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Internal
Revenue
Service

Farmer's Tax Guide

For use in preparing

1994 Returns

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

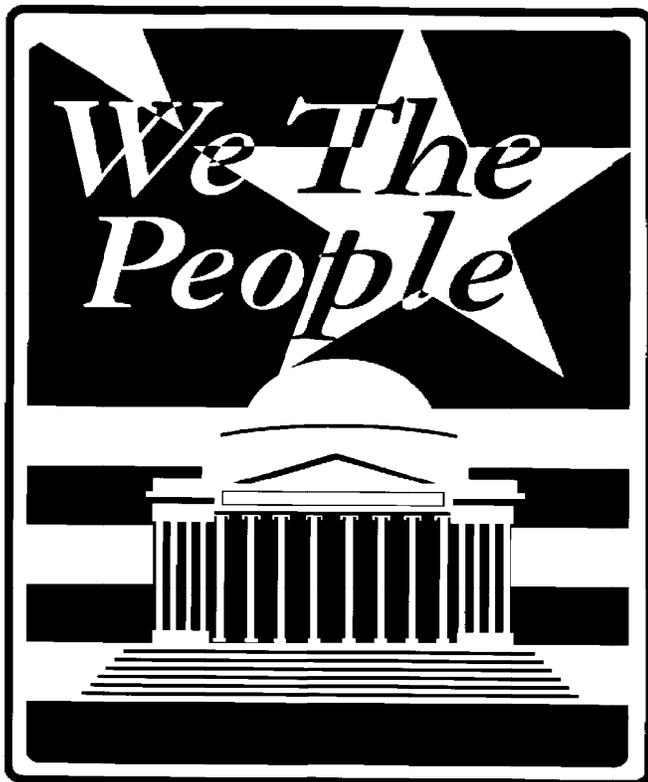
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Introduction

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 any subject, get the specific IRS tax publication covering that subject. Many of these free publications are referred to throughout this publication.

Ordering publications and forms. To order free publications and forms, call our toll-free telephone number 1-800-TAX-FORM (1-800-829-3676). You can also write to the IRS Forms Distribution Center nearest you. Forms



Distribution Center addresses and publication titles are listed at the end of this publication.

Telephone help. You can call the IRS with your tax question Monday through Friday during regular business hours. Check your income tax package or telephone book for the local number or you can call toll free 1-800-829-1040.

Telephone help for hearing-impaired persons. If you have access to TDD equipment, you can call 1-800-829-4059 with your tax question or to order forms and publications. See your tax package for the hours of operation.

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, PC: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 1994

The following items highlight a number of administrative and tax law changes for 1994.

Legislation. For information on any legislative changes, see Publication 553, *Highlights of 1994 Tax Changes*.

Higher earned income credit. The maximum earned income credit has been increased from \$2,364 in 1993 to \$2,528 in 1994. To claim the credit, you must have earned income (including net earnings from self-employment) and adjusted gross income of less than \$25,296 and meet certain other requirements.

Other earned income credit changes. The earned income credit has been expanded to include those who earn under \$9,000 and do not have a qualifying child. The health insurance credit and the extra credit for a child born during the year are no longer available.

More information. For more information, see Publication 596, *Earned Income Credit*.

Payment voucher for Form 1040. To help modernize the federal tax payment system, the IRS is sending Form 1040-V, *Payment Voucher*, to certain taxpayers this year. IRS plans to eventually send preprinted vouchers to all Form 1040 filers in order to process payments more accurately and efficiently.

If you receive Form 1040-V and have a balance due on Form 1040, use the voucher to

make your payment. Follow the instructions that come with the voucher.

Deferral of additional 1993 taxes. If you filed Form 8841, *Deferral of Additional 1993 Taxes*, with your 1993 tax return, the second installment is due April 17, 1995. If you are due a refund on your 1994 tax return, you can apply part or all of the refund to the second installment. See the Form 1040 instructions for more information.

Standard mileage rate. The standard mileage rate for 1994 is 29 cents a mile for all business miles on a passenger automobile (including vans, pickups, or panel trucks). See Chapter 5.

Limits on depreciation of 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 1994 is \$2,960. Your depreciation cannot exceed \$4,700 for the second year of recovery, \$2,850 for the third year of recovery, and \$1,675 for each later tax year. See Chapter 8.

Electronic deposit of taxes. You may enroll in a system that will allow you to make tax deposits through direct electronic funds transfers, without the need for coupons, paper checks, or visits to an authorized depository. For more information, call 1-800-829-5469, or write to:

IRS
Cash Management Site Office
Atlanta Service Center
P.O. Box 47669
Stop 295
Doraville, GA 30362

New 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 *Ordering publications and forms*, at the beginning of this publication.

New Form 1099-C. Beginning in 1994, certain financial entities, including financial institutions, credit unions, and federal government agencies, are required to report on Form 1099-C, *Cancellation of Debt*, any canceled debt of \$600 or more. The form must be filed even though the debtor may not be subject to tax on the debt. For example, qualified farm debt is reportable. See Chapter 4.

Tax rates and maximum net earnings for self-employment taxes. The self-employment tax rate on net earnings from self employment for 1994 is 15.3%. This rate is a total of 12.4% for social security (old-age, survivors, and disability insurance) and 2.9% for Medicare (hospital insurance). In 1994, the maximum amount subject to the social security tax (12.4%) is \$60,600. There is no maximum limit on the amount subject to the Medicare tax (2.9%).

For 1995, there is no ceiling on the net earnings subject to the Medicare tax (2.9%).

The maximum amount subject to the social security tax (12.4%) will be published in Publication 553. See Chapter 15.

Tax rates and wage maximums for social security and Medicare taxes. The tax rate for social security and Medicare taxes for 1994 is 7.65% for both the employee and the employer (a total of 15.3%). The 7.65% tax is a total of 6.2% for social security (old-age, survivors, and disability insurance) and 1.45% for Medicare (hospital insurance). In 1994, the maximum amount subject to the social security tax (6.2%) is \$60,000. There is no ceiling on the amount subject to the Medicare tax.

For 1995, there is no ceiling on the wages subject to the Medicare tax (1.45%). All wages are subject to the Medicare tax. The maximum amount subject to the social security tax (6.2%) will be published in Circular A. See Chapter 16.

Federal unemployment (FUTA) tax rate. The gross FUTA tax rate remains at 6.2% through 1995.

Payment voucher for Forms 940 and 940-EZ. For 1994, 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.

Health insurance for self-employed persons. The 25% deduction for health insurance costs for self-employed persons expired for tax years beginning after 1993. However, as this publication was being prepared for print, Congress was considering legislation to extend the provision. See Publication 553.

Club membership dues. No deduction is allowed for dues paid or incurred after 1993 for membership in any club organized for business, pleasure, recreation, or any other social purpose.

Waiver of estimated tax penalty. If you have an underpayment of tax for a period before April 16, 1994, any estimated tax penalty will be waived to the extent it was created or increased by any provision of the Revenue Reconciliation Act of 1993. See Publication 505.

Household employees. *Caution:* Late legislation changed the social security and Medicare withholding rules for household employees and simplified reporting for employers, effective January 1, 1994. See Publication 926.

Contributions to qualified retirement plan. The amount of a participant's compensation that can be taken into account for computing contributions to a Keogh or SEP plan is generally limited to \$150,000 for plan years beginning on or after January 1, 1994. See Chapter 17.

Important Reminders

The explanations and examples in this publication reflect the interpretation by the Internal Revenue Service 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 some 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.

Alternative minimum tax. Changes to alternative minimum tax for 1993 include:

Tax rates and exemption amounts. For tax years beginning after 1992, the alternative minimum tax rate for taxpayers other than corporations has been increased and graduated. The exemption amounts have also been increased.

Energy items. New alternative minimum tax rules for tax years beginning after 1992 apply to independent oil and gas owners or royalty owners.

Charitable contributions. The treatment of a charitable contribution of certain appreciated tangible personal property as a tax preference item was repealed for contributions of tangible personal property made after June 30, 1992, and for contributions of other property made after December 31, 1992.

See Chapter 14 for more information.

Form W-4 for 1995. You should make new Forms W-4 available to your employees and encourage them to check their income tax withholding for 1995. Those employees who owed a large amount of tax or received a large refund for 1994 may need to file a new Form W-4. See Chapter 34.

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 34.

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 34.

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.

General business credit. The following credits are part of the general business credit.

Targeted jobs credit. This credit cannot be claimed on wages paid to individuals hired after December 31, 1994.

Research credit. This credit was extended from July 1, 1992, through June 30, 1995.

Low-income housing credit. This credit was permanently extended for all tax years ending after June 30, 1992.

For more information, see Form 3800, *General Business Credit*.

Depreciation. The recovery period for non-residential real property placed in service after May 12, 1993, has been lengthened from 31.5 to 39 years. See Chapter 8.

Section 179 deduction. For property placed in service in tax years beginning after December 31, 1992, the limit on the section 179 deduction is increased from \$10,000 to \$17,500. See Chapter 8.

Amortization of goodwill and certain other intangibles. You may now have to amortize goodwill and certain other intangible property over a period of 15 years. See Chapter 8.

This amortizable property is called section 197 property and if held for more than one year, it may qualify for capital gain treatment on its sale or other disposition. See Chapter 10.

Deductions for clean-fuel vehicles and certain refueling property. Deductions are allowed for clean-fuel vehicles and certain clean-fuel vehicle refueling property placed in service after June 30, 1993. For more information, see Chapter 15 in Publication 535.

Credit for qualified electric vehicles. A tax credit is available for qualified electric vehicles placed in service after June 30, 1993. For more information, see Chapter 15 in Publication 535.

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 penalties 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 $\frac{1}{2}$ 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) Failing 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.

Free tax help. Publication 910, *Guide to Free Tax Services*, provides information on where to get help in preparing tax returns. It describes the kind of year-round services available in resolving questions on bills, letters, and notices received from Internal Revenue Service Centers, as well as questions on the status of tax refunds. The publication also lists free taxpayer information publications. It gives a brief description of their content and a list of tax forms and schedules discussed in the publication. For information about getting Publication 910, see *Ordering publications and forms*, at the beginning of this publication.

Written tax questions. You can send written tax questions to your IRS District Director. If you do not have the address, you can get it by calling the toll-free number. The IRS is working to decrease the time it takes to respond to your correspondence. If you write, the IRS can 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 covering such areas 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*.

Hearing-impaired taxpayers who have access to TDD equipment may 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.

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. 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. This information is also used by the U.S. Census Bureau for its economic census. See the list of *Principal Agricultural Activities Codes* on page 2 of Schedule F.

Rounding off dollars. You may 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.

Electronic filing. You may be able to have your tax return filed electronically instead of on a paper form. This method can be used by many tax return preparers and other professional filers who do not prepare returns but use this method to file returns already completed by taxpayers. These preparers and filers send tax return information over telephone lines to an Internal Revenue Service Center. They will charge you for this service. However, by filing electronically, you can have your refund deposited directly into your savings or checking account.

Electronic filing of federal tax returns is available to preparers in all 50 states. Also, in some states, preparers can file an electronic state tax return simultaneously with the federal return. Federal/state electronic filing is offered statewide in Colorado, Connecticut, Idaho, Indiana, Iowa, Kansas, Louisiana, Maine, Michigan, Mississippi, Missouri, New Mexico, New York, North Carolina, Oklahoma, Oregon, South Carolina, Utah, West Virginia, and Wisconsin. It is also offered in limited programs in Arizona, Arkansas, Delaware, Georgia, Kentucky, Montana, Nebraska, New Jersey, Rhode Island, and Virginia. In these states, check with your preparer to see if you can participate in the program.

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 1995*.

Fiscal year taxpayers. Generally, the due dates listed in the calendar 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.

1995—Calendar Year

During January

Employers. Give copies of Form W-2 for 1994 as soon as possible to each agricultural employee whose wages are to be reported on Form 943. The due date for giving Form W-2 to your employees is January 31, 1995. Copy A of Form W-2 must be filed by February 28, 1995.

January 17

Farmers. You may elect to pay your 1994 estimated income tax with Form 1040-ES. You can then file your 1994 federal income

tax return, Form 1040, by April 17. If you do not pay with Form 1040-ES at this time, file your 1994 return by March 1.

January 31

Farm employers. File Form 943 to report social security and Medicare taxes and withheld income tax for 1994. Deposit any undeposited tax. (If the total is less than \$500 and not a shortfall, 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 1994. (You may need Forms 1099-INT or 1099-MISC.) See Chapter 2.

Federal unemployment (FUTA) tax. File Form 940 (or 940-EZ) for 1994. 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 and Medicare taxes and withheld income tax for 1994. 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 1994. 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. Report certain payments of \$600 or more made during 1994 to a taxpayer other than a corporation. See Chapter 2. Use Forms 1096 to summarize and transmit Forms 1099-INT and 1099-MISC.

All employers. File Form W-3, *Transmittal of Income and Tax Statements*, along with Copy A of all the Forms W-2 you issued for 1994. See Chapter 2.

March 1

Farmers. File your 1994 income tax return (Form 1040) and pay any tax due. However, you have until April 17 if you paid your 1994 estimated tax by January 17, 1995.

March 15

Corporations. File a 1994 calendar year income tax return, Form 1120 or 1120-A. See Publication 542, *Tax Information on Corporations*.

April 17

Individual farmers. File an income tax return (Form 1040) for 1994 and pay any tax due if you did not file by March 1. See Chapter 2.

Partnerships. File a 1994 calendar year return. Use Form 1065. See Publication 541, *Tax Information on Partnerships*.

May 1

Federal unemployment (FUTA) tax. If you are liable for FUTA tax (see Chapter 16), you must deposit your actual federal unemployment tax liability with a depository. No deposit is necessary if the liability for the quarter does not exceed \$100.

July 31

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

October 31

Federal unemployment (FUTA) tax. If you are liable for FUTA tax, you must deposit your actual federal unemployment tax liability with a depository. No deposit is necessary if the liability for the quarter, plus undeposited federal unemployment 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 pay only the tax owed. Items such as invoices, canceled checks, and receipts for bills paid by cash that support entries in your books should be filed in an orderly manner and stored in a safe place.

Topics

This chapter discusses:

- How to keep records
- How long to keep records

Useful Items

You may want to see:

Publication

- 463** Travel, Entertainment, and Gift Expenses
- 534** Depreciation
- 917** Business Use of a Car
- 937** Employment Taxes

Form (and Instructions)

- Schedule F (Form 1040)** Profit or Loss From Farming
- W-2** Wage and Tax Statement
- W-4** Employee's Withholding Allowance Certificate
- 4562** Depreciation and Amortization
- 8824** Like-Kind Exchanges

How To Keep Records

Good records can save you time and money. You need good records for efficient farm management, preparation of financial statements, and to support items of income and expense reported on your tax return. Here are some ways in which they may help.

Identify source of receipts. Your records should identify the source, date, and amount of your receipt and show whether the income is taxable or nontaxable.

Record deductible expenses. You may forget expenses when you prepare your tax return unless you record them when they occur. After entering the item in your records, keep the source document or receipt in a safe, well-organized file.

Figure depreciation deduction. You should note in a permanent record the depreciable assets used in your farming business. Depreciation allows you to recover the cost of farm business property by deducting part of it each year of its depreciable life on your tax return. You must keep a record of the cost and any other information pertaining to the basis of your assets. This is needed to figure your depreciation deduction and any gain or loss upon disposition of the asset. If you sell or make capital improvements to your assets, only a permanent record will show how much of their cost you have recovered. See Chapter 20 for a sample depreciation worksheet and a completed Form 4562.

This information is also needed to correctly report a disposition of an asset on your tax return. In addition, if you exchange property for

the same kind of property, these permanent records will enable you to complete and file Form 8824. You must file this form with your tax return to report the like-kind exchange of any business or investment property. For more information, see Chapter 10.

Figure earnings for self-employment social security tax. The self-employment tax is part of the system for providing social security coverage for people who work for themselves. The social security benefits you receive when you retire or become disabled, or the benefits your family receives in case of your death, depend on the amount you contributed to your social security account based on your net earnings. Your records should show how much of your earnings are subject to self-employment tax.

Support items reported on income tax return. If your income tax return is examined by the IRS, you may be asked to explain and support the items reported. Adequate and complete records are always supported by sales slips, invoices, receipts, bank deposit slips, canceled checks, certain financial account statements, and other documents.

Financial account statements as proof of payment. If you cannot provide a canceled check to prove payment of an expense item, you may be able to prove it with certain financial account statements. These include account statements prepared by a third party who is under contract to prepare statements for the financial institution. To be acceptable, they must meet the following requirements:

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

These account statements must show a high degree of legibility and readability. For this purpose, legibility is the quality of a letter or number enabling it to be identified positively excluding all other letters and numbers. Readability is the quality of a group of letters or numbers enabling it to be recognized as words or complete numbers. However, this does not mean the information must be typed or printed.

Proof of payment alone does not establish that you are entitled to a tax deduction. You should also keep other documents as discussed in *Support items reported on income tax return*, earlier.

Recordkeeping. Generally, there are no special kinds of records required. However, your records should contain all the information you need to figure your income, deductions, credits, and other items shown on your income tax return. You may want to keep records of Forms 1099, preproductive expenses, conservation documents, and other items shown on Schedule F (Form 1040) that pertain to your business operations. You should also keep good records pertaining to all assets both depreciable and nondepreciable.

A farm income and expense record is illustrated in Chapter 20.

Specific information on recordkeeping for farmers exempt from federal excise tax on diesel fuel used in off-highway vehicles is provided under *How To Claim a Credit or Refund* in Chapter 18.

Travel expenses. You are required to support your expenses for business travel with adequate records or sufficient evidence to prove your own statements. This includes expenses for local travel, gifts, entertainment, and the business use of certain **listed property**. Adequate records include account books, diaries, trip sheets, or similar items.

Listed property generally includes all passenger automobiles; entertainment, amusement or recreation-type property; and computer equipment not used exclusively at a regular business location. Passenger automobiles include any four-wheeled vehicle manufactured primarily for use on public streets, roads, and highways and rated at 6,000 pounds or less of unloaded gross vehicle weight (gross vehicle weight for trucks and vans). For more information on listed property, see Chapter 4 in Publication 534.

Records for travel expenses and listed property. You should record the elements of an expense or of a business use at or near the time of the expense, and keep sufficient documentary evidence to support it. This type of record has more value than a statement prepared later when generally there is a lack of accurate recall.

See Publications 463, 534, and 917 for more information.

How Long To Keep Records

Keep the records that support items of income or expense reported on your tax return until the period of limitations for the tax return runs out. (A period of limitations is the limited period of time after which no legal action can be brought.) Usually, this is 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.

In some cases, you must keep records longer than the period of limitations.

Employment taxes. If you are an employer, you must keep all your employment tax records for at least 4 years after the date the

tax becomes due or is paid, whichever is later. This includes copies of Form W-4, undelivered copies of Form W-2, and all payroll records. For more detailed information on employment tax records, see *Recordkeeping* in Publication 937.

Basis. Keep records that support your basis in property as long as they are needed to figure the correct basis of your original or replacement property (including all capital improvements). See Chapter 7 for more information on basis.

Tax returns. Keep copies of your tax returns. They will help in preparing future tax returns and in making computations if you later file a claim for refund. They may also be helpful to the executor or administrator of your estate, or to the IRS, if your original return is not available.

- S corporation returns

Useful Items

You may want to see:

Publication

- 349** Federal Highway Use Tax on Heavy Vehicles
- 505** Tax Withholding and Estimated Tax
- 541** Tax Information on Partnerships
- 542** Tax Information on Corporations
- 589** Tax Information on S Corporations

Form (and Instructions)

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

Filing Requirements

The filing requirement amounts below are the exemption amount, \$2,450, plus the standard deduction for the filing status and age.

Who Must File	
Filing Status Is:	Income At Least:
Single	
Under 65	\$ 6,250
65 or older	7,200
Head of Household	
Under 65	\$ 8,050
65 or older	9,000
Married, Joint Return	
Both under 65	\$ 11,250
One spouse 65 or older	12,000
Both 65 or older	12,750
Not living with spouse at end of year (or on date spouse died)	2,450
Married, Separate Return	
All (any age)	\$ 2,450
Qualifying Widow(er) with Dependent Child	
Under 65	\$ 8,800
65 or older	9,550

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 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 \$3,800, or
- 2) Had only unearned income, such as interest and dividends, and the total is more than \$600, or
- 3) Had both earned and unearned income, and the total is more than \$600.

Self-employed. If you are self-employed, you must file a return if you had net earnings of \$400 or more from self-employment, even

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 a Form 1099-MISC to report these payments.

Estimated tax. When you figure your estimated tax for 1995, 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 category that applies to you, you must file a 1994 federal income tax return even if no tax is due. This also applies to minor children. Gross income is explained later in the chapter.

Topics

This chapter discusses:

- Filing requirements
- Identification number
- Estimated tax
- Main tax forms used by farmers
- Partnership returns
- Corporation returns

though you are not otherwise required to file an income tax return. See Chapter 15.

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

More information. See the Form 1040 instructions for more information on who must file a return for 1994.

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 levied for each failure to show the number.

Which number to use. If you have to file an excise, alcohol, tobacco, firearms, or employment tax return, you should have an employer identification number and 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, 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.

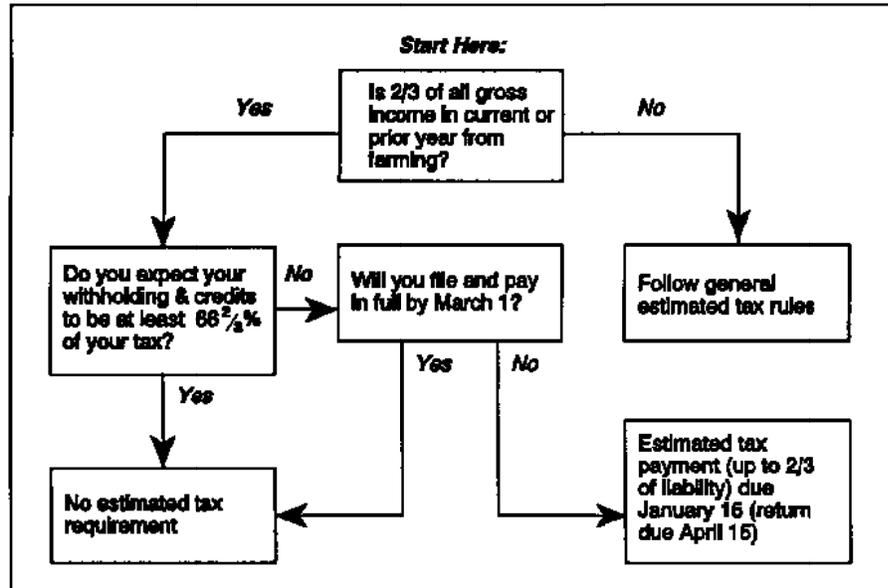
To apply for an employer identification number, use Form SS-4. You can get this form from any social security office or by calling IRS at 1-800-829-3676.

Estimated Tax and Return Due Date

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.

Figure 2-A. Estimated Tax for Farmers



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.

The amount of your gross income is used to determine if you must file an income tax return. It is also used to determine if you qualify as a farmer. To see if you qualify as a farmer, first figure the amount of 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 on line 12, column (g).
- 9) Capital gain distributions reported on line 14, Schedule D (Form 1040).
- 10) Gains on sales of business property from Form 4797, column (h) of lines 7 and 19.
- 11) Taxable IRA distributions, pensions, annuities, and social security benefits.

- 12) Gross rental income from line 3, Schedule E (Form 1040).
- 13) Gross royalty income from line 4, Schedule E (Form 1040).
- 14) Your taxable net income from an estate or trust (line 36, Schedule E, Form 1040).
- 15) Income from a REMIC reported on line 38, Schedule E (Form 1040).
- 16) Gross farm rental income from line 7, Form 4835.
- 17) Farm income from line 11, Schedule F (Form 1040).
- 18) Your distributive share of gross income from a partnership.
- 19) Your pro rata share of gross income from an S corporation.
- 20) Unemployment compensation.
- 21) Other income reported on line 21, Form 1040 that is not reported with any of the items listed above.

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

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

Farm employees. 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 also may 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 your gross income that comes from farming.

Example 1. James Smith had the following total gross income and farm gross income in 1994:

	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
Totals	\$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 1994. However, he can still qualify as a farmer if at least two-thirds of his gross income was from farming in 1993.

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 1994 since at least two-thirds of his gross income is from farming ($\$95,000 \div \$140,000 = 67.9\%$).

Qualified Farmer Due Dates

If at least two-thirds of your total gross income for 1993 or 1994 is from farming, you have only one payment due date for estimated tax—January 17, 1995.

For your 1994 tax, you may either:

- 1) Pay all your estimated tax by January 17, 1995, and file your Form 1040 by April 17, 1995, or
- 2) File your Form 1040 by March 1, 1995, and pay all the tax that is due. You are not required to make an estimated tax payment. If you pay all the tax due, you will not receive a penalty for not paying estimated tax.

Fiscal years. 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 on or before 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 on or before the 15th day of the 4th month after the end of your tax year.

Amount of required annual payment. If at least two-thirds of your gross income for 1993 or 1994 is from farming, the required annual payment due January 17, 1995, is the smaller of:

- 1) 66% (.6667) of your total tax for 1994, or
- 2) 100% of the total tax shown on your 1993 return. (The return must cover all 12 months.)

Nonqualified Farmer Due Dates

If you did not qualify as a farmer in 1994 because less than two-thirds of your total gross income was from farming and you do not expect to qualify in 1995, you do not qualify for the special estimated tax payment and return due dates. You generally must make quarterly estimated tax payments on April 17, June 15, and September 15, 1995, and on January 16, 1996. You must file your return by April 15, 1996.

For more information on estimated taxes, see Publication 505.

Penalty

If you do not pay all your required estimated tax by January 17, 1995, and do not file your return and pay the tax by March 1, 1995, 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 pay it and file Form 2210-F with your return, you will get a penalty notice from the IRS. You should pay the penalty as instructed by the notice.

If you file your return by April 17 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

Payment date on a 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 day that is not a Saturday, Sunday, or legal holiday.

Automatic extension of time to file Form 1040. If you do not choose to file your return by March 1, 1995, the due date for your 1994 return will be April 17, 1995. 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, 1995. To get this extension, file Form 4868, *Application for Automatic Extension of Time To File U.S. Individual Income Tax Return*, by April 17, 1995. For more information, see the instructions for Form 4868.

This extension **does not** extend the March 1, 1995, filing date for farmers who did not make an estimated tax payment and who want to avoid an estimated tax penalty. Therefore, if you did not make an estimated tax payment by January 17, 1995, and you file your tax return after March 1, 1995, you will be subject to a penalty for underpaying your estimated tax even if you filed Form 4868.

Return Forms

When filing your income tax return, arrange your forms and schedules in the correct order using the sequence numbers located in the upper right corner of the form. Attach all other statements or attachments last, arranged in the same order as the forms or schedules they support. Some of these forms and schedules are illustrated in Chapter 20.

The following forms and schedules are used by farmers.

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. This schedule is used to list nonbusiness itemized deductions.

Schedule B. This schedule is used to report interest and dividend income of over \$400.

Schedule C. This schedule is used to list income and deductions and to determine the net profit or loss from a nonfarm business.

Schedule C-EZ. This schedule is used in place of Schedule C, if gross receipts from a nonfarm business are \$25,000 or less and business expenses are \$2,000 or less.

Schedule D. This schedule is used to report gains and losses from sales of capital assets.

Schedule E. This schedule is used to report income or losses from rents, royalties, partnerships, estates, trusts, and S corporations.

Schedule F. This schedule is used by farmers filing on either 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. This schedule is used to figure self-employment tax. See Chapter 15.

Form 1040-ES. Use this form to figure and pay estimated tax. See Publication 505.

Form 3800. Form 3800, *General Business Credit*, is used to figure the general business credit. See Chapter 9 for information on the credits that comprise the general business credit.

Form 4136. Form 4136, *Credit for Federal Tax Paid on Fuels*, is used to figure the credit for federal tax on gasoline and special fuels. See Chapter 18.

Form 4684. Form 4684, *Casualties and Thefts*, is used to report gains and losses from casualty and theft of business and personal use property.

Form 4797. Form 4797, *Sales of Business Property*, is used to report gains and losses from the sale or exchange of business property and from certain involuntary conversions.

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

Form 6251. Form 6251, *Alternative Minimum Tax—Individuals*, is used to figure the alternative minimum tax. See Chapter 14.

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

Form 4255. Form 4255, *Recapture of Investment Credit*, is used to figure the tax from the recapture of investment credit.

Form 4562. Form 4562, *Depreciation and Amortization*, is used to explain the deductions for depreciation and amortization.

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

Other Forms

The following forms may also be filed by farmers in certain situations.

Form 1065. Form 1065, *U.S. Partnership Return of Income*, is filed for all farm partnerships. See *Partnerships* later in this chapter.

Form 1120. Form 1120, *U.S. Corporation Income Tax Return*, is filed by corporations. **Form 1120-A.** *U.S. Corporation Short-Form Income Tax Return*, a short version of Form 1120, can be used by many small corporations instead of Form 1120. See *Corporations* later in this chapter.

Form 1120S. Form 1120S, *U.S. Income Tax Return for an S Corporation*, is used by S corporations. See *S Corporations*, later in this chapter.

Form 943. Form 943, *Employer's Annual Tax Return for Agricultural Employees*, is filed on or before January 31 of the following year if a farmer was required to withhold and pay social security and Medicare taxes, and withheld income tax on farm labor wages paid during the calendar year. If the farmer deposited all taxes by January 31, Form 943 may be filed as late as February 10.

Form 8109. Form 8109, *Federal Tax Deposit Coupon*, is used to deposit employment taxes and all other taxes that are deposited. In general, income tax withheld and both employer and employee social security and Medicare taxes that total \$500 or more must be deposited. The IRS will send a coupon book to use for deposits when a farmer applies for an employer identification number. See Chapter 16.

Form 940. Form 940, *Employer's Annual Federal Unemployment (FUTA) Tax Return*, is filed on or before January 31 of the following year if the farmer was subject to FUTA tax. If all tax was deposited by January 31, Form 940 may be filed as late as February 10. **Form 940-EZ** is a simplified version of Form 940. See Chapter 16.

Form W-2. Form W-2, *Wage and Tax Statement*, is prepared for each employee to whom a farmer paid any amount for services, including any payment that was not in cash, if the farmer is in a trade or business. The farmer must show, in the space marked *Wages, tips, other compensation*, the total amount paid to the employee. Copies B and C of Form W-2 must be given to the employee on or before the last day of January. Copy A of each Form W-2 must be sent to the Social Security Administration with a completed Form W-3, *Transmittal of Income and Tax Statements*, on or before the last day of February. See Chapter 16.

Form 2290. Form 2290, *Heavy Vehicle Use Tax Return*, is filed if a truck or truck tractor registered in the farmer's 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 Publication 349.

Form 8645. Form 8645, *Soil and Water Conservation Plan Certificate*, is used to certify that soil and water conservation expenses are consistent with an approved conservation plan. See the instructions for Schedule F (Form 1040).

Form 8822. Form 8822, *Change of Address*, is used to notify IRS of a change in home or business address. The suite, room, or other unit number should be included if it is required in the address. The form must be sent to the

Internal Revenue Service Center for the old address.

Form 8824. Form 8824, *Like-Kind Exchanges*, is filed with Schedule D (Form 1040) or Form 4797 for like-kind exchanges. See Chapter 10.

Information Returns

Information returns are forms that provide information, other than amounts of tax due, that is required by the IRS. There are many information forms, including Form W-2 discussed earlier. This discussion, however, is limited to Form 1099-MISC, Form 1099-INT, and Form 1096.

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, veterinarians, rents, commissions, fees, prizes, awards, independent contractors, and other payments and compensation, including payments to subcontractors and payments for 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.

Payments for merchandise, freight and similar charges, and for rental payments to real estate agents need not be reported. 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.

Payments for compensation to employees are reported on Form W-2, **not** on Form 1099-MISC. See Chapter 16.

Form 1099-INT. You report interest payments, including interest paid on installment sale contracts, of \$600 or more on Form 1099-INT, *Interest Income*.

Preparation of returns. You must prepare separate copies of Form 1099-INT and Form 1099-MISC for each person. One copy of the form must be filed with the IRS. Each person who received payment from you must be given a statement (or copy of the form) by January 31 of the following year. Instructions for completing these forms are in a booklet titled *Instructions for Forms 1099, 1098, 5498, and W-2G*.

Form 1096. When sending copies to the IRS, you must 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. Information returns filed late, without all information required to be on the return, or with incorrect information may be subject to a penalty. See the *Instructions for Forms 1099, 1098, 5498, and W-2G*, for information on penalties for filing Forms 1099.

Partnerships

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 partnerships. Members of the same family may, and often do, form valid partnerships. For instance, a husband and wife or parents and children may 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 Partnerships* 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 the operation of a farm or other business, they should report their partnership income on the partnership return, Form 1065.

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 though the items were not distributed. No tax is payable on the return of a partnership.

Self-employment tax. Unless you are a limited partner, your distributive share of income from a partnership is self-employment income. The self-employment tax of a member of a partnership engaged in farming is discussed in Chapter 15.

Ending partnership. When you create a partnership, you do not usually recognize any gain or loss on contributions of money or property you make to the partnership. However, you will usually have to recognize gain or loss when you end the partnership.

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

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 under *Corporations*.

Filing requirements. 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 the amount of each partner's distributive share of income, gain, loss, deductions, credits, etc. A return must be filed for each tax year of the partnership even though the partnership has no income. However, a return is not required before the first tax year the partnership has income or deductions.

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 a partner 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 will usually be considered to meet this requirement if it can show that all partners have fully reported their shares of all partnership items on their timely filed income tax returns. In addition, the partnership must have no foreign or corporate partners, and each partner's proportionate share of each partnership item must be the same.

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

Corporations

A corporation, for federal income tax purposes, includes associations, joint stock companies, trusts, and partnerships that actually operate as associations or corporations.

Organizations that are unincorporated and have certain corporate characteristics are classified as associations and taxed as corporations. These organizations must have associates and be organized to carry on business and divide any gains. They 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.

However, other factors may also be significant in classifying an organization as an association. An organization will be treated as an association if its corporate characteristics make it more nearly resemble a corporation than a partnership or trust. The facts in each case determine whether or not these 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 either 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.

Filing requirements. 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 Corporations

A qualifying corporation may choose to be generally exempt from federal income tax. Its shareholders will then include in income their

share of the corporation's separately stated items of income, deduction, loss and credit and their share of nonseparately stated income or loss. A corporation that makes this choice is known as an S corporation.

To make this election, a corporation, in addition to other requirements, must not have more than 35 shareholders. Each of its shareholders must also consent to the election.

Although it is generally not liable for federal income tax, 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 files its return on Form 1120S. In addition, an S corporation may have to make quarterly estimated tax payments.

For more information, see Publication 589.

3. Accounting Periods and Methods

Introduction

Each taxpayer (business or individual) must figure taxable income on the basis of an annual accounting period. Each taxpayer must also use a consistent 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 years
- Fiscal tax years
- The cash method of accounting
- The accrual method of accounting
- Changes in accounting method

Useful Items

You may want to see:

Publication

- 538** Accounting Periods and Methods

Form (and Instructions)

- 3115** Application for Change in Accounting Method

Accounting Periods

Your "tax year" is the annual accounting period you use for keeping your records and reporting your income and expenses. The accounting periods you can use are:

- A calendar year, or
- A 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 tax year. If you adopt the calendar year for your annual accounting period, you must maintain your books and records and report your income and expenses for the period from January 1 through December 31 of each year.

If you filed your first return using the calendar tax 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 tax year unless you get permission to change. 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 tax year if:

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

Fiscal tax year. A regular fiscal tax year is 12 consecutive months ending on the last day of any month except December. If you adopt a fiscal tax year, you must maintain your books and records and report your income and expenses using the same tax year.

Partnerships and S corporations. Special restrictions apply to the tax year that may be adopted by partnerships and S corporations. 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 accounting treatment 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, discussed later, even for your first return, unless you get consent from the IRS. After you file your first return, if

you want to change your accounting method, you must first get consent from the IRS. The methods you may use are:

- 1) Cash method,
- 2) Accrual method,
- 3) Special methods of accounting for certain items of income and expenses, and
- 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, provided you keep a complete and separate set of books and records for each business.

Special methods. There are special methods of accounting for certain items of income and expenses. One of these methods is the **crop method**. Methods of accounting for depreciation, amortization, and depletion are explained in Chapter 8. Methods of accounting for installment sales are explained in Chapter 12.

Crop method. If you do not complete harvesting and disposing of your crops in the same tax year you plant them, you may, with consent from the IRS, choose to use the crop method. Under this method, deduct the entire cost of producing the crop, including the expenses of seed or young plants, in the year you realize the income from the crop. You cannot use this method for timber or any commodity covered by the uniform capitalization rules.

Combination (hybrid) method. Generally, you may use any combination of cash, accrual, and special methods of accounting if the combination clearly shows income and you use it consistently. However, the following restrictions apply:

- 1) If inventories are necessary to account for your income, you must use an accrual method for purchases and sales. You may use the cash method for all other items of income and expenses. See *Farm Inventories*, later in this chapter.
- 2) If you use the cash method for figuring your income, you must use the cash method for reporting your expenses.
- 3) If you use an accrual method for reporting your expenses, you must use an accrual method for figuring your income.

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

Cash Method

The cash method is used by most farmers because they find it easier to keep cash method records. However, if you use inventories to figure your gross income, you must use an accrual method for your purchases and sales. The cash method cannot be used by certain farm corporations and partnerships, or by any tax shelter. See *Accrual Method*, later.

Income

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

Constructive receipt. You have constructive receipt of income when an amount is credited to your account or made available to you without restriction. You do not need to have possession of it. The receipt of a check is constructive receipt of money, even though you do not deposit or cash it during 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 any items under a deferred payment contract that calls for payment the following year, there is no constructive receipt in the year of sale.

Example. You are a farmer who uses the cash method and a calendar year. You sell grain in December 1994 under a bona fide arm's-length contract that calls for payment during 1995. You include the proceeds of the sale in your 1995 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 selling price in your 1994 income, regardless of when you receive actual payment.

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

- 1) The amount of cash and the value of merchandise or other property you receive during the tax year from the sale of raised livestock, poultry, vegetables, fruits, etc.
- 2) Your profit from the sale of all other livestock or other items. To find your profit from the sale of livestock or other items purchased, deduct the cost or other basis of the property, plus selling expenses, from the sale proceeds. The cost of items you purchased for resale is not usually deducted in the year paid unless the payment and the sale occur in the same year. However, see Chapter 5 for when to deduct the cost of chickens, seeds, and young plants.
- 3) All amounts you receive from breeding fees, fees from rent of teams 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 may 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

Farm business expenses are deductible only in the tax year they are paid. However, certain prepaid expenses for supplies may only be deducted when the supplies are actually used or consumed. See Chapter 5.

Inventories are not used to figure income on the cash method. However, if you are subject to the uniform capitalization rules (discussed later), you may use the farm-price method or the unit-livestock-price method to account for the costs of any plant or animal, even if the plant or animal is not held or treated as inventory property. See *Items Purchased for Resale* in Chapter 5.

Accrual Method

Under an accrual method of accounting, income is generally reported in the year earned, and expenses are deducted or capitalized in the year incurred. The purpose of an accrual method of accounting is to match your income and expenses in the correct year.

Income

Generally, all items of income from farming operations are included in your gross income when you earn them, even though you may receive payment in another tax year. All events that fix your right to receive the income must have happened and you must be able to figure the amount with reasonable accuracy.

Items to include in income. If you use an accrual method, you must use inventories to figure your gross income. Increases and decreases in inventory values of livestock, crops, produce, feed, etc., at the end of the year as compared with the beginning of the year are reflected in figuring your gross income. Complete inventories of these items are required for reporting on an accrual method. For more information on inventories, see *Farm Inventories*, later in this chapter. To figure gross income on an accrual method, **add** the following items:

- 1) The sale proceeds of all livestock and products you sell during the year,
- 2) The inventory value of livestock and products you have on hand that are not yet sold at the end of the year,
- 3) All miscellaneous items of income you earn during the year, such as breeding fees, fees from the rent of teams of animals, machinery, or land, or other incidental farm income,
- 4) Any subsidy or conservation payments you receive that are considered income, and
- 5) Your gross income from all other sources.

Then **subtract** the total of the following:

- 1) Inventory value of the livestock and products you had on hand at the beginning of the year, and
- 2) The cost of any livestock or products you purchased during the year, except livestock held for draft, dairy, or breeding purposes, unless included in inventory.

Expenses

You deduct farm business expenses in the tax year you become liable for them, whether or not you pay them in that year, unless they are subject to the uniform capitalization rules, discussed in Chapter 7. All events must have occurred that establish the fact of liability, you must be able to reasonably determine the amount of the liability, and economic performance must have occurred.

Economic performance generally occurs as the property or services are provided, even if you have not paid the expenses. An exception for recurring items allows certain expenses to be treated as incurred in a tax year even though economic performance has not occurred. See Publication 538.

Cash Versus Accrual Methods

A comparison of the cash and accrual methods of accounting is illustrated in the following examples. These two methods are explained in greater detail later.

Example 1. You are a farmer who uses an accrual method. You keep your books on the calendar year basis. You sell some grain in December 1994. You are not paid until January 1995. You must include both the sale proceeds and your cost incurred in producing the grain in 1994 on your return for tax year 1994. Profit or loss on the sale must be reported for the year all events occurred that fix your right to receive income from the transaction if your profit or loss can be determined with reasonable accuracy.

Example 2. Assume in Example 1 that you used the cash method and that there was no constructive receipt of the sale proceeds in 1994. Under this method, the sale proceeds are included in income for 1995, the year payment is received. The cost of producing the grain is deductible in the year it is paid.

Accrual Method Required

An accrual method is required for a farming business that is a tax shelter, unless it is excepted from the rule, as 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) The principal purpose of the entity is the avoidance or evasion of federal income tax, 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 having 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 amount of 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 who does not actively participate in the management of the enterprise.

Accrual Method Not Required

The accrual method of accounting is not required to be used by:

- 1) S corporations,
- 2) Corporations whose gross receipts for each tax year beginning after 1975 are \$1 million or less,
- 3) Corporations, or partnerships 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, and
- 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:

- 1) Corporations in which at least 50% of the total combined voting power of all classes of stock entitled to vote and at least 50% of the total number of shares of all other classes of stock of the corporation are owned by members of the same family.
- 2) Corporations if, on October 4, 1976, and since then, members of two families own, directly or indirectly, at least 65% of the total combined voting power of all classes of stock entitled to vote and at least 65% of the total number of shares of all other classes of stock of the corporation.
- 3) Corporations if, on October 4, 1976, and since then, members of three families own, directly or indirectly, at least 50% of the total combined voting power of all classes of stock entitled to vote and at least 50% of the total number of shares of all other classes of stock and substantially all of the remaining stock is owned by corporate employees or their family members or by a tax-exempt employees' trust for the benefit of the corporation's employees.

