actually 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 assumes 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 treated as a payment received in the year of sale. The contract price is \$4,000:

| | | |
|-----------------------------------|----------|-----------------|
| Selling price | \$ 9,000 | |
| Minus: Mortgage | (6,000) | |
| Amount actually received | \$ 3,000 | |
| Add difference: | | |
| Mortgage | 6,000 | |
| Less installment sale basis | 5,000 | 1,000 |
| Contract price | | <u>\$ 4,000</u> |

Your gross profit on the sale is also \$4,000:

| | |
|-------------------------------------|----------------|
| Selling price | \$9,000 |
| Minus: Installment sale basis | (5,000) |
| Gross profit | <u>\$4,000</u> |

Your gross profit percentage is 100%. Report 100% of each payment as gain from the sale. You also 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.

Debts paid by buyer. If the buyer pays any of your debts, such as a loan or back taxes, it may be considered a payment to you in the year of sale.

If the buyer assumes the debt instead of paying it off, only part of it may have to be treated as a payment. Compare the debt to your installment sale basis in the property being sold. If the debt is less than your installment sale basis, none of it is treated as a payment. If it is more, only the difference is treated as a payment. If the buyer assumes more than one debt, any part of the total that is more than your installment sale basis is considered a payment. These rules are the same as the rules discussed earlier under *Mortgage assumed*. However, they apply to only two types of debts the buyer assumes:

- 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 your business, such as a balance due for inventory you purchased.

If the buyer assumes any other type of debt, such as a personal loan, it is treated as if the buyer had paid off the debt at the time of the sale. The value of the assumed debt is 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*, discussed earlier. The value of the payment is the property's fair market value on the date you receive it.

Fair market value. This is the price at which property would change hands between a buyer and a seller, neither being required to buy or sell, and both having reasonable knowledge of all the necessary facts. If your installment sale fits this description, value assigned to property in your agreement with the buyer is good evidence of its fair market value.

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 fair market value. Because the note is itself a payment on your installment sale, any payments you later receive from the third party are not considered payments on 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% note of a third party. The fair market value 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 a fair market value equal to 60% of its face value (\$3,000 ÷ \$5,000), 60% of each payment of principal you receive on this note is a return of capital. The remaining 40% is ordinary income. The interest you receive is reported in full 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 fair market value. Accrual basis taxpayers, see Regulations section 15A.453-1(e)(2).

Buyer's note. The buyer's note (unless payable on demand) is not considered payment on the sale. Its full face value is included when figuring the selling price and the contract price. Payments you receive on the note are reported on the installment method.

Guarantee. If a third party or government agency guarantees the buyer's payments to you on an installment obligation, the guarantee itself is not considered payment.

Deposit. A deposit you receive before the year of sale is treated as a payment in the year of sale if, under the contract, it becomes part of the down payment.

Unstated interest. An installment sale agreement generally provides that each deferred payment on the sale will include interest or that there will be an interest payment in addition to the principal payment. Interest provided in the contract is called **stated interest**.

If an installment sale with some or all payments due more than one year after the date of sale does not provide for interest, part of each payment due more than 6 months after the date of sale will 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 any interest figured at the rate specified in the sales contract.

The applicable federal rates are published monthly in the Internal Revenue Bulletin. You can get this information by contacting an IRS office.

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 substantially all of the use of which by the buyer is not in a trade or business or an investment activity.

Unstated interest reduces the stated selling price of the property. It also increases the seller's interest income and the buyer's interest expense.

More information. For more information, see *Unstated Interest* 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 and personal property that can be reported on the installment method. It may also include the sale of farm inventory, which cannot be reported on the installment sale 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 capital asset or property used in the business, and by the length of time held. 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, 1996, you sold your farm, including the equipment and livestock (cattle used for breeding), for a lump-sum price. 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 July 1 and January 1. 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 |

* 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 1995 in anticipation of selling the farm. There was no section 179 deduction claimed on any asset.

| | Selling Price | Selling Expense | Adjusted Basis | Gain |
|-----------|------------------|------------------|------------------|------------------|
| Home | \$ 50,000 | \$ 2,500 | \$ 30,000 | \$ 17,500 |
| Farm | | | | |
| 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 |
| Equipment | 7,000 | 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> |

* 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.

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 can be 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 gain of \$2,727 is depreciation recapture income to the extent of the depreciation claimed (\$1,977). The remaining gain of \$750 can be 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 on the cattle of \$18,167 is less than the depreciation claimed (\$19,167), the total gain is depreciation recapture income.

The total depreciation recapture income reported in Part II of Form 4797 is \$42,767. (This is the sum of: \$3,001 + \$18,167 + \$6,961 + \$12,661 + \$1,977.) Depreciation recapture income is reported as ordinary income in the year of sale.

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

Assets not reported on 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. Their selling price (\$60,000) is subtracted from the total

selling price (\$300,000). The selling price for the assets included in the installment sale is \$240,000.

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.

| | Installment | | Gross Profit |
|-----------|------------------|------------------|------------------|
| | Selling Price | Sale Basis | |
| Home | \$ 50,000 | \$ 32,500 | \$ 17,500 |
| 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>\$240,000</u> | <u>\$140,250</u> | <u>\$ 99,750</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 as section 1231 property. The \$750 gain on their sale is reported as ordinary income as payments are received. See chapter 11 for the definition of section 1231 property.

Contract price and gross profit percentage. The contract price is \$190,000 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 (\$60,000).

Gross profit percentage for the sale is 52.5% (\$99,750 gross profit ÷ \$190,000 contract price). The gross profit percentage for each asset is figured as follows:

| | % |
|----------------------------------|----------------|
| Home (\$17,500 ÷ \$190,000) | 9.2105 |
| Farm land (\$57,500 ÷ \$190,000) | 30.2632 |
| Buildings (\$23,750 ÷ \$190,000) | 12.5000 |
| Truck (\$250 ÷ \$190,000) | 0.1316 |
| Cattle* (\$750 ÷ \$190,000) | 0.3947 |
| Total | <u>52.5000</u> |

* Held less than 2 years

Figuring the gain to report on the installment method. Only 76% of each payment is reported on the installment method [\$190,000 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 1996 is \$75,000 (\$50,000 down payment + \$25,000 payment on July 1). The installment sale part of the total 1996 payments is \$57,000 (\$75,000 × .76). Figure the gain to report for

each asset by multiplying its gross profit percentage times \$57,000.

| | Income |
|-----------------------------------|-----------------|
| Home—9.2105% × \$57,000 | \$ 5,250 |
| Farm land—30.2632% × \$57,000 | 17,250 |
| Buildings—12.5% × \$57,000 | 7,125 |
| Truck—0.1316% × \$57,000 | 75 |
| Cattle*—0.3947% × \$57,000 | 225 |
| Total installment income for 1996 | <u>\$29,925</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.

Gain on home. Enter the \$5,250 gain on the sale of your home on Schedule D as a long-term capital gain unless you can postpone or exclude the gain. See *Your personal residence* in chapter 10.

Section 1231 gains. The gains on the land, buildings, and truck are section 1231 gain and may be reported as capital or ordinary gain when combined with certain other gains and losses.

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 1996. You figure installment income for the years after 1996 by applying the same gross profit percentages to the payments you receive each year. If you receive \$50,000 during the year, \$38,000 is considered received on the installment sale (76% × \$50,000). You realize income as follows:

| | Income |
|-------------------------------|-----------------|
| Home—9.2105% × \$38,000 | \$ 3,500 |
| Farm land—30.2632% × \$38,000 | 11,500 |
| Buildings—12.5% × \$38,000 | 4,750 |
| Truck—0.1316% × \$38,000 | 50 |
| Cattle*—0.3947% × \$38,000 | 150 |
| Total installment income | <u>\$19,950</u> |

* Held less than 2 years

For each year you receive payments on the sale, you will report the gain on the sale of your home as long-term capital gain unless you can postpone or exclude it. You will report the gain on cattle held less than 2 years as ordinary income. You will combine your section 1231 gains with certain other gains and 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 | \$240,000 |
| Minus: Installment basis | 140,250 |
| Gross profit | <u>\$ 99,750</u> |
| | |
| Gain reported in 1996 (year of sale) | \$ 29,925 |
| Gain reported in 1997: | |
| \$38,000 × 52.50% | 19,950 |
| Gain reported in 1998: | |
| \$38,000 × 52.50% | 19,950 |
| Gain reported in 1999: | |
| \$38,000 × 52.50% | 19,950 |
| Gain reported in 2000: | |
| \$19,000 × 52.50% | 9,975 |
| | <u>\$ 99,750</u> |

- Postponing gain
- Reporting gains and losses

Useful Items

You may want to see:

Publication

- 536** Net Operating Losses
- 544** Sales and Other Dispositions of Assets
- 547** Casualties, Disasters, and Thefts (Business and Nonbusiness)

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 these publications and forms.

13.

Casualties, Thefts, and Condemnations

Important Change

Business or income-producing property located in a federal disaster area. A special rule applies to property you acquire to replace destroyed business or income-producing property that was located in a federal disaster area. For details, see *Replacement Property* under *Postponing Gain*, later.

Introduction

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.

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, you can postpone recognition of the gain on your income tax return if you receive or buy qualified replacement property within the specified replacement period. For more information, see *Postponing Gain*, later.

Topics

This chapter discusses:

- Casualties and thefts
- How to figure gain or loss
- Other involuntary conversions

Casualties and Thefts

If your property is destroyed, damaged, or stolen, you may have a deductible loss. If the insurance or other reimbursement is more than the adjusted basis of the destroyed, damaged, or stolen property, you have a gain.

Casualty. A casualty is the damage, destruction, or loss of property resulting from an identifiable event that is sudden, unexpected, or unusual.

Events that may cause casualty damage, destruction, or loss include:

- 1) Fire, flood, storm, lightning, freezing, earthquake, shipwreck, airplane crash, hurricane, and similar occurrences.
- 2) Car or truck accidents not resulting from your willful act or negligence.

Gradual deterioration. Damage from gradual or progressive deterioration, such as from rust, corrosion, or termites, is not a casualty. However, drought or disease may cause another type of involuntary conversion. See *Other Involuntary Conversions*, later.

Theft. A theft is the unlawful taking and removing of money or property with the intent to deprive the owner of it. It includes larceny, robbery, and embezzlement. Misrepresentation, however, is not a theft.

Example. You bought a farm. The seller assured you that a well produced adequate water, but the well went dry after you took possession. You do not have a deductible theft loss.

Farming Losses

Certain casualty or theft losses that occur in the business of farming are deductible losses. The following is a discussion of some losses you can deduct and some you cannot deduct.

Livestock or produce purchased for sale.

Losses of livestock or produce bought for sale are deductible if you report your income on the cash method. If you report 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 on the cash method. You have already deducted 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 on an accrual method, a casualty or theft loss is 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 deduction.

Damage to crops. Damages to crops, whether or not covered by insurance, are not deductible as casualty losses. These damages are losses of anticipated income. The costs of raising the damaged crops are deductible as business expenses.

Losses from death of tree seedlings. If, because of an abnormal drought, the failure of planted tree seedlings is greater than normally anticipated, you may have a deductible casualty loss. The loss equals the previously capitalized reforestation costs you had to duplicate on replanting. You deduct the loss the year the seedlings died.

Income loss. A loss of future profits is not deductible. For example, if an ice storm damages standing timber and reduces its rate of growth or the quality of future timber, the loss is not deductible. To qualify as a casualty, the damage must cause existing timber to be unfit for use.

Loss of timber. If you sell timber downed by 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 the 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*, discussed later.

Raised draft, breeding, dairy, or sporting animals. Losses of raised draft, breeding, dairy, or sporting animals do not result in deductible casualty or theft losses, unless you use inventories to determine your income and you included the animals in your inventory. If you do not use inventories and you deducted the cost of raising the livestock, the livestock has no cost or other basis for income tax purposes. However, if you did not elect out of the capitalization rules, you may still have a tax basis in the livestock.

When you include livestock in inventory, its last inventory value is its basis. This is true of both raised and purchased inventoried animals. When an inventoried animal held for draft, breeding, dairy, or sport is lost by casualty or theft during the year, decrease your inventory at the beginning of the year by the value at which you included the animal in inventory. Use this inventory value, the basis of the animal, to determine the amount of your gain or loss. See Schedule D (Form 1040) or Form 4797.

Losses of Personal Use Property

Casualty and theft losses of property held for personal use may be deductible on your federal income tax return, if you itemize deductions on Schedule A (Form 1040).

\$100 rule. You cannot deduct the first \$100 of loss from a casualty or theft of personal-use property. This \$100 rule applies after you have subtracted any reimbursement. It applies to **each** casualty or theft occurring during your tax year.

10% rule. You can deduct casualty or theft losses of personal-use property only to the extent your total of these losses during the year is greater than 10% of your adjusted gross income. This is the amount on line 31 of Form 1040. You must reduce each separate casualty or theft loss by \$100 before applying this rule.

Example. In June, you discovered that your house was burglarized. This was your only casualty or theft loss during the year. Your theft loss after insurance reimbursement was \$2,000. Your adjusted gross income was \$29,500. To figure your deduction, first apply the \$100 rule and then the 10% rule. Your loss after applying the \$100 rule is \$1,900 (\$2,000 – \$100). After you apply the 10% rule, you do not have a casualty or theft loss deduction because your loss (\$1,900) is less than 10% of your adjusted gross income (\$2,950).



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.

Items not included with deductible losses.

The following are not deductible as casualty or theft losses of personal-use property:

- 1) Expenses related to a casualty or theft of property, such as temporary housing, car rental, lights and fuel, or moving expenses. (However, if the expense is related to your business, it may be a deductible business expense.)
- 2) Cost of repairing, replacing, or cleaning up after a casualty. See *Repair costs*, discussed later.
- 3) Expenses because of injury to yourself or other persons.
- 4) Loss from mislaid cash or property.
- 5) Damage by rust or erosion.

How To Figure a Loss

How you figure the deductible casualty loss depends on whether the loss was to business or personal-use property and whether the property was partly or completely destroyed.

Business property partly destroyed. The amount of a casualty loss of farm business property partly destroyed is figured as follows:

- 1) Determine the difference between the fair market value of the property immediately before the casualty and the fair market value immediately after the casualty. Fair market value is explained in chapter 12.
- 2) If the amount in (1) is less than the adjusted basis of your property at the time of the casualty, subtract any insurance or other reimbursement from that amount, and the balance is your casualty loss. See chapter 7 for an explanation of adjusted basis.
- 3) If, the amount in (1) is more than the adjusted basis of your property, subtract the insurance or other reimbursement from your adjusted basis, and the balance is your casualty loss.

Example. A fire on your farm damaged a tractor and the barn in which it was stored. The tractor had an adjusted basis of \$3,300, and was worth \$2,800 just before the fire and \$1,000 immediately afterward. The barn had an adjusted basis of \$8,000, and was worth \$25,000 just before the fire and \$15,000 immediately afterward. You received insurance of \$600 on the tractor and \$6,000 on the barn. Figure your deductible casualty loss separately for the two items of property.

| | <u>Tractor</u> | <u>Barn</u> |
|--|----------------|-----------------|
| 1) Adjusted basis | \$3,300 | \$ 8,000 |
| 2) Value before fire | \$2,800 | \$25,000 |
| 3) Value after fire | 1,000 | 15,000 |
| 4) Decrease in value (2 minus 3) | \$1,800 | \$10,000 |
| 5) Loss (lesser of 1 or 4) | \$1,800 | \$ 8,000 |
| 6) Minus: Insurance | 600 | 6,000 |
| 7) Deductible casualty loss | <u>\$1,200</u> | <u>\$ 2,000</u> |

Because these assets were only partly destroyed, the lower of adjusted basis or the decrease in value for the tractor and barn is the amount used before the adjustment for insurance. For the partial or complete destruction of crops or livestock, the loss would have been figured the same way as it was figured for your farm business property, but only if it is a deductible loss.

Business property completely destroyed.

If your business property is completely destroyed or stolen, your casualty loss is the adjusted basis of your property minus any salvage value and insurance or other reimbursement you receive or expect to receive. This is true even though the fair market value of your property before the loss was less than its adjusted basis.

Separate losses. When a loss occurs to farm property, make a separate computation for each identifiable item of property. If damage occurs to a farm building and to an orchard, both of which are part of the same realty, determine the loss in value by taking them into account separately.

Personal-use real property. In figuring the loss to personal-use real property and improvements, consider all the improvements, such as buildings and ornamental trees, as part of one property, and figure only a single loss for the one property.

Figure your casualty or theft loss by subtracting any insurance or other reimbursement you receive or expect to receive from the smaller of:

- 1) The decrease in the fair market value of the property as a result of the casualty or theft, or
- 2) Your adjusted basis in the property before the casualty or theft.

The decrease in fair market value is the difference between the property's value immediately before the casualty or theft and its value immediately afterwards. Fair market value is defined in chapter 12. Basis is the measurement, for tax purposes, of your investment in the property. Basis is discussed in chapter 7.

Example. You bought a farm in 1958 for \$20,000. The adjusted basis of the residential part is \$6,000. In 1996, a windstorm blew down shade trees and three ornamental trees planted at a cost of \$600 on the residential part. The fair market value of the residential part immediately before the storm was \$30,000, and \$26,000 immediately after the storm. Your adjusted gross income for 1996 is \$20,000. The trees were not covered by insurance.

| | |
|--|-----------------|
| 1) Adjusted basis | \$ 6,000 |
| 2) Value before the storm | \$30,000 |
| 3) Value after the storm | 26,000 |
| 4) Decrease in value (2 minus 3) | <u>\$ 4,000</u> |
| 5) Amount of loss (lesser of 1 or 4) | \$ 4,000 |
| 6) Minus: Insurance | -0- |
| 7) Loss after reimbursement | \$ 4,000 |
| 8) Minus: \$100 | 100 |
| 9) Loss after \$100 rule | \$ 3,900 |
| 10) Minus: 10% of \$20,000 | <u>2,000</u> |
| 11) Deductible loss | <u>\$ 1,900</u> |

Personal property owned for personal use.

Personal property is generally any property that is not real property. If your personal property is stolen or is damaged or destroyed by a casualty, you must figure your loss separately for each item of property.

Repair costs. You can use the cost of cleaning up and making repairs after a casualty as a measure of the decrease in value of the property if:

- 1) They are needed to restore the property to its condition before the casualty,
- 2) The cost of repairs is not excessive,
- 3) They only take care of the damage, and
- 4) The value of the property after repairs is no more than its value before the casualty.

The cost of debris removal can be used, like the cost of repairs, as evidence of the amount of the casualty loss if these conditions are satisfied.

Adjustments to basis. If your property is partly or totally destroyed by casualty and you are compensated for the loss by insurance or other reimbursement, decrease the basis of the property by the insurance or other reimbursement received. The insurance or reimbursement represents a return of part or all of the capital you invested in the property.

If a casualty to property results in a deductible loss, in addition to decreasing its basis by the insurance, also decrease the basis by the deductible loss. Increase the basis by any amounts spent to rebuild or restore the property.

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, see *Disaster area losses*, later.

Leased property. If you lease property from someone else, you can deduct a loss on the property in the year the liability is fixed, not the year it is paid. You are not entitled to a deduction until your liability under the lease is ascertainable with reasonable accuracy. This could include a settlement, adjudication, or abandonment of the claim.

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.

Reimbursements. If you have a reasonable prospect of being reimbursed for part or all of your loss, subtract the expected reimbursement to figure your loss. Reduce your loss even if you do not receive payment until a later tax year. If you later receive less than the amount expected, you can deduct the difference when you determine that you cannot reasonably expect any more reimbursement.

Example. A collision with another car in 1995 completely destroyed your personal car. The negligence of the other driver caused the accident. Your car had a fair market value of \$2,000. At the end of the year, there was a reasonable prospect that you would recover the total damages from the owner of the other car. You do not have a deductible loss for 1995. In January 1996, the court awards you a judgment of \$2,000. In July 1996, you can show with reasonable certainty that the other driver is totally without funds. You can claim a loss in 1996 of \$2,000 reduced by \$100 and 10% of your 1996 adjusted gross income.

Reimbursement in a later year. If you receive more reimbursement than expected after deducting the loss in an earlier year, include the extra reimbursement in your income in the year you receive it. However, if any part of the deduction did not reduce your tax for the earlier year, do not include the extra reimbursement for that part of your deduction. Do not refigure your tax for the year you claimed the deduction.

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.

Disaster area losses. If you have a deductible loss from a disaster in an area declared by the President of the United States to be eligible for federal disaster assistance, you can choose to deduct that loss on your return or amended return for the immediately **preceding tax year**. If you do this, consider this loss as occurring in the preceding year.

Make the election to deduct the loss in the preceding year by the later of:

- 1) The due date (without extensions) of your tax return for the year the disaster occurred, or
- 2) The due date (with extensions) of the preceding year's return.

Disaster losses to your main home. If your main home or any of its contents were damaged as a result of a disaster in an area declared by the President of the United States to be eligible for federal disaster assistance:

- 1) You do not recognize gain from insurance proceeds for unscheduled personal property that was part of the contents of your damaged home.
- 2) You can treat any other insurance proceeds for your damaged home or its contents as a common pool of funds. If this pool of funds is used to purchase property similar or related in service or use to your damaged home or its contents, you can elect to recognize gain only to the extent that the amount of the pool of funds exceeds the cost of the replacement property.
- 3) The period for replacing your damaged property is extended from 2 years to 4 years after the close of the first tax year in which any gain is realized.
- 4) Renters receiving insurance proceeds as a result of disaster damage to their property in a rented home also qualify for relief to the extent the rented home would be their main home if they owned it.

Proof of Loss

To take a deduction for a casualty or theft loss, you must be able to show that there was a casualty or theft, and support the amount deducted.



It is important that you have records that will prove your deduction. If you do not have the actual records to support your deduction, you can use other satisfactory evidence that is sufficient to establish your deduction.

Casualty. For a casualty, you should be able to show:

- 1) The type of casualty (car accident, fire, storm, etc.) and when it occurred,
- 2) That the loss was a direct result of the casualty, and
- 3) 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 damages.

Theft. For a theft, you should be able to show:

- 1) When you discovered that your property was missing,
- 2) That your property was stolen, and
- 3) That you were the owner of the property.

How To Figure a Gain

You have a gain from a casualty or theft if your reimbursement is more than the adjusted basis of the damaged, destroyed, or stolen property. Use the adjusted basis to figure your gain even if the decrease in FMV of your property is smaller. Reduce your gain by your expenses to collect the reimbursement. However, you can postpone reporting the gain if you acquire qualified replacement property, as explained later under *Postponing Gain*.

Example. A tornado severely damaged your barn. The adjusted basis of the barn was \$2,500. Your insurance company reimbursed you \$4,000 for the damaged barn. However, you had legal expenses of \$200 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) Adjusted basis | \$ 2,500 |
| 2) Insurance received | 4,000 |
| 3) Gain (2 minus 1) | \$ 1,500 |
| 4) Expenses to collect insurance | 200 |
| 5) Gain on casualty | <u>\$ 1,300</u> |

Other Involuntary Conversions

In addition to casualties and thefts, there are other events that bring about involuntary conversions of property. Some of these are described in the following paragraphs.

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 like a forced sale, the owner being the seller and the condemning authority being the buyer.

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.

Threat of condemnation. Treat the sale of your property under threat of condemnation as a condemnation.

Personal residence. You can choose to treat the condemnation of your personal residence as an involuntary conversion (a forced sale) or a voluntary sale. See chapter 10.

Irrigation project. Property located within an irrigation project sold or otherwise disposed of to conform to the acreage limits of federal reclamation laws is a condemnation.

Livestock Losses

Diseased livestock. If livestock die from disease, are destroyed because of disease, or are 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.

Drought sales of livestock. You can elect to postpone for one year reporting the gain from a sale or exchange of livestock, including poultry, if the sale was due to drought conditions. See *Sales Caused By Drought Conditions* in chapter 4.

When you sell or exchange livestock (other than poultry) held for draft, breeding, or dairy purposes solely because of drought, treat it as an involuntary conversion. Only livestock sold in excess of the number you normally would sell under usual business practice, in the absence of drought, 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 the gain for more than one year. See *Postponing Gain*, later.

