Gains and Losses

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

**Sales and Exchanges**

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

***Determining Gain or Loss***

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

**Basis and adjusted basis.**     
The basis of property you buy is usually its cost. The adjusted basis of property is basis plus certain additions and minus certain deductions. See chapter 6 for more information about basis and adjusted basis.

**Amount realized.**     
The amount you realize from a sale or exchange is the total of all money you receive plus the fair market value (defined in chapter 6) of all property or services you receive. The amount you realize also includes any of your liabilities assumed by the buyer and any liabilities to which the property you transferred is subject, such as real estate taxes or a mortgage.

  If the liabilities relate to an exchange of multiple properties, see *Treatment of liabilities* under *Multiple Property Exchanges* in chapter 1 of Publication 544.

**Amount recognized.**     
Your gain or loss realized from a sale or exchange of property is usually a recognized gain or loss for tax purposes. A recognized gain is a gain you must include in gross income and report on your income tax return. A recognized loss is a loss you deduct from gross income. For example, if your recognized gain from the sale of your tractor is $5,300, you include that amount in gross income on Form 1040. However, your gain or loss realized from the exchange of property may not be recognized for tax purposes. See *Like-Kind Exchanges,* next. Also, a loss from the disposition of property held for personal use is not deductible.

***Like-Kind Exchanges***

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

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

* Qualifying property.
* Like-kind property.

These two requirements are discussed later.

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

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

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

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

**Example.**

You traded an old tractor with an adjusted basis of $1,500 for a new one. The new tractor costs $30,000. You were allowed $8,000 for the old tractor and paid $22,000 cash. You have no recognized gain or loss on the transaction regardless of the adjusted basis of your old tractor. If you had sold the old tractor to a third party for $8,000 and bought a new one, you would have a recognized gain or loss on the sale of your old tractor equal to the difference between the amount realized and the adjusted basis of the old tractor.

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

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

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

**Nonqualifying property.**   The rules for like-kind exchanges do not apply to exchanges of the following property.

1. Property you use for personal purposes, such as your home and your family car.
2. Stock in trade or other property held primarily for sale, such as crops and produce.
3. Stocks, bonds, or notes. However, see *Qualifying property* above.
4. Other securities or evidences of indebtedness, such as accounts receivable.
5. Partnership interests.

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

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

  An exchange of a tractor for a new tractor is an exchange of like-kind property, and so is an exchange of timber land for crop acreage. An exchange of a tractor for acreage, however, is not an exchange of like-kind property. Neither is the exchange of livestock of one sex for livestock of the other sex. An exchange of the assets of a business for the assets of a similar business cannot be treated as an exchange of one property for another property. Whether you engaged in a like-kind exchange depends on an analysis of each asset involved in the exchange.

***Personal property.***   Depreciable tangible personal property can be either like kind or like class to qualify for nontaxable exchange treatment. Like-class properties are depreciable tangible personal properties within the same General Asset Class or Product Class. Property classified in any General Asset Class may not be classified within a Product Class. Assets that are not in the same class will qualify as like-kind property if they are of the same nature or character.

***General Asset Classes.***   General Asset Classes describe the types of property frequently used in many businesses. They include the following property.

1. Office furniture, fixtures, and equipment (asset class 00.11).
2. Information systems, such as computers and peripheral equipment (asset class 00.12).
3. Data handling equipment except computers (asset class 00.13).
4. Airplanes (airframes and engines), except planes used in commercial or contract carrying of passengers or freight, and all helicopters (airframes and engines) (asset class 00.21).
5. Automobiles and taxis (asset class 00.22).
6. Buses (asset class 00.23).
7. Light general purpose trucks (asset class 00.241).
8. Heavy general purpose trucks (asset class 00.242).
9. Railroad cars and locomotives, except those owned by railroad transportation companies (asset class 00.25).
10. Tractor units for use over-the-road (asset class 00.26).
11. Trailers and trailer-mounted containers (asset class 00.27).
12. Vessels, barges, tugs, and similar water-transportation equipment, except those used in marine construction (asset class 00.28).
13. Industrial steam and electric generation and/or distribution systems (asset class 00.4).

***Product Classes.***   Product Classes include property listed in a 6-digit product class (except any ending in 9) in sectors 31 through 33 of the North American Industry Classification System (NAICS) of the Executive Office of the President, Office of Management and Budget, United States, 2007 (NAICS Manual). It can be accessed at [http://www.census.gov/naics](http://www.irs.gov/app/scripts/exit.jsp?dest=http%3A%2F%2Fwww.census.gov%2Fnaics). Copies of the hard cover manual may be purchased from the National Technical Information Service (NTIS) at [http://www.ntis.gov/products/naics.aspx](http://www.irs.gov/app/scripts/exit.jsp?dest=http%3A%2F%2Fwww.ntis.gov%2Fproducts%2Fnaics.aspx) or by calling 1-800-553-NTIS (1-800-553-6847) or (703) 605-6000. A CD-ROM version with search and retrieval software is also available from NTIS.

**Partially nontaxable exchange.**   If, in addition to like-kind property, you receive money or unlike property in an exchange on which you realize gain, you have a partially nontaxable exchange. You are taxed on the gain you realize, but only to the extent of the money and the fair market value of the unlike property you receive. A loss is not deductible.

**Example 1.**

You trade farmland that cost $30,000 for $10,000 cash and other land to be used in farming with a fair market value of $50,000. You have a realized gain of $30,000, but only $10,000, the cash received, is recognized (included in income).

**Example 2.**

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

**Example 3.**

Assume in *Example 1* that the fair market value of the land you received was only $15,000. Your $5,000 loss is not recognized.

***Unlike property given up.***

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

**Like-kind exchanges between related persons.**

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

***Related persons.***

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

  For the complete list of related persons, see *Related persons* in chapter 2 of Publication 544.

**Example.**

You used a gray pickup truck in your farming business. Your sister used a red pickup truck in her landscaping business. In December 2007, you exchanged your grey pickup truck, plus $200, for your sister's red pickup truck. At that time, the fair market value (FMV) of the grey truck was $7,000 and its adjusted basis was $6,000. The FMV of the red pickup truck was $7,200 and its adjusted basis was $1,000. You realized a gain of $1,000 (the $7,200 FMV of the red pickup truck, minus the grey pickup's $6,000 adjusted basis, minus the $200 you paid). Your sister realized a gain of $6,200 (the $7,000 FMV of the grey pickup truck plus the $200 you paid, minus the $1,000 adjusted basis of the red pickup truck).

However, because this was a like-kind exchange, you recognized no gain. Your basis in the red pickup truck was $6,200 (the $6,000 adjusted basis of the grey pickup truck plus the $200 you paid). She recognized gain only to the extent of the money she received, $200. Her basis in the grey pickup truck was $1,000 (the $1,000 adjusted basis of the red pickup truck minus the $200 received, plus the $200 gain recognized).

In 2008, you sold the red pickup truck to a third party for $7,000. Because you sold it within 2 years after the exchange, the exchange is disqualified from nonrecognition treatment. On your tax return for 2008, you must report your $1,000 gain on the 2007 exchange. You also report a loss on the sale as $200 (the adjusted basis of the red pickup truck, $7,200 (its $6,200 basis plus the $1,000 gain recognized), minus the $7,000 realized from the sale).

In addition, your sister must report on her tax return for 2008 the $6,000 balance of her gain on the 2007 exchange. Her adjusted basis in the grey pickup truck is increased to $7,000 (its $1,000 basis plus the $6,000 gain recognized).

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

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

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

* Transfer and receive properties in two or more exchange groups.
* Transfer or receive more than one property within a single exchange group.

**Deferred exchange.**

A deferred exchange is one in which you transfer property you use in business or hold for investment and later receive like-kind property you will use in business or hold for investment. (The property you receive is replacement property.) The transaction must be an exchange (that is, property for property) rather than a transfer of property for money used to buy replacement property unless the money is held by a qualified intermediary (defined later).

A deferred exchange for like-kind property may qualify for nonrecognition of gain or loss if the like-kind property is identified in writing and transferred within the following time limits.

1. You must identify the property to be received within 45 days after the date you transfer the property given up in the exchange.
2. The property must be received by the earlier of the following dates.
   1. The 180th day after the date on which you transfer the property given up in the exchange.
   2. The due date, including extensions, for your tax return for the tax year in which the transfer of the property given up occurs.

To comply with the 45-day written notice requirement to identify property to be received, you must designate and clearly describe the replacement property in a written document signed by you. For more information, see *Identifying replacement property* in chapter 1 of Publication 544.   A **qualified intermediary** is a person who enters into a written exchange agreement with you to acquire and transfer the property you give up and to acquire the replacement property and transfer it to you. This agreement must expressly limit your rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by the qualified intermediary. A qualified intermediary cannot be your agent at the time of the transaction or certain persons related to you or your agent.

A taxpayer who transfers property given up to a qualified intermediary in exchange for replacement property formerly owned by a related person is not entitled to nonrecognition treatment if the related person receives cash or unlike property for the replacement property.   For more information, see *Deferred Exchange* in chapter 1 of Publication 544.

***Transfer to Spouse***

No gain or loss is recognized on a transfer of property from an individual to (or in trust for the benefit of) a spouse, or a former spouse if incident to divorce. This rule does not apply if the recipient is a nonresident alien. Nor does this rule apply to a transfer in trust to the extent the liabilities assumed and the liabilities on the property are more than the property's adjusted basis.