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

Farm Inventories

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

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

Hatchery business. If you are in the hatchery business, you must include eggs in the process of incubation in your inventory.

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

Supplies. You must inventory supplies which are acquired for sale or become a physical part of items held for sale. Do not include other supplies in inventory. The cost of these supplies should be deducted in the year used or consumed in operations. However, incidental supplies can be deducted 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 such animals are livestock. You may, therefore, use any of the inventory and accounting methods discussed in this chapter.

Growing crops. You generally are not required to inventory growing crops. However, if your crops have a preproductive period of more than 2 years, you may have to capitalize or include costs associated with these crops in inventory. You cannot take a current year 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, you are subject to the uniform capitalization rules even if the preproductive period of raising a plant is 2 years or less. If you are required to use an accrual method, all animals are subject to the uniform capitalization rules, regardless of age or whether the animals are held primarily for slaughter.

Inventory Valuation Methods

The methods generally available for the valuation of your farm inventories include: cost, the lower of cost or market, and the farm-price method. In addition to these methods, livestock may be inventoried under the unit-livestock-price method.

Costs required to be allocated under the uniform capitalization rules may be determined using inventory methods, such as the farm-price method or the unit-livestock-price method by any farmer and for any plant or

animal, even if the plant or animal is not held or treated as inventory property by the farmer.

Farm-price method. Under this method, each item, whether raised or purchased, is valued at the market price less the estimated direct cost of disposition. Market price means the current price at the nearest market in the quantities you usually sell. Cost of disposition includes broker's commission, freight and hauling to market, and other marketing costs.

If you use this method, you must use it for the entire inventory, except that your livestock may 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. Under this method, livestock is grouped or classified according to kind and age, and a standard unit price is used for each animal within a class or group. The unit prices 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 make any changes to your classifications or unit prices without consent of the IRS.

All raised livestock must be included in inventory if this method is used, regardless of whether held for sale or for draft, breeding, dairy, or sporting purposes. This method accounts only for an increase in the cost of raising an animal to maturity. It does not provide for any decrease in the market value of an animal after it reaches maturity. In addition, if you raise cattle, this method does not require you to inventory hay that you grow and use for feeding a herd.

Animals sold or lost should not be included in the year-end inventory. If your records do not show which animals were sold or lost, the first animals acquired are the ones you treat as sold or lost. Thus, the animals on hand at the end of the year are considered the ones most recently acquired.

Purchased animals. All livestock purchased primarily for sale must also be included in inventory. Livestock purchased for draft, breeding, dairy, or sporting purposes may be included in inventory or treated as depreciable assets. However, you must be consistent from year to year regardless of the practice you have chosen. You may not change your practice unless you get the consent of the IRS.

Animals you purchase after maturity must be inventoried or capitalized at their purchase price. If the animals purchased are not mature at the time of purchase, the cost should be increased at the end of each tax year according to the established unit prices. However, do not make an increase in the year of purchase to 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.

Change in Accounting Method

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

A change in your accounting method includes a change not only in your overall method, such as from the cash to an accrual method or vice versa, but also in your treatment of any material item, such as in figuring depreciation.

Consent not required. You do not need prior approval from the IRS to change your accounting method in the following situations:

- 1) You valued your livestock inventory at cost, or at the lower of cost or market, and you change to the unit-livestock-price method, or
- 2) You are a family farm corporation, as 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.

Family farm corporations. If you must change to an accrual accounting method because your annual gross receipts are more than \$25 million, you must establish a suspense account to reduce your section 481 adjustments that must be included in income. See section 447(i) of the Internal Revenue Code for information about suspense accounts.

Consent required. You need prior approval from the IRS to change your accounting method in the following situations:

- 1) A change from the cash to an accrual method or vice versa,
- 2) A change in the method or basis used to value inventories,
- 3) A change involving the adoption of any other specialized method of computing net income, such as the crop method, or a change in the use of this specialized method,
- 4) A transfer of draft, dairy, or breeding animals from inventory to a fixed asset account, and
- 5) A case in which you have chosen to report loan proceeds from the Commodity Credit Corporation as income in the year received and now want to change to reporting in the year of sale.

How to secure consent. Generally, you must file a current Form 3115. A user fee must be sent with the application.

In most cases, you must file the application within the first 180 days of the tax year for which you request the change. However, if you

want to change your method to report Commodity Credit 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 Commodity Credit loans to 180 days. See *Commodity Credit loans* in Chapter 4.

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

Extension of time to file application. If you have good reason for filing late, the IRS may grant you an extension. Applications received within 90 days after the due date may qualify for an automatic extension. See Revenue Procedures 92-20 (C.B. 1992-1, p. 685) and 92-85 (C.B. 1992-2, p. 490) for more information. However, if you file your request later than 9 months after the beginning of your tax year, the reasons must be unusual and compelling.

4. Farm Income

Important Change for 1994

New Form 1099-C. Beginning in 1994, certain financial entities, including financial institutions, credit unions, and federal government agencies, are required to report on Form 1099-C, *Cancellation of Debt*, any canceled debt of \$600 or more. The form must be filed even though the debtor may not be subject to tax on the debt. For example, qualified farm debt is reportable. See *Cancellation of Debt*, later.

Introduction

You receive income from many sources. You must report your income no matter what its source, unless it is excluded by law. Where you report income on your tax return depends its source. For more information, see Publication 525 and the instructions for Form 1040.

This chapter discusses income you report on Schedule F. Do not confuse this income with the definition of gross farm income for estimated tax purposes (Chapter 2), soil and water conservation expenses (Chapter 6), or self-employment tax (Chapter 15).

Accounting method. The rules discussed in this chapter assume that 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 even though it is not yet in your possession. See *Constructive receipt* under *Cash Method* in Chapter 3.

If you use an accrual method of accounting rather than the cash method, 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 loan) for property or services, you must include the payments in income in the year you receive them. If at a later date you receive an additional amount, include it in income in the year you receive it. You may be required to include commodity credit loans in income in the year you receive them. See *Commodity Credit Loans* later in this chapter. If you are reporting the sale of property on the installment method, you can choose to include all the income in the year of sale. See Chapter 12.

Topics

This chapter discusses:

- Schedule F
- Sales of livestock and produce
- Sales caused by drought conditions
- 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
- 534** Depreciation
- 550** Investment Income and Expenses
- 908** Tax Information on Bankruptcy
- 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

Schedule F

Report the income from your farm on Schedule F (Form 1040). This schedule is used 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 any 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:

- 1) Gains from sales of farmland or depreciable farm equipment, or
- 2) Gains from sales of livestock held for draft, breeding, sport, or dairy purposes.

Gains and losses from the sale of farming assets, such as machinery or farmland, 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 the produce or livestock (including poultry) you raise on your farm, any money you receive and the fair market value of any property or services you receive are ordinary income. Your profit from the sale of produce or livestock bought for resale is also ordinary income. Report these amounts on Schedule F for the year you receive payment. Your profit or loss from the sale of produce or livestock bought for resale is the difference between your basis in the produce or livestock and any money plus the fair market value of any property you receive for the produce.

Sales of livestock held for draft, breeding, dairy, or sporting purposes may result in ordinary gains or losses or in 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.

Table 4-1 shows where to report the sale of these items on your tax return.

Sales by an agent. The net proceeds from the sale of your produce or livestock by someone acting as your agent must be included in gross income for the year the agent receives

payment, even though your arrangement with the agent is that you will not be paid until a later year. See *Constructive receipt* in Chapter 3.

Sales Caused By Drought Conditions

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. This election applies to all livestock.

A drought sale of livestock (other than poultry) is an involuntary conversion. If you plan to replace the livestock, see Chapter 13 for more information.

If, because of drought conditions, you sell more animals than you would have had you followed your usual business practice, you may choose to include the gain from the sale of the additional animals in income next year instead of this year, provided the following conditions are met:

- 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 still 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.

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 year 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 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 1994. You realize \$35,100 from the sale. On August 9, 1994, as a result of drought, the affected area was declared a disaster area eligible for federal assistance. The income you may elect to postpone until 1995 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).
- 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 in the absence of drought.
- 6) The total number of animals sold and the number sold because of drought during the tax year.

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

Item Sold	Schedule F	Form 4797
Raised produce and livestock	X	
Produce and livestock bought for resale	X	
Livestock held for draft, breeding, dairy, or sporting purposes		X
Animals not held primarily for sale		X

- 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.

If you have drought sales in more than one year, you must make a separate election for each year.

Rents (Including Crop Shares)

The rent you receive for the use of your farmland is generally rental income, not farm income, and is reported on Form 4835 and Schedule E (Form 1040). However, if you materially participate in the farming operations on the land, the rent is farm income and is reported on Schedule F. See *Landlord Participation in Farming* in Chapter 15.

Pasture income and pasture 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. But if you simply rent your pasture, 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 report on the cash or an accrual method. 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 net earnings from self-employment under the optional method discussed in 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 1994, 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. Your children sell their crop shares during 1994 and 1995, and payments for the crop shares 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 the income you received. You must include the fair market value of the crop shares in 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 may 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 Commodity Credit 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.

Commodity Credit 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 Commodity Credit Corporation (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 loan as income for the year received, however, 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 the election, include on line 7a of Schedule F the amount of the loan as income for the year you receive it. Attach a statement to your return showing the details of the loan.

When you make this choice to report the CCC loan proceeds as income, the amount you report becomes your basis in the commodity. If you later sell the commodity 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 need only report as income at the time of sale 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.

Reporting Market Gain

If you have a loan from the CCC which is secured by the pledge of an eligible commodity you produced, you should be aware that in some cases reporting the market gains shown on Form CCC-1099-G, *Certain Government Payments*, may result in duplicate reporting of income. Eligible commodities include cotton, wheat, feed grains, rice, oilseeds, and honey. 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 1994, Mike pledges 1,000 pounds of cotton as collateral for a CCC price support loan at \$.50 per pound. In 1995, Mike decides to redeem the cotton at a time 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 then 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 1995 of \$80, which is the difference between the original loan rate (\$.50 per pound) and the subsequent 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 1995 tax return will depend upon whether he has made an election under section 77 of the Code to include CCC loans in gross income in the year received.

With section 77 election. Mike has income of \$500 in 1994 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 CCC

loan. No gain or loss is recognized on this repurchase. Mike has income of \$180 in 1995 from the sale of the cotton (\$600 sale price – basis of \$420). He should report the \$500 CCC loan as income in 1994 and the \$180 from the sale as income in 1995. Because Mike has already included the \$500 CCC loan in income, including the \$80 market gain shown on the 1995 Form CCC–1099–G in income would result in an overstatement of his income in the amount of \$80. Therefore, for 1994, Mike should report the \$500 CCC loan of line 7a of Part I of Schedule F (Form 1040). For 1995, he should report the \$80 market gain as an “agricultural program payment” on line 6a of Part I of Schedule F, but should not report the \$80 market gain as a “taxable amount” on line 6b of Part I of Schedule F.

Note. The line numbers may change in the 1995 version of Schedule F. Check the 1995 instructions.

Without section 77 election. Mike has income of \$80 from market gain in 1995. Because he has not made a section 77 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 1995 generates income of \$600 (\$600 sale price – basis of \$0) to Mike. He should report as income in 1995 both the \$600 from the sale and the \$80 market gain. The \$80 market gain should be 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 1994, who 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 Tom the authority to repay the loan on Mike’s behalf. In 1995, 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 1995 from the CCC showing a “market gain” of \$80. The proper reporting of the market gain will again depend upon whether Mike has made a section 77 election.

With section 77 election. Mike has income of \$500 in 1994 from the CCC loan. He also has income of \$50 in 1994 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 should report both the \$500 CCC loan and the \$50 from the option as income in 1994. Because he has already included the \$500 CCC loan in income, including the \$80 market gain shown on the 1995 Form CCC–1099–G in income would result in an overstatement of his income in the amount of \$80. Therefore, for 1994, Mike should report the \$500 CCC loan on line 7a of Part I of Schedule F. For 1995, Mike should report the \$80 market gain as an “agricultural program payment” on line 6a of Part I of

Schedule F, but should not report the \$80 market gain as a “taxable amount” on line 6b of Part I of Schedule F. See *Note*, earlier.

Without section 77 election. Mike has income of \$50 in 1994 from the granting of the option to Tom. Because Mike has not made a section 77 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 1995 generates income of \$420 (\$420 sale price – basis of \$0) to Mike. He should report the \$50 from the option as income in 1994 and the \$420 from the sale of the commodity and the \$80 market gain shown on Form CCC–1099–G as income in 1995. The \$80 market gain should be reported on both lines 6a and 6b of Part I of Schedule F. See *Note*, earlier.

Commodity Credit (PIK) Certificates

You may receive payments under some government programs in the form of commodity credit certificates, sometimes called generic commodity certificates, or PIK (payment-in-kind) certificates. You can sell them, use them to pay price support loans and other debts to the federal government, hold them and redeem them for cash later in the year, or use them to buy commodities from the CCC.

If you receive these commodity credit certificates, or if they are made available as payment under government programs, include the face value of the certificates in income. These payments are taxable in 1994 even if you return them to the Department of Agriculture (USDA) for repayment in 1995. Similarly, these payments are taxable in 1994 even if you do not cash, deposit, or redeem the 1994 certificates representing the payments until 1995. The amount you include in income becomes your basis to figure gain or loss on the certificates when you do sell them, redeem them, or otherwise dispose of them.

You should receive a 1994 Form 1099–G from USDA for all payments.

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 this program, you can receive compensation 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. This payment provides compensation for the loss of potential income you could have realized if you had used the land for production of an agricultural commodity.

The annual CRP payment is a receipt from farm operations, which you report in Part I of Schedule F. However, if you do not materially participate in production or management of production of the farm products on your 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 generally are 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.

Election to include in year after disaster. If you use the cash method of accounting, you can elect to include crop insurance proceeds in income for the tax year following the tax year in which the crops were damaged. You can make this election if you can show that you would have included your income from the damaged crops in any tax year following the year the damage occurred. However, if you receive the insurance proceeds in the tax year following the tax year in which the crops were destroyed or damaged, then you include the proceeds in gross income for the year you receive them without having to make the election.

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, either received as a donation or purchased at a below-market price.

Title I 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 such 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 the feed expense.

Other Payments

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

Fertilizer and Lime

If you receive fertilizer or lime under a government program, include the value of the fertilizer or lime (as figured in the government program) in your income. The manner of claiming the offsetting deduction is explained under *Fertilizer and Lime* in Chapter 5.

Improvements

If the government payments are based on improvements, such as a pollution control facility, they are still included in income. Your basis in the facility is increased by the amount of these payments included in income. The full cost of the facility is then capitalized. Your basis in the facility is not reduced by the amount of the payments, since they have been included in income.

Your basis can be recovered through annual deductions for depreciation or amortization, starting on the date the facility is placed in service. Generally, you may elect to amortize the cost of a certified pollution control facility over a period of 60 months. See *Pollution Control Facilities* under *Amortization* in Chapter 8. Otherwise, you may depreciate the facility.

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. Form 1099-G is available at local offices of the IRS.

See Chapter 2 for more information about the preparation of Forms 1099.

Cost-Sharing Exclusion

Part or all of the payments you receive under certain federal or state cost-sharing conservation, reclamation, and restoration programs may be excluded from the income you report on your tax return. 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 that it 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 Agricultural Stabilization and Conservation Service (ASCS) and the Soil Conservation Service (SCS).

Income realized. The amount of gross income you realize upon a 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 above.
 - 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 to you that is 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 greater of:

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

Note. 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. In 1994, 100 acres of your land was reclaimed under a contract with the Soil 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 under (1) is determined to be \$1,380. Under (2), it is \$1,550. The excludable portion is the greater of these amounts, or \$1,550. Therefore, you figure the amount to be included in gross income as follows:

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

Report the total received on line 6a, Schedule F. Report only the taxable amount on line 6b.

Effects of the exclusion. When you figure the basis in property you acquire or improve using cost-sharing payments excluded from income, subtract the amount of the excluded payments from your capital costs. Your basis cannot reflect any amounts excluded from income.

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 that you exclude from income.

To the extent the exclusion applies, you should so indicate on an attachment to your tax return (or amended return) for the tax year you receive the last payment from the government for the improvement. State the dollar amount of the cost funded by the government payment, the value of the improvement, and the amount you are excluding.

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 may 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 restrictions and rules mentioned above 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 line 5a of Schedule F for the tax year you receive them. This includes the amount of money you receive as a patronage dividend, the stated dollar value of qualified written notices of allocation you receive, and the fair market value of other property you receive. However, nonqualified allocations, explained later, are not included in income when you receive them. See *Purchases of depreciable and capital assets and Personal purchases*, later, for a discussion of amounts not to include in income.

Qualified written notice of allocation. A qualified written notice of allocation is taxable in the year received at its stated dollar value. For the written notice of allocation to be qualified:

- 1) You must receive a written notice of your right of redemption at the time you receive the written notice of allocation.
- 2) It must also be redeemable in cash at any time for a period of at least 90 days after it is issued.
- 3) It must be paid, as part of a patronage dividend or as part of a payment by a cooperative, in money or qualified check equal to at least 20% of the dividend or payment.
- 4) You must also have agreed to include the stated dollar value in income in the year the notice is received.

Manner of consent. You make the agreement either in writing or by 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. You also consent to an allocation if you endorse and cash a qualified check, paid as part of the notice of allocation, on or before the 90th day after the close of the payment period for the tax year of the cooperative.

Loss on redemption. A loss incurred on the redemption of a qualified written notice of allocation that you receive in the ordinary course of your farming business is deductible as an ordinary loss in Part II of Schedule F. The loss is measured by the difference between the stated dollar amount included in income on receipt and the amount received on redemption.

Nonqualified notices of allocation. All other written notices of allocation are not qualified or included in income when received. Any nonqualified notice of allocation you receive from the cooperative 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 is ordinary income to the extent of its stated dollar value and it is reported in Part I of Schedule F for the tax year of disposition. Any amount received in excess of 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.

Purchases of depreciable and capital assets. Do not include in income dividends you receive that come directly from the purchase of capital assets or depreciable property used in your business that would otherwise be taxable under the preceding rules. You must, however, reduce the basis of these assets by the amount of the dividends. If the dividends are more than your unrecovered cost, include the excess in income 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, 1993, 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 Appendix B, Publication 534). Mr. Brown files his return on a calendar year basis. For 1993, 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). On July 1, 1994, the cooperative association paid a patronage dividend to Mr. Brown of \$300 in cash for his purchase of the machine. Mr. Brown adjusts the basis of the machine and figures his depreciation deduction for 1994 (and later years) as follows:

Cost of machine on July 1, 1993	\$2,900
Minus: 1993 depreciation	\$311
1994 cash patronage dividend	300
Adjusted basis for depreciation for 1994:	<u>\$2,289</u>
Depreciation rate: $1 + 6\%$ (remaining recovery period as of 1/1/94) = $15.38\% \times 1.5 = 23.08\%$	
Depreciation deduction for 1994	
($\$2,289 \times 23.08\%$)	<u>\$ 528</u>

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

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

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 which item the dividend comes from, include the dividend amount in income as ordinary income.

Personal purchases. Dividends you receive that are directly from the purchase of personal, family, or living items, such as supplies, equipment, or services that were not used in your business, are not included in income. This rule also applies to amounts you receive from the sale, redemption, or other disposition of a nonqualified written notice of allocation resulting from these purchases. If the dividend or nonqualified allocation cannot be traced to these purchases, it is treated in the regular manner already described. Include these dividends in the amounts you show on both lines 5a and 5b of Schedule F.

Per-Unit Retain Certificates

A per-unit retain certificate is any written notice that discloses to you the stated dollar amount of a per-unit retain allocation 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 by-laws or charter state that membership constitutes consent, to take into account the stated dollar amount of these certificates in the year of receipt. Thus, if you receive qualified per-unit retain certificates, include the stated dollar amount of these 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 nonqualified certificates. If you receive nonqualified certificates, you include nothing in income for the tax year you receive them. However, any amount you receive from the redemption, sale, or other disposition of a nonqualified certificate, to the extent the stated dollar amount exceeds its basis, is ordinary income reported in Part I of Schedule F for the tax year of disposition.

Cancellation of Debt

Beginning in 1994, 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*. If the canceled debt meets one of the exceptions or exclusions explained next, do not report it as income. However, you may be required to file Form 982. See *Tax Benefit Reduction*, later.

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 indebtedness for which you are liable or which attaches to property you hold.

Exceptions to General Rule

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.

Cancellation of 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 canceled. A student loan is a loan to assist you in attending an educational institution.

You do not include in income the amount of your student loan that is canceled because under the loan provision 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.

Exclusion of Canceled Debt

You do not include a canceled debt in gross income in the following situations:

- 1) The cancellation takes place in a bankruptcy case under Title 11 of the United States Code (the federal bankruptcy code).
- 2) The cancellation takes place when you are insolvent and the amount excluded is not more than the amount by which you are insolvent.
- 3) The canceled debt is a qualified farm debt and it is canceled by a qualified person. The terms “qualified farm debt” and “qualified person” are explained later.
- 4) The canceled debt is discharge of qualified real property business indebtedness, except for C corporations. For more information on this type of canceled debt, see Chapter 7 in Publication 334.

If a debt cancellation is excluded from income because it takes place under the bankruptcy code, 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. 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.

No debt canceled in a bankruptcy case is 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.

Insolvency. You are insolvent when, and to the extent, your liabilities exceed the fair market value of your assets. Your liabilities and the fair market value of your assets must be determined immediately before the discharge of your debts.

If you are insolvent, exclude from gross income the amount of canceled debt up to the amount by which you are insolvent. If the amount of canceled debt exceeds the amount by which you are insolvent, you can then apply the rules for qualified farm debt to the excess, provided you qualify for the qualified farm debt exclusion. Otherwise, you include the excess in gross income. Use the amount excluded for insolvency to reduce tax benefits, as explained later under *Tax Benefit Reduction*. Reduce the tax benefits under the insolvency rules before applying the rules for qualified farm debt.

Example 1. 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).

Example 2. You transferred property to a bank to satisfy a debt for which you are personally liable and which is secured by the property. You owe the bank \$12,000. The property has a fair market value of \$10,000, and your adjusted basis in the property is \$8,000. Assuming this is your only asset, you are insolvent for the difference between the amount of your debt (\$12,000) and the fair market value of the transferred property (\$10,000). You must recognize a gain of \$2,000 for the difference between the fair market value and your adjusted basis in the property.

Qualified farm debt. 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 and is not one of the following:

- 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).

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.

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

Tax Benefit Reduction

If you exclude canceled debt from income in a bankruptcy case or during insolvency, or because the canceled debt is a qualified farm debt, you must use the excluded amount to reduce certain tax benefits. This prevents an excessive tax benefit from the cancellation. Tax benefits, for this purpose, include the basis of depreciable property, as well as those listed later.

The tax benefit reduction rules for qualified farm debt are different from the rules for bankruptcy and insolvency. However, in all three cases, you may apply any portion of the canceled amount to reduce the basis of depreciable property before reducing other tax benefits.

Election to reduce basis first. You can choose to apply any portion of the excluded amount of your 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 amount of depreciation or amortization otherwise allowable for the period immediately following the basis reduction.

Reduction of tax benefits. If you do not elect to reduce the basis of your depreciable property first, or if you make the election and the amount canceled exceeds the bases of your depreciable property, you must reduce the following tax benefits, in the order listed, by any remaining canceled debt.

- 1) **Net operating loss.** Reduce any net operating loss for the tax year the debt cancellation takes place, and any net operating loss carryover to that tax year. This reduction is on a dollar-for-dollar basis.
- 2) **General business credit carryovers.** Reduce any carryovers to or from the tax year of the debt cancellation. Reduce these carryovers at the rate of 33½ cents for each dollar of debt cancellation exclusion.
- 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 at the rate of 33½ cents for each dollar of debt exclusion.
- 4) **Capital losses.** Reduce any net capital loss for the tax year of the debt cancellation and any capital loss carryover to that year. This reduction is on a dollar-for-dollar basis.
- 5) **Basis.** For each dollar of debt cancellation, reduce the basis of your property by one dollar. This reduction applies to the basis of both depreciable and nondepreciable property. The reduction in basis cannot be more than the excess of the total basis of property you hold immediately after the debt cancellation over your total

liabilities immediately after the cancellation.

- 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 on a dollar-for-dollar basis. Reduce the credit carryover at the rate of 33½ cents for each dollar of debt cancellation exclusion.
- 7) **Foreign and possession tax credits.** Reduce any carryover to or from the tax year of the debt cancellation. Reduce these credits at the rate of 33½ cents for each dollar of debt cancellation.

Qualified farm debt rules. You can exclude from income the cancellation or discharge of qualified farm debt to the extent you are solvent. The debt must be discharged by a qualified person, defined under *Qualified farm debt*, earlier. The amount excluded must be used to reduce certain tax benefits, explained later. **The rules for reducing tax benefits for qualified farm debt are not the same as the rules for bankruptcy or insolvency.**

If your canceled debt is qualified farm debt, the amount you exclude from income cannot exceed the sum of your adjusted tax benefits and the total adjusted bases of your “qualified property,” defined later. If the income you realize from the discharged debt exceeds this limit, 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 tax credit carryovers to or from the year of the discharge, multiplied by 3.

You multiply the credits by 3 to make them more 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.

Order of reduction. Reduce adjusted tax benefits (1), (2), (3) and (4), in that order, by the excluded amount (to the extent not used under *Election to reduce basis first*, earlier). Then, before reducing adjusted tax benefit (5), apply any remaining excluded amount to reduce your basis in "qualified property."

"Qualified property" is any property you use or hold for use in your business or for the production of income. You must reduce the basis of this property in the following order:

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

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.

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. Figure the ordinary income part by treating the amount of this basis reduction as a depreciation deduction. Any property having its basis reduced under these provisions that is not section 1245 or section 1250 property is treated as section 1245 property. For section 1250 property, make the determination of straight-line depreciation as though there were no basis reduction for debt cancellation. Sections 1245 and 1250 and the recapture of gain as ordinary income are explained in Chapter 11.

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

Also use this form to exclude the discharge of qualified real property business indebtedness or to elect to reduce depreciable property basis before reducing other tax benefits. However, if you do not make this election on your original return, you must establish reasonable cause with IRS before you can make the election on an amended return or claim for credit. This election may be revoked only with IRS consent.

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.

More information. For more information on debt cancellation, see Publication 908.

Income from Other Sources

This section discusses other types of income you may receive.

Illegal federal irrigation subsidies. The federal government operating through the Bureau of Reclamation has made irrigation water available for agricultural purposes from certain reclamation and irrigation projects referred to in the Reclamation Reform Act of 1982. For water delivered after 1987, 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 an amount less than full cost, the excess of full cost over the amount you paid is an illegal subsidy. You must include the amount of this illegal subsidy in gross income. Report this amount on line 10 of Schedule F. You cannot take a deduction for the amount you are required to include in income. For more information, contact your local Bureau of Reclamation.

Timber sales. Timber sales, including sales of logs, firewood, lumber, and pulpwood, are discussed in Chapter 10.

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.

Granting the right to remove the deposits. If you enter into a legal relationship granting someone else the right to excavate and remove these natural deposits from your property, determine whether the transaction is a sale or another type of transaction (for example, a lease). Your income from the deposits is capital gain if the transaction is a sale. Otherwise, the income is ordinary income, but it is subject to an allowance for depletion.

The transaction is a sale if you retain no economic interest in the deposit. You are considered to retain an economic interest if, under the terms of the legal relationship, you must depend on the income derived from extraction of the deposit for a return of your capital investment in the deposit. On the other hand, if you are to receive a specified sum or an amount fixed without regard to how much is produced and sold from the deposit, your transaction is a sale. You cannot take deductions for depletion, but your income is capital gain. See

Chapter 10 for the tax treatment of capital gains.

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.

Fuel tax credits and refunds. 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.

Refunds and reimbursements. Reimbursements, refunds, and recoveries of other items for which you took a deduction in an earlier year should be included in income for the tax year you receive them. 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 1993. He deducted all of the \$1,000 on his 1993 Schedule F. The full amount of the deduction reduced his tax. Then, in February 1994, the landowner reimbursed him for \$500 of the cost of the fertilizer. The tenant farmer must include all of the \$500 in his income for 1994 because all of the 1993 deduction decreased his tax in the earlier year.

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 recapture the benefit you received from the deduction by including part of the deduction in income.

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

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, and constructing electric or telephone lines, etc., may result in income, a reduction in the basis of all or part of your farmland, or both.

Example. You sold a right-of-way for a gas pipeline through your property for \$1,000. Only a specific part of your farmland was affected. You reserved the right to continue farming the surface land after the pipe was laid. If the \$1,000 received for the right-of-way is less than the basis properly allocated to the part of your land affected by the right-of-way, then the basis is reduced by \$1,000. If the amount received is more than the basis of the affected part of your land, the excess is gain from the sale of section 1231 property. See Chapter 11. If, instead of selling a right-of-way, you sold part of your land, you would have a gain or loss from the sale of section 1231 property.

If during construction of the line, growing crops were damaged and you later received a settlement of \$250 for this damage, the \$250 you received for the destroyed crops is income. Gains and losses are discussed in Chapters 10 and 11.

Property sold, destroyed, stolen, or condemned. If property you own is sold or exchanged, stolen, destroyed by fire, flood, or other casualty, or condemned by a public authority, you will usually have a gain or loss. If the gain is taxable or the loss deductible, it may be ordinary gain or loss or capital gain or loss. In some situations, the tax on your gain may be postponed to a later year. See Chapters 11 and 13.

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.

Barter income. If you do work for someone and are paid in farm products, property, or in work done for you, you must report the fair market value of what you receive as income. 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.

Prizes. Prizes won on farm livestock or products at contests, exhibitions, fairs, etc., are income. If you receive a prize in cash, include the full amount. If you receive a prize in produce or other property, include the fair market value of the property received.

See Publication 525 for information about prizes.

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

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 loan that is 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.

5.

Farm Business Expenses

Important Change for 1994

Health insurance deduction for the self-employed. The deduction for 25% of health insurance costs for the self-employed expired for tax years beginning after 1993. However, as this publication was being prepared for print, Congress was considering legislation to extend this provision. For information on late legislative changes, see Publication 553, *Highlights of 1994 Tax Changes*.

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. 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. 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 Soil Conservation Service of the USDA. 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

- 349** Federal Highway Use Tax on Heavy Vehicles
- 463** Travel, Entertainment, and Gift Expenses
- 535** Business Expenses
- 536** Net Operating Losses
- 538** Accounting Periods and Methods
- 587** Business Use of Your Home
- 917** Business Use of a Car

- 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
- 5213** Election To Postpone Determination as To Whether the Presumption Applies That an Activity Is Engaged in for Profit

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, farm business expenses are not deductible under an accrual method of accounting until economic performance occurs. Economic performance generally occurs as the property or services are provided to you, whether or not you paid the expense. See Publication 538 for more information about economic performance.

Reimbursed expenses. If you are reimbursed, either reduce the amount of the expense or report the reimbursement 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 can 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. For more information, see 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.

Prepaid farm supplies. 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.

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.

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 1994, 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 1994 are \$5,500. Your other deductible farm expenses totaled \$10,000 for 1994. Therefore, your deduction for prepaid farm supplies may not exceed \$5,000 (50% of \$10,000) for 1994. The excess prepaid farm supplies of \$500 (\$5,500 – \$5,000) are deductible in the 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, and grandchildren.

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.

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 other property such as inventory items, capital assets, or assets used in your business. The cost of boarding hired farm labor is a deductible labor cost. Other deductible costs you incur for hired farm labor include health insurance and workers' compensation insurance.

If you must withhold social security, Medicare, and income taxes from your employees' cash wages, the full amount of wages before withholding is deductible. See Chapter 16 for more information on employment taxes. The social security and Medicare taxes you must pay on wages to your employees are deductible as a farm business expense on Schedule F. See *Taxes* later in this chapter.

Deductible Pay

The kinds of pay you can deduct include the fair market value of property transferred to your employees and wages paid 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. See *If you trade property for unlike property* in Chapter 11.

Child as an employee. You can deduct reasonable wages or other compensation paid to your children for doing farm work if there is a **true employer-employee relationship**. 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. 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 wages paid to your spouse if a **true employer-employee relationship** exists between you and your spouse. Wages paid to your spouse are subject to social security and Medicare taxes. 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, such 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:

- Jobs Credit, Form 5884
- Empowerment Zone Employment Credit, Form 8844
- Indian Employment Credit, Form 8845

See the forms and their instructions for more information.

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 asserted tax deficiencies for 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.

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 includable in the gross income of that person. See Chapter 8 in Publication 535 for more information.

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 an expense 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 such debt proceeds.

In general, the interest on a loan is allocated in the same way as the loan itself is allocated. 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. You allocate interest on a loan the same way as the loan is allocated. 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.

See Chapter 8 in Publication 535 for more information.

Prepaid interest. You generally cannot deduct interest paid in advance in the year you pay it. Deduct interest allocable to periods after the close of the year in which you pay it over the period of the loan. See Chapter 8 in Publication 535 for more information.

Loan expenses. You prorate and deduct loan expenses, such as legal fees and commissions, paid 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. Certain farm corporations and partnerships, and all tax shelters, including farm syndicates, generally must use an accrual method.

Fertilizer and Lime

You can deduct in the year paid or incurred the cost of fertilizer, lime, and other materials applied to farmland to enrich, neutralize, or condition it. 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.

Farmland is land used for producing crops, fruits, or other agricultural products or for sustaining livestock. Farmland for this choice does not include land you have never used for producing crops or sustaining livestock. Therefore, you cannot deduct initial land preparation costs.

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. 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, farmland, 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. See Chapter 16 for information on employment taxes.

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 need not be stated separately, but can be included as 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.

A state tax on gross income (as distinguished from net income) directly attributable

to the business of farming carried on by an individual or a partnership is deductible as a business expense.

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, see Publication 349.

Self-employment tax deduction. You can deduct one-half of your self-employment tax in figuring your adjusted gross income on Form 1040. See Chapter 15.

Insurance

You can deduct the following types of insurance expenses on Schedule F:

- 1) Premiums for 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.

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, 1994, 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, 1994. Only the cost for the 6 months in 1994 is deductible as an insurance expense on your 1994 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 1995 and 1996, \$1,000 ($\frac{12}{36}$ of \$3,000) is deductible. The remaining \$500 is deductible in 1997. Had the policy been effective on January 1, 1994, the deductible expense would have been \$1,000 for each of the years 1994, 1995, and 1996, 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 paid in crop shares because you deducted 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. In 1994, 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 Revenue Procedure 75–21, 1975–1 CB 715 and Revenue Procedure 75–28, 1975–1 CB 752.

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. See section 7701(h) of the Internal Revenue Code.

Depreciation

If you use property in your farm business that 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

To deduct expenses for the business use of your home, you must use part of your home exclusively and regularly either as:

- 1) The principal place of business for any business in which you engage (even if not your principal business), or
- 2) A place where you meet or deal with clients or customers in the normal course of your trade or business.

The principal place of business of a farm is the entire farm. Thus, if your home office is on your farm, the office and the surrounding farmland 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.

You can deduct expenses for the business use of a structure not attached to your home, such as a garage, if used exclusively and regularly for your business.

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

Deduction limit. There is a limit on your deductions for certain expenses for the business use of your home. Total deductions for otherwise nondeductible expenses, such as utilities, insurance, and depreciation, 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 losses, and
- 2) All other business expenses, other than those related to the business use of your home.

If certain expenses for the business use of your home are more than the limit, you can carry the excess to the next 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 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 to determine your deduction for truck or car expenses, under certain conditions you can use a standard mileage rate of 29 cents a mile for all miles of business use in 1994. You can use the standard mileage rate only for cars and light trucks, such as vans, pick-ups, 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 917.

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 your duties require you to be absent from your farm substantially longer than an ordinary work day and your duties require you to sleep or rest while away from your business.

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 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 telegraph.
- 5) Transportation from the place where you eat and sleep to your temporary work assignment.
- 6) Similar expenses related to ordinary and necessary travel.
- 7) Tips for any of the above expenses.

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. 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, record-keeping, and the standard meal allowance, see Publication 463.

Reimbursements to employees. You can generally deduct as business expenses reimbursements paid 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, however, you must report the reimbursements as wages on Form W–2 and deduct them as wages. For more information, see Chapter 16 of Publication 535.

Marketing Quota Penalties

You can deduct on Schedule F penalties paid 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 cost 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 1994, you buy 50 steers you will sell in 1995. You deduct the purchase price, plus any freight cost, in 1995 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. See *Special Rules for Farm Property* in Chapter 7.

Example. You use the cash method of accounting. In 1994, you buy 500 baby chicks to raise for resale in 1995. You also buy 50 bushels of winter seed wheat in 1994 that you sow in the fall. You can deduct the cost of both the baby chicks and the seed wheat in 1994, 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. See *Crop method* 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. 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. 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

Corporations—line 30 of Form 1120 or line 26 of Form 1120-A.

If the amount on that line is **not** a negative figure, 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, or
- 4) Nonbusiness deductions.

Example. Glenn Johnson is a dairy farmer. He is single and has the following income and deductions on his Form 1040 for 1994.

INCOME	
Wages from part-time job in gas station	\$ 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 – expenses of \$72,000)	\$ 5,000
Net short-term capital loss on sale of stock	1,000
Personal exemption	2,450
Standard deduction	3,800
Loss on small business investment company stock	1,000
Glenn's total deductions	<u>\$13,250</u>

Glenn's deductions exceed his income by \$9,600 (\$13,250 – \$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	2,450
Nonbusiness deductions (standard deduction, \$3,800) minus nonbusiness income (interest, \$425)	3,375
Total adjustments to net loss	<u>\$6,825</u>

When these items are eliminated, Glenn's net loss is reduced to \$2,775 (\$9,600 – \$6,825). This amount is his NOL for 1994.

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 your NOL to the third tax year before the NOL year. If it is not all used that year, carry the unused part to the next year, the second year before the NOL year. If it is not all used in the second year, carry the remaining unused part

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:

- Individuals—line 35 of Form 1040.
- Estates and trusts—line 22 of Form 1041.

to the next tax year, the year before the NOL year.

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 figure the overpayment of tax for all 3 carryback years.

Carryovers. If you do not use up the entire NOL in the 3 carryback years, you can carry the unused NOL forward to the 15 tax years following the NOL year. Carry it to the first tax year after the NOL year and continue to carry over any unused part until you 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. To make this choice, attach a statement to your tax return for the NOL year showing that you choose 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 take an NOL deduction. Each partner or shareholder figures his or her individual NOL based on a separate share of the partnership's or S corporation's loss.

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 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 deduct certain capital expenses as soil and water conservation expenses, or if you elect, as a section 179 deduction. See Chapters 6 and 8.

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 forestation or reforestation before cutting the timber through amortization deductions. See *Depletion and Amortization* in Chapter 8.

For more information about timber, see Agriculture Handbook Number 681, *Forest Owners' Guide To Timber Investments, The Federal Income Tax, and Tax Recordkeeping*. Copies are \$7 each and are available from the U.S. Government Bookstore. Place your order using Stock #001-000-04540-7 at the following address:

U.S. Government Bookstore
999 Peachtree St., NE
Suite 120
Atlanta, GA 30309

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. 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.

Not for profit. In determining whether you operate your farm for profit, your intentions are important, but all factors relating to your farming activity must be taken into account. No one factor or group of factors is decisive. Among the factors normally 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 you do not carry on your activity for profit, you take deductions only in the following order, only as far as stated in the three categories, and only if you itemize them on Schedule A. 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.

Category 1. You can take the full amount of any deduction allowed for personal as well as for business activities. All nonbusiness deductions, such as those for mortgage interest and taxes, and the deductible part of casualty losses (see Chapter 13) belong in this category. The amounts allowable for home mortgage interest are explained in Publication 936.

Category 2. Next, take deductions that do not result in an adjustment to the basis of property, 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. Last, take business deductions that decrease the basis of property, 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 not deductible in the first category belong in this category. When you have more than one asset, 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. The individual stockholder's or partner's distributive shares reflect these limits.

Presumption that your farming activity is for 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. 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 deductions from that activity.

If a taxpayer dies before the end of the 5-year (or 7-year) period, the period is considered to have ended 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 years in which 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*.

Using the presumption at a later time. If you are starting out in farming and do not yet have 3 (or 2) years showing a profit, you may want to take advantage of this presumption at a later time, 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. File Form 5213 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 from the activity. 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, there is no limit on your deductions under these rules. If you do not show 3 (or 2) years of profit (and cannot otherwise show that you operated your farm for profit), the limit applies retroactively to any year in the 5-year (or 7-year) period 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.

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. See Chapter 10.

Cost of unharvested crops bought with land. Capitalize the part of the purchase price of land allocable to unharvested crops. You

cannot deduct it 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.

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

6. Soil and Water Conservation Expenses

Introduction

If you are in the business of farming, you may 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. Expenses for land in a foreign country do not apply.

The deduction cannot be more than 25% of your gross income from farming. If the total of these expenses is more than 25% of your gross income from farming, you may deduct the excess in later years. This is explained later under *Limit on Deduction*.

Ordinary and necessary expenses that are otherwise deductible are not soil and water conservation expenses and are not subject to the 25% limit. These include interest and taxes, the cost of periodically clearing brush from productive land, 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
- Deductible conservation expenses
- Depreciable conservation assets

- Limit on deduction
- Choosing to deduct
- Sale of a farm

Useful Items

You may want to see:

Form (and Instructions)

- 8645** Soil and Water Conservation Plan Certification
-

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.

Farm rental. If you are an owner 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.

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.

Plan Certification

You can deduct your expenses for soil and water conservation only if they are consistent with a plan approved by the Soil Conservation Service (SCS) 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 farmland is located. There are three types of approved plans:

- 1) **SCS individual site plans.** These plans are issued individually to farmers who request assistance from SCS to develop a conservation plan designed specifically for their farmland.

- 2) **SCS county plans.** These plans include a listing of farm conservation practices that are approved for the county where the farmland is located. Expenses for conservation practices not included on the SCS 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 may be approved individual site plans or county plans. Individual site plans can be obtained from SCS offices and comparable agencies.