Example. Under usual business practice you 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.

Reporting drought sales of livestock. When you sell or exchange livestock held for draft, breeding, or dairy purposes because of drought and you choose to postpone the gain, as discussed next under *Postponing Gain*, show the following information on your return for the tax year in which you first realize any of the gain:

- 1) Evidence of the drought conditions that forced the sale or exchange of the livestock,
- 2) The gain realized on the sale or exchange,
- 3) The number and kind of livestock sold or exchanged, and
- 4) The number of livestock of each kind you would have sold or exchanged under your usual business practice.

Show on the return for the year in which you replace the livestock:

- 1) The date you bought replacement livestock,
- 2) The cost of the replacement livestock, and
- 3) The number and kind of the replacement livestock.

Postponing Gain

You can choose to postpone reporting the gain if you acquire replacement property that is similar or related in service or use to your 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, include the gain in your income up to the amount of the unspent reimbursement.

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 actual reimbursement, award, or sales proceeds from 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 or stock you acquire by gift or inheritance does not qualify as replacement property.

Soil or environmental contamination. If, because of soil or 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 cost of planting a new crop, however, does not qualify as a replacement for the destroyed crop.

Timber downed by casualty. You can treat the money you receive from the sale of timber downed by a casualty, such as high winds, earthquakes, or volcanic eruptions, as a reimbursement. If you use that money to buy qualified replacement property (other standing timber) within the replacement period, you can postpone reporting the gain.

Business or income-producing property located in a federal disaster area. If your destroyed business or income-producing property was located in a federally declared disaster area, **any** tangible replacement property you acquire for use in a business is treated as similar or related in service or use to the destroyed property. This rule applies to property located in areas that were declared federal disaster areas after December 31, 1994, in tax years ending after that date. For more information, see *Disaster Area Losses* in Publication 547.

Replacement Period

To postpone reporting your gain from an involuntary conversion, 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:

- 1) The date on which you disposed of the condemned property, or
- 2) 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 be able to get an extension of the replacement period if you apply to the District Director of the Internal Revenue Service for your area. Make your application before the end of the replacement period. Include all the details about your need for an extension. 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 time if you can show reasonable cause for not making the replacement within the regular period.

How to postpone the gain. Report your election to postpone your gain, along with all necessary details, on your return for the tax year in which you realize the gain.

Replacement property acquired before return filed. If you acquire replacement property before you file your return for the year you realize the gain, attach a statement to your return. Show in the statement the amount realized from the involuntary conversion, how you figured the gain, and 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, attach a statement to your return. Show in the statement all the facts relating to the involuntary conversion. Also show how you figured the gain, and that you choose to replace the property within the required replacement period.

You then attach another statement to your return for the year in which you buy the replacement property. Show in this statement detailed information on the replacement property. If you acquire part of your replacement property in one year and part in another year, make a statement for each year. Include in the statement detailed information on the replacement property bought in that year.

Substituting replacement property. Once you designate property as replacement property, you cannot substitute other qualified replacement property. The designation is made by the statement with your return reporting that you have acquired replacement property. However, if after you replace the property you discover it does not qualify as replacement property, you can, within the replacement period, substitute the other qualified replacement property.

Taxpayer's death. If a taxpayer dies in the year the gain is realized, but before replacement property is acquired, there can be no election to postpone the gain. Instead, report the gain on the decedent's final income tax return.

Amended return. File an amended return for the tax year in which the gain was realized if you made the election to postpone tax on the gain and later did not acquire replacement property within the replacement period, or the replacement property costs less than anticipated at the time you made the election.

Reporting Gains and Losses

You may have to file the following forms to report your gains or losses from involuntary conversions:

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

Form 4797. Use this form to report gain or loss from a sale, exchange, or involuntary conversion of business property.

Schedule D (Form 1040). Use this form to report:

- 1) Gain from an involuntary conversion of personal-use property.
- 2) Gain from a sale, exchange, or involuntary conversion of business property held for more than 1 year.

Schedule A (Form 1040). Use this form to report your losses from personal-use property on line 19 of Schedule A.

Schedule F (Form 1040). Deduct your losses from casualty or theft of livestock or produce bought for sale under *Other expenses* in Part II, line 34 of Schedule F (Form 1040), if you use the cash method of accounting and have not otherwise accounted for these losses.

14.

Alternative Minimum Tax

Introduction

The tax laws give special treatment to some kinds of income and allow special deductions and credits for some kinds of expenses. These tax benefits enable some taxpayers with substantial economic income to significantly reduce their regular tax. To ensure that these taxpayers pay a minimum amount of tax on their income, Congress enacted the alternative minimum tax (AMT). This tax is figured on **Form 6251, Alternative Minimum Tax—Individuals**. This chapter explains whether you will need to fill in and file Form 6251.

The AMT that applies to corporations is discussed in Publication 542.

Topics

This chapter discusses:

- Whether you need to fill in Form 6251
- Completing Form 6251
- Whether to attach Form 6251 to your tax return
- 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
- Sch K-1 (Form 1041)** Beneficiary's Share of Income, Deductions, Credits, etc.
- Sch K-1 (Form 1065)** Partner's Share of Income, Credits, Deductions, etc.
- Sch K-1 (Form 1120S)** Shareholder's Share of Income, Credits, Deductions, etc.
- 6251** Alternative Minimum Tax—Individuals
- 8615** Tax for Children Under Age 14 Who Have Investment Income of More Than \$1,300
- 8801** Credit for Prior Year Minimum Tax—Individuals, Estates, and Trusts

See chapter 21 for information about getting these publications and forms.

Do You Need To Fill In Form 6251?

You need to fill in and file Form 6251 if you owe alternative minimum tax (AMT) or if you need to show the IRS that you do not owe AMT (as explained under *Do You Need to Attach Form 6251 to Your Return?* later).

If your return is affected by any of the following items, fill in Form 6251.

- 1) Accelerated depreciation.
- 2) Tax shelter farm or passive activities.
- 3) Installment sale income.
- 4) Net operating loss deduction.
- 5) Incentive stock options.
- 6) Tax-exempt interest from private activity bonds.
- 7) Intangible drilling, depletion, circulation, research, experimental, pollution control, or mining exploration/development costs.
- 8) Percentage-of-completion income from long-term contracts.
- 9) Interest paid on a home mortgage not used to buy, build, or substantially improve your home.
- 10) Investment interest expense.
- 11) Foreign tax credit.

Child under age 14. Form 6251 should be filled in for a child under age 14 if the child's adjusted gross income from Form 1040, line 32, exceeds the child's earned income by more than \$1,300.

Worksheet. If your return is not affected by any of the items listed earlier, fill in the *Table 14-1* worksheet to see if you should complete Form 6251.

Completing Form 6251

If you must complete Form 6251 because your return was affected by any of the items listed earlier (or because the filled-in *Table 14-1* shows you must), keep the following rules in mind.

Partner, shareholder, or beneficiary. If you had any of the tax benefits listed earlier as a partner in a partnership, a beneficiary of an estate or trust, or a shareholder in an S corporation, include the benefit on Form 6251.

Partner. If you are a partner, you must include your share of the partnership's adjustments and tax preference items when you fill in Form 6251. These will be furnished to you on Schedule K-1 (Form 1065). The partnership itself does not pay AMT.

S corporation shareholder. If you are a shareholder in an S corporation, you must include your share of the corporation's adjustments and tax preference items when you fill in Form 6251. These will be furnished to you on Schedule K-1 (Form 1120S).

Beneficiary. If you are a beneficiary of an estate or trust, you must include your share of the estate's or trust's distributable net alternative minimum taxable income (AMTI) and tax preference items when you fill in Form 6251. These will be furnished to you on Schedule K-1 (Form 1041). The estate or trust may have to pay AMT on any remaining AMT taxable income.

Do You Need To Attach Form 6251 to Your Return?

After you complete Form 6251, attach it to your return only if:

- 1) You are liable for the AMT.
- 2) You have certain credits (such as the credit for child and dependent care expenses, etc.) that are limited by the amount shown on line 24 (or in some cases, line 26). The forms used to figure these credits have information on the tentative minimum tax limit.
- 3) The total of lines 7 through 14 is negative and you would be liable for the AMT without taking those lines into account.

Earned income credit. You must reduce any earned income credit claimed on your return by any AMT.

Recordkeeping



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

You may be able to take a credit against your regular tax if any of the following apply.

- 1) You paid alternative minimum tax (AMT) in 1995.
- 2) You had a minimum tax credit carryforward from 1995 to 1996.
- 3) You had an unallowed unconventional-source fuel credit, orphan drug credit, or qualified electric vehicle credit in 1995.



Table 14-1. **Worksheet To See If You Should Fill In Form 6251**

| | |
|---|-----------|
| 1. Enter the amount from Form 1040, line 35..... | 1. _____ |
| 2. If you itemized deductions on Schedule A, go to line 3. Otherwise, enter your standard deduction from Form 1040, line 34, and go to line 5..... | 2. _____ |
| 3. Enter the smaller of the amount on Schedule A, line 4, or 2.5% of the amount on Form 1040, line 32..... | 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 \$45,000 (\$22,500 if married filing separately; \$33,750 if single or head of household)..... | 6. _____ |
| 7. Subtract line 6 from line 5. If zero or less, stop here ; you don't need to fill in Form 6251..... | 7. _____ |
| 8. Enter \$150,000 (\$75,000 if married filing separately; \$112,500 if single or head of household)..... | 8. _____ |
| 9. Subtract line 8 from line 5. If zero or less, enter -0- here and on line 10 and go to line 11..... | 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. If the total is over \$175,000 (\$87,500 if married filing separately), stop here and fill in Form 6251 to see if you owe the alternative minimum tax..... | 11. _____ |
| 12. Multiply line 11 by 26% (.26)..... | 12. _____ |

Is line 12 more than the amount on Form 1040, line 38 (less any amount from Form 8814, line 8, Form 4970, or Form 4972)?

Yes. Fill in Form 6251 to see if you owe the alternative minimum tax.
No. Do not fill in Form 6251.

You figure the credit on **Form 8801**. You subtract any credit for prior year minimum tax from the regular tax on your return.

Reduction for canceled debt. You may have to reduce the credit if you exclude from income a debt that was canceled after 1993:

- 1) In a bankruptcy case,
- 2) When you were insolvent, or
- 3) That was a qualified farm debt.

If you have to reduce the credit, you must reduce the amount available at the beginning of the year after the debt was canceled. For more information, see *Cancellation of Debt* in chapter 4.

15.

Self-Employment Tax

Important Change for 1996

Tax rates and maximum net earnings for self-employment taxes. The self-employment tax rate on net earnings remains the same for 1996 and 1997. This rate, 15.3%, is a total of 12.4% for social security (old-age, survivors, and disability insurance), and 2.9% for Medicare (hospital insurance).

The maximum amount subject to the social security part for 1996 is \$62,700. For 1997, the maximum amount subject to the social security part will be published in the 1996 revisions of Publication 533, *Self-Employment Tax*, and Publication 553, *Highlights of 1996 Tax Changes*. All your net earnings are subject to the Medicare tax.

Introduction

Farmers pay SE tax on their SE income. Farmers who have employees may have to pay employment taxes. See chapter 16 for information on employment taxes.

SE tax is part of a system that provides farmers and other self-employed individuals with social security and medical insurance (Medicare) coverage. Self-employed individuals are those who operate their own businesses. Farmers who operate their own farms on land they either own or rent are usually self-employed.

Topics

This chapter discusses:

- Who must pay self-employment tax
- Self-employment income
- Figuring self-employment tax
- Landlord participation in farming

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. Partnership Return of Income
- Sch K-1 (Form 1065)** Partner's Share of Income, Credits, Deductions, etc.

See chapter 21 for information about getting these publications and forms.

General Information

Social security benefits. Social security benefits are available to self-employed persons just as they are to wage earners. Your payments of self-employment tax (SE tax) contribute to your coverage under the social security system. Social security coverage provides you with retirement benefits, disability benefits, and medical insurance (Medicare) benefits.

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 quarters of coverage. A "quarter of coverage" means a period of 3 calendar months during which you were paid a certain amount of income subject to social security tax.

For 1996, you receive a quarter of social security coverage, up to four quarters, for each \$640 of income subject to social security. Therefore, for 1996, if you had income of \$2,560 that was subject to social security taxes (self-employment and wages), you will receive four quarters of coverage. Note that no quarters of coverage will be credited if you have less than \$400 of annual net earnings.

For an explanation of the number of quarters of coverage you must have to be insured, and of the benefits available to you and your family under the social security program, consult your nearest Social Security Administration office.

Social security number. You must have a social security number to pay SE tax. If you do not have a number, apply for one on Form SS-5, *Application for a Social Security Card*. You can get this form at any Social Security office or by calling 1-800-772-1213.

If you have a social security number from the time you were an employee, do not apply again. If you have a number but lost your card, file Form SS-5, showing where and about when you first applied for it. You will get a card showing your original number, not a new one.

If your name has changed since you received your social security card, complete Form SS-5 to report a name change.

Estimated tax. You may have to pay estimated tax. This depends on how much income and SE taxes you expect for the year and how much of your income will be subject to withholding tax. The SE tax is treated, and collected, as part of the income tax.

You may have to pay a penalty if you do not pay the correct installment of estimated tax by its due date.

You must include the estimated SE tax in your estimated tax payments. However, if at least two-thirds of your income is from farming and you file your Form 1040 and pay all of the tax that is due by the first day of the third month after the end of your tax year, you do not have to pay any estimated tax. See chapter 2 for more information about estimated tax.

Reporting self-employment tax. Figure your SE tax from both farm and nonfarm businesses on one Schedule SE.

First figure your net SE income from farming and show the amount on line 1 of Schedule SE.

Next enter your net SE income from your nonfarm business on line 2 of Schedule SE. Then add these amounts together and enter the total on line 3. This gives your total net income from self-employment from all sources.

Complete the rest of Schedule SE to figure your total SE tax. Enter this amount on line 45 of Form 1040.

If you file a joint return, the tax is figured separately on the SE income of you and your spouse. However, you are both liable for the total SE tax due on the return.

Self-employment tax deduction. You can deduct half of your SE tax as a business expense in figuring your adjusted gross income. This is an income tax adjustment only. It does not affect either your net earnings from self-employment or your SE tax.

To deduct the tax, enter on Form 1040, line 25, the amount shown on the "Deduction for one-half of self-employment tax" line of Schedule SE.

Who Must Pay Self-Employment Tax

You must pay SE tax if you were self-employed and your net earnings from self-employment were \$400 or more.

You are self-employed if you carry on your own trade or business (such as running a farm) as a sole proprietor, an independent contractor, a member of a partnership, or are otherwise in business for yourself. A trade or business is generally an activity carried on for a livelihood, or in good faith to make a profit.

The SE tax rules apply even if you are now fully insured under social security or are now receiving benefits.

Share farmers. If, under an income-sharing arrangement, you produce a crop or raise livestock on land belonging to another and your share of the crop or livestock, or the proceeds from their sale, depends on the amount produced, you are a self-employed farmer. Your income from the income-sharing arrangement is your SE income.

If you produce a crop or livestock on land belonging to another 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 self-employed or an employee of the landowner. This will depend on whether you are under the direction and control of the landlord.

Example. A share farmer produces a crop on land owned by another person, on a 50–50 crop-share basis. By 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. A house to live in is provided for the share farmer. 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. But, for the services performed in caring for the landowner's hogs, the share farmer is an employee, and the value of the ten hogs received is not SE income. This income is taxable for income tax purposes.

4–H Club or FFA project. If your child participates in a 4–H Club or FFA (Future Farmers of America) project, any profit the child receives from sales or prizes related to the project may be subject to income tax. Report the income on line 21 of Form 1040. However, the profit may not be subject to SE tax if the project is primarily for educational purposes and not for profit, and is completed by the child 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.

Husband and wife partners. You and your spouse may operate a farm as a partnership. (Partnerships are discussed earlier in chapter

2.) If you and your spouse operate a farm as partners, report the income on a partnership return, Form 1065, and attach separate Schedules K–1 to show each partner's share of the net income. If you file a joint return, include both partners' share of the partnership's income on your Form 1040 and attach a separate Schedule SE (Form 1040) to report each partner's SE tax.

However, if your spouse is your employee, not your partner, you must pay social security and Medicare taxes for him or her. For more information, see chapter 16.

Self-Employment Income

Net SE income usually includes all farm and nonfarm business income minus all business deductions allowed for income tax purposes. You must claim all allowable deductions when figuring net SE income. Net SE income is determined using the same accounting method as used for income tax purposes.

Some specific items included in determining net SE income (net farm profit on Schedule F) are:

- 1) Taxable patronage dividends (distributions) from cooperatives,
- 2) Government agricultural program payments, including commodity program payments, and conservation reserve program (CRP) payments,
- 3) Taxable commodity credit loans,
- 4) Storage fees paid by the Commodity Credit Corporation under a resale agreement to farmers for storing their own grain,
- 5) Refunds and rebates, if they represent a reduction in a deductible expense item, including the fuel tax credits,
- 6) Prizes or awards on farm produce or livestock,
- 7) Crop damage payments,
- 8) Value of merchandise received for farm products,
- 9) Standing crop sales, if not sold with land that was held more than 1 year,
- 10) Crop shares received as rent. (These are net SE income in the year they are converted to money or the equivalent of money, if you meet one of the four material participation tests explained later under *Landlord Participation in Farming* at the time the crop shares are produced),
- 11) 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), and
- 12) Lost income payments received from insurance or other sources for reducing or stopping farming activities. Even if you

are not farming when you receive the payment, it is SE income if it relates to your farm business (even though it is temporarily inactive). A connection exists if it is clear that the payment would not have been made but for your conduct of your farm business, and

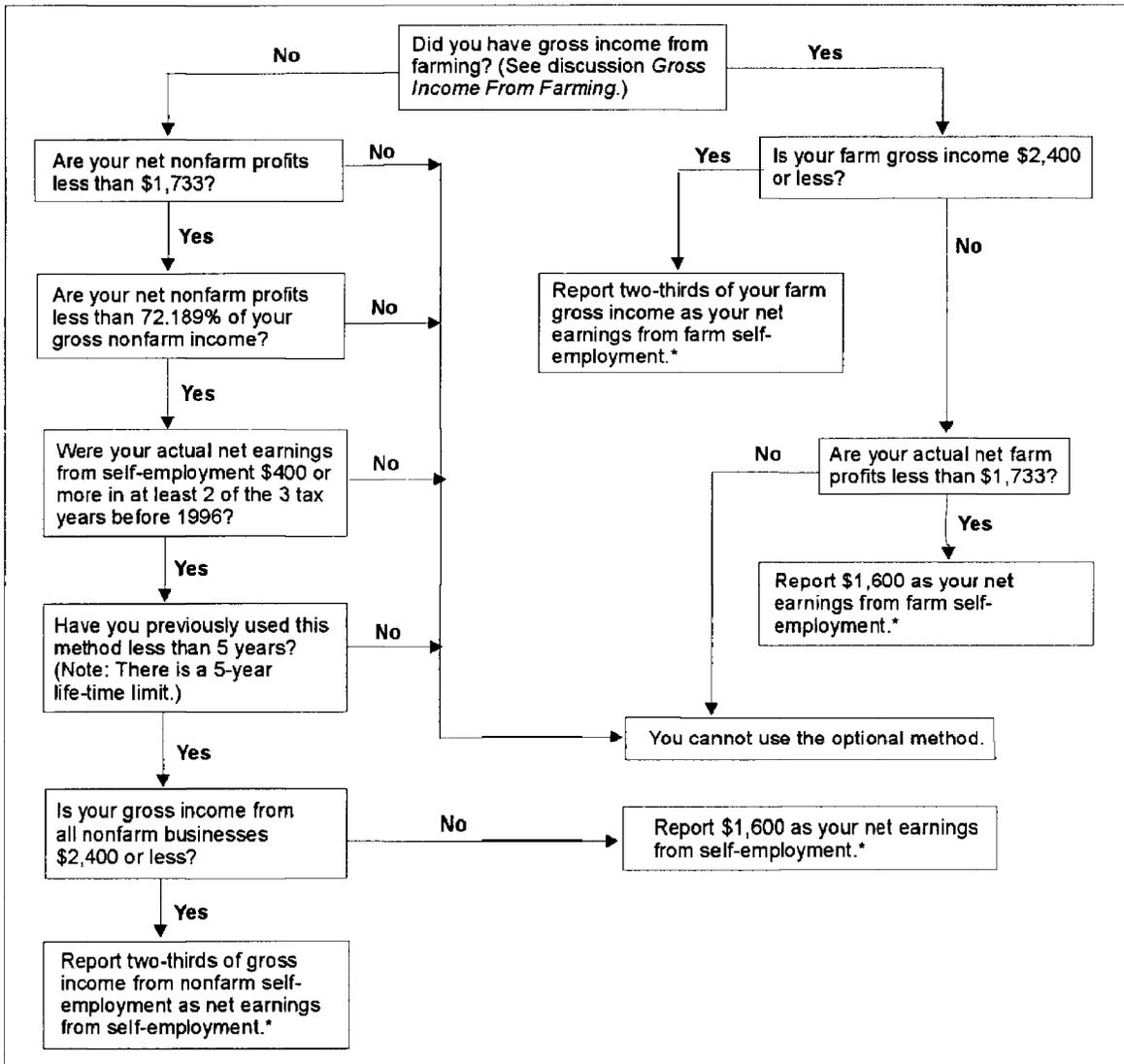
- 13) Your distributive share of income or loss from your partnership's trade or business.

In addition, there are certain kinds of income and deductions you usually do not take into account in figuring your net SE income, even though they are included in figuring your income tax:

- 1) Rent from real estate and from personal property leased with real estate is not SE income. It does not matter if the rent is received in crop shares, cash, or other property. This rule applies 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 SE income unless you receive it in your trade or business, such as interest on accounts receivable.
- 3) Dividends on securities are not SE income unless you are a dealer in securities.
- 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 when figuring SE income. It does not matter whether the disposition is a sale, exchange, or an involuntary conversion. For example, gains or losses from the disposition of the following types of property are not included:
 - a) Investment property.
 - b) Depreciable property or other fixed assets used in your trade or business.
 - c) Livestock held for draft, dairy, breeding, or sporting purposes, and not held primarily for sale, regardless of how long the livestock was held, or whether raised or purchased.
 - d) Standing 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 if the cutting is treated as a sale or exchange.
- 5) Wages received for services performed as an employee and covered by social security or railroad retirement are not SE income.
- 6) Certain deductions and exemptions that are used when figuring income tax should not be used to reduce your SE income. Specifically, do not use:
 - a) Deductions for personal exemptions for yourself, your spouse, or your dependents,

Figure 15-1. Can I Use the Optional Methods?



* If you use both optional methods, see *Using Both Methods* for limits on the amount to report.

- b) The standard deduction or itemized deductions,
 - c) The net operating loss deduction,
 - d) Nonbusiness deductions, including contributions for yourself to a Keogh or SEP plan, and
 - e) The self-employed health insurance deduction.
- 7) A limited partner figures net SE income by excluding the distributive share of partnership income or loss. But guaranteed payments received for services performed are included as SE income.
- 8) A retired partner does not include retirement payments received from the partnership under a written plan that provides for lifelong periodic payments as long as the retired partner's capital interest has been fully paid and the partner performs no services for the partnership.

Figuring Self-Employment Tax

There are three steps to figure the SE tax you owe:

- 1) Figure your net earnings from self-employment.
- 2) Figure the amount that is subject to the tax.
- 3) Multiply that amount by the tax rate.

There are three ways to figure net earnings from self-employment.

- 1) The regular method,
- 2) The farm optional method, and
- 3) The nonfarm optional method.

See *Figure 15-1. Can I Use The Optional Methods?*

The tax rates are the same for net earnings figured under each method. The SE tax rate is 15.3% (12.4% social security tax plus 2.9% Medicare tax). You will find the general rules for figuring SE tax in the discussion of the regular method, later.

Net earnings subject to SE tax. Whether you have to pay SE tax on any part of your net earnings from self-employment generally depends on the total of your net earnings for the year, and on the total of any wages or tips you earn for the year.