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

For more information on transfers of property incident to divorce, see *Property Settlements* in Publication 504, Divorced or Separated Individuals.

**Ordinary or Capital Gain or Loss**

You must classify your gains and losses as either ordinary or capital (and your capital gains or losses as either short-term or long-term). You must do this to figure your net capital gain or loss.

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

**Capital gain or loss.**

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

***Section 1231 transactions.***

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

***Capital Assets***

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

The following items are examples of capital assets.

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

**Personal-use property.**

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

**Long and Short Term**

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

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

**Holding period.**

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

**Example.**

If you bought an asset on June 19, 2007, you should start counting on June 20, 2007. If you sold the asset on June 19, 2008, your holding period is not longer than 1 year, but if you sold it on June 20, 2008, your holding period is longer than 1 year.

***Inherited property.***

If you inherit property, you are considered to have held the property longer than 1 year, regardless of how long you actually held it. This rule does not apply to livestock used in a farm business. See *Holding period* under *Livestock,* later.

***Nonbusiness bad debt.***

A nonbusiness bad debt is a short-term capital loss. See chapter 4 of Publication 550.

***Nontaxable exchange.***

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

***Gift.***

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

***Real property.***

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

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

**Figuring Net Gain or Loss**

The totals for short-term capital gains and losses and the totals for long-term capital gains and losses must be figured separately.

**Net short-term capital gain or loss.**

Combine your short-term capital gains and losses. Do this by totaling all of your short-term capital gains. Then total all of your short-term capital losses. Subtract the lesser total from the greater. The difference is your net short-term capital gain or loss, whichever is greater.

**Net long-term capital gain or loss.**

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

**Net gain.**

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

**Net loss.**

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

**Treatment of Capital Losses**

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

**Capital loss carryover.**

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

* Your net loss on Schedule D (Form 1040), line 16, is more than the yearly limit (line 21).
* The amount shown on Form 1040, line 41, (your taxable income without your deduction for exemptions), is less than zero.

If either of these situations applies to you for 2008, see *Capital Losses* under *Reporting Capital Gains and Losses* in chapter 4 of Publication 550 to figure the amount you can carry over to 2009.

To figure your capital loss carryover from 2008 to 2009, you will need a copy of your 2008 Form 1040 and Schedule D (Form 1040).

**Capital Gains Tax Rates**

The tax rates that apply to a net capital gain are generally lower than the tax rates that apply to other income. These lower rates are called the maximum capital gains rates.

The term “net capital gain” means the amount by which your net long-term capital gain for the year is more than your net short-term capital loss.

See Schedule D (Form 1040) and its instructions.

**I**

**ncreased section 1202 exclusion of gain from qualified small business stock.**

  Taxpayers other than corporations generally can exclude from income 50% of their gain from the sale or trade of qualified small business stock held more than 5 years. If the stock is qualified enterprise zone business stock during substantially all of the time you held the stock, you can exclude 60% of your gain. See Publication 954, Tax Incentives for Distressed Communities, and Publication 550 for more information.

**Unrecaptured section 1250 gain.**

This is the part of any long-term capital gain on section 1250 property (real property) due to straight-line depreciation. Unrecaptured section 1250 gain cannot be more than the net section 1231 gain or include any gain that is otherwise treated as ordinary income. Use the worksheet in the Schedule D (Form 1040) instructions to figure your unrecaptured section 1250 gain. For more information about section 1250 property and net section 1231 gain, see chapter 3 of Publication 544.

***Noncapital Assets***

Noncapital assets include property such as inventory and depreciable property used in a trade or business. A list of properties that are not capital assets is provided in the Schedule D (Form 1040) instructions.

**Property held for sale in the ordinary course of your farm business.**

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

**Land and depreciable properties.**

 Land and depreciable property you use in farming are not capital assets. They also include livestock held for draft, breeding, dairy, or sporting purposes. However, 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. The sales of these business assets are reported on Form 4797. See chapter 9 for more information.

***Hedging (Commodity Futures)***

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

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

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

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

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

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

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

Gain or loss on transactions that hedge supplies of a type regularly used or consumed in the ordinary course of its trade or business may be ordinary.

If you have numerous transactions in the commodity futures market during the year, you must be able to show which transactions are hedging transactions. Clearly identify a hedging transaction on your books and records before the end of the day you entered into the transaction. It may be helpful to have separate brokerage accounts for your hedging and speculation transactions.

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

For more information on the tax treatment of futures and options contracts, see *Commodity Futures* and *Section 1256 Contracts Marked to Market* in Publication 550.

**Accounting methods for hedging transactions.**

The accounting method you use for a hedging transaction **must clearly reflect income.**

This means that your accounting method must reasonably match the timing of income, deduction, gain, or loss from a hedging transaction with the timing of income, deduction, gain, or loss from the item or items being hedged. There are requirements and limits on the method you can use for certain hedging transactions. See Regulations section 1.446-4(e) for those requirements and limits.

 Hedging transactions must be accounted for under the rules stated above unless the transaction is subject to mark-to-market accounting under section 475 or you use an accounting method other than the following methods.

1. Cash method.
2. Farm-price method.
3. Unit-livestock-price method.

  Once you adopt a method, you **must** apply it consistently and must have IRS approval before changing it.

  Your books and records must describe the accounting method used for each type of hedging transaction. They must also contain any additional identification necessary to verify the application of the accounting method you used for the transaction. You must make the additional identification no more than 35 days after entering into the hedging transaction.

**Example of a hedging transaction.**

You file your income tax returns on the cash method. On July 2, 2008, you anticipate a yield of 50,000 bushels of corn this year. The present December 2008, futures price is $2.75 a bushel, but there are indications that by harvest time the price will drop. To protect yourself against a drop in the price, you enter into the following hedging transaction. You sell 10 December 2008, futures contracts of 5,000 bushels each for a total of 50,000 bushels of corn at $2.75 a bushel.

  The price did not drop as anticipated but rose to $3 a bushel. In November, you sell your crop at a local elevator for $3 a bushel. You also close out your futures position by buying 10 December 2008, contracts for $3 a bushel. You paid a broker's commission of $1,400 ($70 per contract) for the complete in and out position in the futures market.

  The result is that the price of corn rose 25 cents a bushel and the actual selling price is $3 a bushel. Your loss on the hedge is 25 cents a bushel. In effect, the net selling price of your corn is $2.75 a bushel.

  Report the results of your futures transactions and your sale of corn separately on Schedule F.

  The loss on your futures transactions is $13,900, figured as follows.

|  |  |
| --- | --- |
| July 2, 2008 - Sold December 2008, corn futures (50,000 bu. @$2.75) | $137,500 |
| Nov. 6, 2008 - Bought December 2008, corn futures (50,000 bu. @$3 plus broker's commission) | 151,400 |
| **Futures loss** | **($13,900)** |

This loss is reported as a negative figure on Schedule F, Part I, line 10.

  The proceeds from your corn sale at the local elevator are $150,000 (50,000 bu. × $3). Report it on Schedule F, Part I, line 4.

  Assume you were right and the price went down 25 cents a bushel. In effect, you would still net $2.75 a bushel, figured as follows.

|  |  |
| --- | --- |
| Sold cash corn, per bushel | $2.50 |
| Gain on hedge, per bushel | .25 |
| **Net price, per bushel** | **$2.75** |

  The gain on your futures transactions would have been $11,100, figured as follows.

|  |  |
| --- | --- |
| July 2, 2008 - Sold December 2008, corn futures (50,000 bu. @$2.75) | $137,500 |
| Nov. 6, 2008 - Bought December 2008, corn futures (50,000 bu. @$2.50 plus broker's commission) | 126,400 |
| **Futures gain** | **$11,100** |

The $11,100 is reported on Schedule F, Part I, line 10.

  The proceeds from the sale of your corn at the local elevator, $125,000, are reported on Schedule F, Part I, line 4.

***Livestock***

This part discusses the sale or exchange of livestock used in your farm business. Gain or loss from the sale or exchange of this livestock may qualify as a section 1231 gain or loss. However, any part of the gain that is ordinary income from the recapture of depreciation is not included as section 1231 gain. See chapter 9 for more information on section 1231 gains and losses and the recapture of depreciation under section 1245.

The rules discussed here do not apply to the sale of livestock held primarily for sale to customers. The sale of this livestock is reported on Schedule F. See chapter 3.

**Holding period.**

 The sale or exchange of livestock used in your farm business (defined below) qualifies as a section 1231 transaction if you held the livestock for 12 months or more (24 months or more for horses and cattle).

**Livestock.**

For section 1231 transactions, livestock includes cattle, hogs, horses, mules, donkeys, sheep, goats, fur-bearing animals (such as mink), and other mammals. Livestock does not include chickens, turkeys, pigeons, geese, emus, ostriches, rheas, or other birds, fish, frogs, reptiles, etc.

***Livestock used in farm business.***

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

**Example 1.**

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

**Example 2.**

You retire and sell your entire herd, including young animals that you would have used for breeding or dairy purposes had you remained in business. These young animals were held for breeding or dairy purposes. Also, if you sell young animals to reduce your breeding or dairy herd because of drought, these animals are treated as having been held for breeding or dairy purposes.