Form 8645. For each year you claim soil and water conservation expenses, you must complete and attach Form 8645 to your income tax return. You use Form 8645 to certify that your soil and water conservation expenses are consistent with an approved conservation plan. However, if you have a carryover from a previous year, you do not have to complete a new form. Simply attach a copy of the original form to your return. If expenses are paid or incurred primarily to produce an agricultural crop, and they also incidentally conserve soil, the expenses are not soil and water conservation expenses. You cannot deduct them as soil and water conservation expenses and you do not need to file Form 8645.

Deductible 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
 - f) Restoration of soil fertility
- 2) The construction, control, and protection of:
 - a) Diversion channels
 - b) Drainage ditches
 - c) Irrigation ditches
 - d) Earthen dams
 - e) Watercourses, outlets, and ponds
- 3) The eradication of brush
- 4) The planting of windbreaks

Note. You cannot exclude from your gross income any cost-sharing payments you receive for soil and water conservation expenses you deduct. See Chapter 4 for information about excluding cost-sharing payments.

New farm or farmland. If you acquire a new farm or new farmland from someone who was using it in farming immediately before you acquired the land, soil and water conservation expenses you 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 may 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.

Preparing land for center pivot irrigation. Expenses to prepare land for center pivot irrigation systems are **not** deductible as soil and water conservation expenses.

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 that are 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 wells. The cost of drilling water wells 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 test holes. If the

test holes produce no water and you continue drilling, the cost of the test holes 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 these expenses. You can deduct the part of an assessment that you would have deducted if you had paid it directly. You deduct 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 deduct at least part of an assessment levied against you by a soil and water conservation or drainage district to pay for depreciable property 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 rules, discussed next, apply to these assessments.

Figuring deductible amount. The amount you can deduct for any conservation district assessment for depreciable property is subject to the following three limits. See *Table 6-1* for information on the limits.

- 1) The total amount you can deduct 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 deduct each year is 10% of your deductible share of the cost + \$500. If the assessment is greater than this amount, special rules apply. See *Maximum yearly deduction*, later.
- 3) The deductible assessment for depreciable property must be added to your other conservation expenses for the year. The total for these expenses is then subject to the limit of 25% of your gross income from farming, discussed later.

Total deduction for the assessment.

You cannot deduct 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 excess 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 pro-rated between the deductible amount and the capital expense.

Maximum yearly deduction. The maximum amount you can deduct in one year is the total of 10% of your deductible share of the cost as explained in *Total deduction for the assessment*, earlier, plus \$500. If the assessment is equal to or less than this amount, you can deduct the entire assessment in the year it is paid. If the assessment is more than this total, the maximum amount you can deduct in one year is 10% of your deductible share of the cost. The remainder of the assessment is deducted in equal amounts over the next 9 tax years.

Limit for all conservation expenses. The yearly limit for all conservation expenses, including deductible assessments for depreciable property, is 25% of your gross income from farming for the tax year. See *Limit on Deduction* for more information.

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

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

To figure the maximum amount deductible 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 deduct only \$70 of the assessment for depreciable property this year (10% of \$700). The balance is deducted at the rate of \$70 a year over the next 9 years.

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

Example 2. Assume that \$1,850 of the \$2,400 assessment in Example 1 is for the digging of 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.

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 excess 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 deduction each year is (10% of your deductible share of the cost) + \$500. › If an assessment is greater than (10% of the deductible cost) + \$500, the limit for that year is 10% of your deductible share of the cost. › Any excess over 10% is deducted 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 deduction. The total is then subject to the limit of 25% of gross income from farming in that year.

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 deduct the entire \$550. The entire assessment, \$2,400, is deductible as a soil and water conservation expense this year, subject to the 25% limit.

Sale or disposal of land during the 9-year period. If you sell or dispose of the land during the 9-year period when you are deducting the balance of the assessment, any remaining assessment not yet deducted is added to the basis of the property. See *Limit on Deduction*, later.

Death of farmer during the 9-year period. If the farmer dies during the 9-year period when the balance of the assessment is being deducted, any remaining assessment not yet deducted is deducted in the year of death.

Limit on Deduction

The total deduction in any tax year for capital expenses for soil and water conservation 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.

Example. Farmer Brown, who uses the cash method of accounting, includes the following items in his "gross income from farming" for purposes of determining the 25% limit:

Cash from sale of corn crop	\$10,000
Gain from sale of breeding cows	500
Total gross income from farming	<u>\$10,500</u>

Items which are included in his gross income but excluded from "gross income from farming" are:

Gain from sale of 40 acres	\$ 8,000
Gain from sale of tractor	\$ 100
Interest on loan to Farmer Smith	\$ 100

For more information on gross income from farming, see Chapter 2.

Carryover of deduction. You may 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 may not be more than 25% of the gross income from farming for the year the deduction is taken.

Example. In 1994, 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 1995 and added to deductible soil and water conservation expenses made in that year. The total of the 1994 carryover plus 1995 expenses is deductible in 1995, subject to the limit of 25% of your gross income from farming in 1995. Any excess expenses over the limit in that year are carried to 1996 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.

Maintaining conservation structures. Ordinary and necessary expenses for maintaining completed soil and water conservation structures, such as the annual removal of sediment from a drainage ditch, are deductible farm business expenses. They are not subject to the 25% limit.

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 those expenses apply to.
- 4) The amount of the 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 may not adjust the basis of the land at the time of the sale for any unused carryover of soil and water conservation expenses. You

may, 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 the disposition of farmland. 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 of the deductions you previously took for soil and water conservation expenses or for land clearing 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 taken. See *Farmland (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 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 figure your original basis in an asset when you get it. You may get assets in various ways, such as by purchase, as a gift, or as an inheritance. You adjust your original basis for events that occur after you get the asset, such as adding improvements or taking depreciation deductions.

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
- 448** Federal Estate and Gift Taxes
- 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

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 cost 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 *Unstated Interest* in Publication 537.

Real Property

Real property, also called real estate, is land and generally anything erected on, growing on, or attached to it.

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 cost. You may not deduct them as taxes.

If you reimburse the seller for taxes the seller paid for you, you can usually deduct them as an expense in the year of purchase. Do not include them in the property cost. In certain cases, you may choose to capitalize taxes you must pay. See Chapter 11 in Publication 535.

Settlement fees or closing costs. Legal and recording fees are some of the settlement or closing costs included in the basis of property. Some others are:

- 1) Abstract fees,
- 2) Charges for installing utility services,
- 3) Surveys,
- 4) Transfer taxes,
- 5) Title insurance, and
- 6) 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 among land, buildings, and other property to figure the basis for each asset. Allocate the fees according to the fair market values of the land and other assets at the time of purchase. See *Allocating the Basis*, later. Settlement costs do not include amounts placed in escrow for the future payment of items such as taxes and insurance.

Expenses paid to obtain a mortgage. If you pay a deductible expense to obtain a mortgage you generally must capitalize and deduct the expense ratably over the term of the mortgage. Do not add the expense, such as points (prepaid interest), 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 obtain a mortgage to purchase 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 purchase price by that amount when determining your basis. For more information, see *Points* in Publication 936, *Home Mortgage Interest Deduction*.

Nondeductible expenses. Any nondeductible expenses you pay to obtain a mortgage, such as an appraisal fee for your home or other nonbusiness property, you generally add to the basis of the property. Other expenses such as fire insurance premiums cannot be added to the basis of the property.

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 nonbusiness assets. If you build nonbusiness property (i.e., a home), or have these assets built for you, your expenses for this construction are part of your cost basis. Some of these expenses include:

- Land,
- Materials and supplies,
- Architect's fees,
- Building permits,
- Payments to contractors,
- Payments for rental equipment, and
- Inspection fees.

In addition, if you use your employees or farm materials and equipment to construct a nonbusiness asset, your cost basis would also include:

- 1) Employee compensation 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

- 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). Also, reduce your basis by any jobs credit, Indian employment credit, or empowerment zone employment credit allowed on the wages you pay in 1). Do not include the value of 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 property that includes land, depreciable property, personal residence, and other items for a lump sum, allocate the cost among the items you buy. Your allocation is based on the ratio of the fair market value (FMV) of each item at the time you buy it to the total FMV of all the property you buy. This allocation is necessary to figure the basis of the items for depreciation purposes and to figure the gain or loss on a later sale or other disposition of any item.

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 to each asset in the sales contract. If this allocation is based on the value of each asset and you and the seller have adverse tax interests, the allocation generally will be accepted.

Example. You bought farm property on March 1, 1994, 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:

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

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

You harvested and sold the wheat in July 1994. Therefore, you deduct its cost of \$1,400 on Schedule F to figure the net farm profit for 1994.

You sold the timber in July 1994. 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 purchased 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 acquire an embryo transplant by purchasing a recipient cow pregnant with the embryo, allocate to the cost basis of the cow the part of purchase price equal to the FMV of the cow. Allocate the remainder of the purchase price to the basis of the calf. Neither the cost allocated to the cow nor the cost allocated to the calf is currently deductible as a business expense.

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

Uniform Capitalization Rules

You are subject to the uniform capitalization rules for costs incurred after 1986 if you:

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

You produce property if you construct, build, install, manufacture, develop, improve, create, raise, or grow the property. Property produced for you under contract is treated as produced by you to the extent you make payments or otherwise incur costs for 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, animals raised for sale (beef cattle, hogs, etc.), or animals used in your farming business for breeding or production purposes (dairy cows).

For the farming business, the uniform capitalization rules generally apply to the production, growing, or raising of property if the property:

- Is produced by a corporation, partnership, or tax shelter required to use the accrual method of accounting, or
- Has a preproductive period of more than 2 years.

You are not subject to the uniform capitalization rules for costs you incur in replanting plants that were lost or damaged because of freezing temperatures, disease, drought, pests, or casualty. See *Damaged Crops*, later.

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 you have during the year in the basis of property you produce or in your inventory costs, rather than deduct them as a current expense. You can recover these costs through depreciation, amortization, or cost of goods sold, when you use, sell, or otherwise dispose of the property.

Costs that are allocable to property being produced include both variable costs, such as feed, labor, and fixed costs, such as depreciation on machinery and buildings. Your fixed and variable costs are shown in Part II of Schedule F (Form 1040).

The following discussion explains how you treat certain costs under the uniform capitalization rules and the special rules that apply to farmers. For more information on these rules, see the regulations under section 263A of the Internal Revenue Code. The regulations contain detailed descriptions of the methods you may use to allocate costs.

Exceptions. The uniform capitalization rules do not apply to certain property. This includes:

- Property you produce that you use for personal or nonbusiness purposes, such as your personal residence,
- Certain developmental costs of mineral property,
- Certain property produced under a long-term contract,
- Costs for personal property acquired for resale if your (or your predecessor's) average annual gross receipts do not exceed \$10 million, and
- Costs of raising, growing, or harvesting trees other than ornamental trees or trees bearing fruit, nuts, or other crops.

See *Special Rules for Farm Property*, later, and Publication 551 for information on other property not subject to these rules.

Direct costs. Capitalize direct material costs and direct labor costs incurred for production or resale activities. Direct material costs include the cost of materials that become an integral part of the property produced plus the cost of materials used in the ordinary course of the activity.

Direct labor costs include the cost of labor that can be identified or associated with the particular property produced. This includes all types of compensation (basic, overtime, sick, vacation, etc.) plus payroll taxes and payments to a supplemental unemployment benefit plan.

Indirect costs. Indirect costs include all costs other than direct material and labor costs. Under the uniform capitalization rules, you must capitalize indirect costs properly allocable to property you produced or acquired for resale. Indirect costs are allocable to property you produced or acquired for resale when the

costs are incurred for or directly benefit these activities. Because your indirect costs may be for production and resale activities and for other activities that are not subject to the uniform capitalization rules, you must make a reasonable allocation between production/resale and other activities. Indirect costs that must be capitalized for production or resale activities include, but are not limited to, 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) Indirect labor including payroll taxes and payments to supplemental unemployment benefit plans.
- 5) Indirect materials and supplies.
- 6) Tools and equipment not otherwise capitalized.
- 7) Quality control and inspection.
- 8) Taxes otherwise allowable as a deduction (other than state, local, and foreign income taxes) that relate to labor, materials, supplies, equipment, land, or facilities. This does not include taxes treated as part of the cost of property.
- 9) Depreciation, amortization, and cost recovery allowance on equipment and facilities to the extent deductible.
- 10) Depletion (even if in excess of cost).
- 11) Insurance on your plant, machinery or equipment, or insurance on a particular activity.
- 12) The following items incurred for production or resale activities—storage and warehousing costs, purchasing costs, handling, processing, assembly, and re-packaging costs, and a portion of general and administrative costs.

Costs provided by a related person. If a related person provides you with materials, labor, or services for a price less than the arm's-length charge (what you would pay to an unrelated person), both you and the related person must account for the transaction as if you purchased the items for their arm's-length charges. For example, you must capitalize an amount equal to the arm's-length charge for the items and the related person must include in income an equal amount.

Costs not capitalized. Costs not required to be capitalized for production or resale activities include amounts incurred for:

- 1) Marketing, selling, advertising, and distribution expenses.
- 2) Casualty, theft, and other losses allowed by Internal Revenue Code section 165.
- 3) Depreciation, amortization, and cost recovery allowances on equipment and facilities that were placed in service but are temporarily idle.
- 4) Income taxes.

- 5) Repair expenses that do not relate to the manufacture or production of property.
- 6) Research and experimental expenses.
- 7) Strike expenses.
- 8) On site storage costs.
- 9) Unsuccessful bidding costs.
- 10) Section 179 deduction claimed on property subject to the uniform capitalization rules.

Special Rules for Farm Property

If a farming business is not required to use the accrual method, the uniform capitalization rules do not apply to animals or property that has a preproductive period of less than two years. If the property has a preproductive period of 2 years or less, you can claim a current deduction for the expenses. However, if a farming business is required to use the accrual method of accounting, the special farm uniform capitalization rules apply regardless of the property's preproductive period. The accrual method is discussed in Chapter 3. The preproductive period is discussed later.

You can also claim a current deduction for expenses if you elect out of the uniform capitalization rules. (See *Election Out of Uniform Capitalization Rules*, later.) For a special rule covering animals and related expenses incurred before 1989, see *Animals*, later.

Farming Business

For 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.

An evergreen tree over 6 years old when severed from its roots is not treated 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 you are subject to the uniform capitalization rules, you must capitalize the direct and indirect costs incurred during the preproductive period. These costs are added to the basis of your growing plant or included 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 of property produced in a farming business is:

- 1) The period before a plant's first marketable crop 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 replanting plants damaged or destroyed by freezing temperatures, disease, drought, pests, or casualty. These are the costs you incur for the replanting, 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 replanting 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 in excess of the acreage of the property on which the damage or loss occurred.

Ownership. Generally, costs must be incurred by the person owning the property at the time the plants were lost or damaged. 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 such 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 such plants or crops.

Election Out of Uniform Capitalization Rules

You can elect not to have the uniform capitalization rules apply to 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 election 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 a citrus or almond grove is planted 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 election. Unless you obtain consent from the IRS, you can only make this election for your **first** tax year during which you are in a farming business that includes the production of property subject to the uniform capitalization rules.

Make the election on Schedule E, Schedule F or any other schedule that you are required 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 election.

If you are eligible, you are treated as having made the election 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 1994, 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. Beginning in 1994, Brian began growing grapes. Brian is now subject to the uniform capitalization rules unless he elects out of the rules beginning with his 1994 tax year.

Revocation of election. Once you have elected not to have the uniform capitalization rules apply, you can only revoke this election with consent from the IRS.

Disposition of plants. If you made the election not to apply the uniform capitalization rules, you must treat any plant that 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, then the recapture amounts treated as ordinary income are also subject to self-employment tax. Recapture these preproductive expenses when you determine your gain on selling or disposing of the property.

Depreciation under election. If you or a related person makes the election out, you must use ADS (see Chapter 8) 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 that the election is in effect. This

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

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 elects not to have the uniform capitalization rules apply to the costs of growing new apple trees. Peter is required to use the alternate depreciation system (ADS) to depreciate all property used predominantly in his farming business (including the growing and harvesting of wheat) if this property is placed in service during a year that the election is in effect.

This means that all assets and equipment and any equipment used to grow and harvest wheat that is placed in service during a year that the election is in effect, must be depreciated using the straight line method over the required number of years as provided by the alternate depreciation system (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. Therefore, Partnership K is required to use the alternate depreciation system (ADS) for any property used predominantly in its farming business that is placed in service during a year that the election made by Peter is in effect.

Animals

Your costs of raising animals are exempt from the uniform capitalization rules if incurred after 1988 and you are not a corporation, partnership, or tax shelter required to use an accrual method of accounting.

Election out of uniform capitalization rules. If you were not required to use the accrual method of accounting, you could have elected not to apply the uniform capitalization rules. This election allowed you to currently deduct the costs of raising animals. However, if you made this election, you were required to use the Alternate Depreciation System (ADS) to depreciate property placed in service during any year 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.

Election revoked. If you revoked this election for your first tax year beginning after 1988, you must continue to use the alternate depreciation system (ADS) for any property placed in service during 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 purchased during the period the election was in effect, you must also 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 elected not to apply the uniform capitalization rules to the costs of raising heifers. During the period the election was in effect, you bought a new tractor and began depreciating it under the alternate depreciation system. 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 revoked your election. You must continue to depreciate the tractor under the alternate depreciation system. You must keep preproductive cost records for all heifers born during the period the election was in effect (1987 and 1988). These heifers are treated as 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).

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 constructing 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 or repair, or for meeting interest charges on the improvements as taxes.

Deducting vs. capitalizing costs. Do not add to your basis costs you can deduct as current expenses. 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) Recognized losses on involuntary exchanges,
- 7) Deductions previously allowed (or allowable) for amortization, depreciation, and depletion,
- 8) Exclusion from income of subsidies for energy conservation measures,
- 9) Credit for qualified electric vehicles,
- 10) Gain on the sale of your old home on which tax was postponed,
- 11) Certain canceled debt excluded from income,
- 12) Rebates received from the manufacturer or seller,
- 13) Patronage dividends received as a result of a purchase of property, (See *Patronage Dividends (Distributions)*, in Chapter 4.)
- 14) Residential energy credit,
- 15) Gas-guzzler tax, and
- 16) 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 elect 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.

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

reimbursement you receive and 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 receive 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 have deducted, or could have deducted, on your tax returns under the method of depreciation you selected. If you deducted more depreciation than you should have, decrease your basis by the amount you should have deducted plus the part of the excess that actually reduced your tax liability for any year. If you took less depreciation than you could have, decrease your basis by the amount you could have deducted. If you did not take a depreciation deduction, figure the amount of depreciation you could have deducted.

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.

Diesel-powered vehicle. If you received 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.

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

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, you must decrease the basis of the property by the amount of the deduction. For more information on these deductions, see Chapter 15 in Publication 535.

Exclusion from income of subsidies for energy conservation measures. If you received 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 received the subsidy by the excluded amount. For more information on this subsidy, see Publication 525, *Taxable and Nontaxable Income*.

Canceled Debt Excluded from Income

You may have to reduce the basis of your property if you exclude canceled debt from income. You can exclude your canceled debt from income if the debt is:

- 1) Canceled in a title 11 bankruptcy 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 depreciable property.

For more information on canceled debt in a bankruptcy case or during insolvency, see Publication 908. For more information on canceled debt that is qualified farm debt, see Chapter 4.

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 important. Adjusted basis is discussed earlier. Fair market value is discussed next.

Fair market value (FMV). The fair market value (FMV) is the price at which the 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. If you change nonbusiness property to a business use or to income-producing property, such as renting your farm dwelling, the basis for figuring depreciation on the property is the lesser of its adjusted basis or its FMV on the date of the change in use.

Property received for services. If you receive property for services, include the property's FMV in income. The amount you include in income becomes your basis. If the services were performed for a price agreed on beforehand, it will be accepted as the FMV of the property if there is no evidence to the contrary.

Taxable Exchanges

A taxable exchange is one in which the gain is taxable, or the loss is deductible. A taxable gain or deductible loss is also known as a **recognized** gain or loss. If you receive property in exchange for other property in a taxable exchange, the basis of the property you receive is usually its FMV at the time of the exchange. A taxable exchange occurs when you receive cash, or 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 any gain is not taxed and any loss cannot be deducted. A nontaxable gain or loss is also 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.

To qualify as a like-kind exchange, both the property you exchange and the property you receive must be held for business or investment purposes. There must be an exchange of like-kind property (depreciable tangible personal property may be like-class property). For other requirements, see *Like-Kind Exchanges*, in Chapter 10.

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

Example. You traded a machine (adjusted basis \$8,000) for another like-kind machine (FMV \$9,000). Both machines were used in your farming business. The basis of the machine received is \$8,000, the same as the machine traded.

Property plus cash. If you trade property in a nontaxable exchange and pay money, the basis of the property you receive is the basis of the property you exchanged increased by 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 is made directly or indirectly between related persons and either party disposes of the property within 2 years after the exchange, the exchange is disqualified from 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 special rule applies, the basis in the property received in the original exchange will be its fair market value.

These rules generally do 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 (or two or more corporations, an individual and a corporation, a grantor and fiduciary, etc.), see the rules relating to losses under *Sales and Exchanges*

Between Related Parties 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 determining 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 receive unlike property or money in addition to like property. The basis of the property you receive is the same as the basis of the old property with the following adjustments:

Decreased by:

- a) Any money you received, and
- b) Any loss recognized on the exchange.

Increased 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 received \$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 received. Your basis in the land received is:

Basis of land traded	\$10,000
Minus: Cash received	<u>3,000</u>
	\$ 7,000
Plus: Gain recognized	<u>3,000</u>
Basis of land received	<u>\$10,000</u>

Example 2. You traded a truck (adjusted basis \$2,750) for another truck (FMV \$2,000). You also received \$1,000. Your gain is \$250 (\$2,000 + \$1,000 – \$2,750). Your basis in the truck you received is:

Adjusted basis of truck traded	\$2,750
Minus: Cash received	<u>1,000</u>
	\$1,750
Plus: Gain recognized	<u>250</u>
Basis of truck received	<u>\$2,000</u>

Allocation of basis. Allocate the basis among the properties, other than money, that you received in the exchange. In making this allocation, the basis of the unlike property is its FMV on the date of the exchange. The remainder is the basis of the like property.

Example. You had an adjusted basis of \$15,000 in a tractor you traded for another tractor that had an FMV of \$12,500. You also received a truck that had an FMV of \$3,000, and \$1,000. 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	<u>1,000</u>
	\$14,000
Plus: Gain recognized	<u>1,500</u>
Total basis of properties received	<u>\$15,500</u>

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 remainder, \$12,500.

Exchange—Loss Not Recognized

If you have an exchange that results in an unrecognized loss, the basis of the new property is the basis of the old property decreased by any money received. Allocate this basis among the properties, other than money, received in the exchange. In making this allocation, the basis of unlike property is its fair market value on the date of the exchange. The remainder is the basis of the like property.

Example. You exchanged a tract of farmland (adjusted basis \$18,000) for a smaller tract of farmland (FMV \$14,000). You also received a car (FMV \$2,500) for personal use and \$500. Do not recognize the loss of \$1,000 (\$17,000 – \$18,000). Your basis in the properties you received is:

Adjusted basis of old land	\$18,000
Minus: Cash you received	<u>500</u>
Total basis of properties received	<u>\$17,500</u>

Of the total basis of \$17,500, \$2,500 is for the car you received and the remaining \$15,000 is the basis of your new tract of land.

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 to the dealer of your old property and your purchase from that dealer of the new property are dependent on each other, you are considered to have traded your old property. Treat the transaction as an exchange no matter how it is carried out. You cannot avoid the trade-in rule by using a subsidiary.

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. Since 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 acquire 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 acquire using the basis of the property you exchanged.

Similar or related property. If you receive 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 with the following adjustments:

Decreased by:

- a) Any loss recognized on the exchange, and
- b) Any money received that was not spent on similar property.

Increased by:

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

Not similar or related property. If you receive 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 amount of gain not recognized on the exchange.

For more information on involuntary exchanges, see Chapter 13.

Property Received as a Gift

To figure the basis of property you receive as a gift, you must know its adjusted basis to the donor just before it was given to you, 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 greater than the donor's adjusted basis, your basis is the donor's adjusted basis at the time you received 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 received 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 received the gift.

Gift received after 1976. If you received 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 less the donor's adjusted basis.

Example. In 1994, you received 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, \$25,400 is figured as follows:

Fair market value	\$50,000
Minus: Adjusted basis	<u>20,000</u>
Net increase in value	<u>\$30,000</u>
Gift tax paid	\$ 9,000
Multiplied by ($\$30,000 \div \$50,000$)	<u>.60</u>
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>\$25,400</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 same as the donor's adjusted basis plus or minus any required adjustment to basis during the period you held the property (see *Adjusted Basis*, earlier). Your basis for loss on the sale or other disposition of property received as a gift is its FMV at the time you received the gift plus or minus any required adjustment to basis during the period you held the property.

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.

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

Property Transferred From a Spouse

The basis of property transferred to you or transferred in trust for your benefit by your spouse, or former spouse if the transfer is incident to divorce, is the same as the transferor's adjusted basis. 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 supply you with records necessary 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 elects 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 may also 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 elect to value the qualified real property on other than its FMV. If so, the executor or personal representative values the qualified real property on the basis of its use as a farm. If this method of valuation is used for estate tax purposes, this value is the basis of the property for the heirs. The qualified heirs should be able to get the necessary value from the executor or personal representative of the estate.

If you are a qualified heir who received special-use valuation property, 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.

Your basis in special-use valuation property may be increased 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 nonfamily member or the property ceases to be used as a farm. This tax may apply if you dispose of the property in a like-kind exchange or it is involuntarily converted.

To increase your basis in the property, you must make an irrevocable election 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, your basis in the property is increased

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 election by filing with Form 706-A a statement that:

- 1) Contains your name, address, and taxpayer identification number,
- 2) Contains the name of the estate and its address and taxpayer identification number,
- 3) Identifies the election as an election under section 1016(c) of the Internal Revenue Code,
- 4) Specifies the property for which the election is made, and
- 5) Provides any additional information required by the Form 706-A instructions.

See Publication 448 for more information on valuation methods for estate tax purposes.

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 or not 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 is also \$50,000.

For more information on community property, see Publication 555.

8.

Depreciation, Depletion, and Amortization

Important Change for 1994

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 1994 is \$2,960. Your depreciation cannot exceed \$4,700 for the second year of recovery, \$2,850 for the third year of recovery, and \$1,675 for

each later tax year. See *Passenger automobiles*, later.

Important Reminder

Amortization of certain intangibles. You must amortize over 15 years certain intangibles that you acquired in connection with a trade or business or an activity for the production of income. For more information, see *Amortization of Certain Intangibles*, 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 under MACRS and use the declining balance method, you must use the 150% declining balance method.

For information on depreciating property placed in service after 1980 and before 1987, see Publication 534.

This chapter also gives basic information on depletion and amortization. It discusses how you are allowed a deduction for depletion of certain exhaustible natural resources and timber and for amortization of certain intangibles.

Records. It is important to keep good records for property you depreciate. Records of depreciable property and of depreciation allowed do not have to be complicated. In fact, simple ones often prove to be the best for income tax purposes. You may use the sample depreciation record shown in Chapter 20. You do not need to file this record with your return. Instead, you can 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
- 534** Depreciation
- 535** Business Expenses
- 544** Sales and Other Dispositions of Assets
- 551** Basis of Assets
- 917** Business Use of a Car
- 946** How To Begin Depreciating Your Property

Form (and Instructions)

- T** Forest Industries Schedules
- 1040X** Amended U.S. Individual Income Tax Return
- 4562** Depreciation and Amortization
- 4797** Sales of Business Property

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

Property is depreciable if it meets these tests.

- 1) It must be used in business or held for the production of income (for example, to earn rent or royalty income),
- 2) It must have a determinable useful life longer than one year, and
- 3) It 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. Personal property is property, such as machinery or equipment, that is not real estate. Real property is land and generally anything that is

erected on, 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. See *Uniform Capitalization Rules* in Chapter 7. However, if you purchase immature livestock for draft, dairy, or breeding purposes, you can depreciate your initial cost. See *Immature livestock* in *How To Figure the Deduction Under MACRS* later, for a discussion of when to begin depreciation.

Logging truck roads. Logging truck roads that have a determinable useful life are depreciable.

Example 1. You build a logging truck road on land you own for use in your timber operations. The road is expected to be used in your timber operations for an indefinite period. Past experience with similar roads indicates that the road surface will have to be replaced in 7 years and the bridges and culverts will have to be replaced in 20 years. The roadbed is not expected to need replacement. The surfacing, bridges, and culverts have determinable useful lives; therefore, they are depreciable. Since the roadbed is not expected to need replacement, it does not have a determinable useful life. Therefore, it is not depreciable.

Example 2. You build a logging truck road on land you own to harvest a certain stand of timber. It is reasonable to expect the harvesting of the timber will take 4 years. After the harvesting has been completed, the cutover land will be reforested and the road abandoned. All parts of the road have a determinable useful life to you. The useful life of the road ends upon completion of the timber harvesting and reforestation. The roadbed, as well as the surfacing, bridges, and culverts are depreciable.

Partial business/investment use. If you use property for business/investment and personal purposes, you can depreciate only the business/investment part. 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. See Chapter 5.

Intangible Property

Intangible property cannot be seen or touched and includes property, such as a copyright, patent, or franchise.

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 elected), your recovery of costs depends on how you are billed. If the cost of the software is included in the price of computer hardware and the software cost is not separately stated, you treat the entire amount as the cost of the hardware and depreciate it as explained in *Modified Accelerated Cost Recovery System (MACRS)*, later. If the cost of the software is 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 elected), you must amortize it over 15 years (rather than depreciate it) if it does not meet all three requirements listed below and it was acquired in connection with the acquisition of a substantial portion of a business.

If you acquire software after August 10, 1993 (after July 25, 1991, if elected), you can depreciate it over 36 months if it meets all three of the following requirements:

- 1) It is readily available for purchase by the general public,
- 2) It is not subject to an exclusive license, and
- 3) It has not been substantially modified.

Even if the software does not meet the above requirements, you can depreciate it over 36 months if it was not acquired in connection with the acquisition of a substantial portion of a business.

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

Some tangible and intangible property, although used in your business or held to produce income, can never be depreciated.

Property placed in service and disposed of in the same year. You cannot deduct depreciation on property placed in service and disposed of in the same tax year. When property is placed in service is explained later.

Land. Land can never be depreciated because it does not wear out or become obsolete and it cannot be used up. Land generally includes the cost of clearing, grading, planting, and landscaping because these expenses are all part of the cost of the land itself. Some land preparation costs, however, may be depreciable. For information on these costs, see Chapter 1 of Publication 534.

Inventory. You can never depreciate inventory. Inventory is any property held primarily for sale to customers in the ordinary course of business.

In some cases, it is not always clear whether the property is inventory or depreciable business property. If unclear, examine carefully all the facts in the operation of the particular business. For examples on this, see *Inventory* in Chapter 1 of Publication 534.

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.

Demolition of buildings. You cannot deduct costs (paid or incurred) to demolish any building. Nor can you deduct any loss from a demolition. Instead, you must add these costs to the basis of your land on which the demolished building stood.

Rented property. Generally, a person who uses property subject to depreciation 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. However, 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. The 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.

Goodwill. Goodwill is intangible property that can never be depreciated 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. Trademark and trade name expenses are also intangible properties and must be capitalized. This means that the full amount cannot be deducted in the current year. For trademarks and trade names acquired before August 11, 1993 (July 26, 1991, if elected), you cannot depreciate or amortize these expenses. For trademarks and trade names acquired after August 10, 1993 (July 25, 1991, if elected), you may have to amortize their costs over 15 years. For more information, see Chapter 12 in Publication 535.

For more information on trademarks and trade names in general, see *Franchise, Trade-mark, 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 recovered your cost or other basis or when you retire it from service. (See *Retired From Service*, later.) You have fully recovered your 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 actually used yet, 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 (placed in service) in a trade or business or for the production of income.

Example 1. You bought a home in 1985 and used it as your personal residence until 1994 when you converted it to rental property. Although its specific use was personal and no depreciation was allowable, the home was placed in service in 1985. However, you can claim a depreciation deduction in 1994 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

Property is retired from service when it is permanently withdrawn from use in trade or business or in the production of income. The period for depreciation ends when property is retired from service.

You can retire property from service by selling or exchanging it, abandoning it, or destroying it.

Depreciation Not Deducted

If, in an earlier year, you did not claim depreciation you were entitled to deduct, you must still reduce your property's basis by the amount of depreciation you did not deduct. If you deduct more depreciation than you should, you must decrease your basis by the amount deducted to the extent of any benefit from excess depreciation claimed.

You cannot deduct unclaimed depreciation in the current year or any later tax year. However, you can claim the depreciation on a timely filed amended return for the earlier year. 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.

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 discusses how you can elect to deduct all or part of the cost of certain qualifying property as an expense rather than taking depreciation deductions over a specified recovery period. You must decide for each item of qualifying property whether to deduct, subject to the yearly limit, or to capitalize and depreciate its cost. If you elect, you can deduct a limited amount of the cost of qualifying property you buy for use in your trade or business in the first year you place the property in service. See *Placed in Service* earlier in *When Depreciation Begins and Ends*.

What Costs Can and Cannot Be Deducted

You can claim the section 179 deduction only on qualifying property purchased for use in your trade or business. You cannot claim the deduction on property you hold only for the production of income.

Acquired by Purchase

Only the cost of property you purchase for use in your business qualifies for the section 179 deduction. However, the cost of property purchased 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 receive is the basis of the trade-in. You cannot claim the section 179 deduction on this part of the basis of the asset. For example, if you buy (for cash and a trade-in) a new truck for use in your business, your cost for the section 179 deduction does not include the adjusted basis of the truck you trade for the new vehicle. See *Adjusted Basis* in Publication 551.

Example. In 1994, 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. The new items were placed in service in 1994. 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. The portion of the adjusted basis of the property traded that carries over to the basis of the new property is not treated as business cost for purposes of section 179. 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.

Partial business 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 the property is placed in service is for trade or business purposes. You must allocate the cost of your property to reflect only the business use. You do this by multiplying the cost of the property by the percentage of business use. This adjusted cost is used to figure your section 179 deduction.

Qualifying Property

You can claim a section 179 deduction on trade or business property for which depreciation is allowable and that is:

- 1) Tangible personal property,
- 2) Other tangible property (not including a building or its structural components), but only if such other property is 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 used in connection with any of the activities in (a), or
 - c) A facility used in connection with 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 tangible property other than 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 and, therefore, not tangible personal property. For the same reason, swimming pools, paved parking areas, wharfs, docks, bridges, fences, and similar property are not tangible personal property.

Business property. All business property, other than structural components, contained in or attached to a building is tangible personal property. Some tangible personal property under local law cannot be tangible personal property for section 179, and some real property under local law, such as fixtures, can be tangible personal property for section 179.

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. As used here, livestock includes poultry.

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 breeding 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 pen will not be eligible property if used 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.

Nonqualifying Property

You cannot claim the section 179 deduction on:

- 1) Property held only for the production of income (for example, certain rental property),
- 2) Real property, including buildings and their structural components,
- 3) Property acquired from certain groups or persons, and

- 4) Certain property you lease to others (if you are a noncorporate lessor).

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. Property is held 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. Property you use in the active conduct of a trade or business is not held **only** for the production of income.

Acquired from certain groups or persons. Property does not qualify for the section 179 deduction if:

- 1) The property is acquired by one member of a controlled group from a member of the same group, or
- 2) The property's basis is either:
 - Determined in whole or in part by its adjusted basis in the hands of the person from whom you acquired it, or
 - Determined under stepped-up basis rules for property acquired from a decedent as discussed in Publication 448, or
- 3) The property is acquired from a related person.

For this purpose, a list of related persons is available in Chapter 2 of Publication 946 or Chapter 2 of Publication 534.

How To Make the Election

You make the election by taking your deduction on Form 4562. You attach and file Form 4562 with:

- 1) The original return you file for the tax year the property was placed in service (whether or not you file your return on time),
- 2) An amended return filed no later than the due date (including extensions) for your return for the tax year the property was placed in service.

How To Figure the Deduction

The maximum section 179 deduction is \$17,500 of the business cost of property you purchase for use in your trade or business. You decide how much of the business cost of property you want to deduct under section 179. You do not have to claim the full \$17,500. Any cost not deducted under section 179 may be depreciated.

If you purchase and place in service more than one item of qualifying property during the year, you can allocate 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 that item costs less than \$17,500, such as \$3,200,

and you meet the taxable income limit (discussed later), your deduction is limited to the property's cost, \$3,200.

Deduction Limits

In figuring your section 179 deduction, you must apply the following limits:

- 1) Maximum dollar limit,
- 2) Investment limit, and
- 3) Taxable income limit.

Maximum dollar limit. The total business cost you can elect to deduct for any year cannot exceed \$17,500. The \$17,500 maximum dollar limit applies to you as a taxpayer and not to each business you operate.

While the maximum dollar amount that can be deducted is \$17,500, there are certain rules that can reduce this amount.

Joint returns. A husband and wife who file a joint return are treated as one taxpayer in determining any reduction to the \$17,500 maximum dollar limit regardless of which spouse purchased 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 \$17,500 maximum dollar limit and for the \$200,000 investment limit that applies to the reduction of the maximum dollar 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:

- 1) The maximum dollar limit (after the investment limit), or
- 2) The total cost of section 179 property you both elected to expense on your separate returns.

Investment limit. For each dollar of business cost of section 179 property placed in service in excess of \$200,000 in a tax year, the \$17,500 maximum dollar limit is reduced (but not below zero) by one dollar.

Example. In 1994, James Smith placed in service machinery costing \$207,000. Since this cost exceeds \$200,000 by \$7,000, 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 1994 of \$10,500.

Taxable income limit. The total cost that can be deducted 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.

Taxable income for this purpose is figured by totaling the net income (or loss) from all trades and businesses you and your spouse (if

filing a joint return) 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 compensation 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, taxable income is figured without regard to:

- 1) The section 179 expense deduction,
- 2) The self-employment tax deduction, and
- 3) 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 the amount of 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. Joyce Jones places in service in 1993 a machine that cost \$8,000. The taxable income from her business for 1993 (determined without a section 179 deduction for the cost of the machine and without the self-employment tax deduction) is \$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 was carried to 1994.

In 1994, 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 1993 because of the limits. However, she can carry the balance of \$1,000 as carryover to 1995.

See *Carryover of disallowed deduction* in Publication 534 for information on figuring the carryover, or use the *Section 179 Worksheet* in Chapter 2 of Publication 534 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. The limit for this other deduction may have to be figured 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.

Passenger automobiles. For passenger automobiles placed in service in 1994, your total section 179 deduction and depreciation cannot exceed \$2,960 for 1994. See *Dollar limit on passenger automobiles (farm vehicles)*, under *Listed Property*, later, for the limits applicable to passenger automobiles placed in service before 1994.

Figuring the deduction. You must figure your section 179 deduction before figuring your depreciation deduction. Then you subtract the amount you elect to deduct under section 179 from the business and investment part of the cost of the qualifying property. You use this unadjusted basis to compute your depreciation deduction.

Note: You cannot take depreciation to the extent that you elect to directly expense the cost of property under section 179.

Example. In 1994, you bought a tractor for \$16,000 and a mower for \$6,200 for use in your farming business. Both items were placed in service in 1994. 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 for 1994. Your \$6,200 deduction for the mower has completely recovered the cost of that item. The cost of your tractor is adjusted by \$11,300. Its unadjusted basis for depreciation is \$4,700. This is figured 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 deducted the cost of qualifying property and the property is not used more than 50% in a trade or business for any tax year before the end of the property's recovery period, you may have to recapture (include in income) part of the deduction.

If you elect the section 179 deduction, the amount deducted is treated as depreciation for purposes of the recapture rules. Thus, any gain you realize from a sale, exchange, or other disposition of property may have to be treated as ordinary income to the extent of the section 179 and depreciation deductions you claimed.

Report any recapture of the section 179 deduction on Form 4797 and Schedule F.

You figure the amount to include in income by subtracting 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, 1992, an item of 3-year property costing \$10,000. The property is not listed property. He used the property only for business in 1992 and 1993. He elected a section 179 deduction of \$5,000. During 1994, he used the property 40% for business and 60% for personal use. He figures his recapture amount as follows:

Section 179 Deduction Claimed (1992)	\$5,000.00	
Allowable Depreciation (Instead of section 179):		
1992 —		
\$5,000 × 25.00%*	\$1,250.00	
1993 —		
\$5,000 × 37.50%*	1,875.00	
1994 —		
\$5,000 × 25.00%* × 40%		
(Business)	500.00	3,625.00
1994 —		
Recapture Amount		<u>\$1,375.00</u>

*Rates from the 150% table, later.

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.

Modified Accelerated Cost Recovery System (MACRS)

The modified accelerated cost recovery system (MACRS) consists of two systems that determine how you depreciate your property. The main system is referred to as the **General Depreciation System (GDS)**. The second system is referred to as the **Alternative Depreciation System (ADS)**. MACRS generally applies to all tangible property placed in service after 1986. However, you could have made a property-by-property election to use MACRS for property placed in service after July 31, 1986, and before January 1, 1987.

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. All real property acquired before 1987 that was changed

from personal use to business or income-producing use after 1986 must be depreciated under MACRS.

When To Use GDS

Most tangible depreciable property falls within the general rule of MACRS, also called the General Depreciation System (GDS). 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 the use of ADS for certain property as discussed under *When To Use ADS*, later.

Although your property may qualify for GDS, you can elect 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. This 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 before 1987 (before August 1, 1986, if election made), that is transferred or converted from personal to business use after 1986 (after July 31, 1986, if election made). Property that does not come under MACRS must be depreciated under ACRS or one of the other depreciation methods based on the useful life of property. They include the straight line and declining balance methods. ACRS is discussed in Chapter 6 of Publication 534 and the other methods of depreciation are discussed in Chapter 7 of Publication 534. Also, you can elect to exclude certain property from MACRS.

Election to Exclude Certain Property

If you properly depreciate any of your property under a method of depreciation that is not based on a term of years, such as the unit-of-

production method, you can elect to exclude that property from MACRS.

To figure a depreciation deduction under the unit-of-production method, you divide the cost or other basis (less salvage) by the estimated number of units to be produced during the life of the property. Apply the resulting amount to the units produced in a year to arrive at your depreciation for that year.

You make this election with your tax return by the return due date (including extensions) for the year your property is placed in service. You make it by reporting your depreciation for the property on line 17, Part III, Form 4562 and attaching a separate sheet as described in the Instructions for Form 4562.

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 and ACRS. See Publication 917 for a discussion of the standard mileage rate.