Minimum amount. You must have \$400 or more of net earnings from self-employment to be subject to the tax. For this purpose, net earnings are figured on line 4 of Schedule SE, Section A or line 4c of Schedule SE, Section B. If your net earnings are less than \$400, you do not have to file Schedule SE (Form 1040) or pay the tax, unless you performed services for a church as an employee and received income of \$108.28 or more.

Maximum amount. No more than \$62,700 of your combined wages, tips, and net earnings in 1996 is subject to any combination of the 12.4% social security part of SE tax, social security tax, or railroad retirement (tier 1) tax.

All your combined wages, tips, and net earnings in 1996 are subject to any combination of the 2.9% Medicare part of SE tax, social security tax, or railroad retirement (tier 1) tax.

If your wages and tips are subject to either social security or railroad retirement (tier 1) tax, or both, and total at least \$62,700, you do not have to pay the 12.4% social security part of the SE tax on any of your net earnings. However, you must pay the 2.9% Medicare part of the SE tax on all your net earnings.

Optional methods. You can generally use the optional methods (discussed later) when you have a loss or a small amount of income from self-employment and:

- 1) You want to receive credit for social security benefit coverage,
- 2) You incurred child or dependent care expenses for which you could claim a credit (this method will increase your earned income, which could increase your credit), or
- 3) You are entitled to the earned income credit (this method will increase your earned income which could increase your credit).

Effect on taxes. 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 your actual SE income or loss under the regular method.

The optional methods may be used only to figure your SE tax. To figure your income tax, include your actual SE income in gross income, regardless of which method you use to figure SE tax.

Example. Your gross nonfarm income is \$900 and your net nonfarm earnings are \$200. You use the nonfarm optional method to get a larger earned income credit. Your net earnings using the optional method are \$600. You must pay SE tax on this amount.

Forms. Use Schedule SE (Form 1040) to figure your SE tax. Report the SE tax on line 45 of Form 1040. If you have to pay SE tax, you must file a Form 1040 (with Schedule SE attached) even if you do not otherwise have to file a federal income tax return.

Joint returns. You cannot file a joint Schedule SE (Form 1040) even if you file a joint income tax return. Your spouse is not considered self-employed just because you are. If your spouse has SE income, it is independently subject to SE tax and should be reported on a separate Schedule SE. If you file a joint return and you both have SE income, each of you must complete a separate Schedule SE (Form 1040); attach both schedules to the joint return. Also 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 subject to SE tax as the income of the spouse carrying on the trade or business. The identity of the person carrying on the trade or business is determined by the facts in each case.

Schedule SE

You must file Schedule SE if:

- 1) You were self-employed, and your net earnings from self-employment (excluding church employee income) were \$400 or more, or
- 2) You performed services for a church as an employee and received income of \$108.28 or more.

TIP Even if you do not have to file Schedule SE, it may be to your benefit to file it and use either optional method in Part II of Section B.

Most taxpayers can use *Short Schedule SE* (Section A) to figure their self-employment tax. However, the following taxpayers must use *Long Schedule SE* (Section B):

- 1) Individuals whose total wages and tips subject to social security (or railroad retirement (tier 1)) tax plus net earnings from self-employment are more than \$62,700,
- 2) Ministers, members of religious orders, and Christian Science practitioners not taxed on earnings from these sources (with IRS consent) who owe SE tax on other earnings,
- 3) Employees who earned wages reported on Form W-2 of \$108.28 or more working for churches or church organizations that elected exemption from social security and Medicare taxes,
- 4) Individuals with tip income subject to social security and Medicare taxes that was not reported to their employers, and
- 5) Individuals who use one of the optional methods to figure SE tax.

Regular Method

Use the following steps to figure SE tax.

Step 1. Figure your net SE income. The net profit from your farming business shown on Schedule F is generally your net SE income. Net profit is figured by subtracting all allowable business expenses and deductions from gross farm income.

If you also have a nonfarm business, your net SE income is the combined net incomes from each of your businesses. You must also include your distributive share of SE income or loss from a partnership. **A loss in one of your businesses will offset the income you earned in another.**

You must claim all allowable deductions, including depreciation, when figuring your net SE income.



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

Step 2. After you figure your net SE income, determine how much is subject to SE tax. The amount subject to SE tax is called net earnings from self-employment. It is figured on *Short Schedule SE*, line 4 or *Long Schedule SE*, line 4a.

Step 3. Figure your SE tax as follows.

- 1) If your net earnings from self-employment plus any wages and tips are not more than \$62,700, and you do not have to use *Long Schedule SE*, use *Short Schedule SE*. On line 5, multiply your net earnings by 15.3% (.153). The result is your SE tax.
- 2) If you had no wages, your net earnings from self-employment are more than \$62,700, and you do not have to use *Long Schedule SE*, use *Short Schedule SE*. On line 5, multiply the line 4 net earnings by the 2.9% (.029) Medicare tax and add the result to \$7,774.80 (12.4% of \$62,700). The total is your SE tax.
- 3) If your net earnings from self-employment plus any wages and tips are more than \$62,700, you must use *Long Schedule SE*. Subtract your total wages and tips from \$62,700 to find the maximum earnings subject to the 12.4% social security part of the tax. If more than zero, multiply the amount by 12.4% (.124). The result is the social security tax amount. Then multiply your net earnings from self-employment by 2.9% (.029). The result is the Medicare tax amount. The total of the social security tax amount and the Medicare tax amount is your SE tax.

Example 1. During 1996, you have \$30,000 in net SE income, and receive no wages subject to social security and Medicare taxes. Multiply the \$30,000 by 0.9235 on *Short Schedule SE* to get your net earnings from self-employment of \$27,705. Your SE tax is 15.3% (0.153) of \$27,705, or \$4,238.87.

Example 2. During 1996, you have \$20,000 in net SE income, and receive \$15,000 in wages subject to social security and Medicare taxes. Multiply the \$20,000 by 0.9235 on *Short Schedule SE* to get your net earnings from self-employment of \$18,470. Your SE tax is 15.3% (0.153) of \$18,470, or \$2,825.91.

Example 3. During 1996, you have \$70,000 in net SE income, and receive no wages subject to social security and Medicare taxes. Multiply the \$70,000 by 0.9235 on *Short Schedule SE* to get your net earnings of \$64,645. Since only \$62,700 of your earnings are subject to the social security part of the SE tax, your tax for this part is \$7,774.80 (12.4% of \$62,700).

Since all your net earnings are subject to the Medicare part of the SE tax, multiply \$64,645 by 2.9% (.029) on *Short Schedule SE* for the Medicare part. The result is \$1,874.71.

Add this to \$7,774.80 for a total SE tax of \$9,649.51.

Example 4. During 1996, you have \$70,000 in net SE income, and receive \$10,000 in wages subject to social security and Medicare taxes. Figure your net earnings on *Long Schedule SE*, line 4a, to be \$64,645. Next, subtract your wages of \$10,000 from \$62,700, the maximum income subject to the social security part of the SE tax. The result is \$52,700. Since only \$52,700 of your income is subject to the social security part of the SE tax, your tax for this part is 12.4% (.124) × \$52,700, or \$6,534.80.

Since all your net earnings are subject to the Medicare part of the SE tax, multiply all the net earnings from self-employment, \$64,645, by 2.9% (.029) on *Long Schedule SE* for the Medicare part. The result is \$1,874.71. Add this to the \$6,534.80 figured above for total self-employment tax of \$8,409.51.

Farm Optional Method

If you are in the farming business, either as an individual or as a partner, you may be able to use the farm optional method to figure your net earnings from farm self-employment. This method allows you to continue paying SE tax for your social security coverage when your net profit for the year is small or you have a loss.

Gross income of \$2,400 or less. If your gross income from farming is \$2,400 or less, you may report two-thirds of this gross income as your net earnings from farm self-employment.

Since two-thirds of \$2,400 is \$1,600, this would count for two quarters of coverage (\$1,600 divided by \$640) under social security. You cannot use your actual earnings to determine quarters of coverage when you are figuring the SE tax on only two-thirds of that amount.

Gross income of more than \$2,400. If your gross income from farming is more than \$2,400, and your actual net farm profits, as shown on line 36 of Schedule F (Form 1040), and line 15a of Schedule K-1 (Form 1065), are less than \$1,733, you may report \$1,600 as your net earnings from farm self-employment. But if your gross income from farming is more than \$2,400 and your actual net farm profits are \$1,733 or more, you cannot use the optional method.

Gross income from farming. Farming income includes what you receive from cultivating the soil or raising or harvesting any agricultural commodities. It also includes income from the operation of a livestock, dairy, poultry, bee, fish, fruit, or truck farm, or plantation, ranch, nursery, orchard, or oyster bed. This includes income you receive in the form of crop shares if you materially participate in production or management of production.

Your gross income will not include any item listed as being excluded under the regular method. If you receive government commodity program payments on land you rent out, do not include these payments unless you meet

one of the four material participation tests, explained later. When you use the farm optional method, you must also exclude income, deductions, and losses that come from any non-farm business.

Cash method of accounting. If you file your return on the cash method and are not a member of a farming partnership, your gross income from farming will ordinarily be the amount shown on line 11 of Schedule F.

Accrual method of accounting. If you file your return using an accrual method and are not a member of a farming partnership, your gross income from farming will ordinarily be the amount shown on line 51 of Schedule F.

Gross income from a farm partnership. Your gross income under the farm optional method includes your distributive share of a partnership's gross income from farming.

To determine your distributive share of gross income from a farm partnership:

- 1) Figure the partnership's gross income from farming.
- 2) Subtract any guaranteed payments to partners for services or the use of capital if the payments are determined without regard to partnership income.
- 3) Determine your share of what is left. The gross income that remains after steps (1) and (2) is divided among the partners in the same way they share the ordinary income or loss of the partnership, unless the partnership agreement provides otherwise.

The result determined in (3) above is your distributive share of the partnership's gross income from farming. If you have no other gross income from farming, including guaranteed payments discussed next, use this distributive share of gross income to determine whether you can use the farm optional method to figure your net earnings from self-employment.

Guaranteed payments. Any guaranteed payments you receive from a farm partnership that are determined without regard to partnership income are gross income from your farming (not the partnership's). Use the total of these payments, your distributive share of gross income from a farm partnership, and any other gross income you receive from farming, to determine whether you can use the farm optional method to figure your net earnings from self-employment.

Example. Bill and John are partners and share in ordinary income or loss on a 50–50 basis, with no guaranteed payments. If the partnership has \$3,000 gross income from farming, each would have \$1,500 gross income for purposes of the optional method.

If Bill had been guaranteed \$1,000 without regard to partnership income, his gross income from farming would be \$2,000 (\$1,000 plus 50% of \$2,000). John's gross income would be \$1,000.

Two or more farms. If you run your own farm and are also a partner in a farm partnership, or in any way have gross income from farming from more than one farm, you must add your farm income from all farming sources to get your total net earnings from farm self-

employment. 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 net earnings from self-employment under the farm optional method are \$1,000 ($\frac{2}{3}$ of \$1,500).

Figuring the tax. If your net earnings under the farm optional method are \$400 or more, multiply the net earnings figure by the tax rate for 1996 (15.3%). The result is the SE tax you owe.

Optional earnings less than actual earnings. If your net earnings under the farm optional method are less than your actual earnings, you can still use the farm optional method. For 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 fall below \$400.

Nonfarm Optional Method

There 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 net earnings from self-employment from your nonfarm business. You may use this method even if you do not use the farm optional method for determining your net earnings from your farm self-employment and even if you have a net loss from your nonfarm business. For more information about the nonfarm optional method, get Publication 533.

Using Both Methods

You may not combine farming income with nonfarm income from self-employment to figure your net earnings under either of the 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 may report less than actual total net earnings but not less than actual net earnings from nonfarm self-employment alone when using both methods. If you use both optional methods, you may report no more than \$1,600 as your combined net earnings from self-employment.

Landlord Participation in Farming

As a general rule, income and deductions from rentals and from personal property leased with the real estate are not taken into account to determine net earnings from self-employment. However, income and deductions from farm

rentals and from personal property leased with the real estate, including government commodity program payments received by a landowner who rents land, are taken into account if the rental arrangement provides that the landlord will, and he or she does, participate materially in the production or management of production of the farm products on the land.

In addition, rent paid in the form of crop shares is included in determining net earnings from self-employment for the year you sell, exchange, give away, or use the crop shares if you meet one of the four material participation tests at the time the crop shares are produced. Feeding such crop shares to livestock is considered using them. Your gross income for figuring your net earnings from self-employment under the *Farm Optional Method* includes the fair market value of the crop shares when they are used as feed.

Materially participating. You are materially participating if you have an arrangement with your tenant for your participation and you meet one of the following four tests:

Test No. 1. You do any three of the following: (a) pay or stand good for at least half the direct costs of producing the crop; (b) furnish at least half the tools, equipment, and livestock used in producing the crop; (c) consult with your tenant; and (d) inspect the production activities periodically.

Test No. 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.

Test No. 3. You work 100 hours or more spread over a period of 5 weeks or more in activities connected with crop production.

Test No. 4. You do things which, considered in their total effect, show that 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 materially participating.

Wage limits. The maximum amount of 1997 wages subject to the social security tax (6.2%) will be published in Circular A. There is no wage base limit for the amount subject to Medicare tax (1.45%). All covered wages are subject to the tax.

Federal unemployment (FUTA) tax. The gross FUTA tax rate remains 6.2% through 1997. The maximum amount of wages subject to FUTA tax remains \$7,000.

Alien farm workers. Wages paid to an alien who is admitted to the United States, performs contract farm labor for you, and then returns to his or her own country when the contract is completed, are exempt from the federal unemployment (FUTA) tax. This exemption, which expired after 1994, has been made permanent as of January 1, 1995. If you paid FUTA tax on these alien workers in 1995, you can file an amended Form 940 for a refund. You must use the 1995 form. Amounts paid in 1996 can be adjusted on the 1996 Form 940. See the form instructions.

Electronic deposit of taxes. If your total deposits of social security, Medicare, and withheld income taxes were more than \$50,000 during 1995, you must begin making electronic deposits for *all* depository tax liabilities that occur after June 30, 1997. See Publication 51 (Circular A).

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.

Farmers must also pay self-employment tax on their earnings from farming. See chapter 15 for information on the self-employment tax.

Topics

This chapter discusses:

- Farm employment
- Social security and Medicare taxes
- Income tax withholding
- Federal unemployment tax (FUTA)
- Reporting and paying employment taxes
- Family members
- Crew leaders
- Earned income credit (EIC)

Useful Items

You may want to see:

Publication

- 15** Circular E, Employer's Tax Guide
- 15-A** Supplemental Employer's 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 these publications and forms.

Farm Employment

In general, you are an employer of farm workers if your employees do any of the following:

- 1) Raise or harvest agricultural or horticultural products on a farm.
- 2) Care for your farm and equipment, when most of the care is done on a farm.
- 3) Handle, process, or package any agricultural or horticultural commodity if you produced more than half of the commodity.
- 4) Do work related to cotton ginning, turpentine, or gum resin products.
- 5) Do housework in your private home if it is on a farm that is operated for profit.

Workers are your employees if they perform services subject to your control. You are not required to withhold taxes on independent contractors who are not your employees. For more information, see Publication 15-A.

Special rules apply to crew leaders. See *Crew Leaders*, later.

Employer identification number. If you have employees, you must have an employer identification number (EIN). You can apply for an EIN either by mail or by telephone. You can get an EIN immediately by calling the Tele-TIN phone number for the service center for your state, or you can send a completed SS-4, *Application for Employer Identification Number*, directly to the service center to receive your EIN in the mail. See the instructions for Form SS-4 for more information.

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 nearest social security office. Form SS-5 can be obtained from any social security office or by calling 1-800-772-1213.

The employee must furnish evidence of age, identity, and U.S. citizenship with the Form SS-5. An employee who is 18 or older

16.

Employment Taxes

Important Changes for 1997

Social security and Medicare taxes. For 1997, the employer and the employee will continue to pay:

- 1) 6.2% each for social security tax (old-age, survivors, and disability insurance), and
- 2) 1.45% each for Medicare tax (hospital insurance).

must appear in person with this evidence at a social security office.

INS Form I-9. You must ask each new employee to complete the employee section of an Immigration and Naturalization Service (INS) Form I-9, *Employment Eligibility Verification*. You must then complete the employer section to verify the employee's identity and eligibility to work. You can get M-274, *Handbook for Employers*, which contains Forms I-9 and instructions, from INS regional and district offices. Contact the INS at 1-800-755-0777 for more information.

Social Security and Medicare Taxes

As a farmer-employer, you may have to pay social security and Medicare taxes if you have one or more agricultural employees, including your parents, your children 18 years of age or older, or your spouse, who meet either of these two tests:

- 1) You paid the employee \$150 or more in **cash** wages during the year, or
- 2) You paid wages of \$2,500 or more during the year to all your employees.

Exceptions. The \$150 and \$2,500 tests do not apply to the following situations:

- 1) If you pay a farm worker less than \$150 in annual cash wages, those wages are not subject to social security and Medicare taxes, even if you pay \$2,500 or more to all your farm workers, if the farm worker:
 - a) Works as a hand-harvest laborer,
 - b) Is paid piece rates in an operation usually paid on this basis in the area,
 - c) Commutes daily from his home to the farm, and
 - d) Worked in agriculture less than 13 weeks in the preceding calendar year.

Payments to these seasonal farm workers, however, count toward the \$2,500-or-more test for other farm workers.

- 2) The wages of your household employee are not subject to social security and Medicare taxes unless you pay the employee cash wages of \$1,000 or more in a calendar year, even if you pay \$2,500 or more to all your farm workers.

The wages you pay a household employee, however, count toward the \$2,500-or-more test for determining the social security and Medicare coverage of other farm workers.

See Circular A for more information on these exceptions. See *Family Members*, later, for special rules that apply to your spouse and children for social security and Medicare withholding.

Cash wages. Cash wages include checks, money orders, and any kind of money or cash. The value of payments made with other items,

such as food, lodging, clothing, transportation passes, and other goods, are not cash wages.

Cash wages paid to farm workers are subject to social security tax, Medicare tax, and income tax withholding. **Commodity wages** paid for farm work are not considered cash wages for these purposes. However, the value of noncash wages is reported 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*.

Only cash wages subject to social security and Medicare taxes will be credited to your employees for social security benefit purposes. Payments not subject to these taxes, such as commodity wages, will not contribute to social security coverage for employees. For information about social security benefits, contact the Social Security Administration.

If the farm wages are taxable, you are required to withhold social security and Medicare taxes from the cash wages paid to the employee. If you employ a family of workers, you must deduct social security and Medicare taxes and prepare a Form W-2 for each family worker who has wages subject to tax, not just the head of the family.

Withheld taxes, together with your employer taxes, must be paid to the IRS. You must file Form 943 with the IRS at the address shown in the form instructions by January 31 of the year following the year covered by the return. If you are liable for \$500 or more of social security and Medicare taxes and withheld income taxes during the year, you must deposit them before you file Form 943. See *Deposits*, later, under *Reporting and Paying Employment Taxes*.

Tax rates and social security wage limits.

For 1997, the employer and the employee will continue to pay:

- 1) 6.2% each for social security tax (old-age, survivors, and disability insurance), and
- 2) 1.45% each for Medicare tax (hospital insurance).

Wage limits. For 1997, the maximum amount of wages subject to the social security tax (6.2%) will be published in Circular A. There is no wage base limit for the Medicare tax (1.45%). All covered wages are subject to the tax.

Circular A. Circular A contains additional information about social security and Medicare tax withholding. You can get Circular A from an IRS Forms Distribution Center.

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 taxes, you must still pay them. Any employee social security or Medicare tax you pay 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 cash wages for social security and Medicare (boxes

3 and 5 on Form W-2) or for federal unemployment tax purposes.

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 such a sect.

More information. For more information, see Publication 517, *Social Security and Other Information for Members of the Clergy and Religious Workers*.

Income Tax Withholding

Farmers and crew leaders must withhold income tax from farm workers who are subject to social security and Medicare taxes. The amount to withhold is figured on gross wages without taking out social security and Medicare taxes, union dues, insurance, etc. You can use one of several methods to determine the amount to withhold. The methods are described in Circular A.

Generally, you must withhold income tax from wages you pay an employee if the wages, cash and noncash, are more than the dollar value of the withholding allowances claimed for that pay period. Do not withhold income tax from the wages of an employee who, by filing Form W-4, certifies that he or she had no income tax liability last year and anticipates no liability for the current year.

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.

 Circular A contains tables showing the correct amount of income tax you should withhold. It also contains additional information about income tax withholding. You can get Circular A and Form W-4 from IRS offices or by calling 1-800-TAX-FORM(1-800-829-3676).

Report the income tax withheld on Form 943 at the same time the social security and Medicare taxes are reported. However, you may have to deposit withheld taxes before you file Form 943.

Form W-4 for 1997. Farmers who have employees should make 1997 Forms W-4 available to their employees and encourage them to check their income tax withholding for 1997. Those employees who owed a large amount of tax or received a large refund for 1996 may want to file a new Form W-4.

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, discussed next. See chapter 2 for information on Form 1099-MISC.

Backup withholding. In certain cases, the law requires you to withhold income tax at a rate of 31% (backup withholding) on payments of 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.

Federal Unemployment Tax (FUTA)

If you as a farmer-employer pay cash wages, you must pay federal unemployment (FUTA) tax if you meet **either** of the following tests.

- 1) You paid cash wages of \$20,000 or more to farm workers in any calendar quarter during the current or preceding calendar year.
- 2) You employed 10 or more farm workers for some part of at least 1 day during any 20 different calendar weeks during the current or preceding calendar year.

These rules do not apply to your spouse, parents, or children under age 21. See *Family Members*, later.

Commodity wages. Payments in kind for farm labor are not considered wages. Do not count them to figure whether you are subject to federal unemployment tax or to figure how much tax you owe.

Tax rate and credit. The gross FUTA tax rate is 6.2%. 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 is not subject to a credit reduction. If your state tax rate (experience rate) is less than 5.4%, you are still allowed the full 5.4% credit.

You cannot take the credit for any state tax you do not pay. If you are exempt from state unemployment tax for any reason, the full 6.2% rate applies.

Credit reduction. The 5.4% credit may be reduced for employers in some states. A credit reduction is required if a state's unemployment fund borrows from the federal government and keeps an outstanding balance for two or more years.

If your state is subject to a credit reduction for 1996, the state's name and the amount of the credit reduction will be shown on Form 940.

More information. For more information on FUTA tax, see Publication 51 (Circular A). For information on depositing FUTA tax, see *FUTA Tax* later.

Reporting and Paying Employment Taxes

There are special rules for reporting and paying employment taxes.

Check or money order. When you pay social security and Medicare taxes, withheld income tax, and FUTA tax—whether through deposits or with your return—you should write the following information on your check or money order:

- 1) Your employer identification number.
- 2) The type of tax you are paying.
- 3) The period covered by the payment.

Penalties. If you pay your taxes late, you may have to pay a penalty as well as interest on any overdue amounts. However, if the first time you are required to deposit employment taxes is after July 30, 1996, and you are late, the IRS may waive the penalty. To qualify, you must have filed your employment tax return on time.

There are also civil and criminal penalties for intentionally not paying taxes, filing a false tax return, or filing no return at all.

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, plus interest. 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” in this case means voluntarily, consciously, and intentionally. Paying other expenses of the business instead of the taxes due is considered to be acting willfully.

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 your share of social security and Medicare taxes.

Form 943. Report withheld income tax and social security and Medicare taxes on Form 943. The 1996 form is due by January 31, 1997.

Deposits. You will generally have to make deposits of social security and Medicare taxes and withheld income tax before Form 943 is due. You must deposit both your part and your employees' part of social security and Medicare taxes.

More information. For more information on deposits, including deposit rules and penalties for late deposits, see Publication 51 (Circular A).

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 request or within 30 days after your final payment of wages to the employee, whichever is later. See *Form W-2* in chapter 2.

FUTA Tax

The federal unemployment tax is imposed on you as the employer. It must not be collected or deducted from the wages of your employees.

