Chapter 12: Agricultural Issues and Rural Investments

Corrections were made to this workbook through January of 2010. No subsequent modifications were made.

ISSUE 1: HEDGING VERSUS SPECULATION

DEFINITIONS

In order to analyze the issue of hedging versus speculation, it is important to understand terms used by the commodity industry.

Commodity Futures Contract. This contract is an agreement to either purchase or sell a specific commodity amount at a predetermined price and date. A typical corn or soybean contract is for 5,000 bushels. Failure to terminate the futures contract can result in the farmer being required to deliver or take delivery of the commodity.

Option Contract. This contract gives the farmer the right to purchase or sell a futures contract. The cash outlay and financial risk for an options contract are much lower than for a futures contract. Every contract has both a buyer and a seller.

Call Option. This is a contract giving the farmer the right to buy a futures contract at a predetermined price at any time before the fixed expiration date. If the farmer exercises the option, the individual holding the call option must sell the underlying futures contract at the predetermined price.

Put Option. This is a contract giving the farmer the right to sell a futures contract at a predetermined price at any time before the fixed expiration date. If the farmer exercises the option, the individual holding the put option must buy the underlying futures contract at the predetermined price.

PURPOSE OF HEDGING

Farmers and ranchers buy and sell commodity futures and options to hedge against fluctuating prices. They also buy and sell commodity futures and options to speculate with fluctuating prices. From an income tax standpoint, hedging and speculation are treated differently. Gains and losses from hedging transactions generate ordinary income and loss[1] and they are not subject to the loss deferral and mark-to-market rules. Gains and losses from speculation are treated as capital gains and losses and they are subject to the loss deferral and mark-to-market rules. Hedging transactions by partnerships or individuals result in gain or loss subject to self-employment (SE) taxes; speculative transactions do not.

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Note. Capital gains can offset capital losses. For individuals, capital losses deductible against ordinary income are limited to $3,000 per year. Corporations are not eligible for the $3,000 deduction against ordinary income.

1. IRC §1221; Treas. Reg. §1-1221-2.

A hedging transaction is defined as a transaction that a taxpayer enters into in the normal course of the taxpayer's trade or business, primarily to reduce (as opposed to simply **manage**) the risk of price changes or currency fluctuations related to ordinary property. They can also be used to reduce the risk of interest rate or price changes or currency fluctuations related to borrowing or ordinary obligations.[2] A taxpayer uses a hedge to lock in a position in a particular commodity. Once locked in, if the physical commodity increases in value, the taxpayer's value in the futures position should go down — one offsets the other with the net result that the hedge maintains the taxpayer's position.

Note. The accounting method used for a hedging transaction must clearly reflect income and reasonably match the timing of the transaction with the timing of the commodity being hedged. Treasury Regulations detail the accounting methods to use for various transactions.[3]

Example 1. Jack Frost planted 200 acres of soybeans and expected a yield of 50 bushels per acre, for a planned production of 10,000 bushels. Jack bought multiple October put options on the Chicago Board of Trade before he planted the crop and while it was growing which totaled 10,000 bushels of soybeans. In doing so, Jack created a hedge position. Jack loses $1,500 on the options and sells the soybeans produced for $55,000. Put options allow the owner the right to sell at a specified price, which creates a short-options position. The growing soybeans represent a long-cash position.

Jack reports the transaction on Schedule F as follows:

	Where Reported	Amount
Sale of soybeans	Part I, line 4	$55,000
Hedge loss	Part I, line 10	(1,500)

E Did you "mate... ...ss during 2009? ... for limit on passive losses. ☐ No

Part I **Farm Income—Cash Method.** Complete Parts I and II (Accrual method. Complete Parts II and III, and Part I, line 11.) Do not include sales of livestock held for draft, breeding, sport, or dairy purposes. Report these sales on Form 4797.