Property Placed in Service Before 1987

The special rules that may prevent you from using MACRS for property placed in service before 1987 (before August 1, 1986, if elected) apply to both personal and real property. However, the rules for personal property are more restrictive. For purposes of these rules, you do not treat either real or personal property as owned before it is placed in service. Therefore, 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 the property user did not change and the property was not MACRS property in the hands of the person from whom it was acquired due to 2) or 3).

Real property. For real property acquired after 1986 (after July 31, 1986, if MACRS was elected), you cannot use MACRS 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.

Note: 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 534.

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 534.

How To Figure the Deduction Under MACRS

Before figuring your depreciation deductions, you must know:

- 1) The basis of your property,
- 2) The date your property was placed in service,
- 3) The property class and recovery period,
- 4) Which convention to use, and
- 5) Which depreciation method to use.

Basis

Basis is a measure of your investment in property you own. When you depreciate property, a certain percentage of your basis in it is deducted each year.

For property that you buy, your basis is usually its cost to you. If you receive property in some other way—such as by inheriting it, receiving it as a gift, building it yourself, or getting it in a tax-free exchange—you must figure your basis in some other way. If you receive your property in one of these other ways, see Chapter 7.

While you own the property, various events may take place that will change your basis. Some events, such as additions or permanent improvements to the property, increase basis. Others, such as casualty losses and the section 179 deduction, decrease basis. See Chapter 7 for more information on items that increase or decrease 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) on the date you change it from personal use, or

- 2) Your original cost or other basis adjusted as follows:
- Increased by the cost of any permanent improvements or additions and other additions to basis, and
 - 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

As discussed in *When Depreciation Begins and Ends*, property is treated as placed in service when it is first ready and available for its specified use whether in a trade or business, the production of income, a tax-exempt activity, or a personal activity. However, depreciation applies only to property placed in service 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 1994 is considered placed in service in the 1994 calendar year even though it will not be used until the spring of 1995.

Example 2. If the planter comes unassembled in December 1994 and is put together in February 1995, it is not considered placed in service until the 1995 calendar year.

Example 3. If the planter was delivered and assembled in February 1994 but not used until April 1994, its placed-in-service date is February 1994, 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.

Items in 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:

- 3-year property,
- 5-year property,
- 7-year property,
- 10-year property,

- 15-year property,
- 20-year property,
- Residential rental property, and
- 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 534.

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.

Conventions

Generally, you use the half-year convention to figure the depreciation deduction for property other than residential rental and nonresidential real property. However, under a special rule,

you may be required to use the mid-quarter convention, discussed later.

For residential rental and nonresidential real property, you must use the mid-month convention.

Half-year convention. 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.

Mid-quarter convention. If the total depreciable bases of MACRS property placed in service during the last 3 months of a tax year exceed 40% of the total depreciable bases of all MACRS property placed in service during that tax year, you must use the mid-quarter convention. In determining the total bases of property, do not include the basis of:

- Residential rental property,
- Nonresidential real property, or
- Property placed in service and disposed of in the same tax year.

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.

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 amount of 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 any quarter as placed in service (or disposed of) in the middle of the quarter.

To figure your MACRS deduction using the mid-quarter convention, first figure your depreciation for the full tax year. Then multiply 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 534.

Mid-month convention. Under the mid-month convention, you treat all property placed in service (or disposed of) in any month as 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.

Note: If you use the MACRS percentage tables (discussed in *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 raising or harvesting any agricultural or horticultural commodity. It includes operating a nursery or sod farm; raising or harvesting crops; raising or harvesting of trees bearing fruit, nuts, or other crops; raising ornamental trees; and 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 such products. It does include processing activities which are normally part of growing, raising, or harvesting agricultural products.

Fruit or nut trees and vines. Trees and vines bearing fruit or nuts are depreciated 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. The use of ADS applies to all property placed 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 *Figuring MACRS Deductions Without Tables* in Chapter 3 of Publication 534.

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 made, the election cannot be changed.

Straight line method. The straight line method lets you deduct the same amount of depreciation each year. To figure your deduction, determine the adjusted basis of your property, its salvage value, and its estimated useful life. Subtract the salvage value, if any, from the adjusted basis. The balance is the total amount of depreciation you can take over the useful life of the property.

Divide the balance by the number of years remaining in the useful life. This gives you the amount of your yearly depreciation deduction. Unless there is a big change in adjusted basis, or useful life, this amount will stay the same throughout the time you depreciate the property. If, in the first year, you use the property for less than a full year, you must prorate your depreciation deduction for the number of months in use.

ADS method. Under GDS, you can elect to use the ADS method for most property. Under ADS, you figure your deduction using a straight line method of depreciation over fixed ADS recovery periods. The ADS recovery periods for most classes of property 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 534.

Election. You make the election to use the ADS method by entering the depreciation on line 15 of Part II of Form 4562.

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.

The election to use the ADS method, once made in a tax year, cannot be changed.

Depreciation Methods Chart

To help you determine the proper method to use for a specific property class, use the following chart. 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

Computing 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. The deduction is the same under both methods.

Percentage tables. Before using the percentage tables, you should know the special rules for using them:

- 1) The rates in the percentage tables must be applied 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.

Unadjusted basis. You must apply the table percentages 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 it is figured without taking into account any depreciation taken in prior 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, and
- 3) Any deduction claimed for clean-fuel vehicle or clean-fuel vehicle refueling property.

Also, if the business property is a vehicle, you must reduce the basis by 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 534.

Adjustment due to casualty loss. If the basis of your property is reduced because of a

casualty, it is an adjustment to basis other than those listed in (3) under *Percentage tables*. Therefore, 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 534 for complete MACRS tables, including tables for the mid-quarter convention.

Example 1. You buy and place in service on August 10, 1994, 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 for 1994 of \$1,071. For 1995, 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. You place the barn in service on June 1, 1994. 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. Your 1995 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 534 for complete MACRS tables, including tables for the mid-quarter 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 *Figuring MACRS Deductions Without Tables* in Chapter 3 of Publication 534.

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.

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. These limits apply if your property is not used more than 50% in a qualified business use during any tax year in its recovery period. If listed property leased after June 18, 1984, limitations are imposed on lessees that are substantially equivalent to those imposed on owners. For more information on listed property that is leased, see Chapter 4 in Publication 534.

A rule that pertains only to passenger automobiles limits the amount of your section 179 and depreciation deductions. See *Dollar limit on passenger automobiles (farm vehicles)*, later.

Listed Property Defined

Listed property includes:

- 1) Any passenger automobile (defined later).
- 2) Any other transportation vehicle.
- 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 transportation vehicles. This term includes trucks, buses, boats, airplanes, motorcycles, and other vehicles used for transporting persons or goods. However, certain types of special purpose farm vehicles, such as 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. The percentage of investment use of listed property cannot be used as part of the percentage of qualified business use to meet the predominant use test. However, the combined total of business and investment use is taken into account to figure your depreciation deduction for the property.

Note: Property does not stop being predominantly used in a qualified business use because of a transfer at death.

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

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 can be claimed is limited.

Maximum deduction for 1994. The maximum depreciation deduction (including section 179) that you can claim for a passenger automobile is determined by when you place it in service. The maximum deductions for 1994 are:

Maximum Depreciation Deduction

Year Placed In Service	1st Year	2nd Year	3rd Year	4th Year and Later
1994	\$2,960	\$4,700	\$2,850	\$1,675
1993	\$2,860	\$4,600	\$2,750	\$1,675
1992	2,760	4,400	2,650	1,575
1991	2,660	4,300	2,550	1,575
1990	2,660	4,200	2,550	1,475
1989	2,660	4,200	2,550	1,475
Pre-1989	2,560	4,100	2,450	1,475

For passenger automobiles placed in service during 1994, the depreciation deduction, including the section 179 deduction, cannot be more than \$2,960 for 1994 (the first tax year of the recovery period). For 1995 and 1996 (second and third tax years), the depreciation deduction will be limited to \$4,700 and \$2,850, respectively. The maximum will be \$1,675 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. A passenger automobile is any four-wheeled vehicle, such as a van or pickup truck, manufactured primarily for use on public streets, roads, and highways and rated at 6,000 pounds or less of unloaded gross vehicle weight (gross vehicle weight for trucks and vans). It includes any part, component, or other item physically attached to the automobile or traditionally included in the

purchase price of an automobile. For more information on passenger automobiles, see Publication 917.

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/investment use by 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. It is not necessary 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, records must be kept for as long as any excess depreciation can be recaptured (included in income).

For property placed in service after 1986, recapture can occur in any tax year of the ADS recovery period.

For more information, see Chapter 6 in Publication 534.

Depletion

If you own mineral property or standing timber, you can take a deduction for depletion. Mineral property includes oil and gas wells, mines, and other natural deposits (including geothermal deposits).

The depletion deduction is available to you as an owner and operator only if you have an economic interest in mineral deposits or standing timber.

You have an economic interest if you have a legal interest in minerals in place or standing timber and you have the right to income from the extraction and sale 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 may have an economic interest in a mineral deposit or timber if each qualifies. If you have no legally enforceable right to share

in the mineral deposit or timber, you do not have 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.

To determine the depletion for each unit, you divide the adjusted basis in the property by the estimated number of recoverable units. Then you multiply the resulting rate for each unit by:

- 1) The units sold during the tax year, if you use the accrual method of accounting, or
- 2) The units sold for which you receive payment, if you are a cash basis taxpayer.

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. If you claim a deduction for depletion of timber, attach Form T to your income tax return.

Example. Sam Brown bought a farm that included standing timber. In 1994, 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 cut and sold 27,000 units in 1994. Sam did not elect to treat the cutting of the timber as a sale or exchange. Sam's depletion for each unit for 1994 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 in 1994, his depletion for each unit would have remained at \$.006. However, his depletion deduction would have been \$120 for 1994 and he would have included the balance of \$42 ($7,000 \times \$.006$) in the closing inventory for 1994.

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

To figure percentage depletion, you multiply your gross income for the tax year from that property by the depletion percentage for that type of property. Your depletion deduction cannot be more than 50% (100% in the case of certain oil and gas properties) of your taxable income from that property.

Taxable income for this purpose is figured without the depletion deduction or any net operating loss deduction.

For more information, see Chapter 13 in Publication 535.

Amortization

You may be able to deduct each year, as amortization, 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.

Amortization of Certain Intangibles

You must amortize over 15 years the capitalized costs of certain intangibles that you acquire after August 10, 1993. These intangibles are called "amortizable section 197 intangibles" and are defined later. They must be held in connection with your trade or business or in an activity engaged in for the production of income. The amount of your deduction is the adjusted basis (for purposes of determining gain) of the intangible amortized over a 15-year period beginning with the month acquired. No other depreciation or amortization

deduction is allowed for section 197 intangibles.

Effective date elections. While this amortization provision generally applies only to property acquired after August 10, 1993, under **two elections**, you may choose to have it apply differently. See Chapter 12 of Publication 535 for information on the elections.

Section 197 Intangibles

The following assets are section 197 intangibles:

- 1) Goodwill,
- 2) Going concern value,
- 3) Workforce in place including its composition, terms, and conditions (contractual or otherwise) of employment,
- 4) Business books and records, operating systems, and any other information base including lists, or other information with respect to current or future 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) A license, permit, or other right granted by a governmental unit or agency (including renewals),
- 9) A covenant not to compete entered into in connection with an acquisition of an interest in a trade or business, and
- 10) A franchise, trademark, or trade name (including renewals).

You cannot amortize any of the intangibles listed in items 1) through 7) that you created, unless you created it in connection with the acquisition of a substantial portion of a business.

For more information on these section 197 intangibles, see Chapter 12 of Publication 535.

Intangibles that are not section 197 intangibles. The following assets are not section 197 intangibles:

- 1) Any interest in land,
- 2) Most computer software (see *Computer software*, later),
- 3) An interest under an existing lease or sublease of tangible property, and
- 4) An interest under an indebtedness 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 not acquired in the acquisition of a substantial part of a business is not section 197 property.

If depreciation is allowed for 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 534.

Additional costs associated with nonsection 197 intangibles. Additional costs that are taken 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. These costs are instead, added to the basis of the real property.

Dispositions

A section 197 intangible is treated as depreciable property used in your trade or business. Therefore, if you dispose of a section 197 intangible that you held for more than one year, the property qualifies as section 1231 property. Any gain on the disposition is treated as ordinary income to the extent of the allowable amortization. The gain or loss on the sale of property held for one year or less is reported 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 it. You must 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 convert existing goodwill, going concern value, or any other section 197 intangible for which a depreciation or amortization deduction would not have been allowable before August 10, 1993, to amortizable property.

For more information, see Chapter 12 in Publication 535.

Anti-Abuse Rule

A section 197 intangible may not be amortized under these rules if you acquired the intangible 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 costs for forestation or reforestation of qualified timber property. 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.

Yearly limit. You can elect to amortize up to \$10,000 (\$5,000 if you are married filing separate returns) of qualified expenses you incur during each tax year. You cannot carry over or carry back qualifying expenses that are in excess of the yearly 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. Qualified timber property is a woodlot or other site in the United States which will contain trees in significant commercial quantities. The woodlot must be one acre or more in size. You must hold the property for the planting, cultivation, caring for, and cutting of trees for sale or use in the commercial production of timber products. Shelter belts and ornamental trees are excluded.

Qualified expenses. Reforestation expenses are the direct costs incurred to plant or seed for forestation or reforestation. This includes site preparation, seeds, seedlings, labor, tools, and depreciation. You include in these costs depreciation on equipment, such as tractors, trucks, tree planters, and similar machines used in the planting and seeding. Reforestation expenses only include those costs that must be capitalized and are included in the adjusted basis of the property. Costs that are currently deductible do not qualify.

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.

Amortization deduction. If you choose to amortize your qualifying expenses, you set up these expenses as your amortizable basis. A mandatory half-year convention is provided. You can take a deduction for only half of a full-year's deduction in the year the reforestation costs were incurred and in the eighth tax year.

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. If you have qualifying reforestation expenses, you can also qualify for the investment credit. See Chapter 9.

Election to amortize. To make this election, you should claim the deduction on Form 4562 and attach a statement to your tax return for the year in which you incur the costs. The statement should describe the expenses and

provide the dates you incurred each expense. You can make the election only on a timely filed return (including extensions) for the tax year in which the expenses were incurred.

Recapture. If you dispose of qualified timber property within 10 years of the year in which the amortizable basis was created and you claimed amortization deductions, part or all of any gain realized on disposition may be recaptured (included in income) as ordinary (fully taxable) income.

Pollution Control Facilities

You can elect to amortize the cost of a certified pollution control facility over a period of 60 months. If the useful life of the facility is greater than 15 years, you must make an adjustment by reducing the amortizable basis of the facility.

Certified pollution control facility. A certified pollution control facility is depreciable property that is a new, identifiable treatment facility used to abate or control water or atmospheric pollution or contamination by removing, altering, disposing, storing, or preventing the creation or emission of pollutants, contaminants, wastes, or heat. It must be appropriately 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.

Amortization. The amortization deduction applies to any new certified pollution control facility used with a plant (or other property) that was in operation before 1976.

If it appears that all or part of the cost of a facility will be recovered from its operations, such as through sales of recovered wastes, the federal certifying authority will certify to that effect, describing the nature of the potential cost recovery. The basis of the facility that may be amortized must be reduced accordingly. For more information, see section 169 of the Internal Revenue Code and the regulations thereunder.

Example. In 1994, 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.

Start-Up Expenses

You can elect to amortize certain costs you incur in the start-up of your business. You amortize your costs over a period of 60 months or more. The period begins with the month you start or acquire your business.

Start-up costs. Start-up costs are those expenses relating to investigating a business, setting up a business, or acquiring a business. These costs are amortized only if they would normally be deductible expenses if paid or incurred to operate a similar existing business.

For more information, see *Going Into Business* in Chapter 12 of Publication 535.

9.

General Business Credit

Introduction

The general business credit consists of any carryover of business credits from prior years plus the total of the following current year business credits:

- 1) Investment credit (Form 3468),
- 2) Jobs credit (Form 5884),
- 3) Alcohol fuels credit (Form 6478),
- 4) Research credit (Form 6765),
- 5) Low-income housing credit (Form 8586),
- 6) Disabled access credit (Form 8826),
- 7) Enhanced oil recovery credit (Form 8830),
- 8) Renewable electricity production credit (Form 8835),
- 9) Empowerment zone employment credit (Form 8844),
- 10) Indian employment credit (Form 8845),
- 11) Credit for employer social security and Medicare taxes paid on certain employee tips (Form 8846), and
- 12) 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 subsequent years.

If you need more information about these credits than you find in this chapter, see the credit forms listed above.

Topics

This chapter discusses:

- Claiming the credit
- Carrybacks and carryovers
- Investment credit
- Investment credit recapture

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

Claiming the Credit

The empowerment zone employment credit is figured separately after all other business credits have been claimed. See *Claiming the empowerment zone employment credit*, later.

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, see 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.

The following discussion of carrybacks and carryovers does not apply to the empowerment zone employment credit. 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. See *Claiming the empowerment zone employment credit*, earlier, for more information.

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 your alternative minimum tax. 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 determine 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 amount of general business credit you can take for the tax year is limited to \$9,013. This is your net income tax, \$27,500, minus the **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 use it to reduce your tax in those years. 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.

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.

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 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 no later than 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 no later than 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 expenses 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 expenses must qualify for amortization. You can take the investment credit for reforestation expenses whether you choose to amortize them or add them to the basis of your property. For more information about these expenses, see *Amortization* in Chapter 8.

Example. Gerald elected to amortize qualified reforestation expenses of \$9,000 he incurred during 1994. He may take a reforestation credit of \$900 (10% of \$9,000) for 1994.

Rehabilitation credit. The rehabilitation credit applies to expenses 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 expenses you can take as a credit is 10% for buildings placed in service before 1936 and 20% for certified historic structures. See Form 3468 for more information.

Energy credit. The 10% energy credit applies to certain expenses for solar or geothermal energy property you placed in service during your tax year. See 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 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 Credit*, earlier.

Carrybacks and carryovers. Even if you cannot take an investment credit for 1994, you may have unused credits from earlier years that may reduce your 1994 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 the spouse or former spouse. However, if the spouse or former spouse later transfers the property, the 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.

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.

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 recapture percentage, from the tables on Form 4255, by the original investment credit taken. 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

Everything you own is, for income tax purposes, either a capital asset or a noncapital asset. The capital gain and loss rules are of special interest to farmers. Under these rules, gains and losses from sales or other dispositions of noncapital assets used in the farming business and held more than 1 year, or longer in the case of livestock held for certain purposes, as explained later in this chapter, are often treated as sales of capital assets.

Because of the tax treatment of gain or loss, it is important for you to classify your gains and losses as either capital or ordinary gains or losses. You must also classify the capital gains and losses as either short-term or long-term gains or losses. These distinctions are essential in order to arrive at your net capital gain or loss and to separate such items from income that belongs on Schedule F (Form 1040).

To figure your gains and losses, you must know the meaning of the terms “basis,” “adjusted basis,” and “fair market value.” These terms are discussed in Chapter 7.

Topics

This chapter discusses:

- Capital and noncapital assets
- Nontaxable exchanges
- Commodity forward contracts, futures contracts, and options on futures
- Livestock
- Converted wetland and erodible cropland
- Timber
- Coal and iron ore
- 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** Nonbusiness Disasters, Casualties, and Thefts
- 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
- 1099-A** Acquisition or Abandonment of Secured Property
- 1099-C** Cancellation of Debt
- 4684** Casualties and Thefts
- 4797** Sales of Business Property
- 8824** Like-Kind Exchanges

Capital Assets

For income tax purposes, all property you own and use for personal purposes or investment is a capital asset. An intangible property right may also be a capital asset.

Some **examples of capital assets** include:

A home. One that is owned and occupied by you and your family.

Household furnishings. Items used by you and your family.

An automobile. This is one that you use for pleasure. If your automobile is used both for pleasure and for farm business, it is partly a capital asset and partly a noncapital asset, defined later.

Stocks and bonds. Securities held by individuals for investment. 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. **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. However, if your losses for the tax year exceed your 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 Form 4684* in Publication 547.

Short term or long term. A sale or exchange of a capital asset usually will result in either a short-term or a long-term capital gain or loss, depending on the period of time the property is held.

If held 1 year or less, the gain or loss resulting from the sale or exchange is short term.

If held more than 1 year, the gain or loss resulting from the sale or exchange is long term.

Inherited property. If you inherit property, your **gain or loss on any later disposition** of the property is treated as a long-term capital gain or loss. 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.

Holding period. To figure if you held property more than 1 year, you begin 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. Count the day you disposed of the property as part of your holding period.

Example. If you bought an asset on June 18, 1994, you should start counting on June 19, 1994. If you sell the asset on June 18, 1995, your holding period is not more than 1 year, but if you sell it on June 19, 1995, your holding period is more than 1 year.

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, the first day of your holding period is the same as the one the donor used to figure the 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 delivery or possession and assumed all of the burdens and privileges of ownership.

However, taking delivery or possession of real property under an option agreement is not enough to start the holding period. The holding period of the seller cannot end before the date the option is exercised.

How to determine gain or loss on sale.

Whether short term or long term, the amount of a capital gain or loss from a sale is the difference between the amount realized and the adjusted basis of the property plus selling expenses. Your gains and losses are figured on Schedule D (Form 1040) (illustrated in Chapter 20).

Net capital 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.

You add your long-term capital gains and losses separately and subtract one total from the other to get your net long-term capital gain or loss. Then add your short-term capital gains and losses separately and subtract one total from the other to get your net short-term capital gain or loss.

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).

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. However, as explained in Chapter 11 under *Section 1231 Property*, your gains and losses from sales and exchanges of your farmland and depreciable properties must be considered together with certain other transactions to determine whether the gains and losses are treated as capital or ordinary gains and losses.

Nontaxable Exchanges

Certain exchanges are nontaxable. 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.

Like-Kind Exchanges

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.

Qualifying property. You must hold the property you exchange for productive use in a trade or business, such as a farming business, or for investment. The exchange must be for property to be held for the same purpose. 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.

The basis of property acquired in an exchange is explained under *Other Basis* in Chapter 7.

Like property. There must be an exchange of like property. A trade of a truck for a tractor is an exchange of like-kind property, and so is a trade of timberland for crop acreage. A trade of a tractor for acreage, however, is not an exchange of like-kind property. Neither is the trade 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 may 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. Neither of the farmers are 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 trade your property for like-kind property and also receive money or unlike property in the exchange, gain on the exchange is taxable 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 farmland that cost you \$3,000 for \$1,000 cash and other land to be used in farming with a fair market value of \$5,000. You have a gain of \$3,000, but only \$1,000, the cash received, is taxable. If, instead of money, you received a tractor with a fair market value of \$1,000, your taxable gain is still limited to \$1,000, the value of the tractor.

Example 2. Assume in Example 1 that the fair market value of the land you received was only \$1,500. Your \$500 loss is not deductible.

Money paid or unlike property given up. If you trade property for like-kind property and also pay money in the exchange, you have no taxable gain or deductible loss. The money is additional investment in the property acquired.

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.

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, they are generally taxable.

Receipt of title from third party. If you received 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 the requirements.

For example, you enter into a contract with Jim Smith to transfer property that you use in your business in exchange for property of a like kind. Jim goes to a third party to buy like-kind property within the 45-day time limit. Jim transfers the like-kind property to you and directs the third party to give you the title. This transaction qualifies as a like-kind exchange for you.

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 which 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.

Identification requirement. The property must meet the identification requirement. The property to be received must be identified on or before the day that is 45 days after the date you transfer the property given up in the exchange. The identification requirement may be met by designating the property to be received in the contract between the parties. The identification requirement will also be met if the contract specifies a limited number of properties that may be transferred and the particular property to be transferred will be determined by contingencies beyond the control of both parties.

Completed transaction requirement. The exchange must meet the completed transaction requirement. The property must be received on or before the earlier of:

- The 180th day after the date on which you transfer the property given up in the exchange, or
- The due date, including extensions, for your tax return for the tax year in which the transfer of the property given up occurs.

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 ordinary income because of depreciation on Form 4797. See Chapter 11 for more information.

For more information on like-kind exchanges, see *Like-Kind Exchanges* under *Nontaxable Exchanges* in Chapter 1 of Publication 544.

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 you, as a farmer-producer, to protect yourself from the risk of unfavorable price fluctuations, 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. Thus, any profit or loss on the hedge is entered on line 10 of Schedule F.

Moreover, the gain or loss on transactions that hedge the purchase of a noninventory supply 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 taxable year that ended before July 18, 1994, and that, as of September 1, 1994, were still open for assessment of tax. See Regulation section 1.1221-2(g)(3) for details.

If you have numerous transactions in the commodity futures market during the year, the burden of proof is on you 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 exceptions, see Regulation section 1.1221-2(g).

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.

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, other than 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 1994, 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 1993. 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, 1994, for \$1,250. Expenses of sale were \$125. The cow was bought July 2, 1991, 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
Gain realized	\$ 584

Converted Wetland and Highly Erodible Cropland

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. This rule is effective for dispositions of land converted to farming use after March 1, 1986.

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 by any other person who used the land at any time after conversion for farming purposes.

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 income or loss. It is reported in the gross receipts/sales and cost of goods sold lines of your return.

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.

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., may be entered as ordinary farm income and expenses on Schedule F (Form 1040).

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

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

Timber cutting treated 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 choose to treat the cutting of timber as a sale or exchange 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 income or loss.

Qualifying for treatment under this rule. For your timber to qualify for 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,
- 2) Cut the timber for sale or use it in your trade or business, and
- 3) Elect to treat the cutting of timber as a sale or exchange of property used in a trade or business (regardless of whether the timber is includible in inventory or held primarily for sale to customers).

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. You may revoke an election you made for a tax year beginning after 1986 only if you can show undue hardship and obtain the consent of the Internal Revenue Service (IRS). A revocation prevents you from again making this election except with the consent of the IRS.

Special revocation. A special rule for an election you made for a tax year beginning before 1987 allows you to revoke the election

for any tax year ending after 1986 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 is being made of the election to treat the cutting of timber as a sale or exchange under IRC section 631(a),
- 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 1994, you have owned 4,000 MBF (1,000 board feet) of standing timber for more than 12 months. It has an adjusted basis for depletion of \$40 per MBF. You are a calendar year taxpayer. On January 1, 1994, the timber had a fair market value of \$120 per MBF. It was cut in April for sale. On your 1994 tax return, you elect to treat the cutting of the timber as a sale or exchange. You report the difference between the fair market value 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, 1994	\$480,000
Minus: Adjusted basis for depletion	160,000
Section 1231 gain	\$320,000

The fair market value would then become your basis of the timber cut, and a later sale of the timber cut, including any byproduct or tree tops, would result in ordinary income or loss.

Cutting contract. If you own standing timber and dispose of it under a cutting contract wherein you retain an economic interest in the timber, you must treat the disposal as a sale or

exchange if you held the timber for more than 1 year before its disposal.

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 choose to treat the date of payment as the date of disposal. You can revoke the election by attaching a statement to the tax return for the tax year that the election is to be effective.

Owner. An owner is any person who owns an economic interest in the timber, including a sublessor and the holder of a contract to cut timber.

Economic interest. This means you acquired an investment interest in standing timber and get, by any form of legal relationship, income from cutting that timber, for a return of your capital investment.

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 byproducts. Gain from the sale of stumps in lots or tonnage by such operators is taxed as ordinary income.

Coal and Iron Ore

If you own, for more than 1 year, coal (including lignite) or iron ore mined in the United States, and dispose of it under a contract in which you retain an economic interest in the coal or iron ore, gain or loss is generally treated in the same manner as for timber sold under a cutting contract, explained previously. The disposition is treated as a sale of section 1231 property. For this rule, the date the coal or iron ore is mined is considered the date of its disposal.

You are considered an **owner** if you own or sublet an economic interest in the coal or iron ore in place. If you own merely an option to purchase the coal in place, you do not qualify as an owner. If you are a co-adventurer, partner, or principal in the mining of coal or iron ore, these rules do not apply to the income you realize from the mining operation.

You have an economic interest if you have a legal interest in minerals in place and you have the right to income from the extraction and sale of the mineral, to which you must look for a return of your capital. More than one party may have an economic interest in a mineral deposit if each qualifies. If you have no legally enforceable right to share in the minerals in place, you do not have an economic interest in that mineral.

Gain or loss. Your gain or loss is the difference between the amount realized from disposal of the coal or iron ore and the adjusted basis you use to figure cost depletion (increased by certain expenditures not allowed as deductions for the tax year). This amount is included on Form 4797 along with your other section 1231 gains and losses.

The expenses of making and administering the contract under which the coal or iron ore was disposed and the expenses of preserving the economic interest retained under the contract are not allowed as deductions in figuring taxable income. Rather, their total along with the adjusted depletion basis is deducted from the amount received to determine the gain. If the total of these expenses plus the adjusted depletion basis is more than the amount received, the result is a loss.

Sale of a Farm

The sale of your farm usually will involve the sale of both nonbusiness property (your residence) 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 residence. 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 *Your personal residence*, 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 a residence, which you have owned since December 1990, and realize gain as follows:

	Farm with residence	Resi- dence only	Farm without residence
Selling price	\$182,000	\$58,000	\$124,000
Cost (or other basis)	40,000	10,000	30,000
Gain	\$142,000	\$48,000	\$ 94,000

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 the residence is a capital gain. This gain is taxable unless you purchase or build another residence for at least \$58,000 within the required period of time or can exclude the gain as explained later under *Gain on sale of residence*.

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 personal residence is on the farm, you must properly adjust the basis to exclude those costs from your farm asset costs, as discussed next.

Your personal residence. Your personal residence 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 the residence. Your residence includes the immediate surroundings and outbuildings relating to it.

If you use a part of your residence for business, appropriate adjustment to the basis must be made for depreciation allowed or allowable. For more information on basis, see *Allocating the Basis* in Chapter 7.

Gain on sale of residence. When you have a gain on the sale of your residence, 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 residence that you purchase at a cost equal to or more than the adjusted sale price of your old residence.

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 residence 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 residence, 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 personal residence. You cannot deduct a loss on your personal residence from a voluntary sale, condemnation, or a sale under threat of condemnation.

For more information on selling your home, see Publication 523.

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 (discussed next). This is true even if the property is voluntarily returned to the lender.

Gain or loss on foreclosure or repossession. The borrower's gain or loss from the foreclosure or repossession described previously 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 of the transferred property and the amount realized. If the transferred property is a capital asset, the owner's gain or loss is a capital gain or loss. If the property is not a capital asset, the gain or loss is an ordinary gain or loss, unless the property can be treated as a capital asset. See *Capital Assets* and *Noncapital Assets* earlier.

Report taxable gains and deductible losses on nonbusiness property on Schedule D (Form 1040). Report any gain from the foreclosure or repossession of your personal residence on Form 2119. Report gains and losses on business property on Form 4797. See *How To Use Form 4797* in Chapter 11.

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 owner 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.

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.

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 *Repossessions* 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 the cancellation is intended as a gift, if the debt is qualified farm indebtedness (see Chapter 4) or qualified real property indebtedness (see Chapter 7 of Publication 334, *Tax Guide for Small Business*), or if you are insolvent or bankrupt (see Publication 908, *Tax Information on Bankruptcy*.)

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. If debt in excess of the property's value is canceled, the lender should also send you Form 1099-C showing your ordinary income from the cancellation. For foreclosures or repossessions occurring in 1994, these forms should be sent to you by January 31, 1995.

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. 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. However, you may not deduct any loss from abandonment of your personal residence or other property held for personal use.

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 the cancellation is intended as a gift, if the debt is qualified farm indebtedness (see Chapter 4) or qualified real property indebtedness (see Chapter 7 of Publication 334, *Tax Guide for Small Business*), or if you are insolvent or bankrupt (see Publication 908, *Tax Information on Bankruptcy*.)

Forms 1099-A and 1099-C. If your abandoned property is secured by 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. If your debt is canceled, the lender should also send you Form 1099-C showing your ordinary income from the cancellation. For abandonments of property and debt cancellations occurring in 1994, these forms should be sent to you by January 31, 1995.

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.

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

- 534** Depreciation
- 544** Sales and Other Dispositions of Assets

Form (and Instructions)

- 4255** Recapture of Investment Credit
- 4797** Sales of Business Property

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 and subject to section 1231 treatment. 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.

In a disposition of depreciable section 1231 property, you figure any ordinary gain from the deduction of depreciation first by using the rules discussed later under *Depreciation Recapture on Personal Property* or *Depreciation Recapture on Real Property*. Any remaining gain is included in the section 1231 computation in Part I of Form 4797.

Sales or Exchanges

Sales or exchanges of the following types of property may result in gain or loss subject to section 1231 treatment.

Cattle and horses held for draft, breeding, dairy, or sporting purposes and held 24 months or longer from the date you acquired them.

Livestock (except cattle, horses, and poultry) held for draft, breeding, dairy, or sporting purposes and held 12 months or longer.

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 section 197 intangibles.

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 or land clearing expenses, explained later.

Unharvested crops on land used in farming if the crop and land are sold or exchanged at the same time and to the same person and if 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).

Timber, or coal or iron ore (discussed in Chapter 10) disposed of under a contract in which you retain an economic interest in the coal or iron ore.

Property held for the production of rents or royalties.

Your distributive share of partnership gains and losses from the sale or exchange of previously listed property held more than 1 year, or for the required period for certain livestock, except for gain attributable to depreciation as explained later.

Other dispositions. Dispositions that may result in gain or loss subject to section 1231 treatment—

Condemnations. The gain or loss on condemnations (property condemned for public use) 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. See *Condemnation* in Chapter 13.

Casualty and theft gains and losses on property 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.

If you trade property for unlike property. Property you trade for unlike property or for services, will generally result in a taxable transaction. (Like-kind property exchanges are discussed under *Nontaxable Exchanges* in Chapter 10.) To determine gain or loss, the fair market value of the property or services you receive is the amount received for your property. A taxable transaction will give rise to ordinary gain or loss if you trade an ordinary asset, such as a load of corn given in exchange for

farm labor, and you generally will have a capital gain or loss if you trade a capital asset in a taxable exchange. If you trade property used in your farm business in a taxable transaction, your gain or loss is a section 1231 gain or loss.

Treatment of gains and losses. A gain or loss on the sale or other disposition of section 1231 property may be a capital gain or loss or an ordinary gain or loss. Net section 1231 gain for the tax year is the excess of section 1231 gains over section 1231 losses. If you have a net section 1231 gain, your gains and losses are treated as long-term capital gains or long-term capital losses, unless you have nonrecaptured section 1231 losses. (See next discussion.) A net section 1231 loss is the excess of section 1231 losses over section 1231 gains. 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 1991, you had a net section 1231 loss of \$2,500. For tax years 1993 and 1994, you had net section 1231 gains of \$1,800 and \$2,000, respectively. In figuring taxable income for 1993, 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. In 1994, you apply your remaining \$700 net section 1231 loss (\$2,500 – \$1,800) against your net section 1231 gain of \$2,000. For 1994, 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.

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 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.

See *Modified Accelerated Cost Recovery System (MACRS)* in Chapter 8 for a discussion of depreciation under the modified accelerated cost recovery system (MACRS).

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 taken 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 depreciation and amortization adjustments on:

Property you exchanged for, or converted to, your section 1245 property in a like-kind exchange or involuntary conversion, and

Your section 1245 property, 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 taken 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 receive property as a gift, the recomputed basis includes any depreciation or amortization adjustments of 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; and
 - 5) The amount of any basis reduction for the investment credit (less the amount of any basis increase for any credit recapture)

Example. In February 1992, you purchased and placed in service for 100% use in your farming business a light-duty truck (5-year property) with an adjusted basis of \$10,000. You file your return on a calendar year. You use the half-year convention and figure your MACRS deductions for the truck were \$2,000 in 1992 and \$3,200 in 1993. You did not take the section 179 deduction on it. The MACRS deduction in 1994, the year of sale, is \$960 (1/2 of \$1,920). You sell the truck in May 1994 for \$7,000. Your adjusted basis is \$3,840 (\$10,000 minus \$6,160). Your recomputed basis is \$10,000 (\$3,840 plus \$6,160). The amount you treat as ordinary income is the **lower** of the following:

- 1) Recomputed basis (\$10,000) minus the adjusted basis (\$3,840), or \$6,160, **or**
- 2) Amount realized (\$7,000) minus the adjusted basis (\$3,840), or \$3,160.

The lower of these two amounts, \$3,160, is the amount of gain treated as ordinary income. Figure this amount in Part III, Form 4797.

Section 1231 gain. Any gain realized that is more than the ordinary income part is a section 1231 gain. As such, it is subject to the rule on nonrecaptured net section 1231 losses for determining whether all or part of the section 1231 gain is treated as long-term capital gain or ordinary income. 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 **productive 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. Show these expenses as depreciation on line 24, Part III, of Form 4797. To figure the amount of these expenses, you may use the farm-price method or the unit-livestock-price method discussed in Chapter 3.

For livestock costs incurred prior to 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 *Depreciation Recapture on Personal Property* 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 (discussed later). 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.

Generally, the deductions taken under ACRS are treated as ordinary income under section 1245, except for the following properties which are treated as section 1250 property if the property was placed in service before 1987:

- 1) 15-year, 18-year, or 19-year real property and low-income housing that is residential rental property,
- 2) 15-year, 18-year, or 19-year real property and low-income housing that is used mostly outside the United States,
- 3) 15-year, 18-year, or 19-year real property and low-income housing on which the alternate ACRS method of depreciation is taken, and
- 4) Low-income housing property.

The ordinary income rules for dispositions of section 1250 property do not apply to an item of property if:

- 1) You figure depreciation for the property using the straight line method or any other

method that does not result in depreciation in excess of 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 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 December 31, 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, and
- 3) Multiply the smaller of (1) or (2) by the applicable percentage, discussed later. If any gain is left after following this procedure, (that is, if (1) is more than (2)) then:
- 4) Figure the additional depreciation for periods after 1969 but before 1976,
- 5) Multiply the smaller of the remaining gain ((1) less (2)) or (4) by the applicable percentage (discussed later), and
- 6) Add the results from (3) and (5) to arrive at the gain that is to be treated as ordinary income.

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. Treat any basis reduction for investment credit as part of your actual depreciation adjustment (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 these types of real property are as follows.

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.

Low-income housing. See Chapter 4 in Publication 544.

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.

Additional 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 remainder 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 farmland for which you were allowed deductions for:

Soil and water conservation expenditures or land clearing expenditures (section 1252 property), and

Property for which you were allowed to exclude from income certain cost sharing payments (section 1255 property).

Farmland (under section 1252). If you had a gain on the disposition of farmland that you held less than 10 years, on which you were allowed deductions for soil and water conservation expenditures discussed in Chapter 6, or land clearing expenditures (for amounts paid or incurred before 1986), you must report a specified 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 and land clearing 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 farmland 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 farmland on January 19, 1987. On October 3, 1994, you sold the land at a \$30,000 gain. Between January 1 and October 3, 1994, you make soil and water conservation expenditures of \$15,000 that are fully deductible in 1994. 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 report a certain 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.

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. This section does apply to the extent such gain is recognized as ordinary income under sections 1231 through 1254, 1256, and 1257 of the Internal Revenue Code. However, this section applies to 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.

How To Use Form 4797

Form 4797 consists of four related parts (see the illustrated form in Chapter 20). 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.

12. Installment Sales

Introduction

Some sales are made under arrangements that provide for part or all of the selling price to be paid in a later year. These sales are called "installment sales."

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: a Sold at a gain b Sold at a loss c Raised livestock sold at a gain	Held less than 24 mos. Part II Part II Part II	Held 24 mos. or more 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: a Sold at a gain b Sold at a loss c Raised livestock sold at a gain	Held less than 12 mos. Part II Part II Part II	Held 12 mos. or more Part III (1245) Part I Part I

The buyer's "installment obligation" to make future payments to you might be in the form of a contract for deed, deed of trust, note, land contract, mortgage, or other evidence of the buyer's indebtedness 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
- Installment payments
- 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

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. However, a cash basis farmer who is not required to maintain inventories can use the installment method to report gain from property held for sale. If you finance the buyer's

purchase of your own property, instead of having the buyer get a loan or mortgage, you probably have an installment sale. However, 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 only as you actually receive payment. Each payment consists of three parts:

- 1) Return of your investment (basis) in the property sold,
- 2) Gain on the sale, and
- 3) Interest.

You are taxed only on the part of each payment that represents interest and your profit on the sale. In this way, the installment method of reporting income relieves you of paying tax on income that you have not yet collected. However, for a sale of depreciable property, you must report in the year of sale any depreciation recapture income up to the amount of the gain. Only the gain in excess of the recapture amount is taken into account under the installment method.

Sale at a loss. If your sale results in a loss, you may not 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.

Installment sale form. 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 usually 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. See *Dispositions of Installment Obligations* in Publication 537.

Cancellation of installment obligation. 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 you cancel it. (A reduction in the selling price changes the gross profit and gross profit percentage.) See Publication 537 for information on the disposition of installment obligations.

Installment obligation transferred because of death. If an installment obligation is transferred as a result of the death of the seller (or other holder of the obligation), the transfer is not treated as a disposition of the obligation. Any unreported gains from the installment obligation are not treated as income to the decedent. No income is required to be reported on the decedent's return due to this transfer. This means that whoever receives the obligation as a result of the holder's death is taxed on the payments as the seller or other holder would have been if the holder lived to receive 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 of the seller must figure gain or loss on the disposition.

For information on disposition of installment obligations, 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 you are not required to maintain an inventory under your method of accounting, 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 Inventories* 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 have an agreement, each payment must be allocated between the inventory and the other assets sold.

Electing out. You must report an installment sale using the installment method unless you elect not to use that method. If you make this election, you will generally report the entire gain in the year of sale. Do this even though you will not be paid all of the selling price until

later. You then do not have to report any gain from the payments you receive in later years.

If you want to make this choice, do not report your sale on Form 6252. Instead, report it on Schedule D (Form 1040) or Form 4797, whichever is appropriate.

When to elect out. Make the election not to have the installment method apply 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 changed.

Note: You must continue to report the interest income on payments you receive for subsequent years.

You may qualify for an automatic extension of six months from the due date of the return, **excluding extensions**, to make this election. You can read the full text of the provision, Revenue Procedures 92-85 and 93-28, at most IRS offices and at many public libraries. See *Electing Out* in Publication 537 for more information on choosing not to use the installment method.

Figuring Installment Income

Each year that you receive payment, you include in income the interest part of the payment as well as the part of the payment that is your gain. You do not include in income the part of the payment that is the return of your basis in the property.

Interest income. You must report interest as ordinary income. Interest is generally not included in a downpayment. 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.

Gain. The rest of each payment is treated as if it were made up of two parts. One part is a return of your investment (basis) in the property you sold. The other part is your gain. The gain is capital gain if the property you sold was a capital asset. However, if you took depreciation deductions on the asset, part of your gain may be treated as ordinary income. See *Gain reported in year of sale*, later in this chapter for more information.