**Example 3.**

You are in the business of raising hogs for slaughter. Customarily, before selling your sows, you obtain a single litter of pigs that you will raise for sale. You sell the brood sows after obtaining the litter. Even though you hold these brood sows for ultimate sale to customers in the ordinary course of your business, they are considered to be held for breeding purposes.

**Example 4.**

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

**Example 5.**

You are in the business of breeding and raising mink that you pelt for the fur trade. You take breeders from the herd when they are no longer useful as breeders and pelt them. Although these breeders are processed and pelted, they are still considered to be held for breeding purposes. The same applies to breeders of other fur-bearing animals.

**Example 6.**

You breed, raise, and train horses for racing purposes. Every year you cull horses from your racing stable. In 2008, you decided that to prevent your racing stable from getting too large to be effectively operated, you must cull six horses that had been raced at public tracks in 2007. These horses are all considered held for sporting purposes.

**Figuring gain or loss on the cash method.**

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

***Raised livestock.***

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

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

**Example.**

A farmer sold a breeding cow on January 8, 2008, for $1,250. Expenses of the sale were $125. The cow was bought July 2, 2004, for $1,300. Depreciation (not less than the amount allowable) was $867.

|  |  |  |
| --- | --- | --- |
| Gross sales price | | $1,250 |
| Cost (basis) | $1,300 |  |
| Minus: Depreciation deduction | 867 |  |
| Unrecovered cost (adjusted basis) | $ 433 |  |
| Expense of sale | 125 | 558 |
| **Gain realized** | | **$ 692** |

***Converted Wetland and Highly Erodible Cropland***

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

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

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

1. It is mostly soil that, in its undrained condition, is saturated, flooded, or ponded long enough during a growing season to develop an oxygen-deficient state that supports the growth and regeneration of plants growing in water.
2. It is saturated by surface or groundwater at a frequency and duration sufficient to support mostly plants that are adapted for life in saturated soil.
3. It supports, under normal circumstances, mostly plants that grow in saturated soil.

**Highly erodible cropland.**

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

**Successor.**

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

***Timber***

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

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

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

**Timber considered cut.**

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

**Christmas trees.**

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

**Election to treat cutting as a sale or exchange.**

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

  To elect this treatment, you must:

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

***Making the election.***

You make the election on your return for the year the cutting takes place by including in income the gain or loss on the cutting and including a computation of your gain or loss. You do not have to make the election in the first year you cut the timber. You can make it in any year to which the election would apply. If the timber is partnership property, the election is made on the partnership return. This election cannot be made on an amended return.

Once you have made the election, it remains in effect for all later years unless you cancel it.

***Election under section 631(a) may be revoked.***

 If you previously elected for any tax year ending before October 23, 2004, to treat the cutting of timber as a sale or exchange under section 631(a), you may revoke this election without the consent of the IRS for any tax year ending after October 22, 2004. The prior election (and revocation) is disregarded for purposes of making a subsequent election. See Form T (Timber), Forest Activities Schedule, for more information.

***Gain or loss.***   Your gain or loss on the cutting of standing timber is the difference between its adjusted basis for depletion and its fair market value on the first day of your tax year in which it is cut.

  Your adjusted basis for depletion of cut timber is based on the number of units (board feet, log scale, or other units) of timber cut during the tax year and considered to be sold or exchanged. Your adjusted basis for depletion is also based on the depletion unit of timber in the account used for the cut timber, and should be figured in the same manner as shown in section 611 and Regulations section 1.611-3.

***Example.***

In April 2008, you owned 4,000 MBF (1,000 board feet) of standing timber longer than 1 year. It had an adjusted basis for depletion of $40 per MBF. You are a calendar year taxpayer. On January 1, 2008, the timber had a fair market value (FMV) of $350 per MBF. It was cut in April for sale. On your 2008 tax return, you elect to treat the cutting of the timber as a sale or exchange. You report the difference between the FMV and your adjusted basis for depletion as a gain. This amount is reported on Form 4797 along with your other section 1231 gains and losses to figure whether it is treated as a capital gain or as ordinary gain. You figure your gain as follows.

|  |  |
| --- | --- |
| FMV of timber January 1, 2008 | $1,400,000 |
| Minus: Adjusted basis for depletion | 160,000 |
| **Section 1231 gain** | **$1,240,000** |

The FMV becomes your basis in the cut timber, and a later sale of the cut timber, including any by-product or tree tops, will result in ordinary business income or loss.

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

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

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

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

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

***Date of disposal.***

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

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

  To make this election, attach a statement to the tax return filed by the due date (including extensions) for the year payment is received. The statement must identify the advance payments subject to the election and the contract under which they were made.

  If you timely filed your return for the year you received payment without making the election, you can still make the election by filing an amended return within 6 months after the due date for that year's return (excluding extensions). Attach the statement to the amended return and write “Filed pursuant to section 301.9100-2” at the top of the statement. File the amended return at the same address the original return was filed.

***Owner.***   An owner is any person who owns an interest in the timber, including a sublessor and the holder of a contract to cut the timber. You own an interest in timber if you have the right to cut it for sale on your own account or for use in your business.

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

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

***Sale of a Farm***

The sale of your farm will usually involve the sale of both nonbusiness property (your home) and business property (the land and buildings used in the farm operation and perhaps machinery and livestock). If you have a gain from the sale, you may be allowed to exclude the gain on your home. For more information, see Publication 523, Selling Your Home.

The gain on the sale of your business property is taxable. A loss on the sale of your business property to an unrelated person is deducted as an ordinary loss. Losses from nonbusiness property, other than casualty or theft losses, are not deductible. If you receive payments for your farm in installments, your gain is taxed over the period of years the payments are received, unless you elect not to use the installment method of reporting the gain. See chapter 10 for information about installment sales.

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

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

**Allocation of consideration paid for a farm.**

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

***Consideration.***

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

***Residual method.***

The residual method must be used for any transfer of a group of assets that constitutes a trade or business and for which the buyer's basis is determined only by the amount paid for the assets. This applies to both direct and indirect transfers, such as the sale of a business or the sale of a partnership interest in which the basis of the buyer's share of the partnership assets is adjusted for the amount paid under section 743(b). Section 743(b) applies if a partnership has an election in effect under section 754.

  A group of assets constitutes a trade or business if either of the following applies.

1. Goodwill or going concern value could, under any circumstances, attach to them.
2. The use of the assets would constitute an active trade or business under section 355.

The **residual method** provides for the consideration to be reduced first by the cash, and general deposit accounts (including checking and savings accounts but excluding certificates of deposit). The consideration remaining after this reduction must be allocated among the various business assets in a certain order.

  For asset acquisitions occurring after March 15, 2001, make the allocation among the following assets in proportion to (but not more than) their fair market value on the purchase date in the following order.

1. Certificates of deposit, U.S. Government securities, foreign currency, and actively traded personal property, including stock and securities.
2. Accounts receivable, other debt instruments, and assets that you mark to market at least annually for federal income tax purposes. However, see Regulations section 1.338-6(b)(2)(iii) for exceptions that apply to debt instruments issued by persons related to a target corporation, contingent debt instruments, and debt instruments convertible into stock or other property.
3. Property of a kind that would properly be included in inventory if on hand at the end of the tax year or property held by the taxpayer primarily for sale to customers in the ordinary course of business.
4. All other assets except section 197 intangibles.
5. Section 197 intangibles (other than goodwill and going concern value).
6. Goodwill and going concern value (whether or not the goodwill or going concern value qualifies as a section 197 intangible).

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

**Property used in farm operation.**

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

**Example.**

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

|  |  |  |  |
| --- | --- | --- | --- |
|  | **Farm** |  | **Farm** |
|  | **With** | **Home** | **Without** |
|  | **Home** | **Only** | **Home** |
| 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 must report the $94,000 gain from the sale of the property used in your farm business. All or a part of that gain may have to be reported as ordinary income from the recapture of depreciation or soil and water conservation expenses. Treat the balance as section 1231 gain.

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

**Partial sale.**

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

***Adjusted basis of the part sold.***

This is the properly allocated part of your original cost or other basis of the entire farm plus or minus necessary adjustments for improvements, depreciation, etc., on the part sold. If your home is on the farm, you must properly adjust the basis to exclude those costs from your farm asset costs, as discussed below under *Sale of your home*.

**Example.**

You bought a 600-acre farm for $700,000. The farm included land and buildings. The purchase contract designated $600,000 of the purchase price to the land. You later sold 60 acres of land on which you had installed a fence. Your adjusted basis for the part of your farm sold is $60,000 ( of $600,000), plus any unrecovered cost (cost not depreciated) of the fence on the 60 acres at the time of sale. Use this amount to determine your gain or loss on the sale of the 60 acres.

***Assessed values for local property taxes.***

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

**Example.**

Assume that in the preceding example there was no breakdown of the $700,000 purchase price between land and buildings. However, in the year of purchase, local taxes on the entire property were based on assessed valuations of $420,000 for land and $140,000 for improvements, or a total of $560,000. The assessed valuation of the land is (75%) of the total assessed valuation. Multiply the $700,000 total purchase price by 75% to figure basis of $525,000 for the 600 acres of land. The unadjusted basis of the 60 acres you sold would then be $52,500 ( of $525,000).