Form 940. FUTA tax is reported on Form 940, *Employer's Annual Federal Unemployment (FUTA) Tax Return*. This form covers one calendar year and is generally due January 31 after the year ends. However, you may have to make deposits of FUTA tax before filing the return. If you deposit the tax on time and in full, you have an extra 10 days to file—until February 10.

Form 940-EZ. You can use Form 940-EZ, a simplified version of Form 940, if:

- 1) You paid unemployment tax to only one state.
- 2) You paid the state tax by the due date of Form 940 or 940-EZ.
- 3) All of your wages taxable for FUTA tax were also taxable for state unemployment tax.
- 4) You did not pay wages subject to the unemployment compensation laws of a credit reduction state.

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 next 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 in the next quarter, a deposit will be required. If the undeposited tax for the 4th quarter (plus any undeposited tax for an earlier quarter) is less than \$100, you can either make a deposit or pay it with your return by the January 31 due date.

More information. See Circular A for more information on depositing FUTA tax.

Family Members

Child of employer. Social security and Medicare do not cover the services of a child under the age of 18 who works for his or her parent in

a trade or business. If these services are for work other than in a trade or business, such as domestic work in the parent's private home, they are not covered by social security and Medicare until the child reaches 21.

FUTA does not cover the services of a child under the age of 21 who works for his or her parent (whether or not in a trade or business).

These rules apply even if the child is paid wages for nonfarm work. Wages for these services are not subject to social security and Medicare or federal unemployment taxes. However, the wages for nonfarm work may still be subject to income tax withholding.

One spouse employed by another. The services of an individual who works for his or her spouse in a trade or business are covered by social security and Medicare taxes, but not by federal unemployment tax. However, the services of one spouse employed by another in other than a trade or business, such as domestic service in a private home, are not subject to social security and Medicare taxes or federal unemployment tax.

Covered services of child or spouse. The services of a child are covered by social security, Medicare, and federal unemployment, and the services of a married individual are covered by federal unemployment, if he or she works for:

- 1) A corporation, even if it is controlled by the child's parent or the individual's spouse.
- 2) A partnership, even if the child's parent is a partner, unless each partner is a parent of the child.
- 3) A partnership, even if the individual's spouse is a partner.
- 4) An estate, even if it is the estate of a deceased parent.

Under these conditions, a child is not considered to work for his or her parent and a married individual is not considered to work for his or her spouse.

Crew Leaders

Farmers can employ or use the services of crew leaders to provide them with farm labor.

Social security and Medicare taxes. For social security and Medicare tax purposes, the crew leader is considered the employer of the workers if the crew leader:

- 1) Furnishes workers to do farm labor.
- 2) Pays (either on his or her own behalf or on behalf of the farmer) the workers he or she furnished to the farmer for their farm labor.
- 3) Has not entered into a written agreement with the farmer under which he or she is designated as an employee of the farmer.

Federal income tax. If the crew leader is considered the employer for social security and Medicare tax purposes, the crew leader is considered the employer for federal income tax purposes.

Federal unemployment tax. For federal unemployment tax purposes, the crew leader is considered the employer of the workers if, in addition to the earlier requirements:

- 1) The crew leader is registered under the Migrant and Seasonal Agricultural Worker Protection Act, or
- 2) 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 considered the employer of the workers in all other situations. In addition, the farmer is considered 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 considered to be the employer in these cases. For information concerning who is a common-law employee, see *Who Are Employees?* in Publication 15 (Circular E).

Earned Income Credit (EIC)

The EIC is a special credit for certain employees that reduces the tax they owe. Even if they do not owe any tax, the credit may give them a refund. Eligible employees can choose to receive advance payment of the EIC from you. To ensure that certain employees are aware of the EIC, you must notify them about the credit.

Advance payments (Form W-5). You must pay part of the EIC to eligible employees who have filed a Form W-5 with you. This allows those employees to receive part of the benefit of their credit each payday, rather than having a single amount credited to them later on their tax return. Employers of farm workers do not have to make advance 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 earned income credit payments made. For more information, see Publication 51 (Circular A).

Notification. You must notify each employee who worked for you at any time during the year and from whom you did not withhold any income tax about the EIC. 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 one of the following.

- 1) Form W-2, which contains the notification on the back of Copy C.
- 2) A substitute Form W-2 with the exact EIC wording shown on the back of copy C of Form W-2.
- 3) Notice 797, *Possible Federal Tax Refund Due to the Earned Income Credit (EIC)*.
- 4) Your own written statement with the exact wording of Notice 797.

For more information about notification requirements and claiming the EIC, see Notice 1015, *Employers – Have You Told Your Employees About the Earned Income Credit (EIC)?*

17.

Retirement Plans

Important Changes

Savings incentive match plan for employees (SIMPLE). Beginning in 1997, you may be able to set up a SIMPLE retirement plan. The SIMPLE plan allows an employer to contribute to a SIMPLE retirement account on behalf of each employee. The SIMPLE plan:

- 1) Can be used only by an employer with 100 or fewer employees, who received at least \$5,000 of compensation from the employer for the preceding year,
- 2) Can be established as an IRA or as part of a 401(k) plan,
- 3) Allows each employee to elect to contribute a percentage of his or her compensation to the SIMPLE plan under a salary reduction arrangement. This amount may not exceed \$6,000 for 1997.
- 4) Requires the employer to match employee's contributions on a dollar-for-dollar basis, up to 3% of compensation, OR the employer may elect to make a 2% nonelective contribution on behalf of all eligible employees, and
- 5) Must be the only retirement plan of the employer.

For more information on the SIMPLE plan, get Publication 560.

Repeal of salary reduction arrangement under a SEP (SARSEP). An employer is no longer allowed to establish a SARSEP **after 1996**. However, participants (including new participants) in a SARSEP that was established before 1997 can continue to elect to have their employer contribute part of their pay to the plan. See *Salary Reduction Arrangement under Simplified Employee Pension (SEP)*.

Minimum required distribution rule modified. *Beginning in 1997*, the definition of the required beginning date that is used to figure the minimum required distribution from qualified retirement plans has changed. Under the new law, the required beginning date of a participant who is still employed after age 70 1/2 is April 1 of the calendar year that follows the calendar year in which he or she retires. For years prior to 1997, participants in qualified plans and IRAs must begin distributions by April 1 of the year following the calendar year in which he or she reaches age 70 1/2, whether or not the participant has retired. The new law change does not apply to IRAs. For more information on the minimum distribution rules, see *Required Distributions* in the *Keogh Plans* discussion in Publication 560.

Excise tax increase on prohibited transactions. Any prohibited transaction that takes place *after August 20, 1996* is subject to an excise tax of 10% on the "amount involved." For more information, see *Prohibited Transactions* in Publication 560.

15% tax on excessive distributions suspended. New law suspends the 15% excise tax on excessive distributions for distributions received after *December 31, 1996* and before the year 2000. For more information, see *Tax on Excess Distributions* in Publication 575, or Publication 553.

New definition of highly compensated employee. For years *beginning after 1996*, the definition of a highly compensated employee has changed. For more information, see *Definitions* under *Simplified Employee Pension (SEP)* in Publication 560.

Family aggregation rules repealed. For years beginning *after 1996*, the special aggregation rules that only apply to self-employed individuals are eliminated. See *Additional Rules for Plans Covering Owner-Employees*, near the end of Publication 560.

Additional pension provisions. New law also modified several other pension provisions. See Publication 553 for additional important changes that may affect your *1996 and 1997 income tax returns*.

Introduction

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 also is considered an employee* for purposes of participating in a retirement plan.

Funding the plan. A retirement plan you establish as an employer can be funded entirely by your contributions, or by a mix of your contributions and employee contributions. Employee contributions do not have to satisfy the minimum funding requirements for your plan.

For example, a retirement plan can require after-tax employee contributions that by themselves do not meet the minimum funding requirements. Employee contributions can be voluntary or mandatory.

Your plan can allow your employees to make *elective deferrals*, although they are considered *employer contributions*. This allows employees to elect to have you contribute part of their current compensation (pay) to a retirement plan. Only the remaining portion of their pay is currently taxable. The income tax on the contributed pay (and earnings on it) is *deferred*.

Employer contributions. Your contributions to an employer-sponsored retirement plan generally are deductible as discussed later under *Deduction Limits*.

Employer contributions that must be capitalized. You cannot currently deduct your employer contributions to a retirement plan (or any other expenses) if the uniform capitalization rules apply to you. If you are subject to these rules, you must capitalize (include in the basis of certain property or in inventory costs) your contributions as discussed in chapter 7 of this publication.

Kinds of plans. Retirement plans are either:

- 1) Qualified plans (includes retirement plans for the self-employed, such as HR-10 (Keogh) plans and simplified employee pensions (SEPs)), or
- 2) Nonqualified plans.

Also, in general, individuals who are employed can set up and contribute to individual retirement arrangements (IRAs).

See Table 17-1 for information about the rules for contributions to IRAs, simplified employee pension-individual retirement arrangements (SEP-IRAs), and Keogh plans.

Topics

This chapter discusses:

- Qualified plans
- Kinds of qualified plans
- Plans for the self-employed
- Keogh plans
- Simplified employee pensions (SEPs)
- Salary reduction arrangements
- Nonqualified plans
- Individual retirement arrangements (IRAs)

Useful Items

You may want to see:

Publication

- 533** Self-Employment Tax
- 560** Retirement Plans for the Self-Employed
- 590** Individual Retirement Arrangements (IRAs)
- 15** Employer's Tax Guide (Circular E)

Form (and Instructions)

- W-2** Wage and Tax Statement
- 5305-SEP** Simplified Employee Pension-Individual Retirement Accounts Contribution Agreement
- 5305A-SEP** Salary Reduction and Other Elective Simplified Employee Pension-Individual Retirement Accounts Contribution Agreement
- 5500-EZ** Annual Return of One-Participant (Owners and Their Spouses) Retirement Plan

See Chapter 21 for information about getting these forms and publications.

Qualified Plans

A qualified retirement plan is a written plan that you can establish for the exclusive benefit of your employees and their beneficiaries.

Contributions to the plan may be made by you, or by both you and your employees. If your plan meets the qualification requirements, you generally can deduct your contributions to the plan when you make them, except for any amount capitalized. For more information, get Publication 560.

Your employees generally are not taxed on your contributions or increases in the plan's assets until they are distributed to them. However, certain loans made from qualified employer plans are treated as taxable distributions. For more information, get Publication 575.

Qualification requirements. To be a qualified plan, the plan must meet many requirements. Among these are rules concerning:

- 1) Who must be covered by the plan,
- 2) How contributions to the plan are to be invested,
- 3) How contributions to the plan and benefits under the plan are to be determined, and
- 4) How much of an employee's interest in the plan must be guaranteed (vested).

For more information, get Publication 560.

Nondiscrimination rules. To prevent discrimination in a plan caused by using separate businesses (and separate plans), all employees of certain related employers are treated as if employed by a single employer. For example, employees of commonly controlled businesses or affiliated service groups are treated as working for a single employer.

TIP Beginning after 1996, *the new law eliminates the following aggregation rules that only apply to plans maintained by self-employed individuals.*

Table 17-1. Key Retirement Plan Rules

| Type of Plan | Last Date for Contribution | Maximum Contribution | When To Begin Distributions ¹ | | |
|--|---|--|--|---|--|
| IRA | Due date of IRA owner's income tax return (NOT including extensions) | Smaller of \$2,000 or taxable compensation | April 1 of year after year IRA owner reaches age 70½ | | |
| SEP-IRA | Due date of employer's return (Plus extensions) | Smaller of \$30,000 or 15% ² of participant's taxable compensation ³ | April 1 of year after year participant reaches age 70½ | | |
| Keogh | Due date of employer's return (plus extensions). ⁴ | <p style="text-align: center;">Defined Contribution Plans</p> <table style="width: 100%; border: none;"> <tr> <td style="width: 50%; vertical-align: top;"> <p>Employee</p> <p>Money Purchase—Smaller of \$30,000 or 25% of employee's taxable compensation</p> <p>Profit-Sharing—Smaller of \$30,000 or 15% of employee's taxable compensation</p> </td> <td style="width: 50%; vertical-align: top;"> <p>Self-Employed Individual</p> <p>Money Purchase—Smaller of \$30,000 or 20% of self-employed participant's taxable compensation⁵</p> <p>Profit-Sharing—Smaller of \$30,000 or 13.0435% of self-employed participant's taxable compensation⁵</p> </td> </tr> </table> <p style="text-align: center;">Defined Benefit Plans</p> <p>Amount needed to provide an annual retirement benefit no larger than the smaller of \$120,000 or 100% of the participant's average taxable compensation for his or her highest 3 consecutive years</p> | <p>Employee</p> <p>Money Purchase—Smaller of \$30,000 or 25% of employee's taxable compensation</p> <p>Profit-Sharing—Smaller of \$30,000 or 15% of employee's taxable compensation</p> | <p>Self-Employed Individual</p> <p>Money Purchase—Smaller of \$30,000 or 20% of self-employed participant's taxable compensation⁵</p> <p>Profit-Sharing—Smaller of \$30,000 or 13.0435% of self-employed participant's taxable compensation⁵</p> | Generally, April 1 of year after year participant reaches age 70½ ⁶ |
| <p>Employee</p> <p>Money Purchase—Smaller of \$30,000 or 25% of employee's taxable compensation</p> <p>Profit-Sharing—Smaller of \$30,000 or 15% of employee's taxable compensation</p> | <p>Self-Employed Individual</p> <p>Money Purchase—Smaller of \$30,000 or 20% of self-employed participant's taxable compensation⁵</p> <p>Profit-Sharing—Smaller of \$30,000 or 13.0435% of self-employed participant's taxable compensation⁵</p> | | | | |

¹ Distributions of at least the required minimum amount must be made each year if the entire balance is not distributed.

² 13.0435% of the self-employed participant's taxable compensation before adjustment for this contribution.

³ Contributions are made to each participant's IRA (SEP-IRA) including that of any self-employed participant.

⁴ The employer must set up by the end of the employer's tax year.

⁵ Compensation is before adjustment for this contribution.

⁶ If the participant reached age 70½ before 1988, distributions must begin by the year he or she retires.

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 might not be permitted to deduct some or all of your IRA contributions.

Your deduction for IRA contributions might be limited if you also participate in a SEP-IRA. See Publication 560. In addition, your IRA deduction might be limited because you (or your spouse) are covered by an employer's retirement plan and your income is above a certain amount. 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 Plans

These are plans that provide 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 **three types** of defined contribution plans: profit-sharing plans, stock bonus plans, and money purchase pension plans.

Profit-sharing plan. This is a plan that lets your employees or their beneficiaries share in the profits of your business. The plan must have a definite formula for allocating the contributions made to the plan among the participating employees and for distributing the funds in the plan.

Stock bonus plan. This type of plan is similar to a profit-sharing plan, but it can only be set up by a corporation. Benefits are payable in stock of the employer.

Money purchase pension plan. Under this plan, your contributions are a stated amount, or are based on a stated formula that is not subject to your discretion. For example, your formula could be 10% of each participating employee's compensation. Your contributions to the plan are not based on your profits.

Defined Benefit Plans

These are any plans that are not defined contribution plans. In general, a qualified defined benefit plan must provide for set benefits. Your contributions to the plan are based on actuarial assumptions. Generally, you will need continuing professional help to have a defined benefit plan.

Plan Approval

The Internal Revenue Service (IRS) will issue a determination or opinion letter regarding a plan's qualification. The determination or opinion of the IRS will be based on how the plan is written, not on how it operates.

You are not required to request a determination or opinion letter to get all the tax benefits of a plan. But, if your plan does not have a determination letter, you may want to request one to ensure that your plan meets the requirements for tax benefits.

Because requesting a determination, opinion, or ruling letter can be complex, you may need professional help. Also, the IRS charges a fee for issuing these letters. Attach Form 8717, *User Fee for Employee Plan Determination Letter Request*, to your determination letter application.

Master and prototype plans. It may be easier for you to adopt an IRS-approved existing master or prototype retirement plan than to set up your own original plan. Master and prototype plans can be provided by the following sponsoring organizations:

- 1) Trade or professional organizations,

- 2) Banks (including some savings and loan associations and federally insured credit unions),
- 3) Insurance companies, or
- 4) Mutual funds.

Adoption of a master or prototype plan does not mean that your plan is automatically qualified. It must still meet all of the qualification requirements stated in the tax law.

Retirement Plans for the Self-Employed

If you are a self-employed person, you can set up certain qualified retirement plans. See *Qualified Plans*, earlier. These plans generally are called Keogh or HR-10 plans. You also can set up a less complicated tax-advantaged retirement plan. See *Simplified Employee Pension (SEP)*, later.

Keogh Plans

Only a sole proprietor or a partnership (not a partner) can set up a Keogh plan. For plan purposes, a self-employed person is both an employer and an employee. It is not necessary to have employees besides yourself to set up a Keogh plan. The plan must be for the exclusive benefit of employees or their beneficiaries. You generally can deduct contributions to the plan. Contributions are not taxed to your employees until plan benefits are distributed to them.

TIP See the glossary near the end of Publication 560 for the definition of employer, employee, and common-law employee.

Deduction Limits

The limit on your deduction for your contributions to a Keogh plan depends on the kind of plan you have.

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 from the business paid (or accrued) during the year to the common-law employees participating in the plan. You must reduce this 15% 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 from the business paid during the year to a participating common-law employee. You must reduce this 25% limit in figuring the deduction for contributions you make for yourself, as discussed later.

Defined benefit plans. The deduction for contributions to a defined benefit plan is based on actuarial assumptions and computations. Consequently, an actuary must figure your deduction limit.



In figuring the deduction for contributions, you cannot take into account any contributions or benefits that exceed the limits discussed under Limits on Contributions and Benefits in Publication 560.

The deduction limit for contributions to a defined benefit plan may be greater than the defined contribution plan limits just described, but actuarial calculations are needed to determine the amount. For more information about these plans, see *Kinds of Plans* in Publication 560.

Deduction of contributions for yourself. To take a deduction for contributions you make for yourself to a plan, you must have **net earnings** from the trade or business for which the plan was established.

Limit on deduction. If the Keogh plan is a **profit-sharing plan**, your deduction for yourself is limited to the smaller of \$30,000 or 13.0435% (15% reduced as discussed below) of your net earnings from the trade or business that has the plan. If the plan is a **money purchase plan**, the deduction is limited to the smaller of \$30,000 or 20% (25% reduced as discussed below) 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. If you are a partner who only contributed capital, and who did not perform personal services, you cannot participate in the partnership's plan. Your net earnings do not take into account tax-exempt 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 allowable deductions from that business. Allowable deductions include contributions to the plan for your common-law employees along with your other business expenses.

If you are a partner other than a limited partner, your net earnings include your distributive share of the partnership income or loss (other than separately computed items such as capital gains and losses) and any guaranteed payments you receive from the partnership. If you are a limited partner, your net earnings include only guaranteed payments you receive for services rendered to or for the partnership. For more information, see *Partners under Who Must Pay Self-Employment Tax* in Publication 533.

Net earnings does not include income passed through to shareholders of S corporations.

Adjustments. You must reduce your net earnings by the income tax deduction for one-

half of 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 can make the adjustment to your net earnings 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 \$150,000 of your compensation in figuring your contribution to a defined contribution plan.

TIP For employees in a collective bargaining unit covered by a plan for which the \$150,000 limit does not apply for the plan year beginning in 1996, the compensation limit is \$250,000.

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, 10 1/2% would be 0.105) _____
- 2) Rate in line 1 plus one (for example, 0.105 plus one would be 1.105) _____
- 3) Self-employed rate as a decimal (divide line 1 by line 2) _____

Now that you have 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 contribution rate shown in 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 25, 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 \$150,000 by your plan contribution rate. Enter the result but not more than \$30,000 \$ _____

Step 7

Enter the smaller of step 5 or step 6. This is your **maximum deductible contribution**. Enter your deduction on line 27, Form 1040. \$ _____

Example. You are a self-employed farmer and have employees. The terms of your plan provide that you contribute 10 1/2% (.105) of your compensation, (defined earlier) and 10 1/2% of your common-law employees' compensation. Your net earnings from line 36, Schedule F (Form 1040) are \$200,000. In figuring this amount, you deducted your common-law employees' pay of \$100,000 and contributions for them of \$10,500 (10 1/2% x \$100,000). You figure your self-employed rate and maximum deduction for employer contributions on behalf of yourself as follows:

Rate Worksheet for Self-Employed

- 1) Plan contribution rate as a decimal (for example, 10 1/2% would be 0.105) 0.105
- 2) Rate in line 1 plus one (for example, 0.105 plus one would be 1.105) 1.105
- 3) Self-employed rate as a decimal (divide line 1 by line 2) 0.0950

Deduction Worksheet for Self-Employed

Step 1

Enter the contribution rate shown in line 3 above..... 0.0950

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). \$200,000

Step 3

Enter your deduction for self-employment tax from line 25, Form 1040 \$ 6,566

Step 4

Subtract step 3 from step 2 and enter the result..... \$193,434

Step 5

Multiply step 4 by step 1 and enter the result..... \$ 18,376

Step 6

Multiply \$150,000 by your plan contribution rate. Enter the result but not more than \$30,000 \$ 15,750

Step 7

Enter the smaller of step 5 or step 6. This is your **maximum deductible contribution**. Enter your deduction on line 27, Form 1040. \$ 15,750

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, plus extensions, of your tax return for that year.

More information. More information on retirement plans for the self-employed and on the reporting forms that must be filed for these plans can be found in Publication 560.

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 some advantages available to Keogh and other 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 an individual retirement arrangement (called a SEP-IRA in this chapter), which is owned by you or your common-law employee.

SEP-IRAs are set up for, at a minimum, each qualifying 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, get Publication 560.

You may be able to use **Form 5305-SEP** in setting up your SEP. See the reproduction of Form 5305-SEP later.

Contribution limits. Contributions you make for a year to a common-law employee's SEP-IRA cannot exceed the smaller of 15% of the employee's compensation or \$30,000. Compensation, for this purpose, generally does not include employer contributions to the SEP.

Annual compensation limit. You generally cannot consider the part of compensation of an employee that is over \$150,000 when you figure your contributions limit for that employee.

TIP For employees in a collective bargaining unit for which the \$150,000 limit does not apply, the compensation limit is \$250,000.

More than one plan. If you also contribute to a defined contribution retirement plan, annual additions to an account are limited to the lesser of (1) \$30,000 or (2) 25% of the participant's compensation. When you figure these limits, your contributions to all of the plans must be added. Since a SEP is considered a defined contribution plan for purposes of these limits, your contributions to a SEP must be added to your contributions to defined contribution plans.

Reporting on Form W-2. Do not include SEP contributions on Form W-2, Wage and Tax Statement, unless there are contributions over the limit that applies or there are contributions under a salary reduction arrangement.

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. However, special rules apply when you figure your maximum deductible contribution. See *Deduction of contributions for yourself*, later.

Deduction limits. The most you can deduct for employer contributions for common-law employees is 15% of the compensation paid to them 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, which does not include:

- 1) The deduction allowed to you for one-half of the self-employment tax, and
- 2) The deduction for contributions on behalf of yourself to the plan.

The deduction amount for (2), above, and your compensation (net earnings) are each dependent on the other. For this reason, the deduction amount for (2) is figured indirectly by reducing the contribution rate called for in your plan. This is done by using the *Rate Worksheet for Self-Employed*, shown earlier.

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 other qualified plans. If you also contributed to any other type of qualified plan, treat the SEP as a separate profit-sharing plan for purposes of applying the overall 25% deduction limit described in section 404(h)(3) of the Internal Revenue Code.

Employee contributions. Participants can also make contributions of up to \$2,000 to their SEP-IRAs independent of employer's SEP contributions. The portion of the IRA contributions that is deductible may be reduced or eliminated because the participant is covered by an employer retirement plan (the SEP plan). See Publication 590 for details.

Salary Reduction Arrangement

A SEP can include a salary reduction (elective deferral) arrangement. Under the arrangement, employees can elect to have you contribute part of their pay to their SEP-IRAs. The income tax on the part contributed is deferred. This choice is called an elective deferral, which remains tax free until distributed (withdrawn).