1	Sales of livestock and other items you bought for resale	1		
2	Cost or other basis of livestock and other items reported on line 1	2		
3	Subtract line 2 from line 1		3	
4	Sales of livestock, produce, grains, and other products you raised		4	55,000
5a	Cooperative distributions (Form(s) 1099-PATR)	5a	5b Taxable amount 5b	
6a	Agricultural program payments (see page F-3)	6a	6b Taxable amount 6b	
7	Commodity Credit Corporation (CCC) loans (see page F-3):			
a	CCC loans reported under election		7a	
b	CCC loans forfeited	7b	7c Taxable amount 7c	
8	Crop insurance proceeds and federal crop disaster payments (see page F-3):			
a	Amount received in 2009	8a	8b Taxable amount 8b	
c	If election to defer to 2010 is attached, check here ▶ ☐	8d Amount deferred from 2008	8d	
9	Custom hire (machine work) income		9	
10	Other income, including federal and state gasoline or fuel tax credit or refund (see page F-4)		10	(1,500)
11	**Gross income.** Add amounts in the right column for lines 3 through 10. If you use the accrual method to figure your income, enter the amount from Part III, line 51 ▶		11	

Part II Farm Expenses—Cash and Accrual Method

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2. IRC §1221(b)(2)(A); Treas. Reg. §§1.1221-2(a) and (b). Property is "ordinary property" if its sale or exchange by the taxpayer could not produce capital gain or loss regardless of the holding period. Thus, an obligation is an "ordinary obligation" if the taxpayer's performance or termination of the obligation could not produce capital gain or loss.

3. Treas. Reg. §1.446-4.

Speculation can be illustrated by the farmer who harvests corn, sells the corn, and buys futures in the marketplace in anticipation of prices rising, believing this strategy is better than storing the commodity. This is speculation and is subject to the mark-to-market rules.[4]

The mark-to-market rules require taxpayers to report the gains and losses from regulated futures contracts and other Section 1256 contracts on an annual basis on Form 6781, *Gains and Losses From Section 1256 Contracts and Straddles.*[5] These rules close out speculative transactions as of December 31. They are marked to market by treating each contract held by the taxpayer as if it was sold for FMV on the last business day of the tax year, thereby requiring profit or loss to be reported on the taxpayer's income tax return. The net gain or loss is allocated 40% to short-term capital gain (or loss) and 60% to long-term capital gain (or loss).[6]

Note. The wash-sale rules do not apply to losses taken into account when an IRC §1256 contract is marked to market.[7]

Example 2. Use the same facts as **Example 1,** except after selling the soybeans, Jack bought 10,000 bushels on the Board and purchased put options (the right to sell) for 10,000 bushels of soybeans with a value of $55,000. This is a speculation transaction because Jack no longer has an opposite position in the cash market. He sold the contract for $70,000 on December 30 of the same year. This resulted in a net gain of $15,000.

This gain is reported on Form 6781 and then carried to Schedule D as follows:

Short-term capital gain	$6,000 ($15,000 × 40%)
Long-term capital gain	$9,000 ($15,000 × 60%)

Note. In the event that the contract is not closed by the end of the year of the purchase, the contract is subject to the mark-to-market rules. The taxpayer will receive Form 1099-B, *Proceeds From Broker and Barter Exchange Transactions,* reporting the value of the contract.

Identification Rule

To receive hedging tax treatment, the transaction must be identified as such by the taxpayer before the close of the day on which the hedge was created.[8] The item being hedged must be identified no more than 35 days after the hedging transaction.[9] In addition, the failure to identify a hedge may trigger disclosure requirements under the tax shelter regulations if a large loss is generated. Identifying it for book purposes (financial statement) is not sufficient, unless the taxpayer's books and records indicate that the identification is also being made for tax purposes.[10]

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4. IRC §1256.

5. IRC §1256 contracts include regulated futures contracts, foreign currency contracts, nonequity options, dealer equity options, and dealer securities futures contracts. IRC §1256(b).

6. IRC §1256(f)(5).

7. Ibid.

8. IRC §1221(a)(7); Treas. Reg. §1.1221-2(f)(1).

9. Treas. Reg. §1.1221-2(f)(2)(ii). If an existing hedging transaction is "recycled" to hedge a different asset or liability, it must be re-identified on the same day that it is recycled. See Treas. Reg. §1.1221-2(f)(1).

10. Treas. Reg. §1.1221-2(f)(4).

Making the Identification. Identification is accomplished by placing an unambiguous statement on the taxpayer's books and records that identifies the transaction as a hedge for tax purposes by specifically referencing the tax rules for hedge treatment. The Regulations provide guidance on making the identification and note that the taxpayer can designate a particular ledger account as containing only hedging transactions. The taxpayer can place a statement on the books and records designating all future transactions in a particular commodity as hedging transactions.[11] The identification should describe the transaction creating the risk being hedged and the type of risk that the transaction creates.