**Sale of your home.**

Your home is a capital asset and not property used in the trade or business of farming. If you sell a farm that includes a house you and your family occupy, you must determine the part of the selling price and the part of the cost or other basis allocable to your home. Your home includes the immediate surroundings and outbuildings relating to it that are not used for business purposes.

  If you use part of your home for business, you must make an appropriate adjustment to the basis for depreciation allowed or allowable

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

***Gain from condemnation.***

If you have a gain from a condemnation or sale under threat of condemnation, you may use the preceding rules for excluding the gain, rather than the rules discussed under *Postponing Gain* in chapter 11. However, any gain that cannot be excluded (because it is more than the limit) may be postponed under the rules.

***Foreclosure or Repossession***

If you do not make payments you owe on a loan secured by property, the lender may foreclose on the loan or repossess the property. The foreclosure or repossession is treated as a sale or exchange from which you may realize gain or loss. This is true even if you voluntarily return the property to the lender. You may also realize ordinary income from cancellation of debt if the loan balance is more than the fair market value of the property.

**Buyer's (borrower's) gain or loss.**

You figure and report gain or loss from a foreclosure or repossession in the same way as gain or loss from a sale or exchange. The gain or loss is the difference between your adjusted basis in the transferred property and the amount realized. See *Determining Gain or Loss,* earlier.

***Amount realized on a nonrecourse debt.***

 If you are not personally liable for repaying the debt (nonrecourse debt) secured by the transferred property, the amount you realize includes the full amount of the debt canceled by the transfer. The total canceled debt is included in the amount realized even if the fair market value of the property is less than the canceled debt.

**Example 1.**

Ann paid $200,000 for land used in her farming business. She paid $15,000 down and borrowed the remaining $185,000 from a bank. Ann is not personally liable for the loan (nonrecourse debt), but pledges the land as security. The bank foreclosed on the loan 2 years after Ann stopped making payments. When the bank foreclosed, the balance due on the loan was $180,000 and the fair market value of the land was $170,000. The amount Ann realized on the foreclosure was $180,000, the debt canceled by the foreclosure. She figures her gain or loss on Form 4797, Part I, by comparing the amount realized ($180,000) with her adjusted basis ($200,000). She has a $20,000 deductible loss.

**Example 2.**

Assume the same facts as in *Example 1* except the fair market value of the land was $210,000. The result is the same. The amount Ann realized on the foreclosure is $180,000, the debt canceled by the foreclosure. Because her adjusted basis is $200,000, she has a deductible loss of $20,000, which she reports on Form 4797, Part I.

***Amount realized on a recourse debt.***

If you are personally liable for repaying the debt (recourse debt), the amount realized on the foreclosure or repossession does not include the canceled debt that is income from cancellation of debt. However, if the fair market value of the transferred property is less than the canceled debt, the amount realized includes the canceled debt up to the fair market value of the property. You are treated as receiving ordinary income from the canceled debt for the part of the debt that is more than the fair market value. See *Cancellation of debt,* later.

**Example 3.**

Assume the same facts as in *Example 1* above except Ann is personally liable for the loan (recourse debt). In this case, the amount she realizes is $170,000. This is the canceled debt ($180,000) up to the fair market value of the land ($170,000). Ann figures her gain or loss on the foreclosure by comparing the amount realized ($170,000) with her adjusted basis ($200,000). She has a $30,000 deductible loss, which she figures on Form 4797, Part I. She is also treated as receiving ordinary income from cancellation of debt. That income is $10,000 ($180,000 − $170,000). This is the part of the canceled debt not included in the amount realized. She reports this income on Schedule F, line 10.

**Seller's (lender's) gain or loss on repossession.**

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

**Cancellation of debt.**

 If property that is repossessed or foreclosed upon secures a debt for which you are personally liable (recourse debt), you generally must report as ordinary income the amount by which the canceled debt is more than the fair market value of the property. This income is separate from any gain or loss realized from the foreclosure or repossession. Report the income from cancellation of a business debt on Schedule F, line 10. Report the income from cancellation of a nonbusiness debt as miscellaneous income on Form 1040, line 21.

You can use Worksheet 8-1 to figure your income from cancellation of debt.   However, income from cancellation of debt is not taxed if any of the following apply.

1. The cancellation is intended as a gift.
2. The debt is qualified farm debt (see chapter 3).
3. The debt is qualified real property business debt (see chapter 5 of Publication 334).
4. You are insolvent or bankrupt (see chapter 3).
5. The debt is qualified principal residence indebtedness (see chapter 3).
6. The discharge of certain indebtedness of a qualified individual because of Midwestern disasters (see Publication 4492-B).

***Abandonment***

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

**Business or investment property.**

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

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

**Example.**

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

**Personal-use property.**

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

**Canceled debt.**

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

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

**Forms 1099-A and 1099-C.**

A lender who acquires an interest in your property in a foreclosure, repossession, or abandonment should send you Form 1099-A showing the information you need to figure your loss from the foreclosure, repossession, or abandonment. However, if the lender cancels part of your debt and the lender must file Form 1099-C, the lender may include the information about the foreclosure, repossession, or abandonment on that form instead of Form 1099-A. The lender must file Form 1099-C and send you a copy if the canceled debt is $600 or more and the lender is a financial institution, credit union, federal government agency, or any organization that has a significant trade or business of lending money. For foreclosures, repossessions, abandonments of property, and debt cancellations occurring in 2008, these forms should be sent to you by January 31, 2009.

**Worksheet 8-1.Worksheet for Foreclosures and Repossessions**

|  |  |
| --- | --- |
| **Part 1.** Figure your income from cancellation of debt. (Note: *If you are  not personally liable for the debt, you do not have income  from cancellation of debt. Skip Part 1 and go to Part 2.)* |  |
| **1.** Enter the amount of debt canceled by the transfer of property |  |
| **2.** Enter the fair market value of the transferred property |  |
| **3.Income from cancellation of debt.\*** Subtract line 2 from line 1. If   less than zero, enter zero |  |
| **Part 2.** Figure your gain or loss from foreclosure or repossession. |  |
| **4.** Enter the **smaller** of line 1 or line 2. Also include any proceeds you  received from the foreclosure sale. (If you are not personally liable   for the debt, enter the amount of debt canceled by the transfer of   property.) |  |
| **5.** Enter the adjusted basis of the transferred property |  |
| **6. Gain or loss from foreclosure or repossession.** Subtract line 5   from line 4 |  |
| \* The income may not be taxable. See *Cancellation of debt.* | |

**Dispositions of Property Used in Farming**

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

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

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

**Depreciation Recapture**

If you dispose of depreciable or amortizable property at a gain, you may have to treat all or part of the gain (even if it is otherwise nontaxable) as ordinary income.

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

***Section 1245 Property***

A gain on the disposition of section 1245 property is treated as ordinary income to the extent of depreciation allowed or allowable.

Any recognized gain that is more than the part that is ordinary income because of depreciation is a section 1231 gain. See *Treatment as ordinary or capital* under *Section 1231 Gains and Losses,* earlier.

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

1. **Personal property** (either tangible or intangible).
2. **Other tangible property** (except buildings and their structural components) used as any of the following. See *Buildings and structural components* below.
   1. An integral part of manufacturing, production, or extraction, or of furnishing transportation, communications, electricity, gas, water, or sewage disposal services.
   2. A research facility in any of the activities in (a).
   3. A facility in any of the activities in (a) for the bulk storage of fungible commodities (discussed later).
3. That part of real property (**not included** in (2)) with an adjusted basis reduced by (but not limited to) the following.
   1. Amortization of certified pollution control facilities.
   2. The section 179 expense deduction.
   3. Deduction for clean-fuel vehicles and certain refueling property placed in service before 2006.
   4. Certain expenditures for child care facilities. (Repealed by Public Law 101-58, Omnibus Budget Reconciliation Act of 1990, section 11801(a)(13) except with regards to deductions made prior to November 5, 1990.)
   5. Expenditures to remove architectural and transportation barriers to the handicapped and elderly.
   6. Certain reforestation expenditures.
4. Single purpose agricultural (livestock) or horticultural structures.
5. Storage facilities (except buildings and their structural components) used in distributing petroleum or any primary product of petroleum.

**Buildings and structural components.**

Section 1245 property does not include buildings and structural components. The term building includes a house, barn, warehouse, or garage. The term structural component includes walls, floors, windows, doors, central air conditioning systems, light fixtures, etc.

Do not treat a structure that is essentially machinery or equipment as a building or structural component. Also, do not treat a structure that houses property used as an integral part of an activity as a building or structural component if the structure's use is so closely related to the property's use that the structure can be expected to be replaced when the property it initially houses is replaced.

The fact that the structure is specially designed to withstand the stress and other demands of the property and cannot be used economically for other purposes indicates it is closely related to the use of the property it houses. Structures such as oil and gas storage tanks, grain storage bins, and silos are not treated as buildings, but as section 1245 property.

**Facility for bulk storage of fungible commodities.**

This is a facility used mainly for the bulk storage of fungible commodities. Bulk storage means storage of a commodity in a large mass before it is used. For example, if a facility is used to store sorted and boxed oranges (the oranges are no longer in a large mass), it is not used for bulk storage. To be fungible, a commodity must be such that one part may be used in place of another.