CAUTION An employer is no longer allowed to establish a SARSEP after 1996. However, participants in a SARSEP that was established before 1997 can continue to elect to have their employer contribute part of their pay to the plan. The new SIMPLE plan,

**Simplified Employee Pension-Individual
Retirement Accounts Contribution Agreement**

(Under section 408(k) of the Internal Revenue Code)

**DO NOT File with
the Internal
Revenue Service**

_____ makes the following agreement under section 408(k) of the
(Name of employer)
Internal Revenue Code and the instructions to this form.

Article I—Eligibility Requirements (Check appropriate boxes—see Instructions.)

The employer agrees to provide for discretionary contributions in each calendar year to the individual retirement account or individual retirement annuity (IRA) of all employees who are at least _____ years old (not to exceed 21 years old) and have performed services for the employer in at least _____ years (not to exceed 3 years) of the immediately preceding 5 years. This simplified employee pension (SEP) includes does not include employees covered under a collective bargaining agreement, includes does not include certain nonresident aliens, and includes does not include employees whose total compensation during the year is less than \$400*.

Article II—SEP Requirements (See Instructions.)

The employer agrees that contributions made on behalf of each eligible employee will be:

- A. Based only on the first \$150,000* of compensation.
- B. Made in an amount that is the same percentage of compensation for every employee.
- C. Limited annually to the smaller of \$30,000* or 15% of compensation.
- D. Paid to the employee's IRA trustee, custodian, or insurance company (for an annuity contract).

Employer's signature and date

Name and title

Paperwork Reduction Act Notice

You are not required to provide the information requested on a form that is subject to the Paperwork Reduction Act unless the form displays a valid OMB control number. Books or records relating to a form or its instructions must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and return information are confidential, as required by Code section 6103.

The time needed to complete this form will vary depending on individual circumstances. The estimated average time is:

- Recordkeeping 7 min.
- Learning about the law or the form 26 min.
- Preparing the form 20 min.

If you have comments concerning the accuracy of these time estimates or suggestions for making this form simpler, we would be happy to hear from you. You can write to the Tax Forms Committee, Western Area Distribution Center, Rancho Cordova, CA 95743-0001. **DO NOT** send this form to this address. Instead, keep it for your records.

Instructions

Section references are to the Internal Revenue Code unless otherwise noted.

Purpose of Form

Form 5305-SEP (Model SEP) is used by an employer to make an agreement to provide benefits to all eligible employees under a SEP described in section 408(k). Do not file this form with the IRS. See Pub. 580, Retirement Plans for the Self-Employed, and Pub. 590, Individual Retirement Arrangements (IRAs).

Instructions to the Employer

Simplified Employee Pension.—A SEP is a written arrangement (a plan) that provides you with a simplified way to make contributions toward your employees' retirement income. Under a SEP, you can contribute to an employee's individual retirement account or annuity (IRA). You make contributions directly to an IRA set up by or for each employee with a bank, insurance company, or other qualified financial institution. When using Form 5305-SEP to establish a SEP, the IRA must be a Model IRA established on an IRS form or a master or prototype IRA for which the IRS has issued a favorable opinion letter. Making the agreement on Form 5305-SEP does not establish an employer IRA described in section 408(c).

When Not To Use Form 5305-SEP.—Do not use this form if you:

1. Currently maintain any other qualified retirement plan. This does not prevent you from maintaining another SEP.
2. Previously maintained a defined benefit plan that is now terminated.
3. Have any eligible employees for whom IRAs have not been established.
4. Use the services of leased employees (described in section 414(r)).
5. Are a member of an affiliated service group (described in section 414(m)), a controlled group of corporations (described in section 414(b)), or trades or businesses under common control (described in sections 414(c) and 414(o)), unless all eligible employees of all the members of such groups, trades, or businesses, participate in the SEP.
6. Will not pay the cost of the SEP contributions. Do not use Form 5305-SEP for a SEP that provides for elective employee

contributions even if the contributions are made under a salary reduction agreement.

Use Form 5305A-SEP, or a nonmodel SEP if you permit elective deferrals to a SEP.

Note: SEPs permitting elective deferrals cannot be established after 1996.

Eligible Employees.—All eligible employees must be allowed to participate in the SEP. An eligible employee is any employee who: (1) is at least 21 years old, and (2) has performed "service" for you in at least 3 of the immediately preceding 5 years.

Note: You can establish less restrictive eligibility requirements, but not more restrictive ones.

Service is any work performed for you for any period of time, however short. If you are a member of an affiliated service group, a controlled group of corporations, or trades or businesses under common control, service includes any work performed for any period of time for any other member of such group, trades, or businesses.

Excludable Employees.—The following employees do not have to be covered by the SEP: (1) employees covered by a collective bargaining agreement whose retirement benefits were bargained for in good faith by you and their union, (2) nonresident alien employees who did not earn U.S. source income from you, and (3) employees who received less than \$400* in compensation during the year.

Contribution Limits.—The SEP rules permit you to make an annual contribution of up to 15% of the employee's compensation or \$30,000*, whichever is less. Compensation, for this purpose, does not include employer contributions to the SEP or the employee's

Page 2 not shown

* This amount reflects the cost-of-living increase effective January 1, 1996. The amount is adjusted annually. The IRS announces the increase, if any, in a news release and in the Internal Revenue Bulletin.

described earlier, is now available to small employers.

This election is available only if:

- 1) At least 50% of your employees eligible to participate choose the salary reduction arrangement,
- 2) You had 25 or fewer employees who were eligible to participate in the SEP (or would have been eligible to participate if you had maintained a SEP) at any time during the preceding year, and
- 3) The deferral each year by each eligible highly compensated employee (as defined in Publication 560) as a percentage of pay (deferral percentage) is no more than 125% of the average deferral percentage (ADP) of all nonhighly compensated employees eligible to participate (the ADP test). You generally cannot consider compensation of an employee in excess of \$150,000 in figuring an employee's deferral percentage.

Limits on elective deferrals. In general, the total income an employee can defer under a salary reduction arrangement included in a SEP and certain other elective deferral arrangements for 1996 is limited to the lesser of 15% of the participant's compensation (as defined in Publication 560) or \$9,500. This limit applies only to the amounts that represent a reduction from the employee's pay, not to any contributions from employer funds.

Employment taxes. Elective deferrals, not exceeding the ADP test, are not subject to income tax in the year of deferral, but are included in wages for social security, Medicare, and unemployment (FUTA) tax purposes.

Reporting SEP Contributions on Form W-2

Your SEP contributions are excluded from your employees' income. Unless there are contributions above the limit that applies, or unless there are contributions under a salary reduction arrangement, do not include these contributions in your employees' 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 employees' Form W-2 wages for social security and Medicare tax purposes only.

Example. Jim's salary reduction arrangement calls for a deferral contribution rate of 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 did not elect to treat deferrals as compensation under the arrangement. To figure the deferral amount, the employer multiplies Jim's salary of \$30,000 by 9.0909%, the reduced rate equivalent of 10% to get the deferral amount of \$2,727.27. (This method is the same one that you, as a self-employed person, use to figure the contributions you make

on your own behalf.) See *Rate Worksheet for Self Employed*, earlier.

On Jim's Form W-2, the employer shows total wages of \$27,272.73 (\$30,000 minus \$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 the employer elects to treat deferrals as compensation under the salary reduction arrangement, Jim's deferral amount would be \$3,000 (\$30,000 x 10%) because, 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 minus \$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 (\$30,000 x 13.0435%) \$3,913.05.

For more information on employer withholding requirements, see Publication 15.

For more information on SEPs, get Publication 560.

Nonqualified Plans

You can deduct contributions made to a non-exempt trust or premiums paid under a non-qualified annuity plan. Your employees generally must include the contributions or premiums in their gross income.

Deduct your contributions to the plan in the tax year in which any of your employees must include an amount of the contributions in their gross income. You can deduct contributions only if you maintain separate accounts for each participating employee.

Transferable interest. When an employee's interest in your contributions or premiums for that employee is transferable, the employee must include those amounts in gross income for the tax year in which you make them. This rule also applies if the employee's interest is not subject to a substantial risk of forfeiture (that is, there is not much of a risk that the employee will lose his or her interest) when you make contributions or pay premiums for that employee.

Nontransferable interest. If, when you make the contributions, the employee's interest in the trust or in the value of the annuity contract is not transferable and is subject to a substantial risk of forfeiture, the employee does not include that interest in gross income until the tax year in which the interest becomes transferable or is no longer subject to a substantial risk of forfeiture.

Individual Retirement Arrangements (IRAs)

You can set up and make contributions to an individual retirement arrangement (IRA) if you

received taxable **compensation** during the year and were not age 70½ by the end of the year.

Compensation. Compensation (for IRA purposes) includes taxable wages, salaries, commissions, bonuses, tips, professional fees, and other amounts received for providing personal services. Compensation also includes taxable alimony and separate maintenance payments.

The IRS treats as compensation any amount properly shown in box 1 (Wages, tips, other compensation) of Form W-2, provided that amount is reduced by any amount shown in box 11 (Nonqualified plans).

Self-employed. If you are self-employed (a sole proprietor or partner), compensation is your net earnings from your trade or business (provided your personal services are a material income-producing factor), reduced by the deduction for contributions on your behalf to retirement plans and the deduction allowed for one-half of your self-employment tax.

Compensation does **not** include any of the following:

- 1) Income received from property (i.e., rental, interest, and dividend income).
- 2) Pension or annuity income, and deferred compensation.
- 3) Foreign earned income and housing cost amounts that you exclude from income.
- 4) Any other amounts that you exclude from income.

Contributions. The most you can contribute for any year to your IRA is the **smaller** of:

- 1) \$2,000, or
- 2) Your compensation that you must include in income for the year.

Deductible contributions. Generally, you can take a deduction for the contributions that you are allowed to make to your IRA. However, if you or your spouse is covered by an employer retirement plan at any time during the year, your allowable IRA deduction may be less than your contribution. It may be reduced or eliminated, depending on your filing status and the amount of your income.

Nondeductible contributions. Although your deduction for IRA contributions may be reduced or eliminated, you can still make contributions of up to \$2,000 or 100% of your compensation, whichever is less. Often the difference between your total permitted contributions and your total deductible contributions, if any, is your nondeductible contribution.

For details on these and other rules, as well as general information on IRAs, get Publication 590.

Excise Taxes

Important Change

Diesel-powered highway vehicles. The rule providing advance refunds of diesel fuel tax is repealed for diesel-powered highway vehicles bought after August 20, 1996. See *Diesel-Powered Highway Vehicles*, later.

Important Reminders

Dyed diesel fuel. Dyed diesel fuel that is used for a nontaxable purpose (such as farm use) is not taxed. However, the excise tax and a penalty will be imposed on users of dyed diesel fuel who know or have reason to know that they used the fuel for a taxable purpose. You cannot use dyed diesel fuel in a registered highway vehicle. For more information, see Publication 510.

Undyed diesel fuel. A registered vendor that sells undyed diesel fuel for use on a farm for farming purposes is allowed to claim a refund or credit of the excise tax on that fuel. Farmers **cannot** claim a refund or credit for the excise tax paid on that fuel. See *How To Buy Diesel Fuel Tax Free*, later.

Introduction

You may be eligible to claim a credit on your income tax return for federal excise tax paid 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.

Also, you may be eligible to claim a one-time credit or refund as the **original** buyer of a diesel-powered car, van, or light truck. This applies even if you do not use the vehicle in a trade or business. See *Diesel-Powered Highway Vehicles*, later.

For information about credits and refunds for fuels used for nontaxable purposes not discussed in this chapter, see Publication 378.

Topics

This chapter discusses:

- Fuels used for farming purposes
- Fuels used in off-highway business use
- How to buy diesel fuel tax free
- Diesel-powered highway vehicles
- How to claim an excise tax 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 1997

Form (and Instructions)

- 4136** Credit for Federal Tax Paid on Fuels
- 8849** Claim for Refund of Excise Taxes

Publication 349, *Federal Highway Use Tax on Heavy Vehicles*, is no longer published. Information previously contained in that publication is in the instructions for Form 2290, *Heavy Vehicle Use Tax Return*.

See chapter 21 for information about getting publications and forms.

Fuels Used on a Farm for Farming Purposes

You may be eligible to claim a credit or refund of excise taxes included in the price of fuel used on a farm for farming purposes. This applies if you are the owner, tenant, or operator of a farm. You may claim only a credit for the tax on gasoline, **special motor fuels**, and compressed natural gas used on a farm for farming purposes. You may 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 used on a farm for farming purposes or for any use of dyed diesel fuel.

The term **special motor fuels** includes such products as benzol, benzene, naphtha, liquid petroleum gas, casing head and natural gasoline. It also includes any other liquid other than gasoline, diesel fuel, kerosene, gas oil, and fuel oil. Treat products called kerosene, gas oil, or fuel oil that do not fall within certain specifications as special motor fuels. For more information, see Publication 510.

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. You must operate the farm for profit. It must be located in any of the 50 states or the District of Columbia.

Farming purposes. You use fuel on a farm for farming purposes if you use it:

- 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, tools, or 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 that was so treated during the tax year. Commodity means a single raw product. For example, apples and peaches are two separate commodities. The more than one-half test applies separately to each commodity.

- 5) To plant, cultivate, care for, or cut trees, or to prepare (other than sawing 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 any of the purposes listed in (1) or (2) for you on your farm, you can claim the credit or refund for the fuel (other than diesel fuel) so used.

If the person performs any other services for you on your farm, **no one** can claim the credit or refund for fuel used on your farm for those other services.

If doubt exists whether the owner, tenant, or the operator of the farm bought the fuel, determine who actually bore the cost of the fuel. Also, if you sell fuel to a neighbor who uses it on a farm for farming purposes, your neighbor may be able to claim the credit on the fuel. Your neighbor (not you) bore the cost of the fuel.

Example 1. Farm owner Nancy Blue hired custom operator Harry Steele to prepare the soil on the her farm for planting. Under the contract, she paid for 200 gallons of gasoline to be used by Harry in cultivating the soil on her 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 and was not reimbursed by Nancy. She 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 because they were not used for a farming purpose listed in (1) or (2) earlier.

Example 2. George Green, the owner of the farm, and his tenant, Sam Smith, share the cost of gasoline used on the farm 50-50. Each can claim a credit for the tax on half the fuel used for farming purposes.

Diesel fuel. If undyed diesel fuel is used for any of the previously listed farming purposes, **the fuel cannot be considered as being used for any other nontaxable purpose.** The credit or refund is allowed only to the **registered ultimate vendor.** Farmers **cannot** claim a refund or credit for this fuel if it is used for farming purposes. See *How To Buy Diesel Fuel Tax Free*, later.

A **registered ultimate vendor** is a seller registered by the IRS who sells undyed diesel fuel to the user of the fuel (the ultimate purchaser).

Custom application of fertilizer and pesticide. Fuel used on a farm for farming purposes includes fuel used in the aerial or other application of fertilizers, pesticides, or other substances. You as the owner, tenant, or operator may claim the credit or refund (other than on diesel fuel). You may waive your right to the claim and allow the applicator to make the claim for the fuel (other than diesel fuel). If you waive your right, the applicator is then treated as having used the fuel on a farm for farming purposes. See *How To Claim a Credit or Refund*, later.

The waiver. To waive your right to the credit or refund, you must:

- 1) Execute in writing an irrevocable statement that you knowingly give up your right to the credit or refund.
- 2) Identify clearly the period that the waiver covers. The effective period of your waiver cannot extend beyond the last day of your tax year in which the fuel was used.
- 3) Sign the waiver before the applicator files his or her claim. Once you sign the waiver, you cannot revoke it. You may authorize an agent, such as a cooperative, to sign the waiver for you.
- 4) Keep a copy of the waiver for your records and give a copy of the signed waiver to the applicator. Do **not** send this waiver to the Internal Revenue Service unless requested to do so.

The waiver may be a separate document or it may 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.

Sign a separate waiver for each tax year or part of a tax year in which the fuel was used. 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.

Sample form of waiver. While no specific form is required, an acceptable statement waiving your right to claim a credit or refund is shown in *Table 18-1*.

Fuel not used for farming. You do not use fuel for farming purposes when you use it:

- 1) 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.
- 2) For personal use, such as mowing the lawn.
- 3) In processing, packaging, freezing, or canning operations.

Table 18-1. **Sample Waiver**

| WAIVER OF RIGHT TO CREDIT OR REFUND | |
|---|--|
| I hereby waive my right as owner, tenant, or operator of a farm located at: | |
| _____ | |
| <i>Address</i> | |
| to receive credit or refund for fuel used by: | |
| _____ | |
| <i>Name of Applicator</i> | |
| on the farm in connection with cultivating the soil, or the raising or harvesting of any agricultural or horticultural commodity. This waiver applies to fuel used during the period: | |
| _____ | |
| <i>Both Dates Inclusive</i> | |
| I understand that by signing this waiver, I give up my right to claim any credit or refund for fuel used by the aerial applicator or other applicator of fertilizer or other substances during the period indicated, and I acknowledge that I have not previously claimed any credit for that fuel. | |
| _____ | |
| <i>Signature</i> | |
| _____ | |
| <i>Date</i> | |

- 4) In processing crude gum into gum spirits of turpentine or gum resin or in processing maple sap into maple syrup or maple sugar.

Fuel used in all-terrain vehicles (ATVs) on a farm for farming purposes, discussed earlier, is eligible for a credit or refund of excise taxes included in the price of the fuel. Fuel used in ATVs for nonfarming purposes is not eligible for a credit or refund of the taxes.

Fuels Used In Off-Highway Business Use

You may be eligible to claim a credit or refund for fuels used in an off-highway business use.

Off-highway business use. Off-highway business use is any use of fuel in a trade or business or in any income-producing activity. The use must not be in a highway vehicle registered for use on public highways. Off-highway business use generally does not include any use in a motorboat.

Note. If undyed diesel fuel is used on a farm for farming purposes (discussed earlier), the fuel cannot be considered as being used in an off-highway business use. See *How To Buy Diesel Fuel Tax Free*, later.

Examples. Off-highway business use in a trade or business or income-producing activity includes fuels used:

- 1) In stationary machines such as generators, compressors, power saws, and similar equipment,
- 2) For cleaning purposes,
- 3) In forklift trucks and bulldozers, and
- 4) In vehicles operating off the highway in construction, mining, or timbering activities if the vehicles are neither registered nor required to be registered.

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, get Publication 378.

How To Buy Diesel Fuel Tax Free

You buy **dyed** diesel fuel excise tax free. You must use it only for a nontaxable purpose, including use on a farm for farming purposes. If you use the dyed diesel fuel for a taxable purpose, such as in a **registered** highway vehicle, you could be subject to the excise tax and a penalty.

You may buy **undyed** diesel fuel tax free for use on a farm for farming purposes from a registered ultimate vendor. This applies to fuel bought by:

- 1) The owner, tenant, or operator of a farm for use on a farm for any of the purposes listed earlier under *Farming purposes*, or

- 2) 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 sample certificate shown in *Table 18-2*. You may include the certificate as part of any business records you normally use to document a sale and purchase.

You cannot claim a credit or refund for the excise tax on diesel fuel used on a farm for farming purposes.

Registered. A vehicle is considered registered if it is registered or required to be registered for highway use under the law of any state, the District of Columbia, or any foreign country in which it is operated or situated. Any highway vehicle operated under a dealer's

tag, license, or permit is considered registered. A highway vehicle is not considered registered solely because a specific permit allows the vehicle to be operated at particular times and under specified conditions.

Diesel-Powered Highway Vehicles

If you buy a qualified diesel-powered car, van, or light truck, you may be eligible for a one-time credit or refund. You can buy the vehicle for either business or personal use. You generally claim the credit on the tax return for the year of purchase. However, if you can claim a refund for certain excise taxes, you may be able to use Form 8849 to claim a refund for the purchase of a vehicle. See *How to claim a refund*, later.

Table 18-2. **Sample Exemption Certificate**

| EXEMPTION CERTIFICATE | |
|--|---|
| <small>(To support vendor's claim for credit or payment under section 6427 of the Internal Revenue Code)</small> | |
| _____ <i>Name, Address, and Employer Identification Number of Seller</i> | |
| The undersigned buyer ("Buyer") hereby certifies the following under penalties of perjury: | |
| A. Buyer will use the diesel fuel to which this certificate relates either — (check one): | |
| 1. <input type="checkbox"/> | 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). |
| 2. <input type="checkbox"/> | 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 <input type="checkbox"/> 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 <input type="checkbox"/> and enter: |
| a. | Effective date _____ |
| b. | Expiration date _____ <i>(period not to exceed 1 year after effective date)</i> |
| c. | Buyer account or order number _____ |
| ø | Buyer will provide a new certificate to the seller if any information in this certificate changes. |
| ø | If Buyer uses the diesel fuel to which this certificate relates for a purpose other than stated in the certificate Buyer will be liable for any tax. |
| ø | 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. |
| _____ <i>Signature and Date Signed</i> | |
| _____ <i>Printed or Typed Name and Title of Person Signing</i> | |
| _____ <i>Name, Address, and Employer Identification Number of Buyer</i> | |



Credit or refund repealed. You cannot claim a credit or refund for a diesel-powered highway vehicle bought after August 20, 1996.

Original buyer. You must be the original buyer to be eligible for the credit or refund. An original buyer is the first person to buy a new qualified diesel-powered vehicle for use other than resale.

If you buy and register a qualified diesel-powered vehicle subject to a lien (even if the lien-holder holds title to the vehicle), you can claim the credit or refund.

The following do not qualify as original buyers:

- 1) State and local governments,
- 2) Nonprofit educational organizations, or
- 3) Dealers who use the vehicle as a demonstrator vehicle. However, the first person to buy the demonstrator vehicle for use other than resale qualifies as the vehicle's original buyer.

Qualified diesel-powered highway vehicle. A qualified diesel-powered highway vehicle is one that:

- 1) Has at least four wheels,
- 2) Has a gross vehicle weight rating of 10,000 pounds or less, and
- 3) Is registered for highway use in the United States under the laws of any state.

Amount of credit or refund. You can claim a credit or refund of \$102 for a car, and \$198 for a light truck or van. A van is a vehicle with no body sections protruding more than 30 inches ahead of the leading edge of the windshield.

Basis reduction. Reduce the basis of any qualified diesel-powered highway vehicle by the amount of credit or refund payable for the vehicle. Consider the basis reduction to occur on the date of purchase.

Example. David bought a new diesel-powered car to use in his business. He claimed the \$102 credit **only** for the tax year in which he bought the car (1995). He reduced his basis in the car by \$102 on the date he bought it.

How to claim the credit. You claim the credit for the purchase of a qualified diesel-powered vehicle on Form 4136. Complete Parts I and III and attach Form 4136 to your income tax return.

Even if you do not have to file an income tax return, you should still file a return to claim this refundable credit. If you do not file a return, you cannot claim the credit. Do not claim a credit for any tax for which you have filed a refund claim.

How to claim a refund. You may be eligible to use Form 8849 to claim the refund available to you as the original buyer of a qualifying diesel-powered highway vehicle. Use Form 8849 only if you qualify to file a quarterly refund

claim, as discussed under *Claiming a Refund*, later.

How To Claim a Credit or Refund

You may be able to claim a credit or refund of the excise taxes included in the price of fuels you use for nontaxable purposes. You can claim only a credit for gasoline, special motor fuel, and compressed natural gas used for farming purposes. You can claim either a credit or a refund for aviation fuel used for farming purposes.

No credit or refund is allowed to anyone for any fuel, such as dyed diesel fuel, bought tax free.

Undyed diesel fuel. You cannot claim a credit or refund for undyed diesel fuel used on a farm for farming purposes. Only the registered vendor that sells the fuel to you can make this claim. However, you can claim a credit or refund for undyed diesel fuel used for other nontaxable purposes, such as off-highway business use. If undyed diesel fuel is used on a farm for farming purposes, you cannot consider it as being used for any other nontaxable purpose.

Taxpayer identification number. To file a claim for credit or refund, you **MUST** have a taxpayer identification number — either a social security number or an employer identification number. See *Identification Number* in chapter 2.