> **Note.** If the hedge is not properly identified, the character of any gain or loss is determined without regard to the hedging rules. This may result in any gain or loss being treated as capital. Because capital losses generally cannot offset ordinary income, the failure to identify a transaction as a hedge could create tax liability for the taxpayer upon audit. The IRS has the power to treat any gain as ordinary income and, by allowing losses as capital losses, put the taxpayer in a worse (or "whipsaw") position.[12] If a taxpayer has both hedging and speculative transactions, separate brokerage accounts may be beneficial.

If the failure to identify a transaction as a hedge is inadvertent, the regulations may provide relief.[13] To qualify for the exception for inadvertent errors, the transaction must meet the definition of a hedge, and all of the taxpayer's hedging transactions in open years must be treated as hedging transactions on original or amended returns. Otherwise, the regulations do not provide any guidance on what constitutes an inadvertent failure to identify.

Failure to identify a transaction as a hedge can also trigger application of the special rules that exist for straddles[14] and the mark-to-market rules.[15] Under the straddle rules, losses are deferred on positions taken in actively-traded property to the extent that built-in gain exists in an offsetting position. In addition, interest and carrying charges must be capitalized if they are allocable to personal property that is part of a straddle. The mark-to-market rules require that any capital gain or loss be treated as 60% long-term and 40% short-term.

> **Note.** If a straddle is composed of at least one position in an IRC §1256 contract, an election can be made on Form 6781 to exclude all positions in the mixed straddle (including §1256 contracts) from the mark-to-market rules. When the election is made, the positions are subject to the loss-deferral, wash-sale, and short-sale rules and the straddle is not a mixed straddle. Without the election, the taxpayer may elect to offset gains and losses in the mixed straddle by either separately identifying the positions of the mixed straddle or establishing a mixed-straddle account.

11. Ibid.
12. The IRS's power rests in the anti-abuse rules. See Treas. Reg. §1.1221-2(G)(2)(iii).
13. Treas. Reg. §1.1221-2(g)(2)(ii).
14. IRC §§1092(c)(1), 263(g). Technically, a "straddle" involves the taxpayer taking "offsetting positions" with respect to personal property.
15. IRC §1256.

Timing. Any income, deduction, gain, or loss from a hedging transaction is matched with the income, deduction, gain, or loss on the item being hedged. Also, in some situations, the hedge-timing rules apply irrespective of whether the transaction was identified as a hedge.[16]

> **Observation.** The hedging transactions tax rules address both character and timing and are designed to match the character and timing of a hedging transaction with the character and timing of the item being hedged. The timing rule for hedges applies regardless of whether a transaction is identified as a hedge. Farmers participating in true hedging programs likely have multiple transactions for a single crop and may combine option purchases and sales to minimize the cost of these programs or to create both a ceiling and a floor for prices. Properly identifying and reporting these many transactions is a challenge for the taxpayer and tax preparer. For more information, see IRS Pub. 550, *Investment Income and Expenses.*

COMMODITY FUTURES TRANSACTIONS INVOLVING ENTITIES

For farming operations that are conducted through multiple entities or when individually-owned land is leased to a farming entity, it is important to ensure that any hedging transaction is engaged in by the taxpayer whose risk is to be hedged. Two Tax Court cases illustrate the point.

- In *Pine Creek Farms, LTD v. Comm'r,*[17] a farming operation was divided among several entities with the taxpayer engaged in producing corn, soybeans, and cattle. Various corporations were engaged in the business of raising and selling hogs. The taxpayer (the crop-farming operation) used the crops to feed its cattle and to sell to the hog-raising corporation. A shareholder of the crop-farming corporation participated in hog production through the hog-raising corporation. The farming corporation had hedging losses attributable to its business operations and also had losses generated by transactions in hog futures.

  The IRS characterized the losses associated with the hog transactions as capital losses based on the fact that the farming corporation was not engaged in hog production and was therefore not minimizing risk associated with its business. The farming corporation argued that even though it did not produce hogs, it sold crops to the hog-raising corporation.

  The Tax Court agreed with the IRS. The crop-farming corporation could not prove a direct relationship between the crops that it raised and the hog-futures transactions. Also, the crop-farming corporation could not establish any relationship between the price of the crops and the price of the hog futures. The transactions in hog futures did not reduce the risk of price changes or currency fluctuations on the farm's ordinary property.