To determine what part of a payment is gain, multiply the payment by the gross profit percentage. The gross profit percentage is figured by dividing the gross profit (gain) on the sale by the contract price.

The following worksheet gives the basic items you must know to figure the gross profit percentage.

1) Selling price	_____
2) Minus the sum of:	
Basis of property sold ...	_____
Selling expenses	_____
3) Gross profit (line 1 less line 2)	_____
4) Contract price	_____
5) Gross profit percentage (line 3 divided by line 4)	_____

The following paragraphs discuss the items on the above worksheet.

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.

Selling price reduced. If the selling price is reduced at a later date, the gross profit on the sale will also change. You must then refigure the gross profit percentage for the remaining payments. Refigure your gross profit using the 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 1992, you sold land with a basis of \$40,000 for \$100,000 and had a gross profit of \$60,000. You received a \$20,000 downpayment and the buyer's note for \$80,000. The note provides for four annual payments of \$20,000 each, plus 12% interest, beginning in 1993. Your gross profit percentage is 60%. You reported a gain of \$12,000 on each payment received in 1992 and 1993. In 1994, you and the buyer agreed to reduce the purchase price to \$85,000 and payments during 1994, 1995, and 1996 are reduced to \$15,000 for each year.

Your adjusted gross profit on the sale is \$45,000. You subtract the total profit reported in 1992 and 1993, or \$24,000, from the adjusted gross profit to determine the remaining profit to be reported. The remaining gain to be reported (\$21,000) is divided by the remaining selling price to be received of \$45,000, to get the new gross profit percentage of 46.67%. You will report a gain of \$7,000 on each of the \$15,000 installments due in 1994, 1995, and 1996.

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 bought is usually its cost to you. The basis of property you inherited, got as a gift, built yourself, or received in a tax-free exchange is figured differently. While you own personal property, various events may change your original basis in the property. Some events, such as

additions or permanent improvements, increase basis. Others, such as deductible casualty losses, decrease basis. The result is called adjusted basis.

The adjusted basis plus selling expenses and depreciation recapture income is referred to in this chapter as the **installment sale basis**.

Gross profit. For an installment sale, gross profit is the amount of gain you report on the installment method. It is the total amount of your gain from the sale minus:

- 1) The amount of gain you must report as ordinary income in the year of sale because of depreciation recapture income (including the section 179 deduction you claimed), and
- 2) The amount of gain you can postpone or exclude on the sale of your home.

To figure your gross profit, subtract the installment sale basis from the selling price. If the property you sold was your home, also subtract 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*, later.

If the selling price is partly payable in cash, with the remainder secured by a mortgage payable from the buyer to you, 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. This percentage usually remains the same for each payment you receive. It is called the **gross profit percentage** and is figured by dividing your gross profit from the sale by the contract price.

Example. You sell property at a contract price of \$200,000, and your gross profit is \$50,000. Your gross profit percentage is 25% (\$50,000 divided by \$200,000). Therefore, 25% of each principal payment, including the downpayment, is reported as your gain from the sale for the tax year the payment is received.

Income from sale. 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.

Gain reported in year of sale. For sales of depreciable property, 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. You cannot use the installment method to report the gain that is equal to the recapture income. Any gain that exceeds the recapture income can be reported on the installment

method. 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.

Installment sales to related persons. Special rules apply if you sell property that you report under the installment method to a related person who then sells or otherwise disposes of the property within two years of the first disposition and before making all the payments on the first disposition. Spouses, children, grandchildren, brothers, sisters, and parents are all considered related persons. A partnership or corporation that you have an interest in, or an estate or trust that you have a connection with, can also be considered a related person. For more information, see *Installment Sales to Related Persons* in Publication 537.

Trading property 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 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 must not include 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

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 downpayment and each later payment of principal on the buyer's debt to you. The sum of all these payments is the contract price.

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 takes over or pays off any of your debts, such as a loan, or any of your expenses, such as a sales commission.

Buyer assumes expenses. If the buyer assumes and pays your expenses from selling your property, it is considered a payment to you in the year of sale. Include these expenses in both the selling and the 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 it, 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 that you will directly collect from the buyer.

Example. You sell property with a basis to you of \$19,000. You have selling expenses of \$1,000. The buyer assumes your existing mortgage of \$15,000 and agrees to pay you a total of \$10,000 (a cash downpayment 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). The contract price is \$10,000 (\$25,000 – \$15,000 mortgage). Your gross profit is \$5,000 (\$25,000 – \$20,000 (installment sale basis)), and your gross profit percentage is 50% (\$5,000 divided by \$10,000). Therefore, you report half of each \$2,000 payment you receive 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 in excess of 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. To this amount, add 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. Therefore, 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)	
Add:		
Mortgage	6,000	
Minus: 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>

Therefore, 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. If the buyer pays off 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 a part of it may have to be treated as a payment. Compare the amount of 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. This follows the same rules discussed earlier under *Mortgage assumed*.

However, these rules apply only to two types of debts that the buyer assumes:

- 1) Those you acquired from your ownership of the property you are selling, such as a mortgage, lien, overdue interest, or back taxes, and
- 2) Those you 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.

Payments 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 the 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, the value assigned to property in your agreement with the buyer is good evidence of its fair market value.

Third-party notes. 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 downpayment, the buyer assigned 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, and 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 divided by \$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.

Bonds. A bond or other evidence of indebtedness 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 section 15A.453-1(e)(2) of the Income Tax Regulations.

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 both selling price and contract price. Payments you receive on the note are reported on the installment method.

Guarantees. 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.

Deposits. Deposits that you receive before the year of sale are treated as payments in the year of sale if, under the contract, they become part of the downpayment.

Unstated Interest

An installment sale 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 that is provided for in the contract is referred to as **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 or imputed interest**.

When the stated interest rate in the contract is lower than the applicable federal rate, the unstated interest is the difference between the federal rate of interest and any interest specified in the sales contract.

The applicable federal rates are published monthly by IRS in the Internal Revenue Bulletin.

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.

The unstated interest reduces the stated selling price of the property. It also increases the seller's interest income and the buyer's interest expense.

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. The sale generally includes the sale of real and personal property that may be reported on the installment method. It also may include farm inventory which cannot be reported under the installment sale method. See *Inventory*, earlier. The selling price must be broken down 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 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.

Example. On January 3, 1994, 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 farmland. The total selling price was \$300,000. The note payments of \$25,000 each, plus adequate interest, were due July 1 and January 1. Your selling expenses were \$15,000.

The adjusted basis and depreciation claimed on each asset sold are as follows:

Asset	Depreciation Claimed	Adjusted Basis
Home		\$30,000
Farmland		61,250
Buildings	\$31,500	28,500
Fences	4,200	300
Cattle held 2 years or more	19,167	833
Equipment	15,811	9,189
Tractor	15,811	9,189
Cattle held less than 2 years	1,977	2,023

The assets included in the sale, their selling prices based on their respective values, the selling expenses allocated to each asset, their adjusted basis, and gain are shown in the following schedule. The selling expense for each asset is 5% of the selling price (\$15,000 selling expenses divided by \$300,000 selling price). You sold the livestock and produce held for sale before the end of 1993 in anticipation of selling the farm. You also did not take a section 179 deduction for any of the assets.

	Selling Price	Selling Expense	Adjusted Basis	Gain
Home	\$ 50,000	\$ 2,500	\$ 30,000	\$ 17,500
Farmland	125,000	6,250	61,250	57,500
Buildings	55,000	2,750	28,500	23,750
Fences	5,000	250	300	4,450

Cattle*	20,000	1,000	833	18,167
Equipment	17,000	850	9,189	6,961
Tractor	23,000	1,150	9,189	12,661
Cattle**	5,000	250	2,023	2,727
	<u>\$300,000</u>	<u>\$15,000</u>	<u>\$141,284</u>	<u>\$143,716</u>

* Held 2 years or more

** Held less than 2 years

The buildings are section 1250 property. There is no depreciation recapture income because the buildings were depreciated using the straight line method. See Chapter 11 for more information on depreciation recapture.

The fences are section 1245 property. All the depreciation of \$4,200 on the fences is depreciation recapture income because it is less than the gain on the fences. The remaining gain of \$250 can be reported on the installment method.

The cattle, which were used for breeding and were held for more than 2 years, are 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 equipment and tractor are section 1245 property. The full gain on each (\$6,961 and \$12,661, respectively) is depreciation recapture income.

The cattle that were held for less than 2 years (also used for breeding) 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 total depreciation recapture income reported in Part II of Form 4797 is \$43,966. (This is the sum of: \$4,200+\$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 fences and the cattle held less than 2 years (\$4,200 and \$1,977) is added to their adjusted basis when making the installment sale computations.

The \$60,000 of the \$300,000 total selling price, which represents the selling price of the cattle held 2 years or more, the equipment, and the tractor is removed from the total selling price because the gain on these items is fully reported in the year of sale. The selling price for the installment sale is \$240,000.

The assets included in the installment sale, their selling price, their "installment sale basis," and the gross profit on each are shown in the following table.

	Selling Price	Installment Sale Basis	Gross Profit
Home	\$ 50,000	\$ 32,500	\$ 17,500
Farmland	125,000	67,500	57,500
Buildings	55,000	31,250	23,750
Fences	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

The gain on the home is reported as capital gain unless you can postpone or exclude all or part of the gain. For more information, see *Your personal residence* in Chapter 10.

Since the ordinary income part of the gain on the fences is reported in the year of sale, the remaining gain (\$250) and the gain on the land and buildings is reported as section 1231 gain. Since the cattle were held for less than 2 years, they do not qualify as section 1231 property. Therefore, all of the \$750 gain is reported as ordinary income. See Chapter 11 for the definition of section 1231 property.

For reporting on the installment method, the contract price is \$190,000. 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).

The gross profit percentages (gross profit divided by the contract price) for the assets are figured as follows:

	Percentage
Home (\$17,500 ÷ \$190,000)	9.2105
Farmland (\$57,500 ÷ \$190,000)	30.2632
Buildings (\$23,750 ÷ \$190,000)	12.5
Fences (\$250 ÷ \$190,000)	0.1316
Cattle held less than 2 years (\$750 ÷ \$190,000)	0.3947
Total	<u>52.50</u>

To determine the gain for each asset, multiply the amount received under the installment method by the gross profit percentage. The amount received under the installment method is 76% of each payment. You get this percentage by dividing the installment method contract price (\$190,000) by the total amount to be received (\$250,000).

The total \$75,000 received in 1994 is the downpayment of \$50,000 and the July 1 installment of \$25,000. Only 76% of \$75,000, or \$57,000, is the amount received under the installment method.

	Income
Home—9.2105% of \$57,000	\$ 5,250
Farmland—30.2632% of \$57,000	17,250
Buildings—12.5% of \$57,000	7,125
Fences—0.1316% of \$57,000	75
Cattle held less than 2 years—0.3947% of \$57,000	225
Total installment income for 1994	<u>\$29,925</u>

The installment sale must be reported on Form 6252. The amounts from Form 6252 are then reported on Form 4797 and Schedule D (Form 1040). The computations shown in the example would be included in schedules, as needed, and attached to Form 6252. 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. The gains on the land, buildings, and fences are section 1231 gains and may be reported as capital gain or ordinary gain when combined with certain other gains and losses. In the year of sale, you must also report on Form 4797 the total depreciation recapture income. See *How To Use Form 4797*, in Chapter 11. The \$225 gain on the cattle held less than 2 years is

ordinary income reported in Part II of Form 4797.

You figure installment *income for years after 1994* by applying the same gross profit percentages to the payments you receive each year on the buyer's note. If you receive \$38,000 (76% of \$50,000) on the installment sale during the year, you will realize income for that year as follows:

	Income
Home—9.2105% of \$38,000	\$ 3,500
Farmland—30.2632% of \$38,000	11,500
Buildings—12.5% of \$38,000	4,750
Fences—0.1316% of \$38,000	50
Cattle held less than 2 years—0.3947% of \$38,000	150
Total installment income	<u>\$19,950</u>

For each year in which you receive payments, you will report the gain on the sale of your home as long-term capital gain and the gain on the cattle held less than 2 years as ordinary income. Your section 1231 gains must be combined with certain other gains and losses in each of the later years to determine whether you report them as ordinary or capital gains. The interest received with each payment is included in full as ordinary income. For more information, see *How To Use Form 4797*, in Chapter 11.

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	<u>140,250</u>
Gross profit	<u>\$ 99,750</u>
Gain reported in 1994 (year of sale)	\$ 29,925
Gain reported in 1995, \$38,000 × 52.50%	19,950
Gain reported in 1996, \$38,000 × 52.50%	19,950
Gain reported in 1997, \$38,000 × 52.50%	19,950
Gain reported in 1998, \$19,000 × 52.50%	9,975
	<u>\$ 99,750</u>

13.

Casualties, Thefts, and Condemnations

Important Reminder

Disaster losses to principal residences. If your principal residence or any of its contents were damaged by a disaster in an area declared by the President of the United States to be eligible for federal disaster assistance:

- 1) You need not recognize gain from insurance proceeds for unscheduled personal property that was part of the contents of your damaged residence, and
- 2) You may treat any other insurance proceeds from your damaged residence or its contents as a common pool of funds.

For more information, see *Disaster losses to principal residences*, 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 on your federal income tax return.

An **involuntary conversion** occurs when you receive money or other property, such as insurance proceeds or a condemnation award, 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
- 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** Nonbusiness Disasters, Casualties, and Thefts

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

Casualties and Thefts

If your property is destroyed, damaged, or stolen, you may have a deductible loss. If the insurance or other reimbursement is more than the adjusted basis of the destroyed, damaged, or stolen property, you may have a 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 may not.

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 of property raised or bought for sale by omitting the item from the closing inventory for the year of the loss. You cannot take a separate deduction.

Livestock, produce, and crops raised for sale.

Losses of livestock, produce, and crops raised for sale are not deductible if you report on the cash method. You have not included the value of the items in income. You have already deducted these items as farm expenses.

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. Do not take a separate deduction.

Damage to crops. Damage to crops, whether or not covered by insurance, are not deductible 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 for 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.

However, if you sell the timber downed by a casualty, treat the proceeds from the sale as a reimbursement. If you use the proceeds to buy replacement property, it can qualify for postponement of gain. See *Replacement Property*, 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.

Other Losses

The deductibility of losses resulting from a casualty or theft to your property held for personal use and other related items are discussed next.

Property held for personal use. Casualty and theft losses of property held for personal use may be deductible on your federal income tax return. Examples of these losses are fire damage to your home, furniture, car, clothing, or other personal property, and storm damage to trees and shrubbery, including ornamental ones. You may also be able to deduct losses from theft.

A casualty or theft loss is generally one of the following amounts, whichever is less:

- 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.

However, there are two rules, discussed next, that apply to casualty or theft losses of property held for personal use that do not apply to business or other income-producing property.

\$100 rule. You may not deduct the first \$100 of loss from a casualty or theft of property held for personal use. 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 may deduct nonbusiness casualty or theft losses only to the extent your total losses during the year are greater than 10% of your adjusted gross income. This is the amount on line 31 of Form 1040. You must first reduce each separate casualty or theft loss by \$100.

Example. In June 1994, you discovered that your house was burglarized. This was your only casualty or theft loss during 1994. Your theft loss after insurance reimbursement was \$2,000. Your adjusted gross income for 1994 is \$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). When you apply the 10% rule, you find 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).

Note. If you have a nonbusiness 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:

- 1) Expenses related to a casualty or theft of property held for personal use, 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 nonbusiness 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 the decrease in the fair market value of your property or the adjusted basis of your property, whichever is less. Reduce this amount by any insurance or other reimbursement you receive or expect to receive. Figure the loss 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, however, 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	<u>1,000</u>	<u>15,000</u>
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	<u>600</u>	<u>6,000</u>
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, 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.

Real property owned for personal use. In figuring the loss to nonbusiness 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.

Example. You bought a farm in 1952 for \$20,000. The adjusted basis of the residential part is \$6,000. In 1994, 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 1994 is \$20,000. The trees were not covered by insurance.

1) Adjusted basis	<u>\$ 6,000</u>
2) Value before the storm	\$30,000
3) Value after the storm	<u>26,000</u>
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	<u>—0—</u>
7) Loss after reimbursement	\$ 4,000
8) Minus: \$100	<u>100</u>
9) Loss after \$100 rule	\$ 3,900
10) Minus: 10% of \$20,000	<u>2,000</u>
11) Deductible loss	<u>\$ 1,900</u>

Repair costs. You may 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 may 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 may 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 may 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 may deduct the difference when you determine that you cannot reasonably expect any more reimbursement.

Example. A collision with another car in 1993 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 1993. In January 1994, the court awards you a judgment of \$2,000. In July 1994, you can show with reasonable certainty that the other driver is totally without funds. You may claim a loss in 1994 of the amount that is more than \$100 and 10% of your 1994 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, 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 may choose to deduct that loss on your 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 original due date of your tax return for the year the disaster occurred, or
- 2) The due date of the preceding year's return, including extensions.

Disaster losses to principal residences. If your principal residence 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 need not recognize gain from insurance proceeds for unscheduled personal property that was part of the contents of your damaged residence, and
- 2) You may treat any other insurance proceeds for your damaged residence 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 residence or its contents, you may elect to recognize gain only to the extent that the amount of the pool of funds exceeds the cost of the replacement property.

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.

In addition, renters receiving insurance proceeds as a result of disaster damage to their property in a rented residence also qualify for relief to the extent the rented residence would be their principal residence if they owned it.

These rules apply to damaged property that resulted from a disaster for which a Presidential declaration was made on or after September 1, 1991, and to tax years ending on or after that date.

For more information, see Publication 547.

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.

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. Reduce your gain by your expenses to collect the reimbursement. However, you may 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. Its fair market value before the tornado struck was \$10,000. The fair market value after the tornado was \$2,000. 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) Value before tornado	\$10,000
3) Value after tornado	<u>2,000</u>
4) Decrease in value (2 minus 3)	<u>\$ 8,000</u>
5) Amount of loss (lesser of 1 or 4)	2,500
6) Insurance received	<u>4,000</u>
7) Gain (6 minus 5)	\$ 1,500
8) Expenses to collect insurance	<u>200</u>
9) Gain on casualty	<u><u>\$ 1,300</u></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. For information on how to treat a gain or a loss due to these events, see the earlier discussion on *How To Figure a Loss*, and *Postponing Gain*, later.

Condemnation

Condemnation is the legal process of taking private property, without the owner's consent, for public use. The federal government, a state government, a political subdivision, or a private organization with the legal power can take

property. The owner receives money or property for the property taken.

Threat of condemnation. Treat the sale of your property under threat of condemnation as a condemnation.

Personal residence. You may 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.

For more information on condemnations, see Publication 544.

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 such occurrences as involuntary conversions.

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. You may be able to postpone for more than one year the gain from an involuntary conversion. 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 gain on 15 animals is a gain due to 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, other property, including real property used for farming purposes, will be treated 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 may 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 replacement property, it can qualify for postponement of gain.

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 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 may 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 will report 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 may not 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 may, 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. Carry your gains and losses from business property or property held for investment to Form 4797.

Schedule D (Form 1040). Report your gains from property held for personal use on Schedule D.

Schedule A (Form 1040). Report your losses from nonbusiness 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 file on the cash method and have not otherwise accounted for such losses.

14.

Alternative Minimum Tax

Important Reminder

Estimated tax. When you figure your estimated tax for 1995, you must include any alternative minimum tax you expect to owe. See Publication 505 for more information about estimated 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 reduce their regular tax to a small amount. To ensure that these taxpayers do not avoid significant tax liability, Congress enacted an additional tax — the alternative minimum tax (AMT).

This chapter discusses the AMT that applies to individuals. The AMT that applies to corporations is discussed in Publication 542.

Topics

This chapter discusses:

- Whether you need to fill in Form 6251
- Figuring AMT
- An example of AMT
- Credit for prior year minimum tax

Useful Items

You may want to see:

Publication

- 534** Depreciation
- 536** Net Operating Losses
- 929** Tax Rules for Children and Dependents

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.
- 4952** Investment Interest Expense Deduction
- 6251** Alternative Minimum Tax—Individuals

- 8615** Tax for Children Under Age 14 Who Have Investment Income of More Than \$1,200
- 8801** Credit for Prior Year Minimum Tax—Individuals, Estates, and Trusts

Do You Need to Fill In Form 6251?

In general, 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. Also, see *Child under age 14*, later. To see if you must file Form 6251 to show the IRS that you do not owe AMT, see *Do you need to attach Form 6251 to your return?* later.

Worksheet. If you are uncertain whether you need Form 6251, fill in the *Table 14-1* worksheet. However, if you claimed or received any of the items listed below, don't use the worksheet. Instead, fill in Form 6251.

- 1) Accelerated depreciation (depreciation in excess of straight-line).
- 2) Income from incentive stock options in excess of the amount reported on your return.
- 3) Tax-exempt interest from private activity bonds.
- 4) Intangible drilling costs.
- 5) Depletion.
- 6) Circulation expenditures.
- 7) Research and experimental expenditures.
- 8) Mining exploration and development costs.
- 9) Amortization of pollution-control facilities.
- 10) Income or loss from tax shelter farm activities.
- 11) Income or loss from passive activities.
- 12) Income from long-term contracts figured under the percentage-of-completion method.
- 13) Income from installment sales of certain property.
- 14) Interest paid on a home mortgage not used to buy, build, or substantially improve your home.
- 15) Investment interest expense reported on Form 4952.
- 16) Foreign tax credit.
- 17) Net operating loss deduction.

Most of these items are tax benefits (adjustments or tax preferences). Those items of interest to farmers are discussed later in this chapter.

You may have received these tax benefits directly, as a member of a partnership, as a shareholder in an S corporation, or as a beneficiary of an estate or trust.

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. _____

NEXT: If line 12 is more than the amount on Form 1040, line 38, complete Form 6251 to see if you owe the alternative minimum tax. If line 12 is equal to or less than the amount on Form 1040, line 38, **do not** fill in Form 6251.

Completing Form 6251

If you must complete Form 6251 for one of the reasons given earlier (including a filled-in *Table 14-1* that shows you must), keep in mind the following rules.

Partner, shareholder, or beneficiary. If you receive 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 AMT taxable income and tax preference items when you fill in Form 6251. These will be furnished to you on Schedule K-1 (Form 1041). See *Beneficiaries of Estates and Trusts* under *Part 1 — Adjustment and Tax Preference Items* later. The estate or trust may have to pay AMT on any remaining AMT taxable income.

Child under age 14. Form 6251 should be filled in for a child under age 14 if the total of the child's adjusted gross income from Form 1040, line 32, is more than the sum of \$1,000 plus the child's earned income.

Do you need to attach Form 6251 to your return? After you complete Form 6251, attach it to your return only if:

- You are liable for the AMT, or
- 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.

You must file Form 6251 even if you are not liable for the AMT if the total of lines 7 through 14 is negative and you would be liable for the AMT without taking those lines into account. This will help show us why you are not liable for the AMT.

Credits. In some cases, certain nonrefundable credits (listed below) are limited by your tentative minimum tax (defined later). Depending on the credit, this is the amount from either line 24 or line 26 of Form 6251. This limit may apply even if you do not owe AMT.

You can claim these nonrefundable credits only up to the amount by which your regular tax exceeds your tentative minimum tax. You cannot claim these credits to the extent their total reduces your regular tax liability below the amount of your tentative minimum tax. In some cases, any excess credit will be allowed as a carryback or carryover under the usual rules for that credit.

These nonrefundable credits are:

- Credit for child and dependent care expenses,
- Credit for the elderly or the disabled,
- Credit for fuel from a nonconventional source,
- Qualified electric vehicle credit,
- Orphan drug credit,
- Investment credit,
- Targeted jobs credit,
- Alcohol fuels credit,

- Research credit,
- Low-income housing credit,
- Enhanced oil recovery credit,
- Disabled access credit,
- Renewable electricity production credit,
- Empowerment zone employment credit,
- Indian employment credit,
- Employer social security credit for certain tips, and
- Mortgage interest credit.

The forms used to figure these credits have more details on how the limit applies to each credit.

Earned income credit. You must reduce any earned income credit you claimed on your return by the amount of your AMT.

Recordkeeping

Because of AMT adjustments, you may have a different AMT basis in certain property or in certain 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.

Form 6251

To figure AMT, complete Form 6251:

- 1) In Part I, figure the total amount of your adjustments for adjustment and tax preference items,
- 2) In Part II, figure your AMT taxable income, and
- 3) In Part III, determine your exemption amount and figure your AMT.

A completed sample Form 6251 is shown later in this chapter.

Part 1 — Adjustment and Tax Preference Items

To figure AMT taxable income, you must make certain adjustments to the taxable income shown on your return for tax benefit items (adjustment items and tax preference items). These adjustments are designed to eliminate the tax advantages of items that receive special tax treatment. The amount of the adjustment is generally the difference between a recomputed amount (for AMT) and the amount shown on the return.

This section discusses adjustments for the following adjustment and tax preference items:

- Standard deduction,

- Itemized deductions,
- Depreciation of tangible property placed in service after 1986,
- Adjusted gain or loss,
- Incentive stock options,
- Beneficiaries of estates and trusts,
- Accelerated depreciation of real property placed in service before 1987,
- Installment sales of certain property,
- Patron's adjustment,
- Tax shelter farm activities, and
- Related adjustments.

The following adjustments and tax preference items are discussed in the Form 6251 instructions:

- Passive activities,
- Tax-exempt interest from private activity bonds,
- Certain charitable contribution carryovers,
- Circulation expenditures,
- Depletion,
- Accelerated depreciation of leased personal property placed in service before 1987,
- Intangible drilling costs,
- Long-term contracts,
- Certain loss limitations,
- Mining exploration and development costs,
- Pollution control facilities placed in service after 1986, and
- Research and experimental expenditures.

Standard Deduction (Line 1)

You cannot claim the standard deduction in figuring your AMT taxable income. If you claimed the standard deduction on line 34 of Form 1040, enter that amount on line 1 of Form 6251.

Itemized Deductions (Lines 2 – 7)

If you itemized deductions on Schedule A (Form 1040), you must make the following adjustments.

Medical expenses (line 2). For regular tax purposes, you can deduct your medical expenses that are in excess of 7.5% of your adjusted gross income (AGI). For AMT purposes, a different limit applies. See Form 6251 and its instructions to figure the adjustment.

Taxes (line 3). You cannot claim an itemized deduction for taxes in figuring AMT taxable income. Enter on line 3 of Form 6251 the amount deducted on line 9, Schedule A. Do not include any generation-skipping transfer taxes.

Home mortgage interest (line 4). For AMT purposes, you cannot deduct interest on a home mortgage:

- Taken out after June 30, 1982, used for a purpose other than to buy, build, or substantially improve your main home or qualified dwelling that is your second home, or
- Taken out before July 1, 1982, and secured by property that, when you got the mortgage, was other than your main home or a qualified dwelling used by you or a member of your family.

A qualified dwelling is any house, apartment, condominium, or mobile home not used on a transient basis.

If you refinanced your mortgage after June 30, 1982, for an amount in excess of your original mortgage, you cannot deduct the interest related to the excess.

Enter on line 4 of Form 6251 the total included on lines 10, 11, or 12 of Schedule A for these home mortgage interest items.

Miscellaneous itemized deductions (line 5). For AMT purposes, you are not allowed to deduct any of your miscellaneous itemized deductions that are subject to the 2% limit. You must enter on line 5 of Form 6251 any deduction claimed on line 26, Schedule A.

Refund of taxes (line 6). Because you do not deduct taxes for AMT purposes, you also do not include refunds of taxes in your AMT taxable income. If you included a refund of taxes on line 10 (or line 21) of Form 1040, enter that amount on line 6 of Form 6251.

Investment interest (line 7). For AMT purposes, your investment interest deduction includes interest incurred to carry tax-exempt private activity bonds. The deduction limit is figured by including interest received from such bonds in your investment income, and by refiguring investment income, gains, and expenses to take into account all adjustments and tax preferences that apply.

You must refigure your investment interest deduction for AMT on a separate Form 4952. Follow the steps under *Line 7 — Investment interest* in the instructions for Form 6251. The difference between this refigured amount (line 8 of your AMT Form 4952) and the amount on line 8 of your regular tax Form 4952, is your AMT adjustment. Enter this difference on line 7 of Form 6251. If your AMT deduction is more than the regular tax deduction, enter the difference as a negative amount.

Depreciation of Tangible Property Placed in Service After 1986 (Line 8)

For AMT purposes, you must use the Alternative Depreciation System (ADS) to depreciate tangible property placed in service after 1986 (or after July 1986 if you elected to use MACRS). Depreciation using ADS is generally figured using the straight line method over a specified recovery period. However, to figure AMT depreciation on personal property (other than property depreciated for regular tax purposes under the straight line method), you must use the 150% declining balance method over the ADS recovery period. You switch to

the straight line method when it results in a higher deduction. ADS is explained in Chapter 3 of Publication 534.

If you depreciate property for regular tax purposes using the straight line method over a General Depreciation System (GDS) recovery period, you must figure AMT depreciation using the straight line method over an ADS recovery period.

Refigure the depreciation on any property that you depreciated under a method other than the AMT method for regular tax purposes. Enter on line 8 of Form 6251 the difference between this AMT depreciation and the regular tax depreciation. (If the AMT depreciation is more than the regular tax depreciation, enter the difference as a negative amount.)

Exceptions. The use of ADS for AMT purposes is not required, and no adjustment is needed, for:

- Property to which MACRS does not apply because of transitional rules under the Tax Reform Act of 1986,
- Property you elect to exclude from MACRS that is depreciated under the unit-of-production method or most other methods of depreciation not expressed in terms of years,
- Certain public utility property,
- Any motion picture film or video tape, or
- Any sound recording.

The section 179 expense deduction is allowed for AMT purposes. Do not recompute depreciation for AMT purposes for any part of the cost of any property for which you made the election under section 179 to treat the cost of the property as an expense deduction.

AMT adjusted basis. The effect of having a different depreciation amount for AMT is that the property's adjusted basis after subtracting depreciation is also different for AMT. This means, for example, that if you sell the property, the gain or loss for AMT will be different. See *Adjusted Gain or Loss*, next.

Adjusted Gain or Loss (Line 9)

If you sold property during the year, you must refigure your gain or loss from the sale using your adjusted basis for AMT purposes. Your AMT adjusted basis is figured by increasing or decreasing your adjusted basis for regular tax purposes by any applicable AMT adjustments for:

- Depreciation,
- Circulation expenditures,
- Research and experimental expenditures,
- Mining exploration and development costs,
- Pollution control facilities, and
- Incentive stock options.

The adjustment is the difference between the gain (or loss) you figured for regular tax purposes and the gain (or loss) you figured using your AMT adjusted basis. Enter the difference as a negative amount on line 9 of Form 6251 if:

- 1) The AMT gain is less than the regular tax gain,
- 2) The AMT loss is more than the regular tax loss, or
- 3) You have an AMT loss and a regular tax gain.

Otherwise, enter the difference as a positive amount.

Example. Nick purchased farm property in 1992 for \$10,000. He sold this property in 1994 for \$7,000. His adjusted basis in the property for regular tax purposes is \$4,000. However, because Nick used accelerated depreciation, his adjusted basis for AMT purposes is \$6,000.

Nick's regular tax gain is \$3,000 (\$7,000 – \$4,000). His AMT gain is \$1,000 (\$7,000 – \$6,000). Since his AMT gain is less than his regular tax gain, Nick enters the difference, \$2,000, as a negative amount on line 9 of Form 6251.

Incentive Stock Options (Line 10)

For AMT purposes, you must treat incentive stock options (ISOs) differently than for regular tax purposes. The AMT adjustment is the excess, if any, of:

- 1) The ISO's fair market value at the first time your rights in the ISO become transferable or are no longer subject to a substantial risk of forfeiture, over
- 2) The amount you paid for the ISO.

Increase your AMT basis in any stock acquired through exercise of an ISO by the amount of the adjustment.

Enter this adjustment on line 10 of Form 6251 for the first tax year in which your rights in the ISO are freely transferable or are not subject to a substantial risk of forfeiture.

Disposition in same year. There is no AMT adjustment if you dispose of stock acquired through exercise of an ISO in the same year your rights in the ISO become freely transferable or are not subject to a risk of forfeiture. In that case, the AMT and regular tax treatments are the same.

Beneficiaries of Estates and Trusts (Line 12)

If you are a beneficiary of an estate or trust, your AMT adjustment will be shown on line 8 of the Schedule K-1 (Form 1041) you receive from the estate or trust. Enter this amount on line 12 of Form 6251.

Accelerated Depreciation of Real Property Placed in Service Before 1987 (Line 14d)

The depreciation you took for regular tax purposes on real property placed in service before 1987, minus the depreciation you would have been allowed to take under the straight line method, is a tax preference item. Enter the amount of this preference (but not less than zero) on line 14d of Form 6251.

You must figure this amount separately for each item of property. Generally, each building

(or its components) is a separate item of property. Do not figure this tax preference for an item of property in the year that you dispose of it.

For real property you depreciate under the accelerated cost recovery system (ACRS), figure straight line depreciation using a recovery period of 19 years for 19-year real property, and no salvage value. However, if the actual recovery period used for regular tax purposes is longer than 19 years, you will not have a tax preference item. ACRS is explained in Chapter 6 of Publication 534.

If you placed property in service after July 1986 and chose to depreciate it using the modified accelerated cost recovery system (MACRS), see *Depreciation of Tangible Property Placed in Service After 1986*, earlier.

For property you depreciate under another method, figure straight line depreciation using the same basis, useful life, and salvage value that you first used to depreciate the property. If you did not use a useful life or salvage value, the useful life or salvage value for straight line depreciation is the one that would have been proper if you had actually taken depreciation under the straight line method.

Installment Sales of Certain Property (Line 14e)

For AMT purposes, you generally cannot use the installment method of accounting to determine your income from a disposition of inventory. You will have an AMT adjustment if you ordinarily use an accrual method of accounting, but you use the installment method to report the income from a disposition under a deferred payment contract of inventory held for sale in your farming business.

The adjustment applies to both the year of the disposition and the year you receive the deferred payment. For the year of disposition, enter as a positive amount on line 14e the difference between your income from the sale figured using your regular accounting method and the income you reported under the installment method. For the year you receive the deferred payment, enter the amount of the deferred payment on line 14e as a negative amount.

Example. You ordinarily use an accrual method of accounting. In 1994, you sold wheat produced on your farm under a contract that defers your right to the sale proceeds until 1995. You use the installment method for regular tax purposes, reporting no income from the sale on your 1994 return. On line 14e of your 1994 Form 6251, you enter as a positive amount your income from the sale figured using your regular accounting method. On your 1995 Form 6251, you must show the income from the sale reported for regular tax purposes as a negative adjustment.

Patron's Adjustment (Line 14j)

Distributions you received from a cooperative may be includible in income. Unless the distributions are nontaxable, enter on line 14j the total AMT patronage dividend and per-unit retain allocation adjustment reported to you by the cooperative.

Tax Shelter Farm Activities (Line 14m)

You need to report this on line 14m only if you have income or loss from a tax shelter farm activity (generally, a farming syndicate) that is not a passive activity. If the activity is a passive activity, use line 11.

You must refigure your income or loss from each tax shelter farm activity using any AMT adjustments and tax preference items. However, a recomputed loss is not allowed, except to the extent you are insolvent as of the end of the tax year. You are insolvent to the extent that your liabilities exceed the fair market value of your assets.

A deferred loss from a tax shelter farm activity is allowed as a deduction in figuring AMT taxable income for later years up to the net AMT income from the activity. Any remaining loss can be deducted in figuring AMT taxable income for the year you dispose of your entire interest in the activity.

Enter on line 14m of Form 6251 the difference between the amount that would be reported for the activity on Schedule E, F, or Form 4835 for the AMT and the amount reported for regular tax purposes. Enter it as a negative amount if:

- 1) The AMT loss is more than the regular tax loss,
- 2) The AMT gain is less than the regular tax gain, or
- 3) You have an AMT loss and a regular tax gain.

Enter any adjustment for amounts reported on Schedule D, Form 4684, or Form 4797 for the activity on line 9 instead.

Note. To avoid duplication, do not enter the same adjustment more than once on Form 6251. For instance, if you have included an AMT adjustment for depreciation in this adjustment, do not enter that same adjustment on line 8.

Related Adjustments (Line 14n)

For AMT purposes, you must refigure certain deductions and certain items of income that are affected by a limit based on your income. See the Form 6251 instructions.

Part II — Alternative Minimum Taxable Income

After you have figured the total amount of your adjustments and tax preference items on line 15 of Part I, you can figure your AMT taxable income in Part II.

Line 16. Since personal exemptions are not allowed in figuring AMT taxable income, begin with your taxable income figured without the deduction for personal exemptions. Enter the amount from line 35, Form 1040, on line 16, Form 6251. This figure may be negative.

If Form 1040, line 37, includes a write-in amount, add lines 36 and 37 and use that result on line 16 instead of the amount from Form 1040, line 35. If your taxable income includes

an amount from the alcohol fuel credit, reduce line 16 by the amount of the credit included in income.

Line 17. If you have a net operating loss (NOL) deduction on line 21 of Form 1040, enter that amount on line 17, Form 6251 as a positive amount. (Also see *Line 20*.)

Line 18. The limit on itemized deductions for people whose AGI is more than \$111,800 (\$55,900 if married filing separately) does not apply in figuring AMT taxable income. If you used the *Itemized Deductions Worksheet* in the Schedule A (Form 1040) instructions to determine your total itemized deductions on line 29 of Schedule A (Form 1040), enter the amount from line 9 of the worksheet on line 18, Form 6251.

Line 19. Combine lines 15, 16, 17, and 18 and enter the result on line 19.

Line 20. If you have an entry on line 17, refigure your NOL deduction and enter the refigured amount on line 20. See *Alternative Tax Net Operating Loss Deduction*, later.

Line 21. Subtract line 20 from line 19 and enter the result on line 21. This is your AMT taxable income.

If you are a married person filing a separate return and your AMT taxable income is more than \$165,000, you must increase your entry on line 21 to figure the phaseout of the exemption amount. See *Exemption Amount* under *Part III — Exemption Amount and Alternative Minimum Tax*, later.

Alternative Tax Net Operating Loss Deduction (Line 20)

If you claimed a net operating loss (NOL) deduction on line 21 of Form 1040, you must refigure it for AMT purposes. The refigured NOL deduction is limited, as explained under *Figuring the Alternative Tax NOL Deduction*, later.

Refigure your NOL deduction in three steps.

- 1) Figure the alternative tax NOL for the loss year.
- 2) Figure the alternative tax NOL carryback or carryover to this year.
- 3) Figure the alternative tax NOL deduction for this year.

Figuring Alternative Tax NOL

For AMT purposes, you figure an NOL in generally the same manner as you figure it for regular tax. (For information on how to figure an NOL, see Publication 536.) However, you must modify the NOL as follows.

- 1) Add or subtract the AMT adjustments for the loss year.
- 2) Subtract the tax preference items for the loss year that increased the NOL.

The result is the alternative tax NOL.

Exception for loss year before 1987. For purposes of figuring the alternative tax NOL deduction for a loss year before 1987, use the amount of the alternative tax NOL carryover to 1987 as the alternative tax NOL.

Figuring Alternative Tax NOL Carryback or Carryover

You can carry an alternative tax NOL back 3 years or forward 15 years under the same rules that apply to a regular tax NOL. If you choose not to carry back your NOL, that choice applies to both the regular tax NOL and the alternative tax NOL.

If the current year is the first year to which the alternative tax NOL is carried, the amount of the carryback or carryover is the amount of the alternative tax NOL. Otherwise, the amount of the carryback or carryover is the amount of alternative tax NOL remaining after subtracting the amount used in all preceding carryback or carryover years.

Amount used in preceding years. The amount of the alternative tax NOL used in each preceding carryback or carryover year must be refigured even if you did not owe AMT each year. The alternative tax NOL used in a tax year beginning after 1986 is an amount equal to 90% of the AMT taxable income for that year (figured without the alternative tax NOL deduction), minus the portion of the alternative tax NOL deduction that is due to earlier loss years, if any. For this purpose, you must modify the AMT taxable income for that year in the same manner that you modify taxable income to figure the use of the NOL for regular tax. (See *Modified taxable income* under *How to Figure an NOL Carryover* in Publication 536.)

Before-1983 NOL carryover. If you have an NOL carryover from a year before 1983, see *Deferred minimum tax* under *Part III — Exemption Amount and Alternative Minimum Tax*, later.

Figuring the Alternative Tax NOL Deduction (ATNOLD)

Your ATNOLD may be limited. To compute the ATNOLD limitation, you must first figure your AMT taxable income without regard to the ATNOLD. To do this, use a second Form 6251 as a worksheet. Complete the form through line 19, but when figuring line 14c, treat line 20 as if it were zero. Multiply line 19 of the second Form 6251 used as a worksheet by 90%. This is your ATNOLD limitation. Enter on line 20 the smaller of the ATNOLD or the ATNOLD limitation. Any alternative tax NOL not used because of the ATNOLD limitation can be carried back or forward. The treatment of alternative tax NOLs does not affect your regular tax NOL.

Example. Scott claimed an NOL deduction on line 21 of Form 1040 of \$25,000. This is from a 1993 NOL that he elected not to carry back. It includes the following 1993 AMT adjustments and tax preference items:

Accelerated depreciation of \$4,000,

Depletion of \$1,000, and

Intangible drilling costs of \$1,500.

Scott refigures his NOL using these items. His alternative tax NOL and carryover to 1994 is \$18,500 (\$25,000 – \$6,500).

To figure the amount of his ATNOLD, Scott completes a second 1994 Form 6251 as a worksheet, through line 19 to figure his AMT taxable income without regard to the ATNOLD (line 20 is treated as zero when figuring line 14c). Line 19 of Scott's 1994 Form 6251 "worksheet" is \$92,500. Scott's alternative tax NOL deduction is the smaller of 90% of \$92,500 (\$83,250) or \$18,500. Therefore, he enters \$18,500 on line 20 of the Form 6251 he will attach to his return.

Carryover of unused alternative tax NOL.

You can carry to the next carryback or carryover year any alternative tax NOL not used because of the ATNOLD limitation. See *Figuring Alternative Tax NOL Carryback or Carryover*, earlier.