**Gain Treated as Ordinary Income**

The gain treated as ordinary income on the sale, exchange, or involuntary conversion of section 1245 property, including a sale and leaseback transaction, is the lesser of the following amounts.

1. The depreciation (which includes any section 179 deduction claimed) and amortization allowed or allowable on the property.
2. The gain realized on the disposition (the amount realized from the disposition minus the adjusted basis of the property).

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

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

**Depreciation claimed on other property or claimed by other taxpayers.**

  Depreciation and amortization include the amounts you claimed on the section 1245 property as well as the following depreciation and amortization amounts.

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

**Example.**

Jeff Free paid $120,000 for a tractor in 2006. On February 23, 2008, he traded it for a chopper and paid an additional $30,000. To figure his depreciation deduction for the current year, Jeff continues to use the basis of the tractor as he would have before the trade to depreciate the chopper. Jeff can also depreciate the additional $30,000 basis on the chopper.

**Depreciation and amortization.**

Depreciation and amortization deductions that must be recaptured as ordinary income include (but are not limited to) the following items.

1. Ordinary depreciation deductions.
2. Section 179 deduction (see chapter 7).
3. Any special depreciation allowance.
4. Amortization deductions for all the following costs.
   1. Acquiring a lease.
   2. Lessee improvements.
   3. Pollution control facilities.
   4. Reforestation expenses.
   5. Section 197 intangibles.
   6. Childcare facility expenses incurred before 1982.
   7. Franchises, trademarks, and trade names acquired before August 11, 1993.
5. Deductions for all the following costs.
   1. Removing barriers to the disabled and the elderly.
   2. Tertiary injectant expenses.
   3. Depreciable clean-fuel vehicles and refueling property (minus any recaptured deduction).
6. Any basis reduction for the investment credit (minus any basis increase for a credit recapture).
7. Any basis reduction for the qualified electric vehicle credit (minus any basis increase for a credit recapture).

**Example.**

You file your returns on a calendar year basis. In February 2006, you bought and placed in service for 100% use in your farming business a light-duty truck (5-year property) that cost $10,000. You used the half-year convention and your MACRS deductions for the truck were $1,500 in 2006 and $2,550 in 2007. You did not claim the section 179 expense deduction for the truck. You sold it in May 2008 for $7,000. The MACRS deduction in 2008, the year of sale, is $893 (½ of $1,785). Figure the gain treated as ordinary income as follows.

|  |  |  |  |
| --- | --- | --- | --- |
| 1) | Amount realized | | $7,000 |
| 2) | Cost (February 2006) | $10,000 |  |
| 3) | Depreciation allowed or allowable (MACRS deductions: $1,500 + $2,550 + $893) | 4,943 |  |
| 4) | Adjusted basis (subtract line 3 from line 2) | | $5,057 |
| 5) | Gain realized (subtract line 4 from line 1) | | 1,943 |
| **6)** | **Gain treated as ordinary income (lesser of line 3 or line 5)** | | **$1,943** |

**Depreciation allowed or allowable.**

You generally use the greater of the depreciation allowed or allowable when figuring the part of gain to report as ordinary income. If, in prior years, you have consistently taken proper deductions under one method, the amount allowed for your prior years will not be increased even though a greater amount would have been allowed under another proper method. If you did not take any deduction at all for depreciation, your adjustments to basis for depreciation allowable are figured by using the straight line method. This treatment applies only when figuring what part of the gain is treated as ordinary income under the rules for section 1245 depreciation recapture.

**Disposition of plants and animals.**

If you elect not to use the uniform capitalization rules (see chapter 6), you must treat any plant you produce as section 1245 property. If you have a gain on the property's disposition, you must recapture the **preproductive** expenses you would have capitalized if you had not made the election by treating the gain, up to the amount of these expenses, as ordinary income. For section 1231 transactions, show these expenses as depreciation on Form 4797, Part III, line 22. For plant sales that are reported on Schedule F (1040), Profit or Loss From Farming, this recapture rule does not change the reporting of income because the gain is already ordinary income.

**Example.**

Janet Maple sold her apple orchard in 2008 for $80,000. Her adjusted basis at the time of sale was $60,000. She bought the orchard in 2001, but the trees did not produce a crop until 2004. Her pre-productive expenses were $6,000. She elected not to use the uniform capitalization rules. Janet must treat $6,000 of the gain as ordinary income.

***Section 1250 Property***

Section 1250 property includes all real property subject to an allowance for depreciation that is not and never has been section 1245 property. It includes a leasehold of land or section 1250 property subject to an allowance for depreciation. A fee simple interest in land is not section 1250 property because, like land, it is not depreciable.

Gain on the disposition of section 1250 property is treated as ordinary income to the extent of additional depreciation allowed or allowable. To determine the additional depreciation on section 1250 property, see *Depreciation Recapture* in chapter 3 of Publication 544.

You will not have additional depreciation if any of the following apply to the property disposed of.

1. You figured depreciation for the property using the straight line method or any other method that does not result in depreciation that is more than the amount figured by the straight line method and you have held the property longer than 1 year.
2. You chose the alternate ACRS (straight line) method for the property, which was a type of 15-, 18-, or 19-year real property covered by the section 1250 rules.
3. The property was nonresidential real property placed in service after 1986 (or after July 31, 1986, if the choice to use MACRS was made) and you held it longer than 1 year. These properties are depreciated using the straight line method.

**Installment Sales**

An installment sale is a sale of property where you receive at least one payment after the tax year of the sale. If you realize a gain on an installment sale, you may be able to report part of your gain when you receive each payment. This method of reporting gain is called the installment method. You cannot use the installment method to report a loss. You can choose to report all of your gain in the year of sale.

***Installment Sale of a Farm***

The installment sale of a farm for one overall price under a single contract is not the sale of a single asset. It generally includes the sale of real property and personal property reportable on the installment method. It may also include the sale of property for which you must maintain an inventory, which cannot be reported on the installment method. See *Inventory,* later. The selling price must be allocated to determine the amount received for each class of asset.

The tax treatment of the gain or loss on the sale of each class of assets is determined by its classification as a capital asset, as property used in the business, or as property held for sale and by the length of time the asset was held. (See chapter 8 for a discussion of capital assets and chapter 9 for a discussion of property used in the business.) Separate computations must be made to figure the gain or loss for each class of asset sold. See *Sale of a Farm* in chapter 8.

If you report the sale of property on the installment method, any depreciation recapture under section 1245 or 1250 of the Internal Revenue Code is generally taxable as ordinary income in the year of sale. See *Depreciation recapture,* later. This applies even if no payments are received in that year.

**Casualties, Thefts, and Condemnations**

**What's New**

**Kansas and Midwestern disaster areas.**The following paragraphs explain the special rules that apply to casualties, thefts, and condemnations of taxpayers in both the

**Kansas** disaster area (defined below) who were affected by storms and tornadoes that began on May 4, 2007, and the

**Midwestern** disaster areas (defined later). For more information, see Publication 4492-A, Information for Taxpayers Affected by the May 4, 2007, Kansas Storms and Tornadoes or Publication 4492-B, Information for Affected Taxpayers in the Midwestern Disaster Areas.Losses of personal use property that arose in these disaster areas are not subject to the $100 or 10% of adjusted gross income limitation. Qualifying losses include losses from casualties and thefts that arose in the disaster area and that were attributable to the storms and tornadoes. If you live in the Kansas disaster area and deducted your loss in 2007 or elected to deduct the loss in 2006, see Publication 4492-

A for special instructions on how to complete your tax forms.If you live in a Midwestern disaster area and you elect to deduct the loss in 2007, see Publication 4492-B for special instructions on how to complete your tax forms.The replacement period for property in these disaster areas that was damaged, destroyed, stolen, or condemned has been extended from 2 to 5 years. For more information, see *Replacement Period* later.

The **Kansas disaster area** covers the Kansas counties of Barton, Clay, Cloud, Comanche, Dickinson, Edwards, Ellsworth, Kiowa, Leavenworth, Lyon, McPherson, Osage, Osborne, Ottawa, Phillips, Pottawatomie, Pratt, Reno, Rice, Riley, Saline, Shawnee, Smith, and Stafford.For purposes of the special rules discussed earlier, the

**Midwestern disaster areas** are areas for which a major disaster has been declared by the President after May 19, 2008, and before August 1, 2008, under section 401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act because of severe storms, tornadoes, or flooding that occurred in Arkansas, Illinois, Indiana, Iowa, Kansas, Michigan, Minnesota, Missouri, Nebraska, and Wisconsin.

**Federally declared disasters.**

New rules apply to losses of personal use property attributable to federally declared disasters declared in tax years beginning after 2007 and that occurred before 2010. A federally declared disaster is any disaster determined by the President of the United States to warrant assistance by the Federal Government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act. A disaster area is the area determined to warrant such assistance. The new rules discussed here do **not** apply to losses in the Midwestern disaster areas.The new rules are as follows.

1. The net disaster loss (defined in (3) below) is not subject to the 10% of adjusted gross income limit.
2. You can deduct a net disaster loss even if you do not itemize your deductions on Schedule A (Form 1040). You do this by completing Form 4684 and entering your net disaster loss on line 6 of the *Standard Deduction Worksheet-Line 40* in the Form 1040 Instructions.
3. Your net disaster loss is the excess of—
   * Your personal casualty losses attributable to a federally declared disaster and occurring in a disaster area, over
   * Your personal casualty gains.