Keep at your principal place of business all records needed to enable the IRS to verify the amount you claimed. You do not have to use any special form, but the records should establish:

- 1) The total number of gallons bought and used during the period covered by your claim.
- 2) The dates of the purchases.
- 3) The names and addresses of suppliers and amounts bought from each during the period covered by your claim.
- 4) The purpose for which you bought and used the fuel.
- 5) The number of gallons used for each purpose.

It is important that your records show separately the number of gallons used for each purpose that qualifies as a claim. For more information about recordkeeping, see Publication 552, *Recordkeeping for Individuals*.

Claiming a Credit

You file a claim for credit (including the fuel tax credit) on Form 4136 and attach it to your income tax return. Do not claim a credit on Form 4136 for any excise tax for which you have already filed a refund claim on Form 8849.

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 57 and check box b of the 1996 Form 1040. If you may not otherwise have to file an income tax return, you must do so to obtain a fuel tax credit. See the instructions accompanying Form 1040.

Partnerships. A partnership cannot claim the credit on Form 1065, *U.S. Partnership Return of Income*. The partnership must attach a statement to Form 1065, showing the number of gallons of each fuel allocated to each partner and the rate that applies. Each partner claims the credit on his or her income tax return for his or her share of the fuel used by the partnership.

Corporations. To claim the credit, corporations either use 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 corporations. To claim the credit, S corporations use line 23c of Form 1120S, *U.S. Income Tax Return for an S Corporation*.

Farmers' cooperative associations. If the cooperative must file Form 990-C, *Farmers' Cooperative Association Income Tax Return*, it uses line 32g to claim the credit.

Trusts. Trusts required to file Form 1041, *U.S. Income Tax Return for Estates and Trusts*, use 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 fuels or you may amend your income tax return for that year. Ordinarily, you must file an amended return by the later of 3 years from the date you filed your original return or within 2 years from the time you paid the tax. A return filed early is considered to have been filed on the due date.

Claiming a Refund

You may be eligible to claim a refund quarterly during your tax year rather than waiting to file your income tax return to claim a credit for the entire tax year. However, you cannot claim a refund for excise tax on gasoline, special motor fuel, and compressed natural gas used on a farm for farming purposes. File a claim for refund on Form 8849.

Quarterly refund claim. You can file a quarterly refund claim for any of the first three quarters of your tax year for which you qualify. To qualify for a quarterly refund, you must claim the following amounts for fuel used during the quarter:

- 1) At least \$1,000 for **gasoline** used for nontaxable purposes (other than use on a farm for farming purposes).
- 2) At least \$1,000 for **special motor fuel** and **compressed natural gas** used for nontaxable purposes (other than use on a farm for farming purposes) and for any credit for diesel-powered highway vehicles.

- 3) At least \$750 for **undyed diesel fuel** (other than for use on a farm for farming purposes).

A special rule for diesel fuel and aviation fuel allows you to aggregate the amount of fuel used in each quarter. You may file a claim for the quarter for which the combined total is at least \$750.

Fourth quarter claims. You cannot file a quarterly claim for refund for the fourth quarter of your tax year. You file claims for the fourth quarter as a credit on your income tax return.

When to file quarterly claim. You must file a quarterly claim by the last day of the third month after the end of the quarter for which the claim is being filed. If you file your claim late, you are not allowed a refund. Instead, you add the amount of disallowed refund to any claim for credit and claim it on your income tax return, as explained earlier. Do not claim a credit against your income tax for any excise tax for which you filed a claim for refund.

Generally, you file Form 8849 with the same IRS Service Center where you file your income tax return. A partnership files a claim for refund in the name of the partnership, and one of the partners must sign it. A corporation files the claim in the name of the corporation, and one of its officers must sign it.

Including the Credit or Refund in Income

Include any credit or refund of excise taxes on fuels you receive in your gross income if you claimed the taxes as an expense deduction that reduced your income tax liability. Do not include as income any credit or refund related to the purchase of a qualified diesel-powered highway vehicle.

The 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 your 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 it.

Example. Ed Brown, a cash-basis farmer, filed his 1996 Form 1040 on March 1, 1997. On his Schedule F, Ed deducted the total cost of gasoline (including \$110 of excise taxes) used on the farm for farming purposes. Then, on Form 4136, Ed claimed the \$110 of excise tax paid on the gasoline as a credit. Ed reports the \$110 as additional income on his 1997 Schedule F.

Accrual method. If you use an accrual method, include the entire claim in gross income for the tax year in which the qualifying use occurred. It does not matter if an accrual-

basis taxpayer filed for a quarterly refund or claimed the entire amount as a credit.

Example. Todd Green, an accrual farmer, filed his 1996 Form 1040 on April 12, 1997. On Schedule F, he deducted the total cost of gasoline (including \$155 of excise taxes) that he used on the farm during 1996. On Form 4136, Todd claimed the \$155 excise tax paid on the gasoline as a credit. He must report the \$155 as additional income on his 1997 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 happens 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 manner, you should tell that employee's supervisor. If the supervisor's response is not satisfactory, you should write to your IRS District Director or Service Center Director.

Representation. You may either represent yourself, or with proper written authorization, have someone else represent you in your place. You can have someone accompany you at an interview. You may make sound recordings of any meetings with our examination 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.

Help from the Problem Resolution Office. Problem resolution officers can help you with unresolved tax problems and can offer you special help if you have a significant hardship

as a result of a tax problem. For more information, write to the Problem Resolution Office at the district office or service center where you have the problem, or call 1-800-829-1040 (1-800-829-4059 for TTY/TDD users).

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 IRS Appeals Office to review your case. You may also ask a court to review your case.

Relief from certain penalties. 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.

Examinations, Appeals, Collections, and Refunds

Examinations (audits). We accept most taxpayer's 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.

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. If you give 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 us about anything you do not understand. If you cannot resolve a question through the mail, you can request a personal interview with an examiner.

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. At the end of your examination, the examiner will give you a report if there are any proposed changes to your tax return. If you do not agree with the report, you may meet with the examiner's supervisor.

Repeat examinations. If we examined your tax 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 determine if we should discontinue the repeat examination. Publication 556, *Examination of Returns, Appeal Rights, and Claims for Refund*, will give you more information about the rules and procedures of an IRS examination.

Appeals. If you do not agree with the examiner's findings, you can appeal them to our Appeals Office. Most differences can be settled without expensive and time-consuming court

trials. Your appeal rights are explained in detail in Publication 5, *Appeal Rights and Preparation of Protests for Unagreed Cases*. If you do not wish to use our Appeals Office or disagree with its findings, you can 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 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 our Appeals system, and you gave us all the information necessary to resolve the case.

Collection. Publication 594, *Understanding The Collection Process*, explains your rights and responsibilities regarding payment of federal taxes. It is divided into several sections that explain the procedures in plain language. The sections include:

- 1) *When you have not paid enough tax.* This section describes tax bills and explains what to do if you think your bill is wrong.
- 2) *Making arrangements to pay your bill.* This covers making installment payments, delaying collection action, and submitting an offer in compromise.
- 3) *What happens when you take no action to pay.* This covers liens, releasing a lien, levies, releasing a levy, seizures and sales, and release of property. Publication 1660, *Collection Appeal Rights (for Liens, Levies and Seizures)*, explains your rights to appeal liens, levies and seizures and how to request these appeals.

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 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.

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 cents. You may round off cents 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, \$129.39 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 gain 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 casualty or theft loss that was more than your income.

If you have an NOL this year, you may be able to get all or part of the income tax you paid for the past 3 tax years refunded, or you may be able to 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 line 35 of Form 1040. If this is the case, get Publication 536, *Net Operating Losses*.

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. The depreciation deduction is taken from the illustrated *Depreciation Worksheet* in the instructions for Form 4562. Farm income is discussed in chapter 4 and farm expenses are discussed in chapter 5. Mr. Brown has filed all required Form 1099 information returns.

Mr. Brown prints his name and social security number at the top of Schedule F. He writes his principal product, "MILK," on line A. On line B he writes the number "240" 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 dairy farming.

On line C, Mr. Brown checks box 1 to indicate he uses the cash method of accounting. He also enters his employer identification number (see chapter 16) on line D. He checks the "Yes" box on line E to show that he materially participated in the operation of his farm business.

Schedule F—Part I (Income)

Mr. Brown keeps records of the various types of farm income he has during the year. He uses this information to complete part I of Schedule F.

Line items. Mr. Brown then fills in all applicable items of farm income.

Line 1. In 1996, Mr. Brown sold steers he had bought for resale. He enters sales of \$12,960.

Line 2. He enters the cost of the steers, \$3,180. 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. Mr. Brown subtracts his cost on line 2 from the sales on line 1 and reports the difference, \$9,780, 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 sales of animals held for draft, dairy, breeding, or sport here. Those sales are reported on Form 4797.

Line 4. Mr. Brown reports the total of all income he received during 1996 from sales of items he raised or produced on his farm for sale. His principal source of farm income is dairy farming, and the amount reported on this line, \$124,599, includes \$98,121 from gross sales of milk.

He also received income from sales of other items raised or produced on his farm for sale. He received \$2,503 from the sale of steers and calves he raised. He grew some vegetables and sold them for \$783. In addition, he includes in the total on this line his sales of corn, hay, and wheat that he raised. He received \$7,050 for the corn, \$8,250 for the hay, and \$7,892 for the wheat.

Lines 5a and 5b. He reports the \$33 of patronage dividends received from cooperatives on line 5a. He enters \$33, the taxable amount of his patronage dividends, on line 5b. See chapter 4.

Lines 6a and 6b. Mr. Brown received CFSA (Consolidated Farmers Service Agency) cost sharing of \$438 on a soil conservation project (diversion channels) completed in 1996. The income was received as materials and services paid for by the government and is reported on both line 6a and line 6b. This amount is reported to the Internal Revenue Service (IRS), generally on Form 1099-G, by the Department of Agriculture (USDA). 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. See chapter 4.

Line 7a. Mr. Brown reported the \$665 loan he received from the 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 in the year of forfeiture.) See chapter 4.

Line 9. Mr. Brown reports his \$1,258 income from custom harvesting.

Line 10. He claimed a gasoline tax credit of \$142 on his 1995 federal income tax return. He includes the entire \$142 in his 1996 income on line 10, because that amount was included in the cost of gasoline he deducted as a farm business expense in 1995. 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 1996.

Line 11—Gross income. Mr. Brown enters \$137,340, the total of the amounts shown on lines 3, 4, 5b, 6b, 7a, 9, and 10.

Schedule F—Part II (Expenses)

Mr. Brown keeps his farm expense records during the year and summarizes the expenses at the end of the year. As a result, he has a record of his deductible expenses. These are the figures he enters in Part II of Schedule F.

Line items. Mr. Brown then fills in all applicable items of farm expense deductions.

Line 12. Mr. Brown uses his pickup truck 100% for his farming business and the actual cost of operating the truck in 1996 was \$2,659. He uses his family car 60% for business. It cost \$2,307 to operate the car in 1996 and he can deduct \$1,384 for the car ($\$2,307 \times .60$). He enters a total of \$4,043 on line 12.

Line 13. The \$2,701 on this line is the amount he paid for pesticides and herbicides purchased during the year.

Line 14. Mr. Brown deducts the \$1,040 spent on diversion channels in 1996. The amount listed here includes the full cost of the government cost-sharing project (line 6). He continues the policy elected in previous years of deducting annual soil and water conservation expenses. The expenses are consistent with a 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.

Line 15. The \$1,575 on this line is the amount he paid a company for spraying his crops. The payment was made to a corporation, so he does not file a Form 1099-MISC to report the payment.

Line 16. Mr. Brown enters the \$27,377 depreciation from Form 4562, discussed later.

Line 18. He enters the cost of feed bought for livestock, \$18,019. He did not include the cost of feed bought for livestock he and his family intend to consume.

Line 19. Mr. Brown enters \$6,544. This is the amount paid for fertilizer and lime.

Line 20. He deducts the \$3,072 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. Mr. Brown 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 (not 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. See chapter 5.

Lines 23a and 23b. Mr. Brown 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 \$1,043 interest paid on obligations incurred to buy livestock and other personal property used in farming or held for sale. Interest on his home is deducted 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 business, including wages paid to Mrs. Brown and the children. He has no employment credits. Not all the wages paid were subject to social security tax, but for those that were, he included the full amount of the wages before reduction for the employee's part of that tax. His part of the social security tax is included in the total taxes deducted on line 31. See chapter 16 for information on employment taxes.

Line 26b. Mr. Brown enters only cash rent paid, \$2,400, for the use of land he rented from a neighbor, Mr. Green. He did not deduct rent paid in crop shares. He completed a Form 1099-MISC for the rent paid to Mr. Green and sent Copy A to the IRS with Form 1096. He gave Mr. Green Copy B of the Form 1099-MISC.

Line 27. The \$5,424 he enters includes \$4,902 for repairs to farm machinery and \$522 for repairs to farm buildings. He did not include the value of his own labor. He prepared Form 1099-MISC for the farm machinery repairs because the repair shop is not incorporated. He sent Copy A to the IRS with Form 1096 and gave Copy B to the repair shop.

Line 28. Mr. Brown enters the cost of seeds and plants used in farming, \$2,132. 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. Mr. Brown enters \$3,201 for taxes paid during 1996, 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, or 60% of the gasoline tax for gasoline used in the family car for farm business, because these taxes were included in the deductions for supplies and gasoline. He included his share of social security and Medicare tax paid for agricultural employees. He filed Form 943 (not shown) in January of 1996 reporting these taxes for calendar-year 1995.

He did not deduct his state income tax or the taxes on his home on Schedule F. He deducts these taxes on Schedule A (Form 1040), which is not shown. He did not deduct any federal income tax paid during the year.

Line 32. He enters \$3,997 for the cost of water, electricity, and telephone used only in farming. He 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 1996 for veterinary fees (\$1,821), livestock medicines (\$650), and breeding fees (\$746). Mr. Brown does not prepare Form 1099-MISC for the veterinarian and breeder fees because both are incorporated.

Line 34. Mr. Brown enters other farm business expenses. These include: \$807 government milk assessment; \$347 for commissions, dues, and fees; \$287 for financial records and office supplies; and \$534 for farm business travel. Farm business travel includes expenses for the State Beef Tour and for attending the farm management conference at State University. He included only 50% of the cost of meals in the deduction.

Line 35—Total expenses. Mr. Brown adds the amounts shown on lines 12 through 34d and enters his total expenses of \$114,749 on line 35.

Line 36—Net farm profit. To arrive at his net farm profit, he subtracts the amount on line 35 (\$114,749) from the amount on line 11 (\$137,340). His net farm profit, entered on line 36, is \$22,591. He also enters that amount on line 18 of Form 1040, and on line 1 of Section A, Schedule SE (Form 1040). Because Mr. Brown 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 1980 and fully depreciated in 1988. No depreciation is allowed for 1996.

Depreciation record. Mr. Brown records 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 1996 deduction.

Basis for depreciation. Mr. Brown bought his farm on January 8, 1978. Timber on the farm was immature and had no fair market value. He immediately divided 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). The fences were fully depreciated in 1987. Mr. Brown made the division based on the respective fair market values of the items on the date the farm was bought. See the example under *Allocating the Basis* in chapter 7.

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. 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 and he uses MACRS (ADS) for all his property placed in service in 1992. He uses the 150% declining balance method and the half-year convention under MACRS for the property placed in service in 1993 and subsequent years.

Depreciable property. One of his purchased dairy cows was killed by lightning in July 1996. Another purchased cow (#52) was sold on February 1, 1996. Both cows were depreciated under MACRS (ADS), using a half-year convention. Therefore, he can claim a half-year's depreciation for each cow in 1996.

Mr. Brown has other breeding and dairy cows that he raised. He did not claim depreciation on them because they have no bases for income tax purposes.

During 1996 the Browns owned two family cars. One of them was not used for farm business. He cannot deduct the depreciation on it. He determined that his other car was used 60% for his farm business and 40% for personal driving.

The *Depreciation Worksheet* contains an itemized listing of Mr. Brown's assets for which he is deducting depreciation in 1996. They must be listed separately to keep track of their basis. The pickup truck and car purchased in 1993 are listed property in the 5-year property class.

New assets. Mr. Brown added three assets to the business in 1996.

- 1) In January, he completed and placed in service a new beef cattle feeding facility. Since the new structure is designed specifically to house, feed, and care for beef cattle, it is a single purpose livestock structure. The structure is 10-year property under MACRS. The total cost of the structure (\$37,500) includes the structure, site preparation, feeding system, and paved feeding area.
- 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 in the 20-year property class.
- 3) In March, he acquired tractor #5 by trading tractor #2 and paying \$23,729.07 cash. The adjusted basis of tractor #2 was \$983.88 when it was traded (Mr. Brown claimed half a year of depreciation). The new tractor has a basis of \$24,712.95 (\$23,729.07 + \$983.88). Form 8824, *Like-Kind Exchanges*, (not shown) was filed to report the trade. He elected to expense part of the cost of the tractor in 1996 and take depreciation deductions for the rest of the basis (cost + basis of trade-in).

Line items. Form 4562 is completed by referring to the *Depreciation Worksheet*.

Line 2. Mr. Brown enters \$61,229 on line 2. This is the total cost of all section 179 property placed in service in 1996. In figuring his cost

he does not include the basis of the traded tractor. The machine shed improvement does not qualify as section 179 property. It is not a single purpose agricultural (livestock) structure.

Line 6. Mr. Brown enters the description of the property (tractor) he is electing to expense under section 179. He enters his cost basis of \$23,729 in column (b). His cost basis for the section 179 deduction is limited to the cash he paid for the tractor. He then enters the tentative deduction, \$17,500, in column (c). However, this amount is subject to the business income limit on line 11. (He did not exceed the investment limit, \$200,000, and is subject to the maximum dollar limit, \$17,500.)

Lines 11 and 12. Mr. Brown's 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 \$17,500 on lines 11 and 12. See chapter 8 for information on the section 179 deduction.

Line 15. All property placed in service in 1996 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. Mr. Brown enters \$2,684, his MACRS depreciation deduction for assets acquired from 1992 through 1994, on line 17 of Part III. None of the assets included are listed property. Those assets are listed in Part V and that total is entered on line 20, explained later.

Line 19. On line 19, he enters \$1,374 for assets placed in service before 1981 and those depreciated under ACRS that are not listed property.

Line 20. Mr. Brown enters his depreciation deduction for listed property, \$2,184, 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 for completing Part V—the car used 60% for business and the pickup truck purchased in 1993. His deduction for the car cannot be more than 60% of the limit for passenger automobiles for the year he purchased the car.

Line 21. Mr. Brown enters the total depreciation on line 21 and carries the total, \$27,377, 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 has a practice of writing down the odometer readings on his vehicles at the end of each year and when he acquires and disposes of the vehicles. In addition, because he used 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 Mr. Brown's name and social security number go on Schedule SE. His wife does not have self-employment income. If Mrs. Brown had self-employment income, she would file her own Schedule SE.

Line items. Mr. Brown figures his self-employment tax on the following lines.

Line 1. He enters his net farm profit, \$22,591. He did not list on Schedule F any income, losses, or deductions that are not included in determining net earnings from farm self-employment (see the items 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 Mr. Brown were engaged in any other business in addition to farming, he would combine his net earnings from self-employment from all his trades or businesses on line 3 of this schedule. However, because farming was his only business, he enters his net earnings from self-employment from farming (the amount shown on line 1).

Line 4. He multiplies line 3 by .9235 and enters \$20,863 on line 4.

Lines 5 and 6. Mr. Brown multiplies line 4 by 15.3% and enters \$3,192 on line 5. This is his self-employment tax for 1996. He also enters \$3,192 on line 45 of Form 1040. He enters \$1,596 on line 6 and also on line 25 of Form 1040 (deduction for one-half of his self-employment tax).

Form 4684—Casualties and Thefts

Mr. Brown's only business casualty was a purchased dairy cow that was killed by lightning on July 7. 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 identifying number at the top of page 2.

Part I. Mr. Brown shows the kind of property, "Dairy cow #42," its location, and the date of purchase 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 fair market value before, \$500, and after, -0-, the casualty, and he shows the difference, \$500, on line 25. Mr. Brown 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. On line 34, he identifies the casualty and enters \$148 on lines 34(b)(i), 35(b)(i), 37, and 38a, and on Form 4797, Part II, line 15(g).

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 examples of items reported on Form 4797.

He prints his name, his wife's name, and 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 depreciated assets in 1996 at a gain. He has information about their cost and depreciation in his records. These items do not appear on the *Depreciation Worksheet*.

He sold a truck on July 9 and a mower on February 14. He also sold one purchased dairy cow, #41, 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 each gain that was ordinary income.

Mr. Brown enters the description of each item on lines 21(A) through 21(C) and relates those lines to the corresponding columns. He completes lines 22 through 27(b) for each disposition of property.

Gain from dispositions. As shown on line 26, column (A), his total gain on the sale of the truck is \$700. His gain on the sale of the mower on line 26, column (B), is \$70. The \$335 gain on the sale of cow # 41 is also reported as ordinary income, as shown on line 26, column (C). The gain on each item is entered in the appropriate column on line 27(b).

Summary of Part III gains. On line 32 he enters \$1,105, the total of columns (A) through (C), line 26. On line 33, he enters \$1,105, the total of columns (A) through (C), line 27(b). This amount is the gain that is ordinary income. He also enters that same amount on line 14, Part II.

He subtracts line 33 from line 32 and enters -0- on line 34. Mr. Brown has no long-term capital gain on the dispositions. All of his gain is ordinary income.

Part I. All of the animals in Part I were held 24 months or more.

Mr. Brown sold at a gain 10 cows he raised and used for dairy purposes. His selling expense was \$101 for these cows. He enters the gain from the sale of these cows on line 2. He also enters on line 2 the gain from the sale of a raised dairy heifer and the loss from the sale of purchased dairy cow #52. He also enters this loss on line 7(g). Because purchased dairy cow #52 was sold at a loss, it was entered in Part I instead of Part III. See *Table 11-1* in chapter 11.

He totals the gains on line 2(h) and enters \$5,479 on line 7(h). He combines the loss on line 7(g) with the gain on line 7(h), and enters

\$5,384 on line 8. Since he has no nonrecaptured net section 1231 losses from prior years, he does not fill in lines 9, 10, and 13. If he had nonrecaptured section 1231 losses, part or all of the gain on line 8 would be ordinary income and entered on line 13. Following the instructions for line 8, he enters \$5,384 as a long-term capital gain on line 12(g) of Schedule D.

Part II. Mr. Brown enters the \$250 gain from the sale of a raised dairy calf held for breeding purposes that is less than 24 months old on line 11. He had previously entered the \$1,105 gain from line 33, Part III, on line 14 and the \$148 loss from Form 4684 on line 15(g). He adds lines 11 through 18 for columns (g) and (h) and enters the results on line 19. He then combines these amounts and enters a net gain of \$1,207 on line 20. He carries the gain from line 20 to line 20b(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 information called for in the appropriate columns.

Lines 1 and 3. Mr. Brown reports as a short-term loss on line 1 his \$50 loss on the 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. He also shows as a short-term capital loss on line 1 an amount he had loaned to a friend. During 1996 this \$50 loan became uncollectible. He enters the name of the debtor and attaches a statement with the required information (not shown). See Publication 550.

Lines 7 and 8. He completes Part I of Schedule D by filling in lines 7 and 8.

Lines 9 and 11. He enters on line 9 his \$745 long-term gain on the sale of H. T. Corporation stock held more than one year and also enters the gross sales price on line 11.

Line 12. Mr. Brown had previously entered on line 12 the gain from line 8 of Form 4797.

Lines 16 and 17. He completes Part II of Schedule D by filling in lines 16 and 17 according to the instructions given on those lines.

Line 18. In Part III, Mr. Brown combines lines 8 and 17 and enters his net gain on line 18. He also enters this amount on Form 1040, line 13.

Mr. Brown does not complete the *Capital Gain Tax Worksheet* in the instructions. His income on line 37 (Form 1040) is less than the amount required to compute his tax using the maximum capital gains rate.