Part III — Exemption Amount and Alternative Minimum Tax

After you have arrived at AMT taxable income, you can figure the tax (the AMT). First, subtract your exemption amount from your AMT taxable income. Your exemption amount depends on your filing status and your taxable income. Next, multiply the balance that is \$175,000 or less (\$87,500 or less if married filing separately) by the AMT rate of 26%. Multiply any balance that is more than \$175,000 (more than \$87,500 if married filing separately) by the AMT rate of 28%. The sum will be your tentative minimum tax. Finally, subtract your regular tax (adjusted as explained later) from your tentative minimum tax. The result, on line 28 of Form 6251, is your AMT. Enter the amount from line 28 on line 48, Form 1040.

Deferred minimum tax. If your regular tax is reduced because of an NOL deduction on line 21, Form 1040, from a year before 1983, you must pay any minimum tax for the loss year that you were able to defer because of the NOL. The amount you must pay is 15% of the portion of the deduction that is for the loss year's excess tax preference items. Include this amount in the total on line 48, Form 1040, and write "Deferred Minimum Tax" and the amount on the dotted line.

Exemption Amount (Line 22)

The AMT is not intended to apply to individuals in the lower tax brackets with small amounts of adjustments or preference items. This is why you subtract an exemption amount from your AMT taxable income before figuring your tentative minimum tax. The exemption amount is phased out for high income individuals.

On line 22 of Form 6251, enter one of the following exemption amounts based on the filing status you used to figure your regular tax:

- \$45,000, if you are married filing a joint return or file as a qualifying widow or widower with dependent child,
- \$33,750, if you file as single or head of household, or
- \$22,500, if you are married filing a separate return.

Note. The exemption amount for a child under 14 may be limited. See *Minor Children*, later.

Phaseout. The exemption amount is reduced by 25 cents for each \$1 that your AMT taxable income exceeds:

- \$150,000, if you are married filing a joint return or file as a qualifying widow or widower with dependent child,
- \$112,500, if you file as single or head of household, or
- \$75,000, if you are married filing a separate return.

Figure your reduced exemption amount on the *Exemption Worksheet* in the instructions for line 22 of Form 6251. Your exemption amount is completely phased out if AMT taxable income exceeds:

- \$330,000, if you are married filing a joint return or file as a qualifying widow or widower with dependent child,
- \$247,500, if you file as single or head of household, or
- \$165,000, if you are married filing a separate return.

Married filing separately. If you are a married person filing a separate return and your AMT taxable income is more than \$165,000, you must increase your AMT taxable income to figure the phaseout of the exemption amount. Use the instructions for line 21 of Form 6251 to figure the increased amount, and substitute that amount for your previous entry on line 21.

The increase in your AMT taxable income is 25% of the amount by which your AMT taxable income exceeds \$165,000. However, the increase cannot be more than \$22,500.

Tentative Minimum Tax (Lines 23 – 26)

To figure your tentative minimum tax, multiply your AMT taxable income minus the appropriate exemption amount (line 23 of Form 6251) by 26% if \$175,000 or less (\$87,500 if married filing separately). Multiply by 28% any amount in excess of \$175,000 (\$87,500 if married filing separately). Enter the sum on line 24. This is your tentative minimum tax unless you have an AMT foreign tax credit. If you have an AMT foreign tax credit, enter it on line 25, then subtract it to arrive at your tentative minimum tax (line 26).

For information on how to figure the AMT foreign tax credit, see the Form 6251 instructions.

Regular Tax (Line 27)

After you have figured your tentative minimum tax, subtract your regular income tax to arrive at your AMT. Regular income tax is your income tax from line 38, Form 1040, plus any tax from Form 4970 entered on line 39, Form 1040, minus any foreign tax credit (line 43, Form 1040).

Note. The AMT of a child under 14 may be limited. See *Minor Children*, next.

Minor Children

Limits apply to the exemption amount and the AMT of a child who must figure regular tax on Form 8615. For information on who must use Form 8615, see Publication 929.

Limit on exemption amount. The child's exemption amount on line 22 of Form 6251 is limited to the child's earned income plus the greater of:

- 1) \$1,000, or
- 2) The child's share of the unused parental minimum tax exemption.

Figure the child's exemption amount on the *Exemption Worksheet* in the Form 6251 instructions for line 22.

Unused parental minimum tax exemption. The unused parental minimum tax exemption is the amount by which the parent's AMT exemption amount exceeds that parent's AMT taxable income.

Limit on AMT. The child's AMT on line 28 of Form 6251 cannot be greater than the amount by which the parent's AMT would increase if the parent's tentative minimum tax and regular tax were increased by the amount of the tentative minimum tax and regular tax of all the parent's children who must figure regular tax on Form 8615. This limit will apply if either the parent or at least one of the other children does not owe AMT. Use the *Worksheet for Limit on AMT for Children Under Age 14—Line 28* in the instructions for Form 6251 to figure the limit.

Example of AMT

John Green is married and has two children. He and his wife, Ann, file a joint return on which they claim four exemptions. They have a net profit from a farm, interest income, and income from an estate.

John and Ann report an adjusted gross income of \$67,000. Their itemized deductions totaled \$28,939 and are as follows:

Deductible state income taxes	\$ 5,900
Real estate tax	3,975
Home mortgage interest	7,000
Miscellaneous itemized deductions	1,000
Cash contributions	5,000
Casualty loss (from Form 4684)	6,064
Total itemized deductions	\$28,939

Figuring regular income tax. John and Ann figure their taxable income as follows:

Adjusted gross income	\$67,000
Minus: Itemized deductions	28,939
	\$38,061
Minus: Exemptions (4 × \$2,450)	9,800
Taxable income	\$28,261

Using the Tax Table, the Greens find that their regular income tax is \$4,241.

Part I — Adjustments and tax preference items. The Greens have adjustments for accelerated depreciation and certain home mortgage interest, so they must fill in Form 6251. Their Form 6251 is illustrated in this chapter. They begin by skipping line 1 because they itemized deductions on Schedule A (Form 1040). Then they enter their adjustments and tax preference items on lines 2 through 14.

Medical expenses. The Greens did not deduct any medical expenses on Schedule A (Form 1040), so they leave line 2 blank.

Taxes. The Greens deducted \$5,900 state income tax and \$3,975 real estate tax on their home on Schedule A (Form 1040). Since state income taxes and real estate taxes on a home are not allowed for AMT purposes, the Greens enter \$9,875 on line 3.

Home mortgage interest. The Greens paid home mortgage interest of \$7,000 during 1994. Of this amount, \$4,550 is from refinancing their mortgage (in 1993) for more than their original mortgage. They did not use any of the funds for home improvements. They enter \$4,550 on line 4.

Miscellaneous itemized deductions. The Greens claimed \$1,000 on Schedule A, line 26 (Form 1040) for miscellaneous itemized deductions. No miscellaneous deductions subject to the 2% of AGI limit are allowed in determining AMT taxable income. They enter \$1,000 on line 5.

Depreciation of property placed in service after 1986. The Greens bought farm equipment that for regular tax purposes they depreciate under the modified accelerated cost recovery system. For AMT purposes, they refigure the depreciation on this property using the 150% declining balance method over 10 years rather than 7 years. The difference, \$8,589, is entered on line 8.

Beneficiaries of estates and trusts. The Greens are beneficiaries of an estate that passes through to them their share of the estate's distributable AMT taxable income adjustment. The Schedule K-1 (Form 1041) they receive shows \$820 on line 8. They enter this amount on line 12.

Patron's adjustment. The Greens are patrons of a cooperative that sent them a Form 1099-PATR showing an AMT patronage dividend adjustment of \$150. The distributions they received from the cooperative were includible in their income, so they enter \$150 on line 14j.

Total adjustments and preference items. The Greens add these items and enter their total adjustments and tax preference items, \$24,984, on line 15.

Part II — Alternative minimum taxable income. They then enter the amount from line 35 of Form 1040, \$38,061, on line 16 of Form 6251. They have no entry on line 17.

AMT taxable income. The total of the Greens' adjustments and tax preferences, \$24,984, are then added to the line 16 amount of \$38,061. The total, \$63,045, is their AMT taxable income. This amount is entered on lines 19 and 21.

Part III — Exemption amount and alternative minimum tax. Since the Greens are filing a joint return, they enter \$45,000 on line 22. Their AMT taxable income is less than \$150,000, so there is no phaseout of the exemption amount. They subtract the \$45,000 from the amount on line 21. The difference, \$18,045, is entered on line 23.

Since the Greens' AMT taxable income is less than \$175,000, they multiply line 23 by 26% and enter the result on lines 24 and 26. This amount, \$4,692, is their tentative minimum tax. From this amount, they subtract their regular tax, \$4,241. The difference, \$451, is their AMT. This amount is entered on line 28. It is then carried to line 48 of Form 1040.

Credit for Prior Year Minimum Tax

You may be able to take a credit against your regular tax if you:

- Paid alternative minimum tax (AMT) in 1993,
- Had a minimum tax credit carryforward from 1993 to 1994, or
- Had an unallowed nonconventional-source fuel credit, orphan drug credit, or qualified electric vehicle credit in 1993.

This section explains how to figure this credit. You figure the credit on **Form 8801**. This section also contains an example that shows how to complete this form.

Figuring the Credit

Your 1994 credit for prior year minimum tax (before applying the credit limit, explained later) is the total of:

- 1) Your 1993 adjusted AMT,
- 2) Any unused credit you carried forward from 1993, (line 26 of your 1993 Form 8801), and
- 3) Any 1993 unallowed credits for nonconventional-source fuel, orphan drugs, and a qualified electric vehicle.

Adjusted AMT. Your adjusted AMT is the amount of AMT you actually paid (line 28 of your 1993 Form 6251), reduced by the part of it generated by exclusion items. If the AMT generated by exclusion items is more than you actually paid, you will have a negative adjusted AMT.

Use Part I of Form 8801 to figure the part of your 1993 AMT generated by exclusion items. Use Part II to figure the credit for 1994 and any carryover to 1995.

Exclusion items. The adjustments and preference items that result in the permanent exclusion of income for regular tax purposes are exclusion items. These exclusion items are:

- The standard deduction,
- Medical and dental expenses,
- Miscellaneous itemized deductions,
- Taxes,
- Interest expense,
- Charitable contribution carryovers from an earlier year for certain donations of appreciated property,
- Tax-exempt interest from certain private activity bonds, and
- Depletion.

Generally, these are the items on lines 1 through 7, plus lines 13, 14a, and 14c of your 1993 Form 6251, plus any adjustments or preference amounts for interest expenses, tax-exempt interest, or depletion included on lines 11, 12, or 14m.

AMT foreign tax credit on exclusion items. In figuring the AMT on these items, you do not use the 90% limit on the AMT foreign tax credit.

Unallowed credits for nonconventional-source fuel, orphan drugs, and electric vehicle. Add to your 1993 adjusted AMT and credit carryover any unallowed 1993 credit for nonconventional-source fuel, orphan drugs, or a qualified electric vehicle. An unallowed credit is any amount that you could not take because it would have reduced your regular tax to less than your tentative minimum tax.

Limit on Credit

You may not be able to use all of your credit this year. Your credit is limited to the amount on Form 1040, line 46 (figured without regard to the credit for prior year minimum tax), minus your tentative minimum tax (Form 6251, line 26).

If your credit is limited, you can carry forward the unused credit to next year. See *Unused Credit*, next.

Unused Credit

After you figure the credit for prior year minimum tax and apply the limit, you may have unused credit. You can carry any unused credit forward to reduce your regular tax liability in future years. You can carry the credit forward until it is completely used.

If your net AMT in a later tax year results in an additional credit, you can add that credit to any carryforward balance from earlier years (See Part II of Form 8801).

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 Debts* in Chapter 4.

Example of Credit for Prior Year Minimum Tax

John and Ann Green, whose 1994 Form 6251 is shown in this chapter, paid a **1993** AMT of \$1,730. They complete Form 8801 to see if they can claim a minimum tax credit for 1994 or carry it forward to 1995. (Their filled-in Form 8801 is shown in this chapter.)

John and Ann used the following amounts to figure their **1993** AMT on Form 6251. (Their 1993 Form 6251 is not shown here.)

Amount from 1993 Form 1040, line 35	\$ 46,650
Adjustments	26,696
Total	\$ 73,346
Minus: Exemption amount	45,000
	\$ 28,346
Multiply by 26%	×26%
	\$ 7,370
Minus: 1993 regular tax before credits	5,640
1993 alternative minimum tax	\$ 1,730

To complete Form 8801, John and Ann must determine which of their 1993 AMT adjustments and preferences are treated as exclusions (explained earlier). They had the following "exclusion" adjustments on their 1993 Form 6251.

Exclusion adjustments:

Medical and dental	\$ 4,000
Miscellaneous itemized deductions from Schedule A, line 24	1,038
Taxes from Schedule A, line 8	8,000
Certain home mortgage interest	7,988
Total exclusion items for 1993	\$21,026

The Greens also had a depreciation adjustment of \$5,670. This is not an exclusion item.

For 1994, the Greens have a regular tax liability (minus allowable credits) of \$4,241 and a tentative minimum tax (line 26, Form 6251) of \$4,692. They also have a minimum tax credit carryforward from 1993 (based on their 1992 AMT) of \$800.

The Greens use their 1993 Form 6251 to complete Form 8801. They combine the amounts from lines 16 through 18 of their 1993 Form 6251 and enter the total (\$46,650) in Part I of Form 8801, on line 1. They enter their total exclusion items (\$21,026) on line 2 of Part I. Their net minimum tax on exclusion items is \$256, as shown on line 15 of Part I.

They then complete Part II. Because their 1994 regular income tax minus allowable credits (line 22 of Form 8801) is less than their 1994 tentative minimum tax (line 23 of Form 8801), they cannot claim a minimum tax credit for 1994. They can carry forward to 1995 a minimum tax credit of \$2,274.

15.

Self-Employment Tax

Important Change for 1994

Tax rates and maximum net earnings for self-employment taxes. The self-employment tax rate on net earnings remains the same for 1994 and 1995. 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 1994 is \$60,600. For 1995, the maximum amount subject to the social security part will be published in the 1994 revisions of Publication 533, *Self-Employment Tax*, and Publication 553, *Highlights of 1994 Tax Changes*. For 1994 and 1995, there is no maximum amount subject to the Medicare part.

Important Reminders

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 contribute to your coverage under the social security system.

You must be *insured* under the social security system before you begin receiving social security benefits (described above). 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 1994, you receive a quarter of social security coverage, up to four quarters, for each \$620 of income subject to social security. Therefore, for 1994, if you had income of \$2,480 that was subject to social security taxes (self-employment and wages) you will receive four quarters of coverage.

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.

Income limits. You must pay self-employment tax if you have net earnings from self-employment of \$400 or more. You must pay the tax even if you are now fully insured under social security or are now receiving benefits.

For 1994, the maximum amount subject to the social security part of the self-employment tax (12.4%) is \$60,600. All earnings from self-employment are subject to the Medicare part of the tax (2.9%).

Net earnings from self-employment. You can take a deduction of 7.65% of your net income from self-employment. You are allowed this deduction only in figuring net earnings subject to self-employment tax. You figure it on line 4 of Schedule SE. This is not the same as the deduction for one-half of self-employment tax taken on Form 1040, line 25.

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 self-employment income, it is independently subject to self-employment tax and should be reported on a separate Schedule SE. Mere ownership, or joint ownership, of farm property does not qualify a spouse for self-employment tax.

You and your spouse may operate a farm as a partnership. To be recognized as a partnership for federal tax purposes, your relationship as partners must be established. If you and your spouse operate a farm as partners, you must 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 self-employment tax.

However, if your spouse is not your partner, but rather is employed by you, you must pay social security taxes for your spouse. For more information, see Chapter 16.

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 self-employment tax as the income of the spouse carrying on the trade or business. Regardless of whether community property laws apply, the identity of the person carrying on the trade or business is determined by the facts in each case.

Social security number. You must have a social security number to pay self-employment tax. Your social security number must be shown on Schedule SE to insure proper credit of your self-employment income to your social security account. If you do not already have a number, you should apply for one on Form SS-5.

If you have a social security number from the time you were an employee, you should not apply again. If you have a number but lost your card, you should file Form SS-5, showing where and about when you first applied for it. You will get your original number and not a new one.

Estimated tax. You must include the estimated self-employment 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, no estimated tax payments are required.

Introduction

Farmers pay self-employment taxes on their self-employment income. Farmers who have employees may have to pay employment taxes. See Chapter 16 for information on employment taxes.

Self-employment 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:

- Self-employment income
- Who must pay the tax
- Figuring self-employment tax
- Landlord participation in farming
- Reporting self-employment tax

Useful Items

You may want to see:

Publication

- 533** Self-Employment Tax

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.

Self-Employment Income

Net self-employment income normally includes all of the items of business income and takes into account deductions allowed for income tax purposes. Unless you are a limited partner, your distributive share of income from a partnership that carries on a trade or business is self-employment income. Net self-employment income is determined using the same accounting method as used for income tax purposes.

Some specific items included in determining net self-employment 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 which was held more than 1 year,
 - 10) Crop shares received as rent. (These are net self-employment income in the year they are converted to money or the equivalent of money, if you meet the material participation test 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 self-employment 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.
- In addition, there are certain kinds of income and deductions you usually do not take into account in figuring your net self-employment 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 self-employment income. It does not matter if the rent is received in crop shares, cash, or other property. However, if you are a real estate dealer and the rent is received in the course of your trade or business, the rental income and related deductions are included in figuring self-employment income. If the landlord materially participates, see *Landlord Participation in Farming*, later.
 - 2) Interest is not self-employment income unless you receive it in your trade or business, such as interest on accounts receivable.
 - 3) Dividends on securities are not self-employment income unless you are a dealer in securities.
 - 4) Capital gains and losses, such as gain or loss on the sale of investment property, are excluded from self-employment income.
 - 5) 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 self-employment 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) Depreciable property or other fixed assets used in your trade or business.
 - b) 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.
 - c) Standing crops sold with land held more than one year.
 - d) 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.
 - 6) Wages received for services performed as an employee and covered by social security or railroad retirement are not self-employment income.
 - 7) Certain deductions and exemptions that are used when figuring income tax should not be used to reduce your self-employment income. Specifically, do not use:
 - a) Deductions for personal exemptions for yourself, your spouse, or your dependents,
 - 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.
 - 8) A limited partner figures net self-employment income by excluding the distributive share of partnership income or loss. But guaranteed payments received for services performed are included as self-employment income.
 - 9) 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.

Caution: The self-employed health insurance deduction expired for tax years beginning after 1993. However, as this publication

was being prepared for print, Congress was considering legislation to extend this deduction. For information on late legislative changes, see Publication 553, *Highlights of 1994 Tax Changes*.

Who Must Pay the Tax

If you carry on a trade or business, such as running a farm, you probably have to pay self-employment tax on your self-employment income. A trade or business is generally an activity carried on for a livelihood, or in good faith to make a profit.

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 self-employment 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 three 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 self-employment income. But, for the services performed in caring for the landowner's hogs, the share farmer is an employee, and the value of the three hogs received is not self-employment 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 self-employment 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.

Figuring Self-Employment Tax

If you were self-employed during the year, you must figure how much of your income is subject to self-employment tax. There are three steps to figure how much tax you owe:

- 1) Determine your net earnings from self-employment.
- 2) Determine how much of those net earnings are subject to the tax.
- 3) Multiply that amount by the tax rate.

When figuring your net earnings, you should include only income and expenses that come about in the regular course of your trade or business (including the farming business). There are three ways to figure self-employment net earnings. These are the regular method, the farm optional method, and the nonfarm optional method.

The tax rates are the same for net earnings figured under each method. You will find the general rules for figuring self-employment tax in the discussion of the regular method later.

How the optional methods can help you. Either or both of the optional methods may help you if you have little income or a loss 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 self-employment tax due under these methods, even if you would have had a smaller tax or no tax using your actual self-employment income or loss under the regular method.

The optional methods may be used only to figure your self-employment tax. To figure your income tax, include your actual self-employment income in gross income, regardless of which method you use to figure self-employment 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 self-employment tax on this amount.

Forms. Use Schedule SE (Form 1040) to figure your self-employment tax on line 47 of Form 1040. If you have to pay self-employment tax, you must file a Form 1040 (with Schedule SE attached) even if you are not otherwise required to file a federal income tax return.

Schedule SE

You must file Schedule SE if:

- 1) You were self-employed, and your net earnings from self-employment from other than church employee income were \$400 or more, or
- 2) You had church employee income of \$108.28 or more.

Even if you are not required 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 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) tax plus net earnings from self-employment are more than \$60,600,
- 2) Ministers, members of religious orders, and Christian Science practitioners not taxed on earnings from these sources (with IRS consent) who owe self-employment 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 (or railroad retirement) and Medicare taxes that was not reported to their employers, and
- 5) Individuals who use one of the optional methods to figure self-employment tax.

For more information on Schedule SE, see the instructions for Schedule SE (Form 1040).

Regular Method

This method can be figured on either *Short Schedule SE* (Section A), or *Long Schedule SE* (Section B). The short schedule is the easier one to use. Use the following steps to figure your tax.

Step 1. Figure your net self-employment income. The net profit from your farming business shown on Schedule F is generally your net self-employment income. Net profit is figured by subtracting all allowable business expenses and deductions from gross business income.

If you have a trade or business, in addition to the farming business, your net self-employment income is the combined net earnings from each of your businesses. You must also include your distributive share of self-employment 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 earnings from self-employment. Making false statements to get or to increase social security benefits may subject you to penalties.

Step 2. After you figure your net self-employment income, determine how much of that income you have to pay tax on. Your net income is reduced by the 7.65% deduction to arrive at net earnings from self-employment, and there is both a minimum and a maximum income limit.

7.65% deduction. Multiply your net income by 0.9235 for the 7.65% deduction ($100\% - 7.65\% = 92.35\%$ or 0.9235). This is your net earnings from self-employment.

Minimum income limit. You must have \$433.13 or more of net self-employment income before reduction by the 7.65% deduction to be subject to the tax ($.9235 \times \$433.13 = \400). If your net income is less than \$433.13 before the 7.65% reduction, you do not have to file Schedule SE (Form 1040) or pay the tax, unless you choose to use an optional method listed earlier.

Maximum income limit. No more than \$60,600 of your combined wages, tips, and net earnings in 1994 is subject to any combination of the 12.4% social security part of self-employment tax, social security tax, or railroad retirement tax.

All of your combined wages, tips, and net earnings in 1994 are subject to any combination of the 2.9% Medicare part of self-employment tax, social security tax, or railroad retirement tax.

If your wages and tips are subject to either social security or railroad retirement tax, or both, and total at least \$60,600, you do not have to pay the 12.4% social security part of the self-employment tax. However, you must pay the 2.9% Medicare part of the self-employment tax on all of your net earnings.

Step 3. Figure your self-employment tax as follows.

- 1) If your net earnings from self-employment plus any wages and tips are not more than \$60,600, and you do not have to use *Long Schedule SE*, use *Short Schedule SE*. On line 5, multiply your net earnings by the 1994 tax rate of 15.3% (.153). The result is the amount of your self-employment tax.
- 2) If you had no wages, your net earnings from self-employment are more than \$60,600, and you do 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 \$7,514.40 (12.4% of \$60,600). The total is the amount of your self-employment tax.
- 3) If your net earnings from self-employment plus any wages and tips are more than \$60,600, you must use *Long Schedule SE*. Subtract your total wages and tips from \$60,600 to find the maximum

amount of 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 self-employment tax.

Example 1. During 1994, you have \$30,000 in net self-employment income, and receive no wages subject to social security and Medicare taxes. You multiply the \$30,000 by 0.9235 on *Short Schedule SE* for the 7.65% deduction ($100\% - 7.65\% = 92.35\%$), and the result is \$27,705. Your self-employment tax is 15.3% (0.153) of \$27,705, or \$4,238.87.

Example 2. During 1994, you have \$20,000 in net self-employment income, and receive \$15,000 in wages subject to social security and Medicare taxes. You multiply the \$20,000 by 0.9235 on *Short Schedule SE* for the 7.65% deduction, and the result is \$18,470. Your self-employment tax is 15.3% (0.153) of \$18,470, or \$2,825.91.

Example 3. During 1994, you have \$70,000 in net self-employment income, and receive no wages subject to social security and Medicare taxes. You multiply the \$70,000 by 0.9235 on *Short Schedule SE* for the 7.65% deduction, and the result is \$64,645. Since only \$60,600 of your earnings are subject to the social security part of the self-employment tax, your tax for this part is \$7,514.40 (12.4% of \$60,600).

Since all of your net earnings are subject to the Medicare part of the self-employment tax, multiply \$64,645 by 2.9% (.029) on *Short Schedule SE* for the Medicare part, and the result is \$1,874.71. Add this to \$7,514.40 and your self-employment tax is \$9,389.11.

Example 4. During 1994, you have \$70,000 in net self-employment income, and receive \$10,000 in wages subject to social security and Medicare taxes. You multiply the \$70,000 by 0.9235 on *Long Schedule SE* for the 7.65% deduction, and the result is \$64,645. Next, you subtract your wages of \$10,000 from \$60,600, the maximum income subject to the social security part of the self-employment tax. The result is \$50,600. Since only \$50,600 of your income is subject to the social security part of the self-employment tax, your tax for this part is 12.4% (.124) \times \$50,600, or \$6,274.40.

Since all of your net earnings are subject to the Medicare part of the self-employment tax, you multiply all of the net earnings from self-employment, \$64,645, by 2.9% (.029) on *Long Schedule SE* for the Medicare part, and the result is \$1,874.71. Add this to the \$6,274.40 figured above for total self-employment tax of \$8,149.11.

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 coverage for self-employment tax 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.

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 before reduction by the 7.65% deduction 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, as explained later.

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 the material participation test. When you use the farm optional method, you must also exclude income, deductions, and losses that come from any nonfarm business.

Cash method. 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. 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. Your gross income from farming is \$1,500, and 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 1994 (15.3%). The result is the amount of self-employment 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 self-employment 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 engaged in a nonfarm business in addition to your farm business, you may be

able to use this method to compute your net earnings from self-employment from your non-farm 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, see Publication 533.

Using Both Methods

You may not combine income from farming 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 non-farm 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 or 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 the 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: (1) pay or stand good for at least half the direct costs of producing the crop; (2) furnish at least half the tools, equipment, and livestock used in producing the crop; (3) consult with your tenant; and (4) 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. If you need more information, contact your Social Security Administration office.

For information on the material participation requirement as it relates to the special-use valuation of qualified real property, see Publication 448, *Federal Estate and Gift Taxes*.

Reporting Self-Employment Tax

If you farm and also have another business, you should figure your self-employment tax from both the farm and the other business on one Schedule SE.

You should first figure your net self-employment income from farming and show the amount on line 1 of Schedule SE.

Next enter the amount of your net self-employment income from your other business on line 2 of Schedule SE. Then add these amounts together and enter the total on line 3. This gives your total net earnings from self-employment from all sources.

Complete Schedule SE as explained in the instructions with your return to figure your total self-employment tax. Enter this amount on line 47 of Form 1040.

Self-Employment Tax Deduction

You can deduct one-half of your self-employment 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 self-employment 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.

16.

Employment Taxes

Important Changes for 1994

Tax rates and maximum wages. The tax rate for social security and Medicare taxes for 1994 and 1995 is 7.65% for both the employer and the employee (a total of 15.3%). The 7.65% tax is a total of 6.2% for social security (old-age, survivors, and disability insurance) and 1.45% for Medicare (hospital insurance). In 1994, the maximum wage amount subject to the social security tax (6.2%) is \$60,600. The maximum amount subject to the social security tax (6.2%) for 1995 will be published in Publication 51, *Circular A, Agricultural Employer's Tax Guide*.

In 1994 and 1995, there is no wage base limitation for the Medicare tax (1.45%). All covered wages are subject to the Medicare tax.

Federal unemployment (FUTA) tax rate. The gross FUTA tax rate remains 6.2% through 1995.

Caution. Late legislation simplified social security coverage and reporting for household employers, effective January 1, 1994. See Publication 926.

Introduction

Farmers who have employees may have to pay employer and withhold employee social security and Medicare taxes (FICA taxes), and withhold income tax. They may also have to pay the federal unemployment (FUTA) tax. This chapter includes information about those taxes. Farmers also must 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
- Income tax withholding
- Social security and Medicare taxes
- Paying social security, Medicare, and withheld income taxes
- Federal unemployment tax
- Family members
- Crew leaders
- Advance payment of earned income credit

Useful Items

You may want to see:

Publication

- 15** Circular E, Employer's Tax Guide
- 51** Circular A, Agricultural Employer's Tax Guide
- 937** Employment Taxes

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

Farm Employment

In general, you are an employer of farm workers if your employees:

- Raise or harvest agricultural or horticultural products on a farm;
- Care for your farm and equipment, when most of the care is done on a farm;
- Handle, process, or package any agricultural or horticultural commodity if you produced more than half of the commodity;
- Do work related to cotton ginning, turpentine, or gum resin products; or
- 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 will and control. You are not required to withhold on independent contractors who are not your employees. For more information, see *Who Are Employees?* in Publication 937.

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). To request an EIN, file Form SS-4, *Application for Employer Identification Number*, with the IRS Service Center for your area listed in the *Instructions for Form SS-4*. If you prefer, you can ask for an EIN immediately by calling the tele-TIN telephone number for your state's IRS Service Center listed in the *Instructions for Form SS-4*. You can request Form SS-4 and the *Instructions for Form SS-4* at IRS or Social Security Administration offices, or by calling 1-800-TAX-FORM (1-800-829-3676).

New employees. You must ask each new employee to complete the employee part of Immigration and Naturalization Service (INS) Form I-9, *Employment Eligibility Verification*. You must then complete the employer part of the form 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.

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. Several methods may be used to determine the amount of income tax withholding. They are described in the 1994 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 withholding allowances 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 income tax liability for the current year.

In general, an employee can claim withholding allowances equal to the number of exemptions the employee will be entitled to in figuring income tax on his or her annual return. An employee may also be able to claim a special withholding allowance and allowances for estimated deductions and credits.

Circular A. 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, depending upon the amount of income and social security and Medicare taxes withheld, you may have to deposit them before you file.

Form W-4 for 1995. Farmers who have employees should make new 1995 Forms W-4 available to their employees, and encourage them to check their income tax withholding situation for 1995. Those employees who owed a large amount of tax or received a large refund for 1994 may want to file a new 1995 Form W-4.

Nonemployee compensation. Generally, you do not have to withhold 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.

Backup withholding. In certain cases, the law requires you to withhold income tax at 31% (backup withholding) on payments of commissions, nonemployee compensation, and other payments for services that you make in the course of farming or other business activities. The backup withholding rules do not apply to wages, pensions, or annuities.

The payer must withhold 31% of the payment if:

- 1) The payee does not furnish a taxpayer identification number to the payer, or,
- 2) The IRS notifies the payer that the payee furnished an incorrect taxpayer identification number.

Backup withholding does not apply to payments reported on Form 1099-MISC (other than payments by fishing boat operators and royalty payments) **unless** at least one of the following situations applies.

- 1) The amount you receive from any one payer is \$600 or more.
- 2) The payer was required to give you a Form 1099-MISC last year.
- 3) The payer made payments to you last year that were subject to backup withholding.

Backup withholding is generally not required for a payment of less than \$10.

Other types of reportable payments are subject to backup withholding under these rules. Payments of interest and dividends may be subject to backup withholding for other reasons. See Publication 505, *Tax Withholding and Estimated Tax*, for more information. Amounts withheld under the backup withholding provisions are reported on Form 945. Also, these amounts are shown on information returns in the 1099 series reporting payments for the year (see *Information Returns* in Chapter 2 of this publication). For more information on information returns and backup withholding, see *1994 Instructions for Forms 1099, 1098, 5498, and W-2G*.

Form W-9 may be used by payers to request payees to furnish a taxpayer identification number and to certify that the number furnished is correct.

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 (cash and noncash) during the year to all your employees and did not meet the *Exception*, below.

See *Family Members*, later, for special rules that apply to your spouse and children for social security and Medicare withholding.

Caution. Late legislation simplified social security coverage and reporting for household employers, effective January 1, 1994. See Publication 926.

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.

Commodity wages you pay to your employees for farm work are not considered cash wages.

Cash wages to farm workers, but not non-cash wages, are subject to social security taxes, Medicare taxes, and income tax withholding. 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*.

Exception. If you pay a farm worker 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 if the farm worker:

- Works as a hand-harvest laborer,
- Is paid piece-rates in an operation usually paid on this basis in the area,
- Commutes daily from his home to the farm, and
- Worked in agriculture less than 13 weeks in the preceding calendar year.

Payments to all of your farm workers, however, count toward the \$2,500-or-more test for other farm workers.

Only cash wages you pay that are subject to social security and Medicare taxes will be credited to your employees for social security benefit purposes. Payments that are 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 will have to deduct social security and Medicare taxes and prepare a Form W-2 for each family worker who has wages subject to tax, not just for the head of the family. These withheld taxes, together with your employer taxes, are to be paid to the IRS. If you are subject to these taxes, you must file Form 943 with the IRS at the address shown in the instructions for that form on or before January 31 of the year following the year covered by the return. If you are liable for \$500 or more of social security taxes and withheld income taxes during the year, you must deposit them before you file. See *Deposit rules*, later.

Tax rates and wage bases. Social security and Medicare taxes have different tax rates and wage bases. The wage base is the maximum wage for the year that is subject to the taxes. You can multiply each wage payment by the tax rate or you can use the tables provided in Circular A. Do not use the withholding allowances that employees claim on Form W-4 to figure social security and Medicare taxes.

The tax rate for social security is 6.2% each for employers and employees (12.4% total) and the wage base for 1994 is \$60,600. The maximum amount subject to the social security tax (6.2%) for 1995 will be published in Circular A.

The tax rate for Medicare is 1.45% each for employers and employees (2.9% total), and in 1994 and 1995, there is no ceiling on the wages subject to the Medicare tax (1.45%). All covered wages are subject to the Medicare tax.

Circular A. Circular A contains tables showing the amount of social security and Medicare taxes you should withhold. It also contains additional information about social security and Medicare tax withholding. You can get Circular A from the 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 farm work 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. For more information, see Publication 517, *Social Security and Other Information for Members of the Clergy and Religious Workers*.

Paying Social Security, Medicare, and Withheld Income Taxes

You must deduct and withhold income, social security, and Medicare taxes from the salaries and wages of your employees if they are subject to social security and Medicare taxes. 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 deduct less than the correct tax from your employees' wages, you are still liable for the full amount. You must also pay your share of the social security and Medicare taxes.

Report the taxes on Form 943. File by January 31, 1995, for calendar year 1994.

Figuring deposits. You will generally have to make deposits of social security and Medicare taxes and withheld income tax before your return is due. Each return period is divided into a number of shorter deposit periods. Whether or not you must make a deposit for a particular deposit period depends on your status as a depositor (monthly or semiweekly), and on your tax liability at the end of the deposit period. Voluntary early deposits during a deposit period do not affect the determination of the tax liability for that period.

Deposit rules. Under the deposit rules, if your accumulated undeposited taxes do not exceed \$100,000 on any day during the year, you will know from your tax liability in your *lookback period*, discussed below, what your deposit dates will be for the entire year.

Lookback period. To find your deposit requirements for a calendar year, you look back to your employment tax liabilities during a lookback period, which, for an agricultural employer, is the calendar year preceding the calendar year just ended. Adjustments made on a supplemental tax return are included only in the year the adjustments are reported. The lookback period for 1995 is the period January 1, 1993, to December 31, 1993. If you are a new employer, you are treated as having no tax liabilities during the period you had no employees.

The lookback period for nonfarm employers is the 12-month period ending with June 30 of the year just ended. If you also have nonfarm employees, you must figure your deposit requirements for farm and nonfarm employees separately. You must also separately apply the one-day rule and safe harbor rules, discussed below, and make separate deposits of tax.

Under the deposit rules, you are either a monthly depositor or a semiweekly depositor. The IRS will send you a notice each November to confirm, based on your lookback period, whether you are a monthly or semiweekly depositor.

In addition to the rules based on the lookback period, there is a one-day rule for accumulated taxes of \$100,000 or more and a de minimis rule for accumulated taxes of less than \$500.

• **Monthly depositor**

You are a monthly depositor for a calendar year if the total amount of reported taxes for the lookback period is not more than \$50,000. Deposit the taxes accumulated on paydays during each month by the 15th day of the following month.

• **Semiweekly depositor**

You are a semiweekly depositor for a calendar year if the total amount of accumulated taxes for the lookback period is more than \$50,000.

Deposit taxes accumulated for Wednesday, Thursday, and/or Friday paydays during each week by the following Wednesday, and

Deposit taxes accumulated for Saturday, Sunday, Monday, and/or Tuesday paydays during each week by the following Friday.

- **One-day rule**

If the amount of your accumulated taxes is \$100,000 or more on any day during a deposit period, either monthly or semiweekly, deposit the taxes on the next banking day. If you are a monthly depositor, you become a semiweekly depositor for the remainder of the calendar year and the following calendar year.

- **De minimis rule**

If the amount of your accumulated taxes during the year is less than \$500, you are not required to make deposits. You may pay the taxes with your timely filed Form 943. If the amount for the year will be \$500 or more (or you are unsure that it will be less than \$500), you must follow the regular deposit rules (semiweekly or monthly) that apply to you.

Semiweekly period in 2 calendar years.

If a calendar year ends on a day other than a Tuesday or Friday, taxes you accumulated during the days covered by the 2 calendar years must be deposited with separate coupons.

Special rule for semiweekly depositors.

If there are fewer than 3 banking days to make a deposit, a minimum of 3 days is allowed to make the deposit if you are not subject to the \$100,000 one-day rule.

New employer. If you are a new employer, you will be treated as a monthly depositor until you have a liability of more than \$50,000 for a lookback period, or you fall under the one-day rule.

Safe harbors. You will meet the deposit requirements if any deposit shortfall does not exceed the greater of (1) \$100, or (2) 2% of the amount of taxes otherwise required to be deposited, and you deposit the shortfall as follows.

- **Monthly depositor**

Deposit the shortfall by the due date of Form 943 or mail it with the return.

- **Semiweekly or one-day depositor**

Deposit the shortfall by the earlier of the return due date covering that deposit, or the first Wednesday or Friday, whichever is earlier, on or after the 15th day of the month following the month the deposit was required to be made.

Penalty. If this safe-harbor rule is not satisfied, a failure to deposit penalty may apply. See *Penalties*, later.

Tax calendar. If you would like a calendar that lists the various due dates on which employers must file returns and make deposits, get Publication 509, *Tax Calendars for 1995*.

How to make deposits. Make your deposit by mailing or delivering a single check or money order covering social security, Medicare, and withheld income taxes to an authorized financial institution or a Federal Reserve

bank. (The federal unemployment tax, explained later, must be paid separately.) Each deposit must be accompanied by a federal tax deposit (FTD) coupon. Write your employer identification number, "Form 943," and the tax period the deposit applies to on your check or money order. You can get the names of authorized institutions from a Federal Reserve bank. It is very important to clearly mark the correct type of tax and tax period on each deposit coupon. This information is used by the IRS to credit your account.

A federal tax deposit coupon book containing a supply of Form 8109 and instructions will automatically be sent to you after you apply for an employer identification number. You will continue to receive coupon books automatically and generally will not need to reorder.

To change your mailing address for the FTD coupons, use Form 8109C, *FTD Address Change*. This will not change your address for other account matters with the IRS. You may continue to use the old coupons until you receive a book with the new address.

If you need to make a deposit and do not have a coupon, contact your local IRS office and provide the following information:

- Business name,
- Address where you want the coupon books sent,
- Number of coupon books, and
- Employer identification number.

Note. Do not use a federal tax deposit coupon to deposit delinquent taxes you have been assessed by the IRS. These payments should be mailed to the IRS Service Center that assessed the taxes together with copies of any related notices.

Timeliness of deposits. The timeliness of a deposit depends on the date the authorized financial institution or Federal Reserve bank receives it. A deposit received after the due date will be considered timely if you can establish that it was mailed at least 2 days before the due date. However, deposits of \$20,000 or more by an employer required to deposit tax more than once a month must be received by the due date to be timely.

If you fail to deposit social security, Medicare, and withheld income taxes on time, you may have to pay a penalty.

Form W-2. By January 31, you must furnish each employee from whom, during the previous year, you withheld income tax or social security and Medicare taxes, or to whom you paid any amount for services, a Form W-2 showing total wages and total income tax and social security and Medicare taxes withheld. However, if an employee requests the form earlier, you must give it to him or her within 30 days of the request or within 30 days after your final payment of wages to that person, whichever is later. See *Form W-2* in Chapter 2 of this publication.

Penalties. If you do not deposit social security, Medicare, and withheld income taxes on time with an authorized financial institution or a Federal Reserve bank, you may have to pay a penalty. In addition, the IRS can require you to file monthly returns for these taxes on Form 941-M, *Employer's Monthly Federal Tax Return*.

The penalty will not apply if the failure to meet the deposit requirements was due to reasonable cause and not to willful neglect.

Federal tax deposit penalties. The penalty for a late tax deposit is based on the length of time the deposit is late. The following penalties apply for late deposits:

- 1) If the deposit is not more than 5 days late, the penalty is 2% of the underpayment.
- 2) If the deposit is more than 5 days late but not more than 15 days late, the penalty is 5% of the underpayment.
- 3) If the deposit is more than 15 days late, the penalty is 10% of the underpayment.
- 4) If the deposit is not made within 10 days after the IRS issues the first notice demanding payment or by the day that notice and demand for immediate payment is given, the penalty is 15% of the underpayment.

Trust fund recovery penalty. If you are a person responsible for withholding, accounting for, or 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.

Additional information. For further information about withholding, depositing, and paying social security, Medicare, and income taxes on farm labor, get Circular A. Also get Circular E for additional information on income tax withholding.

Federal Unemployment Tax

If you as a farmer-employer pay cash wages, you must pay federal unemployment (FUTA) tax if you meet either of the following two 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, or
- 2) You employed 10 or more farm workers for some part of at least 1 day during each of 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 either to figure whether you are subject to federal unemployment tax or to figure how much tax you owe.

Wages of foreign workers. The federal unemployment tax does not apply to wages paid to an alien who was admitted to the United States to perform farm labor before 1995 under a contract to you and who returns to his or her own country when the contract is completed. However, wages paid to an alien worker are counted in figuring whether you are subject to the federal unemployment tax for your other farm workers under the two tests above.

Only employer pays 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.

Tax rate. For 1994, the gross tax rate is 6.2% on the first \$7,000 of cash wages paid to each employee. The rate remains the same for 1995. You may receive a credit of up to 5.4% for the state unemployment tax you pay. If your state tax rate (experience rate) is less than 5.4%, you are still allowed the full 5.4% credit. Thus, your net federal liability may be as low as 0.8% in 1994 if your state is not subject to a credit reduction. The federal liability, however, remains in effect even though you may be exempt from state unemployment tax or your employees are ineligible for unemployment compensation benefits. Form 940 is designed to take state credits into account.