**Special rules for individuals impacted by Hurricanes Katrina, Rita, and Wilma.**If you claimed a casualty or theft loss deduction and in a later year you received more reimbursement than you expected, you do not recompute the tax for the year in which you claimed the deduction. Instead, you must include the reimbursement in your income for the year in which it was received, but only to the extent the original deduction reduced your tax for the earlier year. However, an exception applies if you claimed a casualty or theft loss deduction for damage to or destruction of your main home caused by Hurricane Katrina, Rita, or Wilma, and in a later year you received a hurricane relief grant. Under this exception, you can choose to file an amended income tax return (Form 1040X) for the tax year in which you claimed the deduction and reduce (but not below zero) the amount of the deduction by the amount of the grant. If you make this choice, you must file Form 1040X by the later of:

* The due date for filing your tax return for the tax year in which you receive the grant, or
* July 30, 2009.

For more information, see IRS Notice 2008-95 at [www.irs.gov](http://www.irs.gov) or Publication 547, Casualties, Disasters, and Thefts.

This chapter explains the tax treatment of casualties, thefts, and condemnations. A casualty occurs when property is damaged, destroyed, or lost due to a sudden, unexpected, or unusual event. A theft occurs when property is stolen. A condemnation occurs when private property is legally taken for public use without the owner's consent. A casualty, theft, or condemnation may result in a deductible loss or taxable gain on your federal income tax return. You may have a deductible loss or a taxable gain even if only a portion of your property was affected by a casualty, theft, or condemnation.

An involuntary conversion occurs when you receive money or other property as reimbursement for a casualty, theft, condemnation, disposition of property under threat of condemnation, or certain other events discussed in this chapter.

If an involuntary conversion results in a gain and you buy qualified replacement property within the specified replacement period, you can postpone reporting the gain on your income tax return. For more information, see Postponing Gain, later.

#### Postponing Gain

Do not report a gain if you receive reimbursement in the form of property similar or related in service or use to the destroyed, stolen, or other involuntarily converted property. Your basis in the new property is generally the same as your adjusted basis in the property it replaces.

You must ordinarily report the gain on your stolen, destroyed, or other involuntarily converted property if you receive money or unlike property as reimbursement. However, you can choose to postpone reporting the gain if you purchase replacement property similar or related in service or use to your destroyed, stolen, or other involuntarily converted property within a specific replacement period.

If you have a gain on damaged property, you can postpone reporting the gain if you spend the reimbursement to restore the property.

To postpone reporting all the gain, the cost of your replacement property must be at least as much as the reimbursement you receive. If the cost of the replacement property is less than the reimbursement, you must include the gain in your income up to the amount of the unspent reimbursement.

**Example 1.**

In 1985, you constructed a barn to store farm equipment at a cost of $20,000. In 1987, you added a silo to the barn at a cost of $15,000 to store grain. In May of this year, the property was worth $100,000. In June the property was destroyed by a tornado. You received $85,000 from the insurance company. You had a gain of $50,000 ($85,000 – $35,000).

You spent $80,000 to rebuild the barn and silo. Since this is less than the insurance proceeds received, you must include $5,000 ($85,000 – $80,000) in your income.

**Example 2.**

In 1970, you bought a cottage in the mountains for your personal use at a cost of $18,000. You made no further improvements or additions to it. When a storm destroyed the cottage this January, the cottage was worth $250,000. You received $146,000 from the insurance company in March. You had a gain of $128,000 ($146,000 − $18,000).

You spent $144,000 to rebuild the cottage. Since this is less than the insurance proceeds received, you must include $2,000 ($146,000 − $144,000) in your income.

**Buying replacement property from a related person.**

You cannot postpone reporting a gain from a casualty, theft, or other involuntary conversion if you buy the replacement property from a related person (discussed later). This rule applies to the following taxpayers.

1. C corporations.
2. Partnerships in which more than 50% of the capital or profits interest is owned by C corporations.
3. Individuals, partnerships (other than those in (2) above), and S corporations if the total realized gain for the tax year on all involuntarily converted properties on which there are realized gains is more than $100,000.

For involuntary conversions described in (3) above, gains cannot be offset by any losses when determining whether the total gain is more than $100,000. If the property is owned by a partnership, the $100,000 limit applies to the partnership and each partner. If the property is owned by an S corporation, the $100,000 limit applies to the S corporation and each shareholder.

**Exception.**   This rule does not apply if the related person acquired the property from an unrelated person within the period of time allowed for replacing the involuntarily converted property.

**Related persons.**   Under this rule, related persons include, for example, a parent and child, a brother and sister, a corporation and an individual who owns more than 50% of its outstanding stock, and two partnerships in which the same C corporations own more than 50% of the capital or profits interests. For more information on related persons, see Nondeductible Loss under Sales and Exchanges Between Related Persons in chapter 2 of Publication 544.

**Death of a taxpayer.**   If a taxpayer dies after having a gain, but before buying replacement property, the gain must be reported for the year in which the decedent realized the gain. The executor of the estate or the person succeeding to the funds from the involuntary conversion cannot postpone reporting the gain by buying replacement property.

#### Replacement Property

You must buy replacement property for the specific purpose of replacing your property. Your replacement property must be similar or related in service or use to the property it replaces. You do not have to use the same funds you receive as reimbursement for your old property to acquire the replacement property. If you spend the money you receive for other purposes, and borrow money to buy replacement property, you can still choose to postpone reporting the gain if you meet the other requirements. Property you acquire by gift or inheritance does not qualify as replacement property.

**Owner-user.**

If you are an owner-user, similar or related in service or use means that replacement property must function in the same way as the property it replaces. Examples of property that functions in the same way as the property it replaces are a home that replaces another home, a dairy cow that replaces another dairy cow, and farm land that replaces other farm land. A passenger automobile that replaces a tractor does not qualify. Neither does a breeding or draft animal that replaces a dairy cow.

**Soil or other environmental contamination.**

If, because of soil or other environmental contamination, it is not practical for you to reinvest your insurance money from destroyed livestock in property similar or related in service or use to the livestock, you can treat other property (including real property) used for farming purposes, as property similar or related in service or use to the destroyed livestock.

**Weather-related sales of livestock.**

 If you sell or exchange livestock because of weather-related conditions (discussed earlier under Livestock Losses) and it is not practical for you to reinvest the sales proceeds in property similar or related in service or use to the livestock, you can treat other property (excluding real property) used for farming purposes, as property similar or related in service or use to the livestock you sold.

**Standing crop destroyed by casualty.**

 If a storm or other casualty destroyed your standing crop and you use the insurance money to acquire either another standing crop or a harvested crop, this purchase qualifies as replacement property. The costs of planting and raising a new crop qualify as replacement costs for the destroyed crop only if you use the crop method of accounting (discussed in chapter 2). In that case, the costs of bringing the new crop to the same level of maturity as the destroyed crop qualify as replacement costs to the extent they are incurred during the replacement period.

**Timber loss.**

Standing timber you bought with the proceeds from the sale of timber downed as a result of a casualty, such as high winds, earthquakes, or volcanic eruptions, qualifies as replacement property. If you bought the standing timber within the replacement period, you can postpone reporting the gain.

**Business or income-producing property located in a federally declared disaster area.**

If your destroyed business or income-producing property was located in a federally declared disaster area, any tangible replacement property you acquire for use in any business is treated as similar or related in service or use to the destroyed property. For more information, see Disaster Area Losses in Publication 547.

**Substituting replacement property.**   Once you have acquired qualified replacement property that you designate as replacement property in a statement attached to your tax return, you cannot substitute other qualified replacement property. This is true even if you acquire the other property within the replacement period. However, if you discover that the original replacement property was not qualified replacement property, you can, within the replacement period, substitute the new qualified replacement property.

**Basis of replacement property.**   You must reduce the basis of your replacement property (its cost) by the amount of postponed gain. In this way, tax on the gain is postponed until you dispose of the replacement property.

#### Replacement Period

To postpone reporting your gain, you must buy replacement property within a specified period of time. This is the replacement period.

The replacement period begins on the date your property was damaged, destroyed, stolen, sold, or exchanged. The replacement period generally ends 2 years after the close of the first tax year in which you realize any part of your gain from the involuntary conversion.

**Example.**

You are a calendar year taxpayer. While you were on vacation, farm equipment that cost $2,200 was stolen from your farm. You discovered the theft when you returned to your farm on November 11, 2007. Your insurance company investigated the theft and did not settle your claim until January 3, 2008, when they paid you $3,000. You first realized a gain from the reimbursement for the theft during 2008, so you have until December 31, 2010, to replace the property.

**Main home in disaster area.**

For your main home (or its contents) located in a federally declared disaster area, the replacement period ends 4 years after the close of the first tax year in which you realize any part of your gain from the involuntary conversion. See Disaster Area Losses, later.

**Property in the Midwestern disaster areas.**

 For property located in the Midwestern disaster areas that was destroyed, damaged, stolen, or condemned, the replacement period ends 5 years after the close of the first tax year in which any part of your gain is realized. This 5-year replacement period applies only if substantially all of the use of the replacement property is in the Midwestern disaster areas.