He does not have a capital loss carryover this year, so he does not complete the *Capital Loss Carryover Worksheet* in the instructions.

Form 1040, Page 1

Mr. Brown is filing a joint return with his wife. He uses the form he received from the IRS.

Presidential Election Campaign Fund. Because Mr. and Mrs. Brown choose to have \$6 (\$3 each) go to the Presidential Election Campaign Fund, he checks both "Yes" boxes.

Filing status. He checks line 2 to indicate he is married and filing a joint return.

Exemptions. He checks boxes 6a and 6b to claim exemptions for himself and his wife, and enters the number of boxes checked in the far right-hand entry space. The Browns' three children live with them. On line 6c he lists their names, social security numbers, relationship, and the number of months they lived in his home. He then enters 3 in the appropriate right-hand entry space. He has no other dependents. He enters a total of 5 in the far right-hand box on line 6d.

Line items. Mr. Brown fills in all applicable items on page 1 of Form 1040.

Line 7. Mrs. Brown worked part time as a substitute teacher for the county school system during 1996. She also works for Mr. Brown on the farm. He enters her total wages, \$4,921 (\$3,721 from the school system and \$1,200 from the farm), as shown on the Forms W-2 that each employer gave her, on line 7 of Form 1040.

Lines 8a and 9. Mr. Brown did not actually receive cash payment for the interest he listed on line 8a. It was credited to his account so that he could have withdrawn it in 1996. He constructively received it and correctly included it in his income for 1996. He enters the \$220 in dividends he received from the H. T. Corporation on line 9.

Patronage dividends from farmers' cooperatives were received on the basis of 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 Mr. Brown did not receive more than \$400 in interest or \$400 in dividends and had no foreign bank accounts or any interest in or distributions from a foreign trust, he is not required to complete Schedule B (Form 1040).

Line 13. The amount shown, \$6,029, is the net gain from the sale of capital assets listed on Schedule D (Form 1040).

Line 14. The amount shown, \$1,207, is the net gain from Form 4797.

Line 18. Mr. Brown enters his net farm profit, \$22,591, from Schedule F (Form 1040).

Line 22. Mr. Brown adds the amounts on lines 7 through 21 and enters the total, \$35,343.

Line 25. Mr. Brown has already entered one-half of his self-employment tax, \$1,596. He enters this amount again on line 30, as it is the only amount entered on lines 23a through 29.

Lines 31 and 32. Mr. Brown subtracts line 30 from line 22 and enters the result, "adjusted gross income," on line 31 and also on line 32 of page 2.

Form 1040, Page 2

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

Line 34. Mr. Brown enters \$6,850 from his Schedule A (Form 1040), which is not shown, because the total of his itemized deductions is larger than the standard deduction for his filing status.

Lines 35, 36, and 37. Mr. Brown subtracts the \$6,850 on line 34 from the \$33,747 on line 32 and enters the result, \$26,897, on line 35. He enters \$12,750 ($5 \times \$2,550$) on line 36 and subtracts this amount from the amount on line 35 to get taxable income on line 37.

Line 38. To determine their tax, he uses the Tax Table in the Form 1040 instructions. Because line 37 is \$14,147 he looks for the income bracket that includes this amount. He finds the bracket for incomes of at least \$14,100, but less than \$14,150, and finds that the tax for married taxpayers filing joint returns is \$2,119. He enters this amount on line 38.

Lines 43 and 44. Because Mr. and Mrs. Brown have none of the credits listed on lines 39 through 42, Mr. Brown enters -0- on line 43, subtracts it from line 38, and enters \$2,119 on line 44.

Line 45. Mr. Brown has already entered the \$3,192 self-employment tax he figured on Schedule SE.

Line 51. He enters \$5,311, which is the total tax for 1996.

Line 52. Mr. Brown enters the income tax withheld from Mrs. Brown's wages, \$227, as shown on the Forms W-2 she received. He attaches Copy B of her Forms W-2 to the front of Form 1040.

Line 53. He did not make estimated tax payments since two-thirds of his gross income for 1995 was from farming. He was sure that at least two-thirds of his gross income for 1996 would be from farming and he would file his Form 1040 no later than March 1, 1997. Farmers who meet these conditions do not have to make estimated tax payments. Therefore, he makes no entry on line 53.

Line 54. The Browns are not entitled to claim the earned income credit on line 54, because their modified adjusted gross income is more than \$28,495.

Line 57. Mr. Brown enters his federal excise tax credit for gasoline used in 1996. He checks box "b" and attaches Form 4136 (not illustrated) to his return, showing how he figured the credit. The credit must be reported as income on Schedule F on his 1997 return.

Line 62. He adds lines 52 and 57 and enters the total on line 58. He subtracts that figure from line 51. The balance, \$4,734, is entered on line 62.

Completing the return. They sign their names and enter the date signed and their occupations. (If the Browns 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 transfers the address label from the instructions to the return after verifying the accuracy of the label, then writes a check payable to the Internal Revenue Service for the full amount on line 62 of Form 1040. On the check, he

writes his social security number (shown first on the mailing label), their telephone number, and "1996 Form 1040." His name and address are printed on the check.

After making a copy of their complete return for his records, Mr. Brown assembles his

original Form 1040, Schedules A, D, F, and SE, and Forms 4136, 4684, 4797, 4562, and 8824 in that order (see "Attachment Sequence Number" in the upper right corner of each schedule or form).

Mr. Brown completes Form 1040-V, *Payment Voucher*, which was included in his tax package (not shown). He carefully follows the instructions for mailing his return and paying the IRS.

For the year Jan. 1–Dec. 31, 1996, or other tax year beginning _____, 1996, ending _____, 19 OMB No. 1545-0074

Label

(See page 11.)

Use the IRS label. Otherwise, please print or type.

Presidential Election Campaign (See page 11.)

| | | | |
|------------|-----------------------------------|-------------|-----------------------------|
| LABEL HERE | Your first name and initial | Last name | Your social security number |
| | VY 543-00-2111 | 543-00-1222 | |
| | Walter A. & Jane W. Brown | DO 04 | |
| | RR 1 Box 25 Hometown, VA 02115 | | |

Spouse's social security number

For help finding line instructions, see pages 2 and 3 in the booklet.

| | | |
|-------------------------------------|-------------------------------------|--|
| Yes | No | Note: Checking "Yes" will not change your tax or reduce your refund. |
| <input checked="" type="checkbox"/> | <input checked="" type="checkbox"/> | |

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 instructions.) 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 ▶ 19____). (See instructions.)

Exemptions

If more than six dependents, see the instructions for line 6c.

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

| (1) First name | Last name | (2) Dependent's social security number. If born in Dec. 1996, see inst. | (3) Dependent's relationship to you | (4) No. of months lived in your home in 1996 |
|----------------|-----------|---|-------------------------------------|--|
| MICHAEL | BROWN | 579 00 9999 | SON | 12 |
| MATTHEW | BROWN | 579 00 9998 | SON | 12 |
| SARAH | BROWN | 579 00 9997 | DAUGHTER | 12 |

6d Total number of exemptions claimed **5**

No. of boxes checked on lines 6a and 6b **2**

No. of your children on line 6c who:

- lived with you **3**
- did not live with you due to divorce or separation (see instructions)

Dependents on 6c not entered above

Add numbers entered on lines above **5**

Income

Attach Copy B of your Forms W-2, W-2G, and 1099-R here.

If you did not get a W-2, see the instructions for line 7.

Enclose, but do not attach, any payment. Also, please enclose Form 1040-V (see the instructions for line 82).

| | | | |
|-----|---|-----|----------|
| 7 | Wages, salaries, tips, etc. Attach Form(s) W-2 | 7 | 4,921 - |
| 8a | Taxable interest. Attach Schedule B if over \$400 | 8a | 375 - |
| b | Tax-exempt interest. DO NOT include on line 8a | 8b | |
| 9 | Dividend income. Attach Schedule B if over \$400 | 9 | 220 - |
| 10 | Taxable refunds, credits, or offsets of state and local income taxes (see instructions) | 10 | |
| 11 | Alimony received | 11 | |
| 12 | Business income or (loss). Attach Schedule C or C-EZ | 12 | |
| 13 | Capital gain or (loss). If required, attach Schedule D | 13 | 6,029 - |
| 14 | Other gains or (losses). Attach Form 4797 | 14 | 1,207 - |
| 15a | Total IRA distributions | 15a | |
| b | Taxable amount (see inst.) | 15b | |
| 16a | Total pensions and annuities | 16a | |
| b | Taxable amount (see inst.) | 16b | |
| 17 | Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E | 17 | |
| 18 | Farm income or (loss). Attach Schedule F | 18 | 22,591 - |
| 19 | Unemployment compensation | 19 | |
| 20a | Social security benefits | 20a | |
| b | Taxable amount (see inst.) | 20b | |
| 21 | Other income. List type and amount—see instructions | 21 | |
| 22 | Add the amounts in the far right column for lines 7 through 21. This is your total income ▶ | 22 | 35,343 - |

Adjusted Gross Income

If line 31 is under \$28,495 (under \$9,500 if a child did not live with you), see the instructions for line 54.

| | | | |
|-----|---|-----|----------|
| 23a | Your IRA deduction (see instructions) | 23a | |
| b | Spouse's IRA deduction (see instructions) | 23b | |
| 24 | Moving expenses. Attach Form 3903 or 3903-F | 24 | |
| 25 | One-half of self-employment tax. Attach Schedule SE | 25 | 1,596 - |
| 26 | Self-employed health insurance deduction (see inst.) | 26 | |
| 27 | Keogh & self-employed SEP plans. If SEP, check <input type="checkbox"/> | 27 | |
| 28 | Penalty on early withdrawal of savings | 28 | |
| 29 | Alimony paid. Recipient's SSN ▶ _____ | 29 | |
| 30 | Add lines 23a through 29 | 30 | 1,596 - |
| 31 | Subtract line 30 from line 22. This is your adjusted gross income ▶ | 31 | 33,747 - |

For Privacy Act and Paperwork Reduction Act Notice, see page 7.

Cat. No. 11320B

Form 1040 (1996)

| | | | | |
|------------------------|-----|---|-----|--------------------------|
| Tax Computation | 32 | Amount from line 31 (adjusted gross income) | 32 | 33,747 - |
| | 33a | Check if: <input type="checkbox"/> You were 65 or older, <input type="checkbox"/> Blind; <input type="checkbox"/> Spouse was 65 or older, <input type="checkbox"/> Blind. Add the number of boxes checked above and enter the total here | 33a | |
| | b | If you are married filing separately and your spouse itemizes deductions or you were a dual-status alien, see instructions and check here | 33b | <input type="checkbox"/> |
| | 34 | Enter the larger of your: { Itemized deductions from Schedule A, line 28, OR Standard deduction shown below for your filing status. But see the instructions if you checked any box on line 33a or b or someone can claim you as a dependent. • Single—\$4,000 • Married filing jointly or Qualifying widow(er)—\$6,700 • Head of household—\$5,900 • Married filing separately—\$3,350 | 34 | 6,850 - |
| | 35 | Subtract line 34 from line 32 | 35 | 26,897 - |
| | 36 | If line 32 is \$88,475 or less, multiply \$2,550 by the total number of exemptions claimed on line 6d. If line 32 is over \$88,475, see the worksheet in the inst. for the amount to enter | 36 | 12,750 - |
| | 37 | Taxable income. Subtract line 36 from line 35. If line 36 is more than line 35, enter -0- | 37 | 14,147 - |
| | 38 | Tax. See instructions. Check if total includes any tax from a <input type="checkbox"/> Form(s) 8814 b <input type="checkbox"/> Form 4972 | 38 | 2,119 - |

If you want the IRS to figure your tax, see the instructions for line 37.

| | | | | |
|----------------|----|---|----|---------|
| Credits | 39 | Credit for child and dependent care expenses. Attach Form 2441 | 39 | |
| | 40 | Credit for the elderly or the disabled. Attach Schedule R | 40 | |
| | 41 | Foreign tax credit. Attach Form 1116 | 41 | |
| | 42 | Other. Check if from a <input type="checkbox"/> Form 3800 b <input type="checkbox"/> Form 8396 c <input type="checkbox"/> Form 8801 d <input type="checkbox"/> Form (specify) | 42 | |
| | 43 | Add lines 39 through 42 | 43 | - 0 - |
| | 44 | Subtract line 43 from line 38. If line 43 is more than line 38, enter -0- | 44 | 2,119 - |

| | | | | |
|--------------------|---|---|---------|---------|
| Other Taxes | 45 | Self-employment tax. Attach Schedule SE | 45 | 3,192 - |
| | 46 | Alternative minimum tax. Attach Form 6251 | 46 | |
| | 47 | Social security and Medicare tax on tip income not reported to employer. Attach Form 4137 | 47 | |
| | 48 | Tax on qualified retirement plans, including IRAs. If required, attach Form 5329 | 48 | |
| | 49 | Advance earned income credit payments from Form(s) W-2 | 49 | |
| | 50 | Household employment taxes. Attach Schedule H | 50 | |
| 51 | Add lines 44 through 50. This is your total tax | 51 | 5,311 - | |

| | | | | |
|-----------------|--|---|-------|-------|
| Payments | 52 | Federal income tax withheld from Forms W-2 and 1099 | 52 | 227 - |
| | 53 | 1995 estimated tax payments and amount applied from 1995 return | 53 | |
| | 54 | Earned income credit. Attach Schedule EIC if you have a qualifying child. Nontaxable earned income: amount and type | 54 | |
| | 55 | Amount paid with Form 4868 (request for extension) | 55 | |
| | 56 | Excess social security and RRTA tax withheld (see Inst.) | 56 | |
| | 57 | Other payments. Check if from a <input type="checkbox"/> Form 2439 b <input checked="" type="checkbox"/> Form 4136 | 57 | 350 - |
| 58 | Add lines 52 through 57. These are your total payments | 58 | 577 - | |

| | | | | |
|---------------|---|---|-----|--|
| Refund | 59 | If line 58 is more than line 51, subtract line 51 from line 58. This is the amount you OVERPAID | 59 | |
| | 60a | Amount of line 59 you want REFUNDED TO YOU | 60a | |
| | b | Routing number | c | Type: <input type="checkbox"/> Checking <input type="checkbox"/> Savings |
| | d | Account number | | |
| 61 | Amount of line 59 you want APPLIED TO YOUR 1997 ESTIMATED TAX | 61 | | |

| | | | | |
|-----------------------|----|---|----|---------|
| Amount You Owe | 62 | If line 51 is more than line 58, subtract line 58 from line 51. This is the AMOUNT YOU OWE. For details on how to pay and use Form 1040-V, see instructions | 62 | 4,734 - |
| | 63 | Estimated tax penalty. Also include on line 62 | 63 | |

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

| | | | |
|--|--|---------|--------------------------------|
| Sign Here | Your signature | Date | Your occupation |
| | <i>Walter A. Brown</i> | 2-22-97 | FARMER |
| Keep a copy of this return for your records. | Spouse's signature. If a joint return, BOTH must sign. | Date | Spouse's occupation |
| | <i>Jane W. Brown</i> | 2-22-97 | TEACHER |
| Paid Preparer's Use Only | Preparer's signature | Date | Preparer's social security no. |
| | Firm's name (or yours if self-employed) and address | | EIN |
| | | | ZIP code |



**SCHEDULE D
(Form 1040)**

Department of the Treasury
Internal Revenue Service (99)

Capital Gains and Losses

▶ Attach to Form 1040. ▶ See instructions for Schedule D (Form 1040).

▶ Use lines 20 and 22 for more space to list transactions for lines 1 and 9.

OMB No. 1545-0074

1996

Attachment
Sequence No. 12

Name(s) shown on Form 1040

WALTER A. & JANE W. BROWN

Your social security number

543 00 211

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

| (a) Description of property (Example: 100 sh. XYZ Co.) | (b) Date acquired (Mo., day, yr.) | (c) Date sold (Mo., day, yr.) | (d) Sales price (see page D-3) | (e) Cost or other basis (see page D-3) | (f) LOSS If (e) is more than (d), subtract (d) from (e) | (g) GAIN If (d) is more than (e), subtract (e) from (d) |
|--|-----------------------------------|-------------------------------|--------------------------------|--|---|---|
| 1 25 shares HT Corp | 12-1-95 | 3-6-96 | 400 - | 450 - | 50 - | |
| J. Smith - Schedule attached (not shown) | | | | | | 50 - |
| 2 Enter your short-term totals, if any, from line 21 | | | 2 | | | |
| 3 Total short-term sales price amounts. Add column (d) of lines 1 and 2 | | | 3 | 400 - | | |
| 4 Short-term gain from Forms 2119 and 6252, and short-term gain or loss from Forms 4684, 6781, and 8824 | | | | | 4 | |
| 5 Net short-term gain or loss from partnerships, S corporations, estates, and trusts from Schedule(s) K-1 | | | | | 5 | |
| 6 Short-term capital loss carryover. Enter the amount, if any, from line 9 of your 1995 Capital Loss Carryover Worksheet | | | | | 6 | |
| 7 Add lines 1 through 6 in columns (f) and (g) | | | | | 7 | (100 -) |
| 8 Net short-term capital gain or (loss). Combine columns (f) and (g) of line 7 ▶ | | | | | 8 | (100 -) |

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

| | | | | | | |
|--|------|--------|---------|---------|----|-------------|
| 9 40 shares HT Corp | 1979 | 6-5-96 | 1,000 - | 255 - | | 745 - |
| 10 Enter your long-term totals, if any, from line 23 | | | 10 | | | |
| 11 Total long-term sales price amounts. Add column (d) of lines 9 and 10 | | | 11 | 1,170 - | | |
| 12 Gain from Form 4797; long-term gain from Forms 2119, 2439, and 6252; and long-term gain or loss from Forms 4684, 6781, and 8924 | | | | | 12 | 5,384 - |
| 13 Net long-term gain or loss from partnerships, S corporations, estates, and trusts from Schedule(s) K-1 | | | | | 13 | |
| 14 Capital gain distributions | | | | | 14 | |
| 15 Long-term capital loss carryover. Enter the amount, if any, from line 14 of your 1995 Capital Loss Carryover Worksheet | | | | | 15 | |
| 16 Add lines 9 through 15 in columns (f) and (g) | | | | | 16 | () 6,129 - |
| 17 Net long-term capital gain or (loss). Combine columns (f) and (g) of line 16 ▶ | | | | | 17 | 6,129 - |

Part III Summary of Parts I and II

| | | | | | | |
|---|--|--|--|--|----|---------|
| 18 Combine lines 8 and 17. If a loss, go to line 19. If a gain, enter the gain on Form 1040, line 13. Note: If both lines 17 and 18 are gains, see the Capital Gain Tax Worksheet on page 23 | | | | | 18 | 6,029 - |
| 19 If line 18 is a loss, enter here and as a (loss) on Form 1040, line 13, the smaller of these losses: a The loss on line 18; or b (\$3,000) or, if married filing separately, (\$1,500) Note: See the Capital Loss Carryover Worksheet on page D-3 if the loss on line 18 exceeds the loss on line 19 or if Form 1040, line 35, is a loss. | | | | | 19 | () |

For Paperwork Reduction Act Notice, see Form 1040 instructions.

Cat. No. 11338H

Schedule D (Form 1040) 1996

**SCHEDULE F
(Form 1040)**

Department of the Treasury
Internal Revenue Service

Profit or Loss From Farming

▶ Attach to Form 1040, Form 1041, or Form 1065.

▶ See Instructions for Schedule F (Form 1040).

OMB No. 1545-0074

1996

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 principal agricultural activity code (from page 2) ▶ **240**

C Accounting method: (1) Cash (2) Accrual

D Employer ID number (EIN), if any: **10:9876543**

E Did you "materially participate" in the operation of this business during 1996? 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 | 12,960 | - | | |
| 2 | Cost or other basis of livestock and other items reported on line 1 | 2 | 3,180 | - | | |
| 3 | Subtract line 2 from line 1 | 3 | | | 9,780 | - |
| 4 | Sales of livestock, produce, grains, and other products you raised | 4 | | | 124,599 | - |
| 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-2): | | | | | |
| 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-2): | | | | | |
| a | Amount received in 1996 | 8a | | | 8b Taxable amount | |
| c | If election to defer to 1997 is attached, check here ▶ <input type="checkbox"/> | 8d | | | Amount deferred from 1995 | |
| 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-2) | 10 | | | 567 | - |
| 11 | Gross income. Add amounts in the right column for lines 3 through 10. If accrual method taxpayer, enter the amount from page 2, line 51 | 11 | | | 137,340 | - |

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-3—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-4): | | |
| 14 | Conservation expenses (see page F-3) | 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 | 27,377 | - | 27 | Repairs and maintenance | 27 | 6,424 |
| 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 | 3,072 | - | 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 | 34d | 534 |
| | | | | | e | | 34e | |
| | | | | | f | | 34f | |
| 35 | Total expenses. Add lines 12 through 34f | 35 | | | 36 | Net farm profit or (loss). Subtract line 35 from line 11. If a profit, enter on Form 1040, line 18, and ALSO on Schedule SE, line 1. If a loss, you MUST go on to line 37 (estates, trusts, and partnerships, see page F-5). | 36 | 114,749 |
| 36 | Net farm profit or (loss). Subtract line 35 from line 11. If a profit, enter on Form 1040, line 18, and ALSO on Schedule SE, line 1. If a loss, you MUST go on to line 37 (estates, trusts, and partnerships, see page F-5). | 36 | | | 37 | If you have a loss, you MUST check the box that describes your investment in this activity (see page F-5). 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 | 22,591 |
| 37 | If you have a loss, you MUST check the box that describes your investment in this activity (see page F-5). 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

1996

Attachment
Sequence No. 17

Department of the Treasury
Internal Revenue Service (99)

▶ 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 2111 |
|--|--|

Who Must File Schedule SE

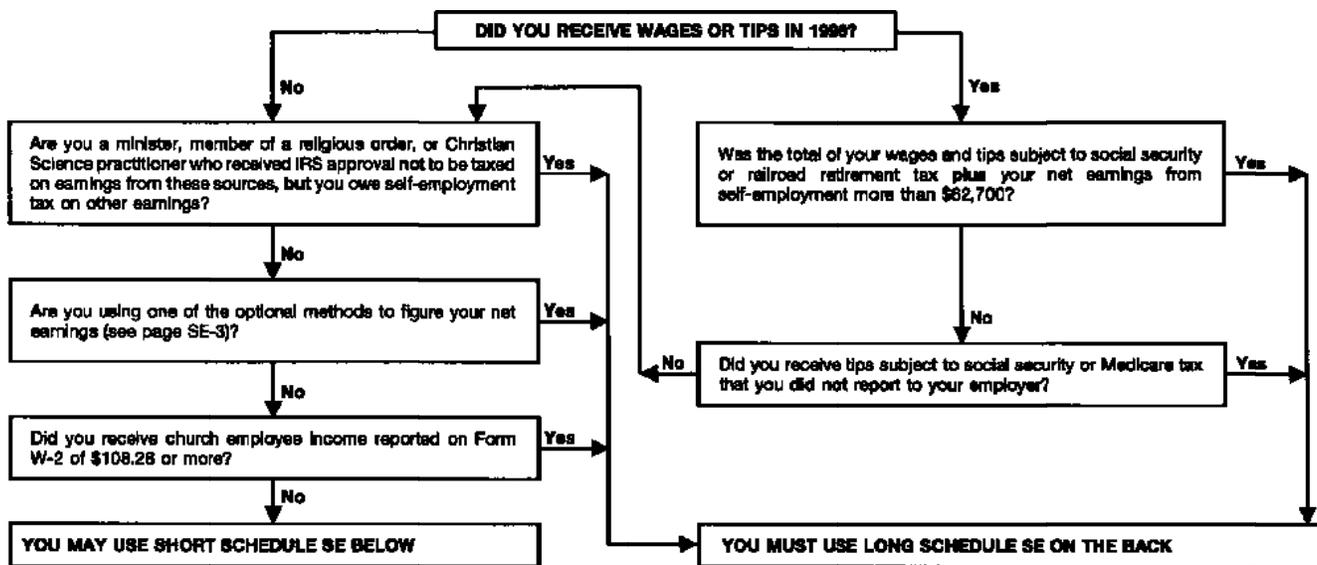
You must file Schedule SE if:

- You had net earnings from self-employment from **other than** church employee income (line 4 of Short Schedule SE or line 4c of Long Schedule SE) of \$400 or more, **OR**
- You had church employee income of \$108.28 or more. Income from services you performed as a minister or a member of a religious order is **not** church employee income. See page SE-1.