Credit reduction. 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. The Department of Labor determines the credit reduction states for the current year by November 10.

Deposit rules for FUTA taxes. If the amount subject to deposit (plus the amount subject to deposit for any prior quarter but not deposited) is more than \$100, you must deposit the FUTA tax with an authorized financial institution or a Federal Reserve bank within one month following the close of the quarter. If the amount is \$100 or less, you do not have to deposit it, but you must add it to the amount subject to deposit for the next quarter. To help ensure proper crediting to your account, write your employer identification number, "Form 940," and the tax period the deposit applies to on your check or money order.

Making deposits. The procedures for making deposits of FUTA tax are the same as those discussed earlier for making deposits of social security, Medicare, and withheld income taxes. See *How to make deposits*, earlier.

Form 940. An annual return, Form 940, must be filed by January 31 following the close of the calendar year for which the tax is due. Any tax still due is payable with the return. If you mail the tax payment with your return, complete the Payment Voucher on the return, but do **not** detach it. Mail the return with the payment to the address shown for "Return with payment" in the instructions. You must file Form 940 on a calendar-year basis even if you operate on a fiscal-year basis.

Form 940 may be filed as late as February 10 following the close of the year if all required deposits were made timely and full payment of the tax is deposited by January 31. Also see *Penalties*, earlier.

Usually, the IRS will mail copies of Form 940 to you. However, if you do not receive them, you may order them from the IRS Forms Distribution Center.

Form 940-EZ. Form 940-EZ, a simplified version of Form 940, can be used by employers:

- 1) Who paid state unemployment taxes to only one state;
- 2) Who paid the state taxes by the due date of Form 940 or Form 940-EZ;
- 3) Whose wages taxable for FUTA tax were also taxable for state unemployment tax; and
- 4) Who did not pay wages subject to the unemployment laws of a credit reduction state.

Additional information. More information on the federal unemployment tax can be found in the instructions for Form 940. If you need information on whether you are subject to income tax withholding, social security and Medicare taxes, or the federal unemployment tax, see the table in Circular A.

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.

Federal unemployment 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).

The above rules apply even if the child is paid wages for nonfarm work. The wages for these services are not subject to social security and Medicare or federal unemployment taxes. But 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 taxes. 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 taxes.

Covered services of a 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; or
- 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 may use the services of, or employ, individuals called 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; and
- 2) Pays (either on his or her own behalf or on behalf of the farmer) the workers furnished by him or her for the farm labor done by them; and
- 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 above 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 situations not covered above. 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 937.

Advance Payment of Earned Income Credit

Employers are generally required to make payments to employees who have filed with them a Form W-5 to receive advance payments of their earned income credit (EIC). This allows those employees to receive 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 pay of the employees each payday. It is figured from tables in Circular A. Employers reduce their liability for income tax withholding, social security taxes, and Medicare taxes by the total amount of the advance earned income credit payments made. For more information, see *Advance Payment of Earned Income Credit* in Publication 937.

Earned income credit notification. You are required to 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 have claimed exemption from withholding on Form W-4.

You can meet the **notification requirement** by giving each employee the official IRS Form W-2, which contains the notification on the back of Copy C, or you can give each employee Notice 797, *Possible Federal Tax Refund Due to the Earned Income Credit (EIC)*. You can also use your own written statement if it has the exact wording of Notice 797, or you can furnish substitute Forms W-2 containing the exact wording shown on the back of Copy C of the official Form W-2. You must so notify each employee, either in person or by First Class Mail, with his or her 1994 Form W-2 or within one week before or after that time, unless you use a substitute Form W-2 as the notice. If you do not furnish Form W-2 on time, you must notify the employee about the EIC by the date Form W-2 was required to be furnished. If Form W-2 is not required for the calendar year, you must notify the employee about the EIC by February 7 of the following year.

You can request supplies of Notice 797 by calling the IRS toll-free telephone number 1-800-TAX-FORM (1-800-829-3676).

17.

Retirement Plans

Important Change for 1994

New compensation limit. Compensation of a participant that can be taken into account for computing contributions to a Keogh or SEP plan is generally limited to \$150,000 for plan years beginning on or after January 1, 1994. See *Deduction Limits* under *Keogh Plans* for more information.

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 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 employer contributions, or by a mix of employer and employee contributions. Employee contributions may not satisfy the minimum funding requirements for your plan. Employee contributions can be voluntary or mandatory. For example, a retirement plan can require after-tax employee contributions that by themselves do not meet the minimum funding requirements.

Although they are considered **employer contributions**, a plan can allow your employees to make **elective deferrals**. 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. Employer contributions to an employer-sponsored retirement plan are generally deductible as discussed later under *Deduction Limits*.

Employer contributions that must be capitalized. You cannot currently deduct employer contributions to a retirement plan, or any other expenses, that you are required to capitalize (include in the basis of certain property or in inventory costs). See chapter 7.

Kinds of plans. Employer retirement plans are either:

- Qualified plans (includes retirement plans for the self-employed, such as HR-10 (Keogh) plans and simplified employee pensions (SEPs)), or
- 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, 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)
- 937** Employment Taxes

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) Pension Benefit Plan

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 requirements, you can generally 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 rules. To be a qualified plan, the plan must meet many requirements. Among these are rules concerning:

- Who must be covered by the plan,
- How contributions to the plan are to be invested,
- How contributions to the plan and benefits under the plan are to be determined, and
- 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.

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 to the plan among the participating employees and for distributing the funds in the plan.

Stock bonus plan. This plan is similar to a profit-sharing plan, but it can only be set up by a corporation. Benefits are payable in the form of the company's stock.

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. You may 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. See Publication 1380, *User Fees*, for more information.

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:

- Trade or professional organizations,
- Banks (including some savings and loan associations and federally insured credit unions),
- Insurance companies, or
- 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 are generally called Keogh or HR-10 plans. You can also 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 can generally deduct contributions to the plan. Contributions are not taxed to your employees until plan benefits are distributed to them.

Deduction Limits

The limits differ depending on the kind of Keogh plan you have. If your plan is a defined contribution plan, the limit for each employee generally is the lesser of \$30,000 or:

- 15% of the employee's taxable compensation, if your plan is a profit-sharing plan, or

- 25% of the employee's taxable compensation, if your plan is a money purchase pension plan.

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, see *Kinds of Plans* in Publication 560.

Deduction of contributions for yourself. To take a deduction for employer contributions made for your benefit 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 of employer contributions 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 where your personal services are a material income-producing factor. Therefore, 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 is 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 *Self-Employment Income*, in Publication 533.

Adjustments. You must reduce your net earnings by the income tax deduction you are allowed for one-half of the self-employment tax. Also, net earnings must be reduced by the deduction for employer contributions made for your benefit. This reduction is made indirectly, as explained next.

Net earnings reduced by adjusting contribution rate. To reduce net earnings by the employer deduction for contributions for yourself presents a problem. This is because the deduction and the net earnings depend on each other. You can make this adjustment to your net earnings indirectly by, in figuring your maximum deduction, reducing the contribution rate called for in the plan.

Figuring your deduction. Use the following worksheet to find the reduced contribution rate. Make no reduction to the contribution rate for any common-law employees.

Self-Employed Person's Rate Worksheet

- 1) Plan contribution rate as a decimal (for example, 10½% 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) 0.0950

Now that you have your self-employed rate, you can figure your maximum deduction for contributions for yourself by completing the following steps:

Self-Employed Person's Deduction Worksheet

- Step 1**
Enter the contribution rate shown in line 3 above _____
- Step 2**
Enter your net earnings 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 sole proprietor and have employees. The terms of your plan provide that you contribute 10½% (.105) of your compensation, (defined earlier) and 10½% of your common-law employees' compensation. Your net earnings from line 31, Schedule C (Form 1040) is \$200,000. In figuring this amount, you deducted your common-law employees' pay of \$100,000 and contributions for them of \$10,500 (10½% x \$100,000). You figure your self-employed rate and maximum deduction for employer contributions on behalf of yourself as follows:

Self-Employed Person's Rate Worksheet

- 1) Plan contribution rate as a decimal (for example, 10½% 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

Self-Employed Person's Deduction Worksheet

- Step 1**
Enter the contribution rate shown in line 3 above 0.0950
- Step 2**
Enter your net earnings 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 \$ 6,435
- Step 4**
Subtract Step 3 from Step 2 and enter the result \$193,565
- Step 5**
Multiply Step 4 by Step 1 and enter the result \$ 18,389
- 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 return for that year.

Additional information. Additional 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 averaging 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 Table 17-2 for a sample Form 5305-SEP.

Employer contributions. You can contribute each year to each employee's SEP-IRA up to the smaller of \$30,000 or 15% of the employee's **compensation** (determined without regard to your contributions to the employee's SEP-IRA). If you are self-employed, SEP contributions you make to **your SEP-IRA**, because a special computation is required, are limited to 13.0435% of your compensation. See *Figuring your deduction* under *Retirement Plans for the Self-Employed*, earlier. Make no reduction to the contribution rate for any common-law employees.

Your contributions are not included in a participant's income when contributed.

Your employees cannot take a deduction for your SEP contribution.

SEP and profit-sharing plans. If you also contributed to a qualified profit-sharing plan, you must reduce the 15% deductible limit for that plan by the allowable deduction for contributions to the SEP-IRAs of those participating in 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 your SEP contributions. The portion of the 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 tax on the part contributed is deferred. This choice is called an elective deferral. This election is available only if:

- At least 50% of your employees eligible to participate choose the salary reduction arrangement,
- You had no more than 25 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

- 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**). For plan years beginning in 1994, you generally cannot consider compensation of an employee in excess of \$150,000 in figuring an employee's deferral percentage.

Note. For employees in a collective bargaining unit covered by a SEP for which the \$150,000 limit is not effective, the compensation limit is \$242,280.

Limits on 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 1994 is limited to \$9,240. 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. Therefore, unless there are contributions in excess of the applicable limit, 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. In 1994, Jim chooses to have \$4,500 taken out of his pay to fund employer contributions to his SEP-IRA. His compensation for the year is \$30,000. On Jim's Form W-2, his employer will show total wages of \$25,500 (\$30,000 minus \$4,500) for income tax and \$30,000 for social security and Medicare wages. Jim will report \$25,500 as wages on his tax return.

For more information on employer withholding requirements, see Publication 937.

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 attributable to 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 have not reached age 70½ by the end of the year. You can have an IRA whether or not you are covered by any other retirement plan. However, you may not be able to deduct any or some of your contributions if you or your spouse are covered by an employer's retirement plan.

Compensation. Compensation includes taxable wages, salaries, commissions, bonuses, tips, professional fees, self-employment income (subject to certain adjustments, discussed below, and provided your personal services are a material income-producing factor), other amounts received for personal services, and taxable alimony and separate maintenance payments.

If you are an employee, compensation includes 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).

If you are self-employed (a sole proprietor or partner), compensation is the net earnings of your trade or business (self-employment income) 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:

- Income received from property, such as rental, interest, or dividend income, or
- Any amounts received as a pension or annuity, or as deferred compensation.

Foreign income. Foreign earned income and other amounts that are excluded from gross income are **not** compensation for IRA purposes.

Contributions. The most you can contribute for any year to your IRA is the **smaller** of:

- \$2,000, or
- Your taxable compensation.

Deductible and nondeductible contributions. Generally, you can take a deduction for the contributions 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 IRA deduction may be reduced or eliminated, depending on your filing status and the amount of your income. Whether or not your allowable contributions are deductible, you can choose to make nondeductible contributions to your IRA. For details on these and other rules, as well as general information on IRAs, get Publication 590.

18. Excise Taxes

Important Reminders

Dyed diesel fuel. Dyed diesel fuel that is used in a nontaxable use (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 use. For more information, see Publication 510.

Undyed diesel fuel. A registered vendor that sells undyed diesel fuel for use on 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 tax on that fuel. See *How To Buy Diesel Fuel Tax Free*, later.

Introduction

You may be eligible to claim a credit on your 1994 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 1995, instead of waiting to claim a credit on your 1995 income tax return.

Also, you may be eligible to claim a one-time credit or refund as the **original** purchaser of a diesel-powered car, van, or light truck. This applies even if the vehicle is not used 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

- 349** Federal Highway Use Tax on Heavy Vehicles
- 378** Fuel Tax Credits and Refunds
- 510** Excise Taxes For 1995

Form (and Instructions)

- 4136** Credit for Federal Tax Paid on Fuels
- 8849** Claim for Refund of Excise Taxes

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 if you are the owner, tenant, or operator of a farm. You may claim **only** a credit for the tax on gasoline, special motor fuel, 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.

Farm. A farm includes livestock (including feed yards for fattening cattle), dairy, fish, poultry, fruit, fur-bearing animals, truck farms, orchards, plantations, ranches, nurseries, ranges, and 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. The farm 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 one-half of that commodity which 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 will be 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 services.

If doubt exists whether the owner, tenant, or the operator of the farm purchased 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 cultivate the soil on the Blue's farm in preparation for planting. Under the contract, Nancy paid for 200 gallons of gasoline to be used by Harry on the farm. In addition, Nancy hired Farmer Brown to grade and pack Nancy's apple crop. Brown purchased 25 gallons of gasoline to use in packing the apples and was not reimbursed by Nancy. Nancy may claim the 200 gallons of gasoline used by Harry on Nancy's farm because it qualifies as fuel used on the farm for farming purposes. No one can claim a credit for the 25 gallons.

Example 2. Mr. Green, the owner of the farm, and his tenant, Mr. Smith, share the cost of gasoline used on the farm 50–50, so each can claim a credit for the tax on one-half the fuel used.

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. See *How To Buy Diesel Fuel Tax Free*, later.

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. The applicator is 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 signed, you cannot revoke the waiver. 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 sufficiently large to put you on notice that you are waiving your right to the credit or refund. In addition, 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.
- 4) In the processing of crude gum into gum spirits of turpentine or gum resin, or in the processing of maple sap into maple syrup or maple sugar.

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. This 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.

Diesel fuel. 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.

Highway vehicle. A highway vehicle includes any self-propelled vehicle designed to carry a load over public highways, whether or not also designed to perform other functions. Examples of vehicles designed to carry a load over public highways are passenger automobiles, motorcycles, buses, highway-type trucks, and truck tractors. It does not matter if:

- 1) The vehicle's design allows it to perform a highway transportation function for only:
 - a) A particular type of load, such as passengers, furnishings, and personal effects (as in a house, office, or utility trailer).
 - b) A special kind of cargo, goods, supplies.
- 2) Machinery or equipment is designed (and permanently mounted) to perform some off-highway task unrelated to highway transportation, except as discussed next.

Vehicles not considered highway vehicles. Generally, the following kinds of vehicles are not considered highway vehicles:

- 1) Specially designed mobile machinery for nontransportation functions. A self-propelled vehicle is not a highway vehicle if the chassis—
 - a) Has permanently mounted to it machinery or equipment used to perform certain operations (construction, manufacturing, drilling, mining, timbering, processing, farming, or similar operations) if the operation of the machinery or equipment is unrelated to transportation on or off the public highways.
 - b) Has been specially designed to serve only as a mobile carriage and mount for the machinery or equipment, whether or not the machinery or equipment is in operation.
 - c) Because of its special design, could not, without substantial structural modification, be used as part of a vehicle designed to carry any other load.
- 2) Vehicles designed for off-highway transportation. A self-propelled vehicle is not a highway vehicle if—

- a) The vehicle is designed primarily to carry a specific kind of load other than over the public highway for certain operations (construction, manufacturing, mining, processing, farming, drilling, timbering, or similar operations).
- b) The vehicle's use of carrying this load over public highways is substantially limited or impaired because of its design. To determine if the vehicle is substantially limited or impaired, you may take into account whether the vehicle may travel at regular highway speeds, requires a special permit for highway use, or is overweight, overheight, or overwidth for regular highway use.

Public highway. A public highway includes any road in the United States that is not a private roadway. This includes federal, state, county, and city roads and streets.

Registered. A vehicle is considered registered when 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.

Fuel used for power take-off. You cannot take a credit or refund for fuel used in the motor (for propulsion) of a highway vehicle that also operates special equipment by means of a power take-off or power transfer. It does not matter if the special equipment is mounted on the vehicle.

Separate motor. The fuel you use in a separate motor to operate special equipment, such as a refrigeration unit, pump, generator, or mixing unit, may qualify for a credit or a refund. If you draw fuel from the same tank to operate both of the motors, you must figure the quantity used in the separate motor operating the special equipment. You may make a reasonable estimate based on your operating experience and supported by your records.

You can use devices that measure the miles the vehicle has traveled (such as hubometers) to figure the gallons of fuel used to propel the vehicle. Add to this amount the fuel consumed while idling or warming up the motor before propelling the vehicle. The difference between your total fuel used and the fuel used to propel the vehicle is the fuel used in the separate motor.

Example. Cera owns a refrigerated truck. It has a separate motor for the refrigeration unit. The same gasoline tank supplies both motors. Using the truck's hubometer, Cera figures that 70% of the gasoline was used to propel the truck. Therefore, she qualifies for a credit or refund on 30% of the gasoline determined to be used in an off-highway business use.

Diesel fuel. Undyed diesel fuel used other than as a fuel in the propulsion engine of a diesel-powered highway vehicle qualifies for a credit or refund. No credit or refund is allowed if the diesel fuel was dyed. Also, if undyed diesel fuel is used on a farm for farming purposes (discussed earlier), the fuel cannot be considered as being used for any other nontaxable purpose. See *How To Buy Diesel Fuel Tax Free*, later.

Fuel lost or destroyed. You cannot treat fuel lost or destroyed through spillage, fire, or other casualty as fuel used in an off-highway business use.

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.
- 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.

How To Buy Diesel Fuel Tax Free

You buy **dyed** diesel fuel tax free for use for a nontaxable purpose, including use on a farm for farming purposes. However, 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 purchased 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*.

The certificate may be included 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.

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 purchase 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 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.

Original purchaser. You must be the original purchaser to be eligible for the credit or refund. An original purchaser 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 purchasers:

- 1) State and local governments.
- 2) Nonprofit educational organizations.
- 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 purchaser.

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.
- 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 such vehicle. Consider the basis reduction to occur on the date of purchase.

Example. David purchased a new diesel-powered car to use in his business. He claimed the \$102 credit *only* for the tax year in which he purchased the car (1994). He reduced his basis in the car by \$102 on the date he purchased it.

How to claim a 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.

If you are not required to file an income tax return, you should do so to take advantage of 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 purchaser 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, purchased 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, the fuel cannot be considered 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.

Records. Keep at your principal place of business all records needed to enable the IRS to verify the amount you claimed. No special form is required, but the records should establish:

- 1) The total number of gallons purchased and used during the period covered by your claim.
- 2) The dates of the purchases.
- 3) The names and addresses of suppliers and amounts purchased from each during the period covered by your claim.
- 4) The purpose for which you purchased 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 on recordkeeping, see Publication 552, *Recordkeeping for Individuals*.

Claiming a Credit

You make a claim for 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 59 and check box b of the 1994 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. The partnership itself 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 applicable tax rates. 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 is required to 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 on an amended return for that year filed within the time prescribed by law. 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 during 1995 rather than waiting to file your 1995 income tax return to claim a credit. 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) or **aviation fuel** used for nontaxable 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 following 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 1994 Form 1040 on March 1, 1995. 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 1995 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 1994 Form 1040 on April 12, 1995. On Schedule F, he deducted the total cost of gasoline (including \$155 of excise taxes) that he used on the farm during 1994. 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 1994 Schedule F.

19.

The Examination and Appeals Process

Topics

This chapter discusses:

- Examination of returns
- Appealing the examination findings

Useful Items

You may want to see:

Publication

- 1 Your Rights as a Taxpayer
- 5 Appeal Rights and Preparation of Protests for Unagreed Cases
- 556 Examination of Returns, Appeal Rights, and Claims for Refund

We examine returns for correctness of income, exemptions, credits, and deductions. After the examination, if we propose any changes to your tax, you may either agree with those changes and pay any additional tax, or you may disagree with the changes and appeal the decision.

Fairness If Your Return Is Examined

Most taxpayers' returns are accepted as filed. But if your return is selected for examination, it does not suggest that you are dishonest. The examination may or may not result in more tax. Your case may be closed without change. Or, you may receive a refund.

Courtesy and consideration. You are entitled to courteous and considerate treatment

from IRS employees at all times. If you ever feel that you are not being treated with fairness, courtesy, and consideration by an IRS employee, you should tell the employee's supervisor. Publication 1 explains the many rights you have as a taxpayer. You can get this publication free by calling us at our toll-free number.

Pay only the required tax. You have the right to plan your business and personal finances in such a way that you will pay the least tax that is due under the law. You are liable only for the correct amount of tax. Our purpose is to apply the law consistently and fairly to all taxpayers.

Privacy and confidentiality. You have the right to have your tax case kept confidential. Under the law, the IRS must protect the privacy of your tax information. However, if a lien or a lawsuit is filed, certain aspects of your tax case will become public record. People who prepare your return or represent you must also keep your information confidential.

You also have the right to know why we are asking you for the information, exactly how we will use it and what might happen if you do not give it.

Examination of Returns

An examination usually begins when we notify you that your return has been selected. We will tell you which records you will need. If you gather your records before the examination, it can be completed with the least amount of effort.

How returns are selected. We select returns for examination by several methods. A computer program called the Discriminant Function System (DIF) is used to select most returns. In this method, the computer uses historical data to give parts of the return a score. IRS personnel then screen the return. Returns most likely to have mistakes are selected for examination.

Some returns are selected at random. We use these examination results to update and improve our selection process.

We also select returns by examining claims for credit or refund and by matching information documents, such as Forms W-2 and the 1099 series, with returns.

Arranging the examination. Many examinations are handled by mail. However, if we notify you that your examination is to be conducted through a personal interview, or if you request such an interview, you have the right to ask that the examination take place at a reasonable time and place that is convenient for both you and the IRS. If the time or place we suggest is not convenient, the examiner will try to work out something more suitable. However, we will make the final determination on how, when, and where an examination takes place.

Transfers to another district. Generally, your individual return is examined in the IRS district office nearest your home. However, not all offices have examination facilities. Your

business return is examined where your books and records are maintained. If the place of examination is not convenient, you may ask to have the examination done in another office or transferred to a different district.

Representation. Throughout the examination, you may represent yourself, have someone else accompany you, or, with proper written authorization, have someone represent you in your absence. If you want to consult an attorney, a C.P.A., an enrolled agent, or any other person permitted to represent a taxpayer during an examination, we will stop and reschedule the interview. We cannot suspend the interview if you are there because of an administrative summons.

Recordings. You can generally make an audio recording of an interview with an IRS Examination officer. Your request to record the interview should be made in writing. You must notify us at least 10 days before the meeting and bring your own recording equipment. We also can record an interview. If we initiate the recording, we will notify you 10 days before the meeting and you can get a copy of the recording at your expense.

Repeat examinations. We try to avoid repeat examinations of the same items, but sometimes this happens. 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 that we can see if we should discontinue the examination.

Explanation of Changes

If we propose any changes to your return, we will explain the reasons for the changes. It is important that you understand the reasons for any proposed change. You should not hesitate to ask about anything that is unclear to you.

Agreement with changes. If you agree with the proposed changes, you may sign an agreement form and pay any additional tax you may owe. You must pay interest on any additional tax. If you pay when you sign the agreement, the interest is generally figured from the due date of your return to the date you paid.

If you do not pay the additional tax when you sign the agreement, you will receive a bill. The interest on the additional tax is generally figured from the due date of your return to the billing date. However, you will not be billed for more than 30 days additional interest, even if the bill is delayed. Also, you will not have to pay any more interest or penalties if you pay the amount due within 10 days of the billing date.

If you are due a refund, we can refund your money more quickly if you sign the agreement form. You will be paid interest on the refund.

Appealing the Examination Findings

If you do not agree with the examiner's report, you may meet with the examiner's supervisor

to discuss your case further. If you still don't agree after receiving the examiner's findings, you have the right to appeal them. The examiner will explain your appeal rights and give you a copy of Publication 5. This publication explains your appeal rights in detail and tells you exactly what to do if you want to appeal. You can also get a free copy by calling us at our toll-free number.

Appeals Office. You can appeal the findings of an examination within the IRS through our Appeals Office. The Appeals Office is independent of your examiner and IRS District Director or Service Center Director. Most differences can be settled through this appeals system without expensive and time-consuming court trials. If the matter cannot be settled to your satisfaction in Appeals, you can take your case to court.

Appeals to the courts. Depending on whether you first pay the disputed tax, you can take your case to the U.S. Tax Court, the U.S. Court of Federal Claims, or your U.S. District Court. These courts are entirely independent of the IRS. However, a U.S. Tax Court case is generally reviewed by our Appeals Office before it is heard by the Tax Court. As always, you can represent yourself or have someone admitted to practice before the court represent you.

If you did not yet pay the additional tax and you disagree about whether you owe it, you generally have the right to take your case to the Tax Court. We will mail you a formal notice (called a "notice of deficiency") telling you that you owe additional tax. You ordinarily have 90 days to file a petition with the Tax Court.

If you have already paid the disputed tax in full and filed a claim for refund (discussed later) for it that we disallowed (or on which we did not take action within 6 months), you may take your case to the U.S. District Court or U.S. Court of Federal Claims.

Court decisions. We follow Supreme Court decisions. However, we can lose cases in other courts involving taxpayers with the same issue and still apply our interpretation of the law to your situation. You have the right to appeal our decision to do so.

Recovering litigation expenses. If the court agrees with you on most of the issues in your case, and finds the IRS's position to be largely unjustified, you may be able to recover some of your litigation expenses from us. But to do this, you must have used up all the administrative remedies available to you within the IRS, including going through our Appeals system. You may also be able to recover administrative expenses from the IRS.

Publication 556 will help you more fully understand your appeal rights. You can get it free by calling our toll-free number.

Other Remedies

If you believe that tax, penalty, or interest was unjustly charged, you have rights that can remedy the situation.

Claims for refund. Once you have paid your tax, you have the right to file a claim for a credit or refund if you believe the tax is too much. You may claim a credit or refund by filing Form 1040X, *Amended U.S. Individual Income Tax Return*.

You should file your claim by mailing it to the Internal Revenue Service Center where you filed your original return. File a separate form for each year or period involved.

Time for filing a claim. Generally, claims for a credit or refund must be filed within 3 years from the date you filed your original return or 2 years from the date you paid the tax, whichever is later. (A return filed early is considered filed on the date it was due.) There are exceptions to this time period if your claim is based on certain carryback items, foreign taxes, bad debts, worthless securities, or if you and the Service have agreed to extend the tax assessment period.

Cancellation of penalties. You have the right to ask that certain penalties (but not interest, as discussed later) be canceled (abated) if you can show reasonable cause for the failure that led to the penalty (or can show that you exercised due diligence, if that is the standard for the penalty).

If you relied on wrong advice given to you by IRS employees on the toll-free telephone system, we will cancel certain penalties that may result. But you have to show that your reliance on the advice was reasonable.

Reduction of interest. If our error caused a delay in your case, and this is grossly unfair, you may be entitled to a reduction of the interest that would otherwise be due. Only delays caused by procedural or mechanical acts that do not involve exercising judgment or discretion qualify. If you think we caused such a delay, please discuss it with the examiner and file a claim.

Business Taxpayers

If you are in an individual business, the rights covered in this discussion generally apply to you. If you are a member of a partnership or a shareholder in a small business corporation, special rules (which may be different from those described here) may apply to the examination of your partnership or corporation items. The examination of these items is discussed in Publication 556. You can get this publication free by calling us at our toll-free number.

Sample Return

This sample return uses actual forms to show you how to prepare your income tax return. 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.

Receipt and expense records. The receipt and expense records shown in this chapter are limited to a few farm account entries made at the beginning of the tax year. The totals, however, include all of Mr. Brown's receipts and expenses for 1994.

Each entry for an income item shows the date and from whom it was received, as well as the amount and kind of income. Each expense entry shows the date of payment, to whom it was paid, and whether it was a business expense or an investment in new property.

You are not required to use these particular forms of records. These illustrations are not the only way records can be kept. They are used only to show a simple way to keep farm records. The Cooperative Extension Service can provide you with more information on farm record systems.

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.

Schedule F—Income

Mr. Brown prints his name and social security number as shown on the address label 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 on line D. He checks the "Yes" box on line E to show that he materially participated in the operation of his farm business.

Line items. Mr. Brown then fills in all applicable items of farm income.

Line 1. In 1994, Mr. Brown sold steers he had bought for resale. He enters the amount of the sales, \$12,960.

Line 2. He enters the cost of the animals, \$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. The cost of the steers sold in 1994 is different from that shown on the farm expense record because most of the steers sold in 1994 were bought in 1993.

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, such as grain, 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 1994 from sales of items he raised or produced on his farm. 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. Related expenses, such as hauling, advertising, and dues, are included as farm expenses in Part II of Schedule F.

He also received income from sales of other items raised or produced on his farm. 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 ASCS cost sharing of \$438 on a soil conservation project (diversion channels) completed in 1994. 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, since 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 1993 federal income tax return. He includes the entire \$142 in his 1994 income on line 10, since that amount was included in the cost of gasoline he deducted as a farm business expense in 1993. He also includes \$250 he received as a director of the local milk marketing cooperative and \$175 received for firewood the Browns cut and sold in 1994.

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—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 1994 was \$2,659. He uses his family car 60% for business. It cost \$2,307 to operate the car in 1994 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 applied to his crops and land.

Line 14. Mr. Brown deducts the \$1,040 spent on diversion channels in 1994. 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 Soil Conservation Service of the USDA. Since the amount was not more than 25% of Mr. Brown's gross income from farming, the entire amount is deductible. He must complete and attach Form 8645, *Soil and Water Conservation Plan Certification* (not shown). See Chapter 6.

Line 15. The \$1,575 on this line is the amount he paid someone else for spraying his crops.

Line 16. Mr. Brown enters the \$27,317 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. The payments for farm machinery repairs, although large, were made to a corporation. He was not required to file a Form 1099-MISC to report the payments.

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 1994, 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 the 60% of the state gasoline tax applying to gasoline used in the family car for farm business, because these taxes were included in the deductions for supplies and gasoline. His share of social security and Medicare tax for agricultural labor used on the farm for calendar year 1993,

which he paid when he filed his Form 943 in January 1994, is included.

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 1994 for veterinary fees (\$1,821), livestock medicines (\$650), and breeding fees (\$746). Mr. Brown prepares Form 1099-MISC for the veterinarian and breeder fees since neither is incorporated. He sent Copy A to the IRS with Form 1096 and gave Copy B to the veterinarian and the breeder.

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. However, he included only 50% of the cost of the 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 \$114,689 on line 35.

Line 36—Net farm profit. To arrive at his net farm profit, he subtracts line 35 from \$137,340, line 11. His net farm profit, entered on line 36, is \$22,651. He also enters that amount on line 18 of Form 1040, and on line 1 of Section A, Schedule SE (Form 1040). Since 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 1994.

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 1994 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 improvements were made on the farm). The fences were fully depreciated in 1987. Mr. Brown made the division on the basis of 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 property as its cost, giving him the basis for figuring his depreciation allowance.

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 the Alternative Depreciation System (ADS) for all his property placed in service in 1990. He uses the 150% declining balance method and the half-year convention under MACRS for the property placed in service in 1991 and subsequent years.

Depreciable property. One of his purchased dairy cows was killed by lightning in July 1994. Another purchased cow (#52) was sold on February 1, 1994. Both cows were depreciated under MACRS, using a half-year convention. Therefore, he can claim a half-year's depreciation for each cow in 1994.

Mr. Brown has other breeding and dairy cows that he raised. He did not claim depreciation on them because he deducted the cost of raising them. They have no basis for income tax purposes.

For part of 1994, he owned two family cars. One of them, which he bought for his wife, 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 1994. They must be listed separately to keep track of their basis. The pickup truck and car purchased in 1991 are listed property in the 5-year property class.

New assets. Mr. Brown added three assets to the business in 1994.

- 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. It is depreciated using the 150% declining balance method. 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 \$984.38 when it was traded (Mr. Brown claimed half a year of depreciation). The new tractor has a basis of \$24,713.45 (\$23,729.07 + \$984.38). 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 1994 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 1994. 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 taxable 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 14. All property acquired in 1994 in each class is combined and entered in Part II, line 14. 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 16. Mr. Brown enters \$2,684, his MACRS depreciation deduction for assets acquired from 1990 through 1993, on line 16 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 19, explained later.

Line 18. On line 18, he enters \$1,374 for assets placed in service before 1981 and those depreciated under ACRS that are not listed property.

Line 19. Mr. Brown enters his depreciation deduction for listed property, \$2,124, on line 19. This is the total shown on line 25(h), 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 1991. His deduction for the car cannot be more than 60% of the limit for passenger automobiles for the year he purchased the car.

Line 20. Mr. Brown totals the depreciation in Part IV of Form 4562 on line 20 and carries the total, \$27,317, 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 22a and 22b of Section A and lines 27 through 33 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, \$22,651. 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, since 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 the amount on line 3 by .9235 and enters \$20,918 on line 4.

Lines 5 and 6. Mr. Brown multiplies the amount on line 4 by 15.3% and enters \$3,200 on line 5. This is his self-employment tax for 1994. He also enters \$3,200 on line 47 of Form 1040. He enters \$1,600 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. Since the cow was business property that was totally destroyed, 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, Mr. Brown must complete Part III to report the sale of certain depreciable property.

Part III. Mr. Brown sold three fully depreciated assets in 1994. 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. All the gain on both items is entered on line 27(b). Gain on the sale of the livestock is also reported as ordinary income. As shown on line 26, column (C), the total gain on the sale of cow #41 is \$335. All of that amount is reported on line 27(b).

Summary of Part III gains. On line 32 he enters \$1,105, the total of property columns (A) through (C), line 26. On line 33, he enters \$1,105, the total of property 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, because the total gain on line 27b is less than the depreciation allowed or allowable on line 27a and he has no other gains on lines 28-31.

He subtracts the amount on line 33 from that on 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

amount of 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 dairy cow #41 was sold at a gain, it was entered in Part III instead of Part I. See *Table 11–1* in Chapter 11.

He totals the gains on line 2 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 and to reconcile his Form 1099-B with amounts shown on his Schedule D. 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 1994 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. Mr. Brown 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.

Mr. Brown 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. Mr. and Mrs. Brown choose to have \$6 (\$3 each) go to the Presidential Election Campaign Fund so 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 the regular \$2,450 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, checks column (2) if they are under age 1, lists their social security numbers where applicable, lists their relationship, enters the number of months they lived in his house in 1994, and 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 6e.

Line items. Mr. Brown fills in all applicable income items on page 1 of Form 1040.

Line 7. Mrs. Brown worked part time as a substitute teacher for the county school system during 1994. She also works for Mr. Brown on the farm. Mr. Brown 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 1994. He constructively received it and correctly included it in his income for 1994. 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 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, \$22,651, from Schedule F (Form 1040).

Line 22. Mr. Brown adds the amounts on lines 7 through 21 and enters the total, \$35,403.

Line 25. Mr. Brown has already entered one-half of his self-employment tax, \$1,600. 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 \$6,745 from his Schedule A (Form 1040), which is not shown, since it is larger than the standard deduction for his filing status.

Lines 35, 36, and 37. Mr. Brown subtracts the \$6,745 on line 34 from the \$33,803 on line 32 and enters the result, \$27,058, on line 35. He enters \$12,250 ($5 \times \$2,450$) on line 36 and subtracts this amount from the amount on line 35 to get taxable income on line 37.

Lines 38 and 40. To determine their tax, he uses the Tax Table in the Form 1040 instructions. Since the amount on line 37 is \$14,808 he looks for the income bracket that includes this amount. He finds the bracket for incomes of at least \$14,800, but less than \$14,850, and finds that the tax for married taxpayers filing joint returns is \$2,224. He enters this amount on line 38 and checks the box for Tax Table. Since line 39 does not apply to him, he makes no entry on it. He enters \$2,224 on line 40.

Lines 45 and 46. Mr. and Mrs. Brown have none of the credits listed on lines 41 through 44, so Mr. Brown enters –0– on line 45, subtracts it from line 40, and enters \$2,224 on line 46.

Line 47. Mr. Brown has already entered the \$3,200 self-employment tax he figured on Schedule SE.

Line 53. He enters \$5,424, which is the total tax for 1994.

Line 54. 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 55. He did not make estimated tax payments since two-thirds of his gross income for 1993 was from farming. He was sure that at least two-thirds of his gross income for 1994 would be from farming and he would file his Form 1040 no later than March 1, 1995. Farmers who meet these conditions do not have to make estimated tax payments. Therefore, he makes no entry on line 55.

Line 56. The Browns are not entitled to claim the earned income credit on line 56, since their adjusted gross income on line 31 and their earned income are more than \$25,296.

Line 59. Mr. Brown enters his credit for gasoline tax. 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 1995 return.

Line 64. He adds the amounts on lines 54 and 59 and enters the total on line 60. He subtracts that figure from the amount on line 53. The balance, \$4,847, is entered on line 64. This is the amount Mr. and Mrs. Brown must pay when they file their return.

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 cover of 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 64 of Form 1040. On the check, he writes his social security number, their telephone number, and "1994 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, and 4562 in that order (see "Attachment Sequence Number" in the upper right corner of each schedule

or form). If the Browns were including supporting statements with their return, they would attach them last, assembled in the same order as the forms and schedules they support.

Mr. Brown also received a Form 1040-V, *Payment Voucher*, in his tax package (not shown). He detaches the voucher and enters the amount of his payment on it. He encloses his return with the payment voucher and check in the envelope that came with the tax package. He did **not** attach the voucher or the check to the return. Mr. Brown carefully follows the instructions on the back of the envelope and mails it to the IRS.

Name(s) shown on Form 1040

John and Ann Green

Your social security number

000:00:0000

Part I Adjustments and Preferences

1	If you itemized deductions on Schedule A (Form 1040), go to line 2. If you did not itemize deductions, enter your standard deduction from Form 1040, line 34, and skip to line 6	1	
2	Medical and dental. Enter the smaller of Schedule A, line 4, or 2 1/2% of Form 1040, line 32	2	
3	Taxes. Enter the amount from Schedule A, line 9	3	9,975
4	Certain interest on a home mortgage not used to buy, build, or improve your home	4	4,550
5	Miscellaneous itemized deductions. Enter the amount from Schedule A, line 26	5	1,000
6	Refund of taxes. Enter any tax refund from Form 1040, line 10 or 21	6	
7	Investment interest. Enter difference between regular tax and AMT deduction	7	
8	Post-1986 depreciation. Enter difference between regular tax and AMT depreciation	8	8,589
9	Adjusted gain or loss. Enter difference between AMT and regular tax gain or loss	9	
10	Incentive stock options. Enter excess of AMT income over regular tax income	10	
11	Passive activities. Enter difference between AMT and regular tax income or loss	11	
12	Beneficiaries of estates and trusts. Enter the amount from Schedule K-1 (Form 1041), line 8	12	820
13	Tax-exempt interest from private activity bonds issued after 8/7/86	13	
14	Other. Enter the amount, if any, for each item and enter the total on line 14.	14	150
	a Charitable contributions		
	b Circulation expenditures		
	c Depletion		
	d Depreciation (pre-1987)		
	e Installment sales		
	f Intangible drilling costs		
	g Long-term contracts		
	h Loss limitations		
	i Mining costs		
	j Patron's adjustment		150
	k Pollution control facilities		
	l Research and experimental		
	m Tax shelter farm activities		
	n Related adjustments		
15	Total Adjustments and Preferences. Combine lines 1 through 14	15	24,984

Part II Alternative Minimum Taxable Income

16	Enter the amount from Form 1040, line 35. If less than zero, enter as a (loss)	16	38,061
17	Net operating loss deduction, if any, from Form 1040, line 21. Enter as a positive amount	17	
18	If Form 1040, line 32, is over \$111,800 (over \$55,900 if married filing separately), and you itemized deductions, enter the amount, if any, from line 9 of the worksheet for Schedule A, line 29	18	
19	Combine lines 15 through 18	19	63,045
20	Alternative tax net operating loss deduction. See instructions	20	
21	Alternative Minimum Taxable Income. Subtract line 20 from line 19. (If married filing separately and line 21 is more than \$165,000, see instructions.)	21	63,045

Part III Exemption Amount and Alternative Minimum Tax

22	Exemption Amount. (If this form is for a child under age 14, see instructions.)		
	If your filing status is:	And line 21 is not over:	Enter on line 22:
	Single or head of household	\$112,500	\$33,750
	Married filing jointly or qualifying widow(er)	150,000	45,000
	Married filing separately	75,000	22,500
	If line 21 is over the amount shown above for your filing status, see instructions.		
23	Subtract line 22 from line 21. If zero or less, enter -0- here and on lines 26 and 28	23	18,045
24	If line 23 is \$175,000 or less (\$87,500 or less if married filing separately), multiply line 23 by 26% (.26). Otherwise, multiply line 23 by 28% (.28) and subtract \$3,500 (\$1,750 if married filing separately) from the result	24	4,692
25	Alternative minimum tax foreign tax credit. See instructions	25	
26	Tentative minimum tax. Subtract line 25 from line 24	26	4,692
27	Enter your tax from Form 1040, line 38 (plus any amount from Form 4970 included on Form 1040, line 38), minus any foreign tax credit from Form 1040, line 43	27	4,241
28	Alternative Minimum Tax. (If this form is for a child under age 14, see instructions.) Subtract line 27 from line 26. If zero or less, enter -0-. Enter here and on Form 1040, line 48	28	451

Department of the Treasury
Internal Revenue Service

▶ Attach to your tax return.