**Property in the Kansas disaster area.**

For property located in the Kansas disaster area that was destroyed, damaged, stolen, or condemned after May 3, 2007, as a result of the Kansas storms and tornadoes, the replacement period ends 5 years after the close of the first tax year in which any part of your gain is realized. This 5-year replacement period applies only if substantially all of the use of the replacement property is in the Kansas disaster area.

**Property in the Hurricane Katrina disaster area.**

For property located in the Hurricane Katrina disaster area that was destroyed, damaged, stolen, or condemned after August 24, 2005, as a result of Hurricane Katrina, the replacement period ends 5 years after the close of the first tax year in which any part of your gain is realized. This 5-year replacement period applies only if substantially all of the use of the replacement property is in the Hurricane Katrina disaster area.

**Weather-related sales of livestock in an area eligible for federal assistance.**

For the sale or exchange of livestock due to drought, flood, or other weather-related conditions in an area eligible for federal assistance, the replacement period ends 4 years after the close of the first tax year in which you realize any part of your gain from the sale or exchange. The IRS may extend the replacement period on a regional basis if the weather-related conditions continue for longer than 3 years.

  For information on extensions of the replacement period because of persistent drought, see Notice 2006-82, available at [www.irs.gov/irb/2006-39\_IRB/ar01.html](http://www.irs.gov/irb/2006-39_IRB/ar01.html). For a list of counties for which exceptional, extreme, or severe drought was reported during the 12 months ending August 31, 2008, see Notice 2008-86, available at <http://www.irs.gov/irb/2008-42_IRB/ar10.html>.

**Condemnation.**

The replacement period for a condemnation begins on the earlier of the following dates.

* The date on which you disposed of the condemned property.
* The date on which the threat of condemnation began.

The replacement period generally ends 2 years after the close of the first tax year in which any part of the gain on the condemnation is realized. But see Property in the Midwestern disaster areas, Property in the Kansas disaster area, and Property in the Hurricane Katrina disaster area earlier for exceptions.

**Business or investment real property.**

If real property held for use in a trade or business or for investment (not including property held primarily for sale) is condemned, the replacement period ends 3 years after the close of the first tax year in which any part of the gain on the condemnation is realized.

**Extension.**

You can apply for an extension of the replacement period. Send your written application to the Internal Revenue Service Center where you file your tax return. See your tax return instructions for the address. Include all the details about your need for an extension. Make your application before the end of the replacement period. However, you can file an application within a reasonable time after the replacement period ends if you can show a good reason for the delay. You will get an extension of the replacement period if you can show reasonable cause for not making the replacement within the regular period.

#### How To Postpone Gain

You postpone reporting your gain by reporting your choice on your tax return for the year you have the gain. You have the gain in the year you receive insurance proceeds or other reimbursements that result in a gain.

**Required statement.**   You should attach a statement to your return for the year you have the gain. This statement should include all the following information.

* The date and details of the casualty, theft, or other involuntary conversion.
* The insurance or other reimbursement you received.
* How you figured the gain.

**Replacement property acquired before return filed.**   If you acquire replacement property before you file your return for the year you have the gain, your statement should also include detailed information about all the following items.

* The replacement property.
* The postponed gain.
* The basis adjustment that reflects the postponed gain.
* Any gain you are reporting as income.

**Replacement property acquired after return filed.**   If you intend to buy replacement property after you file your return for the year you realize gain, your statement should also say that you are choosing to replace the property within the required replacement period.

  You should then attach another statement to your return for the year in which you buy the replacement property. This statement should contain detailed information on the replacement property. If you acquire part of your replacement property in one year and part in another year, you must attach a statement to each year's return. Include in the statement detailed information on the replacement property bought in that year.

**Reporting weather-related sales of livestock.**   If you choose to postpone reporting the gain on weather-related sales or exchanges of livestock, show all the following information on a statement attached to your return for the tax year in which you first realize any of the gain.

1. Evidence of the weather-related conditions that forced the sale or exchange of the livestock.
2. The gain realized on the sale or exchange.
3. The number and kind of livestock sold or exchanged.
4. The number of livestock of each kind you would have sold or exchanged under your usual business practice.

  Show all the following information and the preceding information on the return for the year in which you replace the livestock.

1. The dates you bought the replacement property.
2. The cost of the replacement property.
3. Description of the replacement property (for example, the number and kind of the replacement livestock).

**Amended return.**   You must file an amended return (Form 1040X) for the tax year of the gain in either of the following situations.

1. You do not acquire replacement property within the replacement period, plus extensions. On this amended return, you must report the gain and pay any additional tax due.
2. You acquire replacement property within the required replacement period, plus extensions, but at a cost less than the amount you receive from the casualty, theft, or other involuntary conversion. On this amended return, you must report the part of the gain that cannot be postponed and pay any additional tax due.

#### Disaster Area Losses

Special rules apply to federally declared disaster area losses. A federally declared disaster is a disaster that occurred in an area declared by the President to be eligible for federal assistance under the Robert T. Stafford Disaster Relief and Emergency Assistance Act. It includes a major disaster or emergency declaration under the act.

A list of the areas warranting public or individual assistance (or both) under the Act is available at the Federal Emergency Management Agency (FEMA) web site at www.fema.gov.

This part discusses the special rules for when to deduct a disaster area loss and what tax deadlines may be postponed. For other special rules, see Publication 547.

**When to deduct the loss.**

You generally must deduct a casualty loss in the year it occurred. However, if you have a deductible loss from a disaster that occurred in an area warranting public or individual assistance (or both), you can choose to deduct that loss on your return or amended return for the tax year immediately preceding the tax year in which the disaster happened. If you make this choice, the loss is treated as having occurred in the preceding year.

Claiming a qualifying disaster loss on the previous year's return may result in a lower tax for that year, often producing or increasing a cash refund.   You must make this choice to take your casualty loss for the disaster in the preceding year by the later of the following dates.

1. The due date (without extensions) for filing your tax return for the tax year in which the disaster actually occurred.
2. The due date (with extensions) for the return for the preceding tax year.

**Federal disaster relief grants.**

Do not include post-disaster relief grants received under the Robert T. Stafford Disaster Relief and Emergency Assistance Act in your income if the grant payments are made to help you meet necessary expenses or serious needs for medical, dental, housing, personal property, transportation, or funeral expenses. Do not deduct casualty losses or medical expenses to the extent they are specifically reimbursed by these disaster relief grants. If the casualty loss was specifically reimbursed by the grant and you received the grant after the year in which you deducted the casualty loss, see Reimbursement received after deducting loss earlier. Unemployment assistance payments under the Act are taxable unemployment compensation.

**Qualified disaster relief payments.**

Qualified disaster relief payments are not included in the income of individuals to the extent any expenses compensated by these payments are not otherwise compensated for by insurance or other reimbursement. These payments are not subject to income tax, self-employment tax, or employment taxes (social security, Medicare, and federal unemployment taxes). No withholding applies to these payments.

  Qualified disaster relief payments include payments you receive (regardless of the source) for the following expenses.

1. Reasonable and necessary personal, family, living, or funeral expenses incurred as a result of a federally declared disaster.
2. Reasonable and necessary expenses incurred for the repair or rehabilitation of a personal residence due to a federally declared disaster. (A personal residence can be a rented residence or one you own.)
3. Reasonable and necessary expenses incurred for the repair or replacement of the contents of a personal residence due to a federally declared disaster.

  Qualified disaster relief payments include amounts paid by a federal, state, or local government in connection with a federally declared disaster to those affected by the disaster.

Qualified disaster relief payments do not include:

1. Payments for expenses otherwise paid for by insurance or other reimbursements, or
2. Income replacement payments, such as payments of lost wages, lost business income, or unemployment compensation.

**Qualified disaster mitigation payments.**

Qualified disaster mitigation payments made under the Robert T. Stafford Disaster Relief and Emergency Assistance Act or the National Flood Insurance Act (as in effect on April 15, 2005) are not included in income. These are payments you, as a property owner, receive to reduce the risk of future damage to your property. You cannot increase your basis in property, or take a deduction or credit, for expenditures made with respect to those payments.

**Sale of property under hazard mitigation program.**

Generally, if you sell or otherwise transfer property, you must recognize any gain or loss for tax purposes unless the property is your main home. You report the gain or deduct the loss on your tax return for the year you realize it. (You cannot deduct a loss on personal-use property unless the loss resulted from a casualty, as discussed earlier.) However, if you sell or otherwise transfer property to the Federal Government, a state or local government, or an Indian tribal government under a hazard mitigation program, you can choose to postpone reporting the gain if you buy qualifying replacement property within a certain period of time. See Postponing Gain earlier for the rules that apply.

**Postponed tax deadlines.**

The IRS may postpone for up to 1 year certain tax deadlines of taxpayers who are affected by a federally declared disaster. The tax deadlines the IRS may postpone include those for filing income, excise, and employment tax returns, paying income, excise, and employment taxes, and making contributions to a traditional IRA or Roth IRA.

  If any tax deadline is postponed, the IRS will publicize the postponement in your area and publish a news release, revenue ruling, revenue procedure, notice, announcement, or other guidance in the Internal Revenue Bulletin (IRB).

**Who is eligible.**

If the IRS postpones a tax deadline, the following taxpayers are eligible for the postponement.