Note: Even if you had a loss or a small amount of income from self-employment, it may be to your benefit to file Schedule SE and use either "optional method" in Part II of Long Schedule SE. See page SE-3.

Exception. If your only self-employment income was from earnings as a minister, member of a religious order, or Christian Science practitioner and you filed Form 4361 and received IRS approval not to be taxed on those earnings, **do not** file Schedule SE. Instead, write "Exempt-Form 4361" on Form 1040, line 45.

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



Section A—Short Schedule SE. Caution: Read above to see if you can use Short Schedule SE.

| | | | | |
|---|---|---|---------------------|--|
| 1 | Net farm profit or (loss) from Schedule F, line 36, and farm partnerships, Schedule K-1 (Form 1065), line 15a | 1 | 22,591 ⁻ | |
| 2 | Net profit or (loss) from Schedule C, line 31; Schedule C-EZ, line 3; and Schedule K-1 (Form 1065), line 15a (other than farming). Ministers and members of religious orders see page SE-1 for amounts to report on this line. See page SE-2 for other income to report. | 2 | | |
| 3 | Combine lines 1 and 2 | 3 | 22,591 ⁻ | |
| 4 | Net earnings from self-employment. Multiply line 3 by 92.35% (.9235). If less than \$400, do not file this schedule; you do not owe self-employment tax ▶ | 4 | 20,863 ⁻ | |
| 5 | Self-employment tax. If the amount on line 4 is: • \$62,700 or less, multiply line 4 by 15.3% (.153). Enter the result here and on Form 1040, line 45. • More than \$62,700, multiply line 4 by 2.9% (.029). Then, add \$7,774.80 to the result. Enter the total here and on Form 1040, line 45. | 5 | 3,192 ⁻ | |
| 6 | Deduction for one-half of self-employment tax. Multiply line 5 by 50% (.5). Enter the result here and on Form 1040, line 25 | 6 | 1,596 ⁻ | |

For Paperwork Reduction Act Notice, see Form 1040 Instructions.

Cat. No. 11358Z

Schedule SE (Form 1040) 1996

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

543-00-211

SECTION B—Business and Income-Producing Property (Use this section to report casualties and thefts of property used in a trade or business or for income-producing purposes.)

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** **HEMETHRAN, VA** **6-22-92**
 Property B _____
 Property C _____
 Property D _____

| | Properties (Use a separate column for each property lost or damaged from one casualty or theft.) | | | |
|---|--|---|---|---|
| | A | B | C | D |
| 20 Cost or adjusted basis of each property | 20 257 - | | | |
| 21 Insurance or other reimbursement (whether or not you filed a claim). See the instructions for line 3. Note: If line 20 is more than line 21, skip line 22. | 21 109 - | | | |
| 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 | 22 | | | |
| 23 Fair market value before casualty or theft | 23 500 - | | | |
| 24 Fair market value after casualty or theft | 24 - 0 - | | | |
| 25 Subtract line 24 from line 23 | 25 500 - | | | |
| 26 Enter the smaller of line 20 or line 25 | 26 257 - | | | |
| Note: If the property was totally destroyed by casualty or lost from theft, enter on line 26 the amount from line 20. | | | | |
| 27 Subtract line 21 from line 26. If zero or less, enter -0- | 27 148 - | | | |
| 28 Casualty or theft loss. Add the amounts on line 27. Enter the total here and on line 29 or line 34 (see instructions). | 28 148 - | | | |

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 includable in income |
|---|---|--------------------------------|--|
| | (i) Trade, business, rental or royalty property | (ii) Income-producing 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 15. If Form 4797 is not otherwise required, see instructions | 31 | | |
| 32 Enter the amount from line 30, column (b)(ii) here and on Schedule A (Form 1040), line 22. Partnerships, S corporations, estates and trusts, see instructions | 32 | | |

Casualty or Theft of Property Held More Than One Year

| | | | |
|---|---------------------|-----|----------------|
| 33 Casualty or theft gains from Form 4797, line 34 | 33 | | |
| 34 Cow killed by lightning | (148 -) | () | |
| 35 Total losses. Add amounts on line 34, columns (b)(i) and (b)(ii) | 35 (148 -) | () | |
| 36 Total gains. Add lines 33 and 34, column (c) | 36 | | - 0 - |
| 37 Add amounts on line 35, columns (b)(i) and (b)(ii) | 37 | | (148 -) |
| 38 If the loss on line 37 is more than the gain on line 36: a Combine line 35, column (b)(i) and line 36, and enter the net gain or (loss) here. Partnerships and S corporations see the note below. All others enter this amount on Form 4797, line 15. If Form 4797 is not otherwise required, see instructions | 38a | | (148 -) |
| b Enter the amount from line 35, column (b)(ii) here. Partnerships and S corporations see the note below. Individuals enter this amount on Schedule A (Form 1040), line 22. Estates and trusts, enter on the "Other deductions" line of your tax return | 38b | | |
| 39 If the loss on line 37 is equal to or less than the gain on line 36, combine these lines and enter here. Partnerships, see the note below. All others, enter this amount on Form 4797, line 3. Note: Partnerships, enter the amount from line 38a, 38b, or line 39 on Form 1065, Schedule K, line 7. S corporations, enter the amount from line 38a or 38b on Form 1120S, Schedule K, line 6. | 39 | | |

Sales of Business Property
 (Also Involuntary Conversions and Recapture Amounts
 Under Sections 179 and 280F(b)(2))

Department of the Treasury
Internal Revenue Service

▶ 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 here the gross proceeds from the sale or exchange of real estate reported to you for 1996 on Form(s) 1099-S (or a substitute statement) that you will be including on line 2, 11, or 22 1

Part I Sales or Exchanges of Property Used in a Trade or Business and Involuntary Conversions From Other Than Casualty or Theft—Property Held More Than 1 Year

| (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) LOSS If (f) is more than (d) plus (e), subtract the sum of (d) and (e) from (f) | (h) GAIN If (d) plus (e) is more than (f), subtract (f) from the sum of (d) and (e) |
|-----------------------------|-----------------------------------|-------------------------------|-----------------------|---|--|---|---|
| 2 Raised Cows | Dec-8-1987 | 1-96 | 4,500.- | -0- | 106.- | | 4,394.- |
| DAIRY Cow | 7-15-91 | 2-1-96 | 302.- | 514.- | 912.- | 95.- | |
| Raised heifer | 6-2-92 | 8-1-96 | 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 34, from other than casualty or theft | 6 | |
| 7 Add lines 2 through 6 in columns (g) and (h) | 7 | (95.-) 5,479.- |
| 8 Combine columns (g) and (h) of line 7. Enter gain or (loss) here, and on the appropriate line as follows: Partnerships —Enter the gain or (loss) on Form 1065, Schedule K, line 6. Skip lines 9, 10, 12, and 13 below. S corporations —Report the gain or (loss) following the instructions for Form 1120S, Schedule K, lines 5 and 6. Skip lines 9, 10, 12, and 13 below, unless line 8 is a gain and the S corporation is subject to the capital gains tax. All others —If line 8 is zero or a loss, enter the amount on line 12 below and skip lines 9 and 10. If line 8 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 as a long-term capital gain on Schedule D and skip lines 9, 10, and 13 below. | 8 | 5,384.- |
| 9 Nonrecaptured net section 1231 losses from prior years (see instructions) | 9 | |
| 10 Subtract line 9 from line 8. If zero or less, enter -0-. Also enter on the appropriate line as follows (see instructions): S corporations —Enter this amount on Schedule D (Form 1120S), line 13, and skip lines 12 and 13 below. All others —If line 10 is zero, enter the amount from line 8 on line 13 below. If line 10 is more than zero, enter the amount from line 8 on line 13 below, and enter the amount from line 10 as a long-term capital gain on Schedule D. | 10 | |

Part II Ordinary Gains and Losses

11 Ordinary gains and losses not included on lines 12 through 18 (include property held 1 year or less):

| | | | | | | |
|--------------------------|----------------|---------------|--------------|------------|------------|--------------|
| Raised Dairy Cows | 10-2-95 | 3-1-96 | 255.- | -0- | 5.- | 250.- |
|--------------------------|----------------|---------------|--------------|------------|------------|--------------|

| | | |
|--|---------------|--------------------------|
| 12 Loss, if any, from line 8 | 12 | |
| 13 Gain, if any, from line 8, or amount from line 9 if applicable | 13 | |
| 14 Gain, if any, from line 33 | 14 | |
| 15 Net gain or (loss) from Form 4684, lines 31 and 38a | 15 | (148.-) |
| 16 Ordinary gain from installment sales from Form 6252, line 25 or 36 | 16 | |
| 17 Ordinary gain or (loss) from like-kind exchanges from Form 8824 | 17 | |
| 18 Recapture of section 179 expense deduction for partners and S corporation shareholders from property dispositions by partnerships and S corporations (see instructions) | 18 | |
| 19 Add lines 11 through 18 in columns (g) and (h) | 19 | (148.-) 1,355.- |
| 20 Combine columns (g) and (h) of line 18. Enter gain or (loss) here, and on the appropriate line as follows: a For all except individual returns: Enter the gain or (loss) from line 20 on the return being filed. b For individual returns: (1) If the loss on line 12 includes a loss from Form 4684, line 35, column (b)(ii), enter that part of the loss here and on line 22 of Schedule A (Form 1040). Identify as from "Form 4797, line 20b(1)." See instructions (2) Redetermine the gain or (loss) on line 20, excluding the loss, if any, on line 20b(1). Enter here and on Form 1040, line 14. | 20 | 1,207.- |
| | 20b(1) | |
| | 20b(2) | 1,207.- |

For Paperwork Reduction Act Notice, see page 1 of separate instructions.

Part III Gain From Disposition of Property Under Sections 1245, 1250, 1252, 1254, and 1255

| 21 | (a) Description of section 1245, 1250, 1252, 1254, or 1255 property: | (b) Date acquired (mo., day, yr.) | (c) Date sold (mo., day, yr.) |
|----|--|--------------------------------------|----------------------------------|
| A | TRUCK | 6-22-81 | 7-9-96 |
| B | HOUSE | 4-19-82 | 2-14-96 |
| C | DAIRY COV #41 | 2-21-86 | 10-28-96 |
| D | | | |

| Relate lines 21A through 21D to these columns | | Property A | Property B | Property C | Property D |
|---|--|------------|------------|------------|------------|
| 22 | Gross sales price (Note: See line 1 before completing.) | 700.- | 70.- | 335.- | |
| 23 | Cost or other basis plus expense of sale | 4,390.- | 1,200.- | 800.- | |
| 24 | Depreciation (or depletion) allowed or allowable | 4,390.- | 1,200.- | 800.- | |
| 25 | Adjusted basis. Subtract line 24 from line 23 | - - - | - - - | - - - | |
| 26 | Total gain. Subtract line 25 from line 22 | 700.- | 70.- | 335.- | |
| 27 | If section 1245 property: | | | | |
| a | Depreciation allowed or allowable from line 24 | 4,390.- | 1,200.- | 800.- | |
| b | Enter the smaller of line 25 or 27a | 700.- | 70.- | 335.- | |
| 28 | If section 1250 property: If straight line depreciation was used, enter -0- on line 28g, except for a corporation subject to section 291. | | | | |
| a | Additional depreciation after 1975 (see instructions) | | | | |
| b | Applicable percentage multiplied by the smaller of line 26 or line 28a (see instructions) | | | | |
| c | Subtract line 28a from line 26. If residential rental property or line 26 is not more than line 28a, skip lines 28d and 28e | | | | |
| d | Additional depreciation after 1969 and before 1976 | | | | |
| e | Enter the smaller of line 28c or 28d | | | | |
| f | Section 291 amount (corporations only) | | | | |
| g | Add lines 28b, 28e, and 28f | | | | |
| 29 | If section 1252 property: Skip this section if you did not dispose of farmland or if this form is being completed for a partnership. | | | | |
| a | Soil, water, and land clearing expenses | | | | |
| b | Line 29a multiplied by applicable percentage (see instructions) | | | | |
| c | Enter the smaller of line 26 or 29b | | | | |
| 30 | If section 1254 property: | | | | |
| a | Intangible drilling and development costs, expenditures for development of mines and other natural deposits, and mining exploration costs (see instructions) | | | | |
| b | Enter the smaller of line 26 or 30a | | | | |
| 31 | If section 1255 property: | | | | |
| a | Applicable percentage of payments excluded from income under section 126 (see instructions) | | | | |
| b | Enter the smaller of line 26 or 31a (see instructions) | | | | |

Summary of Part III Gains. Complete property columns A through D through line 31b before going to line 32.

| | | | |
|----|---|----|---------|
| 32 | Total gains for all properties. Add property columns A through D, line 26 | 32 | 1,105.- |
| 33 | Add property columns A through D, lines 27b, 28g, 29c, 30b, and 31b. Enter here and on line 14 | 33 | 1,105.- |
| 34 | Subtract line 33 from line 32. 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 | 34 | - - - |

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) |
|----|---|------------------------|
| 35 | Section 179 expense deduction or depreciation allowable in prior years | 35 |
| 36 | Recomputed depreciation. See instructions | 36 |
| 37 | Recapture amount. Subtract line 36 from line 35. See the instructions for where to report | 37 |

Depreciation and Amortization
(Including Information on Listed Property)

1996

Attachment
Sequence No. **67**

Department of the Treasury
Internal Revenue Service

▶ See separate instructions. ▶ Attach this form to your return.

Name(s) shown on return

WALTER A. & JANE W. BROWN

Business or activity to which this form relates

FARMING

Identifying number

543-00-2111

Part I Election To Expense Certain Tangible Property (Section 179) (Note: If you have any "listed property," complete Part V before you complete Part I.)

| | | | |
|------------------|---|------------------------------|------------------|
| 1 | Maximum dollar limitation. If an enterprise zone business, see page 2 of the instructions | 1 | \$17,500 |
| 2 | Total cost of section 179 property placed in service. See page 2 of the instructions | 2 | 61,229.- |
| 3 | Threshold cost of section 179 property before reduction in limitation | 3 | \$200,000 |
| 4 | Reduction in limitation. Subtract line 3 from line 2. If zero or less, enter -0- | 4 | - 0 - |
| 5 | Dollar limitation for tax year. Subtract line 4 from line 1. If zero or less, enter -0-. If married filing separately, see page 2 of the instructions | 5 | 17,500.- |
| 6 TRACTOR | | (b) Cost (business use only) | (c) Elected cost |
| | | 23,729.- | 17,500.- |
| 7 | Listed property. Enter amount from line 27. | 7 | |
| 8 | Total elected cost of section 179 property. Add amounts in column (c), lines 6 and 7 | 8 | 17,500.- |
| 9 | Tentative deduction. Enter the smaller of line 5 or line 8 | 9 | 17,500.- |
| 10 | Carryover of disallowed deduction from 1995. See page 2 of the instructions | 10 | - 0 - |
| 11 | Business income limitation. Enter the smaller of business income (not less than zero) or line 5 (see instructions) | 11 | 17,500.- |
| 12 | Section 179 expense deduction. Add lines 9 and 10, but do not enter more than line 11 | 12 | 17,500.- |
| 13 | Carryover of disallowed deduction to 1997. Add lines 9 and 10, less line 12 ▶ | 13 | - 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 1996 Tax Year (Do Not Include Listed Property.)

Section A—General Asset Account Election

14 If you are making the election under section 168(f)(4) to group any assets placed in service during the tax year into one or more general asset accounts, check this box. See page 2 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 |
|--------------------------------|--------------------------------------|--|---------------------|----------------|--------------|----------------------------|
| 15a 3-year property | | | | | | |
| b 5-year property | | | | | | |
| c 7-year property | | 7,213.- | 7 | HY | 150DB | 773.- |
| d 10-year property | | 37,500.- | 10 | HY | 150DB | 2,213.- |
| e 15-year property | | | | | | |
| f 20-year property | | 1,300.- | 20 | HY | 150DB | 49.- |
| g 25-year property | | | 25 yrs. | | S/L | |
| h Residential rental property | | | 27.5 yrs. | MM | S/L | |
| i Nonresidential real property | | | 39 yrs. | MM | S/L | |

Section C—Alternative Depreciation System (ADS) (See page 4 of the instructions.)

| | | | | | | |
|----------------|--|--|---------|----|-----|--|
| 16a Class life | | | | | S/L | |
| b 12-year | | | 12 yrs. | | S/L | |
| c 40-year | | | 40 yrs. | MM | S/L | |

Part III Other Depreciation (Do Not Include Listed Property.) (See page 4 of the instructions.)

| | | | |
|----|--|----|----------------|
| 17 | GDS and ADS deductions for assets placed in service in tax years beginning before 1996 | 17 | 2,624.- |
| 18 | Property subject to section 168(f)(1) election | 18 | |
| 19 | ACRS and other depreciation | 19 | 1,374.- |

Part IV Summary (See page 4 of the instructions.)

| | | | |
|----|--|----|-----------------|
| 20 | Listed property. Enter amount from line 26. | 20 | 2,184.- |
| 21 | Total. Add deductions on 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 | 21 | 27,377.- |
| 22 | For assets shown above and placed in service during the current year, enter the portion of the basis attributable to section 263A costs | 22 | |

For Paperwork Reduction Act Notice, see page 1 of the separate instructions.

Part V Listed Property—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 5 of the instructions for limitations for 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 | |
|---|-------------------------------|---|----------------------------|--|------------------------|--------------------------|-------------------------------|---------------------------------|--|
| 24 Property used more than 50% in a qualified business use (See page 5 of the instructions.): | | | | | | | | | |
| CAR | 1-6-93 | 60% | 12,350- | 7,410- | 5 | 15000/MY | 1,005- | -0- | |
| Picasso Touch | 5-21-93 | 100% | 7,076- | 7,076- | 5 | 15000/MY | 1,179- | -0- | |
| | | % | | | | | | | |
| 25 Property used 50% or less in a qualified business use (See page 5 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 | 2,184- | |
| 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 |
| 28 Total business/investment miles driven during the year (DO NOT include commuting miles) | 6,270 | | 11,350 | | | | | | | | | |
| 29 Total commuting miles driven during the year | -- | | -- | | | | | | | | | |
| 30 Total other personal (noncommuting) miles driven | 4,180 | | -- | | | | | | | | | |
| 31 Total miles driven during the year. Add lines 28 through 30. | 10,450 | | 11,350 | | | | | | | | | |
| 32 Was the vehicle available for personal use during off-duty hours? | ✓ | | ✓ | | | | | | | | | |
| 33 Was the vehicle used primarily by a more than 5% owner or related person? | ✓ | | ✓ | | | | | | | | | |
| 34 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.

| | Yes | No |
|---|-----|----|
| 35 Do you maintain a written policy statement that prohibits all personal use of vehicles, including commuting, by your employees? | | |
| 36 Do you maintain a written policy statement that prohibits personal use of vehicles, except commuting, by your employees? See page 6 of the instructions for vehicles used by corporate officers, directors, or 1% or more owners | | |
| 37 Do you treat all use of vehicles by employees as personal use? | | |
| 38 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? | | |
| 39 Do you meet the requirements concerning qualified automobile demonstration use? See page 6 of the instructions | | |

Note: If your answer to 35, 36, 37, 38, or 39 is "Yes," you need 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 |
|--|---------------------------------|---------------------------|---------------------|--|-----------------------------------|
| 40 Amortization of costs that begins during your 1996 tax year: | | | | | |
| 41 Amortization of costs that began before 1996 | | | | | 41 |
| 42 Total. Enter here and on "Other Deductions" or "Other Expenses" line of your return | | | | | 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 |
|--------------------------------|------------------------|---------------------|----------------------------|-----------------------|--------------------------|------------------------|--------------------|-----------------|-----------------|------------------------|
| <i>STRAIGHT LINE</i> | | | | | | | | | | |
| BARN | 1-8-78 | 6,400 | 100% | | 4,608 | 2,048 | SL | 25 | | 256 |
| Silo | 1-2-80 | 16,000 | " | | 12,800 | 4,000 | SL | 20 | | 800 |
| <i>ALTERNATE ACRS</i> | | | | | | | | | | |
| MACHINE SHED | 1-2-86 | 6,000 | 100% | | 3,162 | 3,838 | Mod SL | 19 | 5.3 | 318 |
| <i>MACRS</i> | | | | | | | | | | |
| TRACTOR # 2 (Tractor 3/96) | 1-8-92 | 7,297 | 100% | 5,000 | 1,149 | 2,297 | SL/HY | 7 | 14.29 | 164.12* |
| DAIRY Cow # 42 (K. Mod 3/96) | 6-22-92 | 600 | " | | 300 | 600 | SL/HY | 7 | 14.29 | 42.87** |
| DAIRY Cow # 52 (Sold 4/96) | 7-15-92 | 900 | " | | 450 | 900 | SL/HY | 7 | 14.29 | 64.31** |
| DAIRY Cow # 54 | 9-9-92 | 1,200 | " | | 600 | 1,200 | SL/HY | 7 | 14.29 | 171.48 |
| <i>Car (listed property)</i> | | | | | | | | | | |
| PLow | 1-6-93 | 12,350 | 60% | | 4,334 | 7,410 | 15008/HY | 5 | 16.66 | 1,005.7** |
| Picnic Table (listed prop) | 4-6-93 | 4,821 | 100% | | 1,599 | 4,821 | 15008/HY | 10 | 10.02 | 483.06 |
| DAIRY Cow # 61 | 5-21-93 | 7,076 | " | | 4,129 | 7,076 | 15008/HY | 5 | 16.66 | 1,178.86 |
| TRACTOR # 4 | 9-1-93 | 1,400 | " | | 628 | 1,400 | 15008/HY | 7 | 12.25 | 171.60 |
| | 10-12-93 | 13,483 | " | 5,000 | 3,814 | 8,483 | 15008/HY | 10 | 10.02 | 850.7 |
| MILK TANK | 1-4-94 | 11,500 | 100% | 10,000 | 448 | 1,500 | 15008/HY | 7 | 15.03 | 225.45 |
| MANURE SPREADER | 5-3-94 | 3,400 | " | | 1,015 | 3,400 | 15008/HY | 7 | 15.03 | 511.02 |
| <i>CATTLE FEEDING FACILITY</i> | | | | | | | | | | |
| MACHINE SHed Improvement | 1-9-96 | 37,500 | 100% | | -.- | 37,500 | 15008/HY | 10 | 7.50 | 2,812.50 |
| TRACTOR # 5 | 2-20-96 | 1,300 | " | | -.- | 1,300 | 15008/HY | 20 | 3.75 | 48.75 |
| | 3-7-96 | 24,713 | " | 17,500 | -.- | 7,213 | 15008/HY | 7 | 10.71 | 772.51 |
| | | | | | | | | | | 9,875.43 |

* DEPRECIATION limited to half year
 ** Limited deduction for passenger automobile

21.

How To Get More Information



You can get help from the IRS in several ways.

Free publications and forms. To order free publications and forms, call 1-800-TAX-FORM (1-800-829-3676). You can also write to the IRS Forms Distribution Center nearest you. Check your income tax package for the address. Your local library or post office may also have the items you need.

For a list of free tax publications, order Publication 910, *Guide to Free Tax Services*. It also contains an index of tax topics and related publications and describes other free tax services available from the IRS, including tax education and assistance programs.

If you have access to a personal computer and modem, you can also get many forms and publications electronically. See *Quick and*

Easy Access to Tax Help and Forms in your income tax package for details. If space permitted, the information is also at the end of this publication.

Tax questions. You can call the IRS with your tax questions. Check your income tax package or telephone book for the local number, or you can call 1-800-829-1040.

TTY/TDD equipment. If you have access to TTY/TDD equipment, you can call 1-800-829-4059 to ask tax questions or to order forms and publications. See your income tax package for details.