Name(s) shown on return

John and Ann Green

Identifying number

000-00-0000

Part I Net Minimum Tax on Exclusion Items

1	Combine lines 16 through 18 of your 1993 Form 6251. Estates and trusts, see instructions	1	46,650
2	Enter adjustments and preferences treated as exclusion items. See instructions	2	21,026
3	Minimum tax credit net operating loss deduction. See instructions	3	()
4	Combine lines 1, 2, and 3. If zero or less, enter -0- here and on line 15 and go to Part II. If more than \$165,000 and you were married filing separately for 1993, see instructions	4	67,676
5	Enter \$45,000 (\$33,750 if single or head of household for 1993, \$22,500 if married filing separately for 1993). Estates and trusts, enter \$22,500	5	45,000
6	Enter \$150,000 (\$112,500 if single or head of household for 1993, \$75,000 if married filing separately for 1993). Estates and trusts, enter \$75,000	6	150,000
7	Subtract line 6 from line 4. If zero or less, enter -0- here and on line 8 and go to line 9	7	-0-
8	Multiply line 7 by 25% (.25)	8	-0-
9	Subtract line 8 from line 5. If zero or less, enter -0-. If this form is for a child under age 14, see instructions	9	45,000
10	Subtract line 9 from line 4. If zero or less, enter -0- here and on line 15, and go to Part II. Form 1040NR filers, see instructions	10	22,676
11	If line 10 is \$175,000 or less (\$87,500 or less if married filing separately), multiply line 10 by 26% (.26). Otherwise, multiply line 10 by 28% (.28), and subtract \$3,500 (\$1,750 if married filing separately) from the result	11	5,896
12	Minimum tax foreign tax credit on exclusion items. See instructions	12	
13	Tentative minimum tax on exclusion items. Subtract line 12 from line 11	13	5,896
14	Enter the amount from your 1993 Form 6251, line 27, or Form 1041, Schedule H, line 38c	14	5,640
15	Net minimum tax on exclusion items. Subtract line 14 from line 13. If zero or less, enter -0-.	15	256

Part II Minimum Tax Credit and Carryforward to 1995

16	Enter the amount from your 1993 Form 6251, line 28, or Form 1041, Schedule H, line 39	16	1,730
17	Enter the amount from line 15 above	17	256
18	Subtract line 17 from line 16. If less than zero, enter as a negative amount	18	1,474
19	1993 minimum tax credit carryforward. Enter the amount from your 1993 Form 8801, line 26	19	800
20	Enter the total of your 1993 unallowed orphan drug credit, 1993 unallowed nonconventional source fuel credit, and 1993 unallowed qualified electric vehicle credit. See instructions	20	
21	Combine lines 18, 19, and 20. If zero or less, stop here and see instructions	21	2,274
22	Enter your 1994 regular income tax liability minus allowable credits. See instructions	22	4,241
23	Enter the amount from your 1994 Form 6251, line 26, or Form 1041, Schedule H, line 37	23	4,692
24	Subtract line 23 from line 22. If zero or less, enter -0-	24	-0-
25	Minimum tax credit. Enter the smaller of line 21 or line 24. Also enter this amount on the appropriate line of your 1994 tax return. See instructions	25	-0-
26	Minimum tax credit carryforward to 1995. Subtract line 25 from line 21. See instructions	26	2,274

Paperwork Reduction Act Notice

We ask for the information on this form to carry out the Internal Revenue laws of the United States. You are required to give us the information. We need it to ensure that you are complying with these laws and to allow us to figure and collect the right amount of tax.

The time needed to complete and file this form will vary depending on individual circumstances. The estimated average time is: Recordkeeping, 1 hr., 33 min.; Learning about the law or the form, 1 hr., 3 min.; Preparing the form, 1 hr.; Copying, assembling, and sending the form to the IRS, 17 min.

If you have comments concerning the accuracy of these time estimates or suggestions for making this form more simple, we would be happy to hear from you. You can write to both the IRS and the Office of Management and Budget at the addresses listed in the Instructions for the tax return with which this form is filed.

General Instructions

Section references are to the Internal Revenue Code.

Purpose of Form

Form 8801 is used by individuals, estates, and trusts to figure the minimum tax credit, if any, for alternative

minimum tax (AMT) incurred in prior tax years after 1986. The form is also used to figure any minimum tax credit carryforward.

Who Should File

Form 8801 should be filed by individuals, estates, and trusts that had:

- An AMT liability in 1993 and adjustments or preferences (other than exclusion items) in 1993,
- A minimum tax credit carryforward from 1993 to 1994, or
- A nonconventional source fuel credit, an orphan drug credit, or a qualified electric vehicle credit not allowed for 1993 (see the instructions for line 20).

Table 17-1. **Key Retirement Plan Rules**

Type of Plan	Last Date for Contribution	Maximum Contribution	Time Limit to Begin Distributions ¹		
IRA	Due date of income tax return (NOT including extensions)	Smaller of \$2,000 or taxable compensation	April 1 of year after year you reach 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 you reach age 70½		
Keogh	Due date of employer's return (plus extensions). (To make contributions for a year to a new plan, the plan must be set up by the last day of the employer's tax year.)	<p style="text-align: center;"><u>Defined Contribution Plans</u></p> <table border="0" style="width: 100%;"> <tr> <td style="width: 50%; vertical-align: top;"> <p><u>Employee</u></p> <p><i>Money Purchase</i>—Smaller of \$30,000 or 25% of employee's taxable compensation</p> <p><i>Profit-Sharing</i>— Smaller of \$30,000 or 15% of employee's taxable compensation</p> </td> <td style="width: 50%; vertical-align: top;"> <p><u>Self-Employed Individual</u></p> <p><i>Money Purchase</i>—Smaller of \$30,000 or 20% of self-employed participant's taxable compensation⁴</p> <p><i>Profit-Sharing</i>— Smaller of \$30,000 or 13.0435% of self-employed participant's taxable compensation⁴</p> </td> </tr> </table> <p style="text-align: center;"><u>Defined Benefit Plans</u></p> <p>Amount needed to provide an annual retirement benefit no larger than the smaller of \$118,800 or 100% of the participant's average taxable compensation for his or her highest 3 consecutive years</p>	<p><u>Employee</u></p> <p><i>Money Purchase</i>—Smaller of \$30,000 or 25% of employee's taxable compensation</p> <p><i>Profit-Sharing</i>— Smaller of \$30,000 or 15% of employee's taxable compensation</p>	<p><u>Self-Employed Individual</u></p> <p><i>Money Purchase</i>—Smaller of \$30,000 or 20% of self-employed participant's taxable compensation⁴</p> <p><i>Profit-Sharing</i>— Smaller of \$30,000 or 13.0435% of self-employed participant's taxable compensation⁴</p>	April 1 of year after year you reach age 70½ (unless the participant reached age 70½ before 1988, in which case the distributions must begin by the year he or she retires)
<p><u>Employee</u></p> <p><i>Money Purchase</i>—Smaller of \$30,000 or 25% of employee's taxable compensation</p> <p><i>Profit-Sharing</i>— Smaller of \$30,000 or 15% of employee's taxable compensation</p>	<p><u>Self-Employed Individual</u></p> <p><i>Money Purchase</i>—Smaller of \$30,000 or 20% of self-employed participant's taxable compensation⁴</p> <p><i>Profit-Sharing</i>— Smaller of \$30,000 or 13.0435% of self-employed participant's taxable compensation⁴</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 Compensation is before adjustment for this contribution.

Table 17-2. Form 5305-SEP

Form 5305-SEP

(Rev. March 1994)

Department of the Treasury
Internal Revenue Service

Simplified Employee Pension-Individual Retirement Accounts Contribution Agreement

(Under section 408(k) of the Internal Revenue Code)

OMB No. 1545-0048
Expires 2-28-97

DO NOT File with the Internal Revenue Service

_____ makes the following agreement under section 408(k) of the Internal Revenue Code and the instructions to this form.

Article I—Eligibility Requirements (Check appropriate boxes—see Specific 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 \$396*.

Article II—SEP Requirements (See Specific 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 total 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

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 more simple, we would be happy to hear from you. You can write to both the Internal Revenue Service, Attention: Reports Clearance Officer, P.O. Box 13181, Washington, DC 20524; and the Office of Management and Budget, Paperwork Reduction Project (1545-0048), Washington, DC 20503. **DO NOT** send this form to either of these addresses. Instead, keep it for your records.

A Change To Note

For years beginning after December 31, 1993, the Revenue Reconciliation Act of 1993 (the Act) reduced to \$150,000 the annual compensation of each employee to be taken into account in making contributions to a SEP. The \$150,000 amount will be indexed for inflation after 1994 in increments of \$10,000 that will be rounded to the next lowest multiple of \$10,000. See Act section 13212 for different effective dates and the transition rules that apply to governmental plans and plans under a collective bargaining agreement.

General 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. 598, Retirement Plans for the Self-Employed, and Pub. 590, Individual Retirement Arrangements (IRAs).

*The amount reflects the cost-of-living increase under section 408(b)(2), effective January 1, 1994. The amount is adjusted annually. Each January, the IRS announces the amounts. If any of a new table set in the Internal Revenue Bulletin.

Specific Instructions

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 IRA 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(p).

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 also maintaining a Model Elective SEP (Form 5305A-SEP) or other SEP to which either elective or non-elective contributions are made.
- 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(n)).
- 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(d)), 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.

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 \$396* 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 total compensation or \$30,000*, whichever is less. Compensation, for this purpose, does not include employer contributions to the SEP or the employee's compensation in excess of \$150,000. If you also maintain a Model Elective SEP or any other SEP that permits employees to make elective deferrals, contributions to the two SEPs together may not exceed the smaller of \$30,000* or 15% of compensation for any employee.

Contributions cannot discriminate in favor of highly compensated employees. You are not required to make contributions every year. But you must contribute to the SEP-IRAs of all of the eligible employees who actually performed services during the year of the contribution. This includes eligible employees who die or quit working before the contribution is made.

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:	
<hr/>	
<i>Address</i>	
to receive credit or refund for fuel used by:	
<hr/>	
<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:	
<hr/>	
<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.	
<hr/>	
<i>Signature</i>	
<hr/>	
<i>Date</i>	

Table 18-2. **Sample Exemption Certificate**

EXEMPTION CERTIFICATE

(To support vendor's claim for credit or payment under section 6427 of the Internal Revenue Code)

Name, Address, and Employer Identification Number of Seller

The undersigned buyer ("Buyer") hereby certifies the following under penalties of perjury:

A. Buyer will use the diesel fuel to which this certificate relates either — (check one):

1. ← On a farm for farming purposes (as defined in §48.6420-4 of the Manufacturers and Retailers Excise Tax Regulations)(and Buyer is the owner, tenant, or operator of the farm on which the fuel will be used).
2. ← On a farm (as defined in §48.6420-4(c)) for any of the purposes described in | (d) of that section (relating to cultivating, raising, or harvesting)(and Buyer is not the owner, tenant, or operator of the farm on which the fuel will be used).

B. This certificate applies to the following (complete as applicable):

1. If this is a single purchase certificate, check here ← and enter:
 - a. Invoice or delivery ticket number _____
 - b. Number of gallons _____
2. If this is a certificate covering all purchases under a specified account or order number, check here ← and enter:
 - a. Effective date _____
 - b. Expiration date _____
(period not to exceed 1 year after effective date)
 - c. Buyer account or order number _____

Buyer will provide a new certificate to the seller if any information in this certificate changes.

If Buyer uses the diesel fuel to which this certificate relates for a purpose other than stated in the certificate Buyer will be liable for any tax.

Buyer understands that the fraudulent use of this certificate may subject Buyer and all parties making such fraudulent use of this certificate to a fine or imprisonment, or both, together with the costs of prosecution.

Signature and Date Signed

Printed or Typed Name and Title of Person Signing

Name, Address, and Employer Identification Number of Buyer

Cash Farm Receipts

LINE NO	Date 1994 Jan	Item	No. or Head	Quantity	Total Amount	Schedule F Part I						
						Livestock Purchased for Resale			Raised Livestock		Poultry	
						Steers			Calves	Steers		
						4	5	6	7	8		9
Column No.	1	2	3									
1	4	Bob Calves - Farm Livestock Sales	2		102				102			
2	12	Hay - Horse Raisers, Inc			1,450							
3	14	Cull cow - FLS (raised)	1		303							
4	18	Corn - County Feed			2,000							
5	21	Milk - Dairy County Co-op		43,729	5,110 80							
6	28	Patronage refund - Central Co-op			16 25							
7	28	Gas tax credit claimed on 1993 return			142							
8												
9												
10												
11												
12												
35												
36												
		TOTALS		66,530	147,783	12,960			1,000	1,503		

Cash Farm Expenses

LINE NO	Date 1994 Jan	Item	No. or Head	Quantity	Total Amount	Schedule F Part I			Schedule F Part II Items				
						Livestock Purchased for Resale		Hired Labor	Repairs		Interest Paid	Feed Purchased	Seeds Sprays and Crop Expense
						Steers			Buildings	Machinery			
						4	5	6	7	8	9	10	11
Column No.	1	2	3										
1	4	Dairy feed - County Feed			1,822							1,822	
2	4	Beef feed - County Feed			436 80							436 80	
3	4	Gasoline - Central Co-op			606 96								
4	7	Wages - J Jones			240		240						
5	12	Vet & medicine - Dr Sharp			63 75								
6	14	Trucking - C Dealer			25								
7	14	Commission - FLS			12 50								
8	19	Breeding fees - MB Stud Service			54								
9	21	Milk hauling - DCC			192 51								
10	21	Dues - DCC			41 93								
11	21	Advertising - DCC			20 87								
12													
35	28	Electricity - Rural Electric			705 34								
36	28	County taxes			1,672 68								
		TOTALS			129,618	3,574	16,416	522	4,902	4,218	18,019	4,838	

Cash Farm Receipts											NON-OPERATING INCOME				
Schedule F Part I											CAPITAL ASSETS SOLD (Schedule D Items)				
L I N E	Field Crops		Milk	Wheat	Vegetables	CCC Loan	Patronage Dividends and Refunds	Agr'l Program Payments	Other	Special Items	21	Purchased or Raised Dairy and Breeding Stock		Buildings and Improvements	Machinery and Equipment
	Hay	Corn										22	23		
	11	12	13	14	15	16	17	18	19	20					
1															
2	450														
3												303			
4		2,000													
5			5,110.00												
6								16.25							
7										42					
8															
9															
10															
11															
12															
35															
36															
	8,250	7,000	98,121	7,892	789	665		33	438	567	1,258	6,493			770

Cash Farm Expenses											NON-OPERATING EXPENDITURES					
Schedule F Part II Items											CAPITAL ASSETS BOUGHT (Schedule D Items)					
L I N E	Fertilizer and Lime	Machine Hire	Supplies	Livestock Expense	Gas Oil and Fuel	Taxes Including Nonfarm Share	Insurance	Utilities	Truck & Milk Market Expense	Conservation Expense	Other	Special Items	Purchased Dairy and Breeding Stock		Buildings and Improvements	Machinery and Equipment
													24	25		
	12	13	14	15	16	17	18	19	20	21	22					
1																
2																
3					606.96											
4																
5				63.75												
6									25							
7																
8				54												
9																
10									192.51							
11									41.93							
12									20.87							
35																
36																
	6,544	1,575	2,807	3,217	5,433	4,193	1,830	4,735	3,874	1,040	3,265					38,800

Depreciation Worksheet

Description of Property	Date Placed in Service	Cost or Other Basis	Business/Investment Use %	Section 179 Deduction	Depreciation Prior Years	Basis for Depreciation	Method/Convention	Recovery Period	Rate or Table %	Depreciation Deduction
STRAIGHT LINE										
Barn	1-8-78	6,400	100%		4,096	2,304	SL	25		\$ 256
Silo	1-3-80	12,000	"		11,200	800	SL	15		800
ALTERNATE ACRS										
Machine shed	1-2-86	6,000	100%		3,526	3,474	Mod SL	19	5.3	318
MACRS										
Tractor #2 (traded 3/94)	1-8-90	7,297	100%	5,000	1,148.50	2,297	SL/HY	7	14.28	164.12
Dairy cow #42 (killed 7/94)	6-21-90	600	"		300	600	SL/HY	7	14.29	42.87
Dairy cow #52 (sold 2/94)	7-15-90	900	"		450	900	SL/HY	7	14.29	64.31
Dairy cow #54	9-7-90	1,200	"		600	1,200	SL/HY	7	14.29	171.48
* Car Listed property										
Car	1-6-91	12,350	60%		4,323.74	7,410	150DB/HY	5	16.66	94.5
Plow	4-5-91	4,921	100%		1,599.13	4,921	150DB/HY	10	10.02	483.06
Pickup truck (listed property)	5-22-91	7,076	"		4,128.85	7,076	150DB/HY	5	16.66	1,178.86
Dairy cow #61	9-1-91	1,400	"		628.18	1,400	150DB/HY	7	12.25	171.50
Tractor #4	10-1-91	13,483	"	5,000	2,813.81	8,483	150DB/HY	10	10.02	850
Milk tank										
Milk tank	1-3-92	11,500	100%	10,000	447.60	1,500	150DB/HY	7	15.02	225.45
Manure spreader	5-1-92	3,400	"		1,014.56	3,400	150DB/HY	7	15.02	511.02
Cattle feeding facility										
Cattle feeding facility	1-8-94	37,500	100%		-0-	37,500	150DB/HY	10	7.50	2,812.50
Machine shed improvement	2-19-94	1,300	"		-0-	1,300	150DB/HY	20	3.75	48.75
Tractor #5	3-7-94	24,713	"	17,500	-0-	7,213	150DB/HY	7	10.71	772.51
										<u>\$ 4,815.43</u>

* Limited deduction for passenger automobile (60% x \$1,575).

**SCHEDULE F
(Form 1040)**

Department of the Treasury
Internal Revenue Service (7)

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

1994

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) ▶ 2140
C Accounting method: (1) <input checked="" type="checkbox"/> Cash (2) <input type="checkbox"/> Accrual	D Employer ID number (EIN), if any 10 9876543

E Did you "materially participate" in the operation of this business during 1994? 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	124,549	
5a Total cooperative distributions (Form(s) 1099-PATR)	5a	33	5b Taxable amount
6a Agricultural program payments (see page F-2)	6a	438	6b Taxable amount
7 Commodity Credit Corporation (CCC) loans (see page F-2):			
a CCC loans reported under election	7a	665	
b CCC loans forfeited or repaid with certificates	7b		7c Taxable amount
8 Crop insurance proceeds and certain disaster payments (see page F-2):			
a Amount received in 1994	8a		8b Taxable amount
c If election to defer to 1995 is attached, check here <input type="checkbox"/>			8d Amount deferred from 1993
9 Custom hire (machine work) income	9	1,258	
10 Other income, including Federal and state gasoline or fuel tax credit or refund (see page F-3)	10	567	
11 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. Attach Form 8545.	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	27,317	27 Repairs and maintenance	27	5,424
17 Employee benefit programs other than on line 25	17		28 Seeds and plants purchased	28	2,132
18 Feed purchased	18	12,019	29 Storage and warehousing	29	
19 Fertilizers and lime	19	6,544	30 Supplies purchased	30	2,207
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	114,689			
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	22,651			
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 5198.			37a <input type="checkbox"/> All investment is at risk.		
			37b <input type="checkbox"/> Some investment is not at risk		

For Paperwork Reduction Act Notice, see Form 1040 instructions.

Cat. No. 11346H

Schedule F (Form 1040) 1994

Depreciation and Amortization
(Including Information on Listed Property)

1994

Department of the Treasury
Internal Revenue Service (7)

▶ See separate instructions. ▶ Attach this form to your return.

Attachment
Sequence No. **67**

Name(s) shown on return
Walter A. and Jane W. Brown

Identifying number
543-00-2111

Business or activity to which this form relates
Farming

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 instructions)	1	\$17,500
2	Total cost of section 179 property placed in service during the tax year (see 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 instructions.)	5	17,500
(a) Description of property		(b) Cost	(c) Elected cost
6	Tractor	23,729	17,500
7	Listed property. Enter amount from line 26.	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 1993 (see instructions)	10	-0-
11	Taxable income limitation. Enter the smaller of taxable 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 1995. 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 1994 Tax Year (Do Not Include Listed Property)

(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
Section A—General Depreciation System (GDS) (see instructions)						
14a	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	2,813
e	15-year property					
f	20-year property	1,300	20	HY	150DB	49
g	Residential rental property		27.5 yrs.	MM	S/L	
h	Nonresidential real property		39 yrs.	MM	S/L	
Section B—Alternative Depreciation System (ADS) (see instructions)						
15a	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)

16	GDS and ADS deductions for assets placed in service in tax years beginning before 1994 (see instructions)	16	2,634
17	Property subject to section 168(f)(1) election (see instructions)	17	-0-
18	ACRS and other depreciation (see instructions)	18	1,374

Part IV Summary

19	Listed property. Enter amount from line 25.	19	2,124
20	Total. Add deductions on line 12, lines 14 and 15 in column (g), and lines 16 through 19. Enter here and on the appropriate lines of your return. (Partnerships and S corporations—see instructions)	20	27,317
21	For assets shown above and placed in service during the current year, enter the portion of the basis attributable to section 263A costs (see instructions)	21	-0-

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

For any vehicle for which you are using the standard mileage rate or deducting lease expense, complete only 22a, 22b, columns (a) through (c) of Section A, all of Section B, and Section C if applicable.

Section A—Depreciation and Other Information (Caution: See instructions for limitations for automobiles.)

22a Do you have evidence to support the business/investment use claimed? Yes No 22b 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	
23 Property used more than 50% in a qualified business use (see instructions):									
Car 91 USA	1-6-91	60 %	12,350	7,410	5	150DB/HY	945*	-0-	
Truck 91 PIC	5-22-91	100 %	7,076	7,076	5	150DB/HY	1,179	-0-	
		%							
24 Property used 50% or less in a qualified business use (see instructions):									
		%				S/L -			
		%				S/L -			
		%				S/L -			
25 Add amounts in column (h). Enter the total here and on line 19, page 1.							25	2,124	
26 Add amounts in column (i). Enter the total here and on line 7, page 1.							26	-0-	

Section B—Information on Use of Vehicles—If you deduct expenses for vehicles:

- Always 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										
27 Total business/investment miles driven during the year (DO NOT include commuting miles)	6,270		11,350									
28 Total commuting miles driven during the year	-0-		-0-									
29 Total other personal (noncommuting) miles driven	4,180		-0-									
30 Total miles driven during the year. Add lines 27 through 29.	10,450		11,350									
31 Was the vehicle available for personal use during off-duty hours?	✓		✓									
32 Was the vehicle used primarily by a more than 5% owner or related person?	✓		✓									
33 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. Note: Section B must always be completed for vehicles used by sole proprietors, partners, or other more than 5% owners or related persons.

	Yes	No
34 Do you maintain a written policy statement that prohibits all personal use of vehicles, including commuting, by your employees?		
35 Do you maintain a written policy statement that prohibits personal use of vehicles, except commuting, by your employees? (See instructions for vehicles used by corporate officers, directors, or 1% or more owners.)		
36 Do you treat all use of vehicles by employees as personal use?		
37 Do you provide more than five vehicles to your employees and retain the information received from your employees concerning the use of the vehicles?		
38 Do you meet the requirements concerning qualified automobile demonstration use (see instructions)? Note: If your answer to 34, 35, 36, 37, or 38 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
39 Amortization of costs that begins during your 1994 tax year.					
40 Amortization of costs that began before 1994				40	
41 Total. Enter here and on "Other Deductions" or "Other Expenses" line of your return				41	

*Limited deduction for passenger automobile. Printed on recycled paper

**SCHEDULE SE
(Form 1040)**

Self-Employment Tax

OMB No. 1545-0074

1994

Attachment
Sequence No. 17

Department of the Treasury
Internal Revenue Service (T)

▶ 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

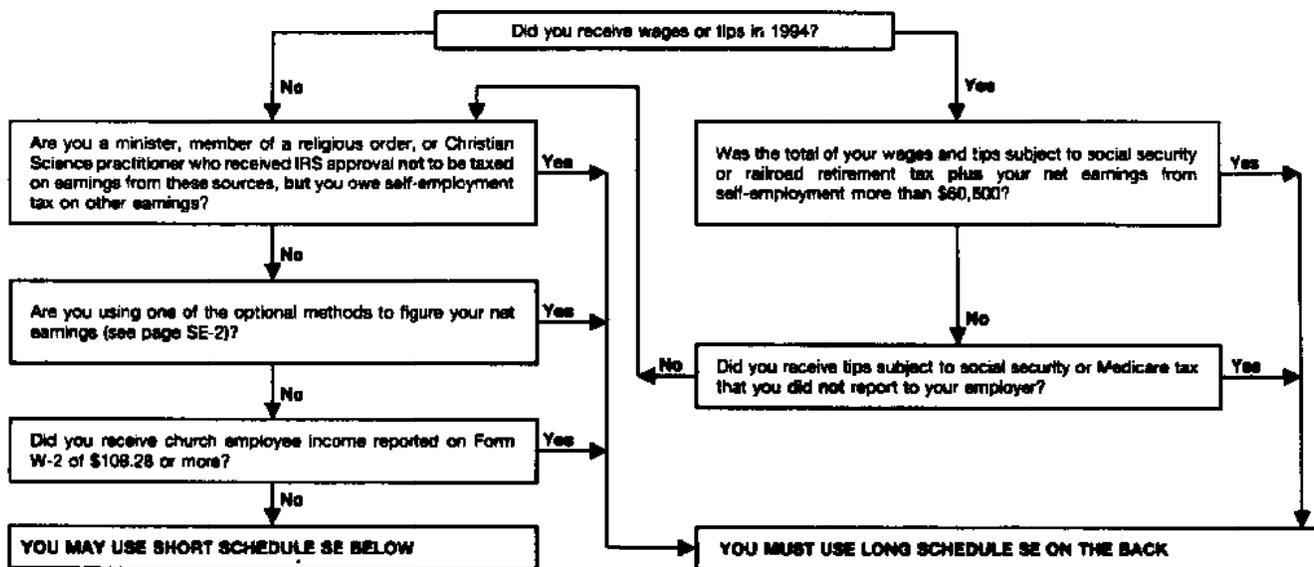
You must file Schedule SE if:

- 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 have 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-2.

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 47.

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	22,651
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	-0-
3	Combine lines 1 and 2	3	22,651
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	20,918
5	Self-employment tax. If the amount on line 4 is: • \$60,600 or less, multiply line 4 by 15.3% (.153). Enter the result here and on Form 1040, line 47. • More than \$60,600, multiply line 4 by 2.9% (.029). Then, add \$7,514.40 to the result. Enter the total here and on Form 1040, line 47.	5	3,200
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	1,600

For Paperwork Reduction Act Notice, see Form 1040 instructions.

Cat. No. 11358Z

Schedule SE (Form 1040) 1994

Name(s) shown on tax return. Do not enter name and identifying number if shown on other side.

Identifying number

Walter A. and Jane W. Brown

543-00-2111

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 Home town, VA 6-21-90
 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	257			
21 Insurance or other reimbursement (whether or not you filed a claim). See the instructions for line 3. <i>Note: If line 20 is more than line 21, skip line 22.</i>	109			
22 Gain from casualty or theft. If line 21 is more than line 20, enter the difference here and on line 29 or line 34, column (c), except as provided in the instructions for line 33. Also, skip lines 23 through 27 for that column. See the instructions for line 4 if line 21 includes insurance or other reimbursement you did not claim, or you received payment for your loss in a later tax year				
23 Fair market value before casualty or theft	500			
24 Fair market value after casualty or theft	-0-			
25 Subtract line 24 from line 23	500			
26 Enter the smaller of line 20 or line 25	257			
<i>Note: If the property was totally destroyed by casualty or lost from theft, enter on line 26 the amount from line 20.</i>				
27 Subtract line 21 from line 26. If zero or less, enter -0-	148			
28 Casualty or theft loss. Add the amounts on line 27. Enter the total here and on line 29 or line 34 (see instructions).				148

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

(a) Identify casualty or theft	(b) Losses from casualties or thefts		(c) Gains from casualties or thefts includible in income
	(i) Trade, business, rental or royalty property	(ii) Income-producing 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)(i) 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			39
<i>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.</i>			

Sales of Business Property
 (Also Involuntary Conversions and Recapture Amounts
 Under Sections 179 and 280F(b)(2))

1994

Attachment
Sequence No. 27

Department of the Treasury
Internal Revenue Service

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

Name(s) shown on return: Walter A. and 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 1994 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 ((f) minus the sum of (d) and (e))	(h) GAIN ((d) plus (e) minus (f))
2							
Raised cows	Before 1987	1994	4,500	-0-	101		4,399
Dairy cow #52	7-15-90	1-15-94	303	514	912	95	
Raised heifer	6-2-91	8-1-94	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 8252, line 28 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	-0-
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 (if more than zero) 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 9 on line 13 below, and enter the amount from line 10 as a long-term capital gain on Schedule D.	10	5,384

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 calf	10-1-93	3-1-94	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	1,105
15 Net gain or (loss) from Form 4684, lines 31 and 38a	15	(148)
16 Ordinary gain from installment sales from Form 8252, 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 19. 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

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	6-21-80	7-9-94
B Mower	4-17-81	2-14-94
C Dairy cow # 41	2-21-85	10-28-94
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.)	22	700	70	335	
23 Cost or other basis plus expense of sale	23	4,390	1,200	400	
24 Depreciation (or depletion) allowed or allowable	24	4,390	1,200	400	
25 Adjusted basis. Subtract line 24 from line 23	25	-0-	-0-	-0-	
26 Total gain. Subtract line 25 from line 22	26	700	70	335	
27 If section 1245 property:					
a Depreciation allowed or allowable from line 24	27a	4,390	1,200	400	
b Enter the smaller of line 26 or 27a	27b	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)	28a				
b Applicable percentage multiplied by the smaller of line 26 or line 28a (see instructions)	28b				
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	28c				
d Additional depreciation after 1969 and before 1978	28d				
e Enter the smaller of line 28c or 28d	28e				
f Section 291 amount (corporations only)	28f				
g Add lines 28b, 28e, and 28f	28g				
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	29a				
b Line 29a multiplied by applicable percentage (see instructions)	29b				
c Enter the smaller of line 26 or 29b	29c				
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)	30a				
b Enter the smaller of line 26 or 30a	30b				
31 If section 1255 property:					
a Applicable percentage of payments excluded from income under section 126 (see instructions)	31a				
b Enter the smaller of line 26 or 31a	31b				

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 columns A through D, line 26	32	1,105
33 Add 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	-0-

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

	(a) Section 179	(b) Section 280F(b)(2)
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	

**SCHEDULE D
(Form 1040)**

Department of the Treasury
Internal Revenue Service (T)

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

1994

Attachment
Sequence No. 12

Name(s) shown on Form 1040

Walter A. and Jane W. Brown

Your social security number

543 00 2111

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

(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see page D-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)
23 shares HT Corp	12-1-93	3-4-94	400	450	50	
J Smith - Schedule attached (not shown)						
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 8252, 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 1993 Capital Loss Carryover Worksheet					6	
7 Add lines 1, 2, and 4 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

40 shares HT Corp	1978	6-5-94	1,000	255		745
10 Enter your long-term totals, if any, from line 23						
11 Total long-term sales price amounts. Add column (d) of lines 9 and 10						
12 Gain from Form 4797; long-term gain from Forms 2119, 2439, and 8252; and long-term gain or (loss) from Forms 4684, 6781, and 8824					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 1993 Capital Loss Carryover Worksheet					15	
16 Add lines 9, 10, and 12 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 25		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)		19	()
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.			

For Paperwork Reduction Act Notice, see Form 1040 instructions.

Cat. No. 11338-1

Schedule D (Form 1040) 1994

For the year Jan. 1—Dec. 31, 1994, or other tax year beginning _____, 1994, ending _____, 19 _____ OMB No. 1545-0074

Label

(See instructions on page 12.)
Use the IRS label. Otherwise, please print or type.

Label Here

Your first name and initial _____ Last name _____

If a parent: VY 543-00-2111 543-00-1222

Home: Walter A. & Jane W. Brown DO 04
RR 1 Box 25

City: Hometown, VA 02115

Your social security number _____
Spouse's social security number _____

For Privacy Act and Paperwork Reduction Act Notice, see page 4.

Presidential Election Campaign
(See page 12.)

Do you want \$3 to go to this fund? _____
If a joint return, does your spouse want \$3 to go to this fund? _____

Yes	No	Note: Checking "Yes" will not change your tax or reduce your refund.
<input checked="" type="checkbox"/>	<input type="checkbox"/>	

Filing Status

(See page 12.)

Check only one box.

- 1 Single
- 2 Married filing joint return (even if only one had income)
- 3 Married filing separate return. Enter spouse's social security no. above and full name here. ▶ _____
- 4 Head of household (with qualifying person). (See page 13.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶ _____
- 5 Qualifying widow(er) with dependent child (year spouse died ▶ 19 _____). (See page 13.)

Exemptions

(See page 13.)

- 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. But be sure to check the box on line 33b on page 2.
 - b Spouse
 - c **Dependents:**
- | (1) Name (first, initial, and last name) | (2) Check if under age 1 | (3) If age 1 or older, dependent's social security number | (4) Dependent's relationship to you | (5) No. of months lived in your home in 1994 |
|--|-------------------------------------|---|-------------------------------------|--|
| Michael | | 579-00-9999 | Son | 12 |
| Matthew | | 579-00-9999 | Son | 12 |
| Sarah | <input checked="" type="checkbox"/> | | Daughter | 12 |
| | | | | |
| | | | | |
- d If your child didn't live with you but is claimed as your dependent under a pre-1985 agreement, check here ▶
 - e Total number of exemptions claimed

No. of boxes checked on 6a and 6b: **2**

No. of your children on 6c who:

- lived with you: **3**
- didn't live with you due to divorce or separation (see page 14): _____

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 page 15.

Enclose, but do not attach, any payment with your return.

7	Wages, salaries, tips, etc. Attach Form(s) W-2	7	4,921
8a	Taxable interest income (see page 15). Attach Schedule B if over \$400	8a	375
b	Tax-exempt interest (see page 16). DON'T 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 page 16)	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 (see page 16)	13	6,029
14	Other gains or (losses). Attach Form 4797	14	1,207
15a	Total IRA distributions	15a	
b	Taxable amount (see page 17)	15b	
16a	Total pensions and annuities	16a	
b	Taxable amount (see page 17)	16b	
17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E	17	
18	Farm income or (loss). Attach Schedule F	18	22,651
19	Unemployment compensation (see page 18)	19	
20a	Social security benefits	20a	
b	Taxable amount (see page 18)	20b	
21	Other income. List type and amount—see page 18	21	
22	Add the amounts in the far right column for lines 7 through 21. This is your total income ▶	22	35,403

Adjustments to Income

Caution: See instructions ▶

23a	Your IRA deduction (see page 19)	23a	
b	Spouse's IRA deduction (see page 19)	23b	
24	Moving expenses. Attach Form 3903 or 3903-F	24	
25	One-half of self-employment tax	25	1,600
26	Self-employed health insurance deduction (see page 21)	26	
27	Keogh retirement plan and self-employed SEP deduction	27	
28	Penalty on early withdrawal of savings	28	
29	Alimony paid. Recipient's SSN ▶ _____	29	
30	Add lines 23a through 29. These are your total adjustments ▶	30	1,600

Adjusted Gross Income

31	Subtract line 30 from line 22. This is your adjusted gross income. If less than \$25,296 and a child lived with you (less than \$9,000 if a child didn't live with you), see "Earned Income Credit" on page 27 ▶	31	33,803
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Tax Computation (See page 23.)	32	Amount from line 31 (adjusted gross income)	32	33,803
	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 your parent (or someone else) can claim you as a dependent, check here ▶ 33b		
	c	If you are married filing separately and your spouse itemizes deductions or you are a dual-status alien, see page 23 and check here ▶ 33c		
	34	Enter the larger of your: { Itemized deductions from Schedule A, line 29, OR Standard deduction shown below for your filing status. But if you checked any box on line 33a or b, go to page 23 to find your standard deduction. If you checked box 33a, your standard deduction is zero. • Single—\$3,800 • Head of household—\$5,600 • Married filing jointly or Qualifying widow(er)—\$6,350 • Married filing separately—\$3,175	34	6,745
	35	Subtract line 34 from line 32	35	27,058
	36	If line 32 is \$83,850 or less, multiply \$2,450 by the total number of exemptions claimed on line 6a. If line 32 is over \$83,850, see the worksheet on page 24 for the amount to enter	36	12,250
	37	Taxable income. Subtract line 36 from line 35. If line 36 is more than line 35, enter -0-	37	14,808
	38	Tax. Check if from a <input checked="" type="checkbox"/> Tax Table, b <input type="checkbox"/> Tax Rate Schedules, c <input type="checkbox"/> Capital Gain Tax Worksheet, or d <input type="checkbox"/> Form 8615 (see page 24). Amount from Form(s) 8814 ▶	38	2,224
	39	Additional taxes. Check if from a <input type="checkbox"/> Form 4970 b <input type="checkbox"/> Form 4972	39	
40	Add lines 38 and 39	40	2,224	
Credits (See page 24.)	41	Credit for child and dependent care expenses. Attach Form 2441	41	
	42	Credit for the elderly or the disabled. Attach Schedule R	42	
	43	Foreign tax credit. Attach Form 1118	43	
	44	Other credits (see page 25). 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)	44	
	45	Add lines 41 through 44	45	-0-
46	Subtract line 45 from line 40. If line 45 is more than line 40, enter -0-	46	2,224	
Other Taxes (See page 25.)	47	Self-employment tax. Attach Schedule SE	47	3,200
	48	Alternative minimum tax. Attach Form 6251	48	
	49	Recapture taxes. Check if from a <input type="checkbox"/> Form 4255 b <input type="checkbox"/> Form 8611 c <input type="checkbox"/> Form 8828	49	
	50	Social security and Medicare tax on tip income not reported to employer. Attach Form 4137	50	
	51	Tax on qualified retirement plans, including IRAs. If required, attach Form 5329	51	
	52	Advance earned income credit payments from Form W-2	52	
	53	Add lines 46 through 52. This is your total tax	53	5,424
Payments Attach Forms W-2, W-2G, and 1099-R on the front.	54	Federal income tax withheld. If any is from Form(s) 1099, check ▶ <input type="checkbox"/>	54	227
	55	1994 estimated tax payments and amount applied from 1993 return	55	
	56	Earned income credit. If required, attach Schedule EIC (see page 27). Nontaxable earned income: amount ▶ and type ▶	56	
	57	Amount paid with Form 4868 (extension request)	57	
	58	Excess social security and RRTA tax withheld (see page 32)	58	
	59	Other payments. Check if from a <input type="checkbox"/> Form 2439 b <input checked="" type="checkbox"/> Form 4136	59	350
	60	Add lines 54 through 59. These are your total payments	60	577
Refund or Amount You Owe	61	If line 60 is more than line 53, subtract line 53 from line 60. This is the amount you OVERPAID. ▶	61	
	62	Amount of line 61 you want REFUNDED TO YOU. ▶	62	
	63	Amount of line 61 you want APPLIED TO YOUR 1995 ESTIMATED TAX ▶	63	
	64	If line 53 is more than line 60, subtract line 60 from line 53. This is the AMOUNT YOU OWE. For details on how to pay, including what to write on your payment, see page 32	64	4,847
	65	Estimated tax penalty (see page 33). Also include on line 64	65	

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 Keep a copy of this return for your records.	Your signature	Date	Your occupation
	<i>Walter A. Brown</i>	2-22-95	Farmer
Paid Preparer's Use Only	Spouse's signature. If a joint return, BOTH must sign.	Date	Spouse's occupation
	<i>Jane W. Brown</i>	2-22-95	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		Check if self-employed <input type="checkbox"/>
			E.I. No.
			ZIP code



IRS Publications

Listed below are selected IRS tax publications. The list includes publications referred to in the chapters of this book, as well as others that might interest you. A full list can be found in Publication 910, *Guide to Free Tax Services*. If you need to order **tax forms and publications** and do not have any tax questions, please call 1-800-TAX-FORM (1-800-829-3676).

General Guides

- 1**
Your Rights as a Taxpayer
- 17**
Your Federal Income Tax
(For Individuals)
- 334**
Tax Guide for Small Business
- 509**
Tax Calendars for 1995
- 553**
Highlights of 1994
Tax Changes
- 910**
Guide to Free Tax Services
- 960**
Capital Construction Fund for
Commercial Fishermen

Employer's Guides

- 15**
Circular E, Employer's Tax
Guide
- 51**
Circular A, Agricultural
Employer's Tax Guide

Specialized Publications

- 349**
Federal Highway Use Tax on
Heavy Vehicles
- 378**
Fuel Tax Credits and Refunds
- 448**
Federal Estate and Gift Taxes
- 463**
Travel, Entertainment, and Gift
Expenses
- 501**
Exemptions, Standard
Deduction, and Filing
Information

- 502**
Medical and Dental Expenses
- 503**
Child and Dependent Care
Expenses
- 504**
Divorced or Separated
Individuals
- 505**
Tax Withholding and
Estimated Tax
- 510**
Excise Taxes for 1995
- 521**
Moving Expenses
- 523**
Selling Your Home
- 524**
Credit for the Elderly
or the Disabled
- 525**
Taxable and Nontaxable Income
- 526**
Charitable Contributions
- 527**
Residential Rental Property
- 529**
Miscellaneous Deductions
- 530**
Tax Information for
First-Time Homeowners
- 533**
Self-Employment Tax
- 534**
Depreciation
- 535**
Business Expenses
- 536**
Net Operating Losses
- 537**
Installment Sales
- 538**
Accounting Periods and
Methods
- 541**
Tax Information on Partnerships
- 542**
Tax Information on Corporations
- 544**
Sales and Other Dispositions

- of Assets
- 547**
Nonbusiness Disasters,
Casualties, and Thefts
- 550**
Investment Income and
Expenses
- 551**
Basis of Assets
- 554**
Tax Information for Older
Americans
- 556**
Examination of Returns, Appeal
Rights, and Claims for Refund
- 559**
Survivors, Executors, and
Administrators
- 560**
Retirement Plans for
the Self-Employed
- 561**
Determining the Value of
Donated Property
- 583**
Taxpayers Starting a Business
- 584**
Nonbusiness Disaster, Casualty,
and Theft Loss Workbook
- 586A**
The Collection Process (Income
Tax Accounts)
- 587**
Business Use of Your Home
- 589**
Tax Information on
S Corporations
- 590**
Individual Retirement
Arrangements (IRAs)
- 594**
Understanding the Collection
Process
- 596**
Earned Income Credit
- 907**
Tax Highlights for
Persons With Disabilities
- 908**
Tax Information on Bankruptcy

- 911**
Tax Information for
Direct Sellers
 - 915**
Social Security Benefits and
Equivalent Railroad Retirement
Benefits
 - 917**
Business Use of a Car
 - 925**
Passive Activity and
At-Risk Rules
 - 926**
Employment Taxes for
Household Employers
 - 929**
Tax Rules for Children
and Dependents
 - 936**
Home Mortgage Interest
Deduction
 - 937**
Employment Taxes
 - 946**
How To Begin Depreciating Your
Property
 - 1544**
Reporting Cash Payments of
Over \$10,000
 - 1635**
Understanding Your EIN
- ### Spanish Language Publications
- 1SP**
Derechos del Contribuyente
 - 579SP**
Cómo Preparar la Declaración
de Impuesto Federal
 - 594SP**
Comprendiendo el Proceso de
Cobro
 - 596SP**
Crédito por Ingreso del Trabajo
 - 850**
English-Spanish Glossary of
Words and Phrases Used in
Publications Issued by the
Internal Revenue Service