1. Any individual whose main home is located in a covered disaster area (defined next).
2. Any business entity or sole proprietor whose principal place of business is located in a covered disaster area.
3. Any individual who is a relief worker affiliated with a recognized government or philanthropic organization and who is assisting in a covered disaster area.
4. Any individual, business entity, or sole proprietor whose records are needed to meet a postponed deadline, provided those records are maintained in a covered disaster area. The main home or principal place of business does not have to be located in the covered disaster area.
5. Any estate or trust that has tax records necessary to meet a postponed tax deadline, provided those records are maintained in a covered disaster area.
6. The spouse on a joint return with a taxpayer who is eligible for postponements.
7. Any other person determined by the IRS to be affected by a federally declared disaster.

**Covered disaster area.**

This is an area of a federally declared disaster area in which the IRS has decided to postpone tax deadlines for up to 1 year.

**Abatement of interest and penalties.**

The IRS may abate the interest and penalties on the underpaid income tax for the length of any postponement of tax deadlines.

#### Reporting Gains and Losses

You will have to file one or more of the following forms to report your gains or losses from involuntary conversions.

**Form 4684.**   Use this form to report your gains and losses from casualties and thefts.

**Form 4797.**   Use this form to report involuntary conversions (other than from casualty or theft) of property used in your trade or business and capital assets held in connection with a trade or business or a transaction entered into for profit. Also use this form if you have a gain from a casualty or theft on trade, business or income-producing property held for more than 1 year and you have to recapture some or all of your gain as ordinary income.

**Schedule A (Form 1040).**   Use this form to deduct your losses from casualties and thefts of personal-use property that you reported on Form 4684.

**Schedule D (Form 1040).**   Use this form to report gain from an involuntary conversion (other than from casualty or theft) of personal-use property. Also, carry over the following gains to Schedule D.

* Net gain shown on Form 4797 from an involuntary conversion of business property held for more than 1 year.
* Net gain shown on Form 4684 from the casualty or theft of personal-use property.

**Schedule F (Form 1040).**   Use this form to deduct your losses from casualty or theft of livestock or produce bought for sale under Other expenses in Part II, line 34, if you use the cash method of accounting and have not otherwise deducted these losses.

**GIFTING YOUR FARM**

**Farm or Ranch**

|  |
| --- |
| The family farm or ranch can make an ideal gift to the Church or one of its institutions. Family farms and ranches may create difficult estate management issues since children frequently do not wish to continue farming or ranching. Selling your farm or ranch in an estate sale often results in an undervalued sale price and the loss of what you and your ancestors have spent years building. A gift of your farm or ranch to the Church or one of its institutions in conjunction with other parts of your financial and estate plan can eliminate many of these challenges.  A typical ranch or farm consists of land, equipment, livestock, and crops. Each of these elements should be considered separately in the planning process to help you and your family achieve your charitable objectives.   1. The typical donor: 2. Has paid off the mortgage. 3. Holds title to the farm or ranch. 4. Does not have children who want to continue farming or ranching. 5. Desires to reduce management responsibilities.   Gift features and benefits:   1. Immediate income tax deduction 2. Avoidance of capital gain taxes 3. Deduction based on fair market value, or present value of remainder interest if placed in a Charitable Remainder Unitrust 4. You may continue living on the farm or ranch if you use a Retained Life Estate Deed   For tax purposes, you must obtain your own appraisal to determine the fair market value you claim on your income tax return. Your tax return must include IRS form 8283 signed by your appraiser.  How Do I Make a Gift of a Farm or Ranch Using Gift Planning-Tools? Farms and ranches can also be given to the Church or one of its institutions with a [Retained Life Estate Deed Using a Personal Residence or Farm.](http://www.ldsphilanthropies.org/planned-giving/ways-i-can-give/tools/retained-life-estate-deed-1.html) This planning tool allows you an immediate income tax deduction while you continue to live on and use your farm or ranch. Farm or ranch property can also make an ideal gift by funding a [Charitable Remainder Unitrust](http://www.ldsphilanthropies.org/planned-giving/ways-i-can-give/tools/charitable-remainder-unitrust-1.html) which provides you both income for life and numerous tax benefits. A farm or ranch can also be given through your [Will](http://www.ldsphilanthropies.org/planned-giving/ways-i-can-give/tools/will-1.html) or [Revocable Trust](http://www.ldsphilanthropies.org/planned-giving/ways-i-can-give/tools/revocable-living-trust-1.html).  Other Facts You Should Know about a Gift of a Farm or Ranch The gift of your farm or ranch may have an emotional impact on family members and should be considered in relationship to other elements of your overall financial and estate plan. |

**Assets Used with This Tool**

* [Charitable Remainder Unitrust (CRUT)](http://www.ldsphilanthropies.org/planned-giving/ways-i-can-give/tools/charitable-remainder-unitrust-1.html)
* [Donor Advised Fund (DAF)](http://www.ldsphilanthropies.org/planned-giving/ways-i-can-give/tools/donor-advised-fund-daf-1.html)
* [Private Foundation](http://www.ldsphilanthropies.org/planned-giving/ways-i-can-give/tools/private-foundation-1.html)
* [Retained Life Estate Deed using a Personal Residence or Farm](http://www.ldsphilanthropies.org/planned-giving/ways-i-can-give/tools/retained-life-estate-deed-1.html)
* [Revocable Living Trust](http://www.ldsphilanthropies.org/planned-giving/ways-i-can-give/tools/revocable-living-trust-1.html)
* [Support Organization](http://www.ldsphilanthropies.org/planned-giving/ways-i-can-give/tools/support-organization-1.html)
* [Testamentary Trust](http://www.ldsphilanthropies.org/planned-giving/ways-i-can-give/tools/testamentary-trust-1.html)
* [Will](http://www.ldsphilanthropies.org/planned-giving/ways-i-can-give/tools/will-1.html)

**Hobby Farming and the IRS**

If you're a homesteader who also works a full-time job away from the farm ... or if like many of Jarvis' readers—you engage in a "bootstrap business" for extra income, you should be aware of some special regulations set down by the government's Internal Revenue Service.

In particular, you ought to become acquainted with the "hobby farming rules" of Internal Revenue Code Section 183, which state—in effect—that the government won't allow you to claim any loss incurred through hobby or pleasure activities as an offset against other taxable income.

This section was—presumably—created by the IRS to dissuade individuals from purchasing unprofitable properties for use as tax write-offs. However, there *is* hope for the good-intentioned part-time farmer. If you can simply demonstrate a profit *motive* to the government, you will be allowed to deduct your farm's losses from your nonfarm income

And about the best way I know to *show* a profit motive is to have records of the net income from your farming activities over a period of time. However, doing so may not be an easy task for the man, woman, or family just starting out on a homestead.

As an aid to such farmers, a "two out of five years" tax rule was enacted in 1969 and revised in 1976. The regulation allows a farmer or part-time entrepreneur to *elect* —in advance—a fiveyear period of time in which to show ability to make a profit.

After you've demonstrated that you have a profit motive by coming out "in the black" on *any* two of the five consecutive years, it will be presumed from then on that you're engaged in the activity for that purpose. Thereafter, the IRS has the burden of proof in any related charge that may be levied against you. (By the way, if your farm activity consists of breeding, training. showing, or racing horses ... you have *seven* years in which to demonstrate two years of profit.)

**OTHER CONSIDERATIONS**

However, suppose you've *tried* to put your agricultural operation into "the black" and found that it just couldn't be done within five years. Well, you may *still* be able to produce sufficient evidence to prove the profit motive, should the government decide to investigate your tax returns. The following factors will usually be considered by the IRS when judging whether or not to challenge a deduction for losses:

***The manner in which the tax-payer conducts his or her FARMING activity*.**

Is it businesslike? Are detailed financial records kept?

Are those records separate from those of personal financial activities? (For instance—although many full-time commercial farmers fail to do so— *you* should keep a *separate* checking account for your agricultural activities.)

The IRS will also note any strategies you've used in attempts to make a profit. An auditor may disallow losses, though, if it appears that your activities are "preparatory" to carrying on an enterprise instead of constituting "on-going" business.

[2] *The time and effort the taxpayer expends in the business*. Naturally, being able to show that you've devoted an impressive amount of management time and physical labor to your hobby will be to your advantage.

[3] *The expertise of the taxpayer or of his or her advisors*. The extent of your background in farming will be weighed carefully. (If you are inexperienced, you might consider hiring a professional manager or consultant to give credibility to your claim.)

[4] *The taxpayer's pursuit of knowledge concerning his or her business activity*. It will be to your advantage to make a *continual* effort to become educated in both production practices and management techniques. Your county extension agent can suggest appropriate publications, courses, and meetings.

[5] *The presence of a taxpayer's residence or recreational facilities on or near the farm*. The absence of a "showplace" appearance to your working acres will be a definite plus ... but, although the fact that your personal residence is on the farm while your primary occupation is off the farm *may* be viewed negatively by the IRS, it shouldn't override the other factors already mentioned.

**NOTHING REPLACES RECORDS**

Of course, farming isn't the only activity covered by the IRS "hobby" regulations. Many part-time pursuits have elements of pleasure and can be profitable as well. Always keep good records of any of your business transactions, so that you can—perhaps—make use of the tax savings that may result from a loss in your hobby or your bootstrap business.