- In *Welter v. Comm'r,*[18] a farmer engaged in commodities transactions through **personal** brokerage accounts. His farming operation, however, was conducted by S corporations that utilized land that the farmer leased to them. The farmer claimed hedge (ordinary gain and loss) treatment on his commodity trading activity, and the IRS disagreed. The commodity trading activity was related to the business activity of the corporations, but the farmer was personally engaged in the transactions and the business activities of the corporations could not be attributed to the farmer.

16. See Rev. Rul. 2003-127, 2003-2 CB 1245.
17. *Pine Creek Farms, LTD v. Comm'r,* TC Memo 2001-176 (Jul. 19, 2001).
18. *Welter v. Comm'r,* TC Memo 2003-299 (Oct. 29, 2003).

TRANSACTION GUIDE FOR HEDGING TRANSACTIONS[19]

Transactions	Classification
Sale of commodity contract (short position) by commodity producer	
Just before planting the crop	Hedging
While crop is growing	Hedging
After crop is sold	Speculation
Purchase of commodity contract (long position) by commodity producer	
Just before planting the crop	Speculation
While crop is growing	Speculation
After crop is sold (store-on-the-board transaction)	Speculation
Purchase of put option (right to sell) by commodity producer	
Just before planting the crop	Hedging
While crop is growing	Hedging
After crop is sold	Speculation
Purchase of call option (right to buy) by commodity producer	
Just before planting the crop	Speculation
While crop is growing	Speculation
After crop is sold	Speculation
Sale of commodity contract (short position) by commodity user	Speculation
Purchase of commodity contract (long position) by commodity user	Hedging
Purchase of put option (right to sell) by commodity user	Speculation
Purchase of call option (right to buy) by commodity user	Hedging
Reversing transaction (commodity market position) to reduce business risk	Hedging
Multiple commodity transactions during growing season — all part of a program that reduces risk	Hedging
Partial risk reduction	Hedging
Hedging price support payments	Hedging

19. Reproduced with permission from the 69th annual Bloethe Tax School manual, p. I-45.

ISSUE 2: SELF-EMPLOYMENT TAX PLANNING STRATEGIES

For some farm clients, 2009 is a much different year than 2008 from a financial standpoint. Thus, different tax planning strategies are needed for 2009 than were utilized for 2008. One strategy includes the farm-optional method for computing earnings for self-employment (SE) tax purposes. The farm-optional method was modified by a provision included in the Food, Conservation, and Energy Act of 2008 (2008 Farm Bill) and may be more useful in 2009 to some farm clients.

SELF-EMPLOYMENT TAX

Self-employed persons pay social security and Medicare taxes as part of their individual income tax return. This SE tax is based on net earnings from self employment, not on taxable income. However, in computing SE tax, the maximum amount of SE income subject to Old Age Survivors Disability Insurance (OASDI) is the excess of the applicable contribution base in effect for the calendar year in which the tax year begins less any wages subject to OASDI received by the individual in the same tax year. However, if net earnings from self employment are less than $433.13, no SE tax is imposed.[20]

The tax on SE income is separately computed on SE income of each spouse, irrespective of whether a joint return is filed. Nonetheless, spouses are jointly and severally liable for SE tax due on a joint return.[21]

Optional Method of Determining SE Earnings

The 2008 Farm Bill contains a provision (effective for tax years beginning after 2007) that increases the dollar thresholds for the farm- and nonfarm-optional methods for computing net earnings from self employment. It makes them subject to annual indexing. Under the provision, the dollar threshold amounts were increased to allow electing taxpayers to secure four credits of social security benefit coverage each taxable year in 2008 and thereafter. For 2009, $4,360 of earnings is necessary to secure four quarters of social security benefit coverage ($1,090 × 4 quarters = $4,360).

> **Note.** For more information on the optional method of calculating SE tax, see pages 419–420 of the 2008 *University of Illinois Federal Tax Workbook.* This can be found on the accompanying CD.

For 2009, an individual who is **not a farmer** may use the **nonfarm-optional method.** This applies only if the individual's net nonfarm income is less than $4,721 and less than 72.189% of the individual's gross nonfarm income. In addition, the individual must have had net earnings from self employment of at least $400 in two of the immediately preceding three years. If these conditions are satisfied, the individual can compute SE earnings as the smaller of two-thirds of gross nonfarm income or $4,360. The election to use the nonfarm-optional method is made on the return by computing SE earnings under the optional method. This method may be used no more than five times during a person's lifetime. The election can be made or revoked after the return is filed by completing an amended return.[22]

For 2009, a **farmer** may use the **farm-optional method** to compute net SE earnings if gross farm income does not exceed $6,540 or net farm profits are less than $4,721. The optional method allows a farmer to compute self-employment earnings as the lesser of 66.67% of gross farm income or $4,360. There is no limit on the number of years that a qualified individual can use the farm-optional method.

20. IRC §1402(b). While the statute specifies $400 as the cut-off, the amount is actually $433.13 because of the 7.65% deduction that is allowed from net profits of a trade or business.

21. Treas. Reg. §1.6017-1(b).

22. IRC §1402(a).

A taxpayer with both farm and nonfarm income can use both optional computational methods if the farm income qualifies for the farm optional method and the nonfarm income qualifies for the nonfarm optional method. If both methods are used to compute net earnings from self employment, the maximum combined total net earnings from self employment for any tax year cannot exceed $4,360 for 2009.

Note. CRP payments paid after 2007 are not treated as SE income if they are received by an individual who is also receiving social security retirement or disability payments. Thus, it may be necessary to distinguish CRP income from other agriculture program payments.

Example 3. Tom is a young, single farmer whose annual Schedules F have historically shown little or no net farm income. Tom is seeking advice from his tax preparer, Sal, regarding optimization of farm-income reporting for income and social security tax purposes.

Observation. This optional method of computing SE earnings is intended to benefit low-income sole proprietors and partners by permitting them to report more than actual net earnings from farming or business operations as SE income in order to receive greater credit towards social security benefits by paying more SE tax.

After considering Tom's facts, Sal suggests that Tom optimize usage of the earned income credit instead of a net farm loss. For years in which Tom has low net income or a net farm loss, he could elect the farm-optional method for computing SE earnings.

For 2009, **individuals without children** can claim earned income credit at the following rates:

Credit Rate	Maximum Credit	Earnings Level Maximum Credit	Phaseout Begins	Phaseout Rate	Complete Phaseout
7.65%	$457	$5,970	$7,470	7.65%	$13,440

For 2009, earned income (farm, W-2, etc.) is optimized for a low-income individual at $5,970. At this level, SE tax is $844 and the earned income credit is $457, resulting in a net tax liability of $387 ($844 – $457). There is no income tax liability (assuming **total** income is $5,970) because the standard deduction and personal exemption amounts exceed taxable income.

Social Security Benefit Coverage

To qualify for social security benefits, a taxpayer must have adequate quarters of earnings coverage to be insured. To qualify for retirement benefits, a taxpayer (born in 1929 or later) must be **fully insured** (40 quarters of earnings coverage). Up to four quarters of coverage can be earned per year.

Disability considerations are also important. An individual under age 24 needs a minimum of six quarters of credit (earned in the 3-year period preceding disability) in order to qualify for disability coverage. For individuals age 31 or over, the number of credits, shown in the table on the following page,[23] is needed. At least 20 of the credits must be earned in the 10 years immediately before the disability. Taking advantage of the optional SE tax election to pay higher social security taxes can be extremely important in earning the requisite quarters of coverage.

23. [http://www.ssa.gov/dibplan/dqualify3.htm] Accessed on Aug. 20, 2009.

Become Disabled at Age	Number of Credits Needed
31–42	20
44	22
46	24
48	26
50	28
52	30
54	32
56	34
58	36
60	38
62 or older	40

Net Farm Loss and Election of Optional SE Tax

When a net farm loss occurs, a self-employed individual should consider electing the optional method for computing SE taxes if the individual does not have significant other earned income subject to social security tax (W-2, etc.). Prior to 2008, if a self-employed individual had no other earned income and all other requirements were met (i.e. gross farm income limits, etc.), the individual was treated as having net earnings for SE tax purposes of $1,600. The earned income credit pays slightly greater than one-half of any SE tax liability incurred.

Example 4. Sam, age 26, is a young, single farmer with no children whose 2009 Schedule F reports gross income of $50,000 and net income of $1,020. Sam has no other income to report for 2009. If Sam does not elect the farm-optional method, his 2009 federal return reports SE tax of $144. This tax is partially offset by an earned income credit of $78, resulting in net tax due of $66. However, Sam did not have sufficient earnings for even one quarter of social security benefit eligibility.

If Sam **does** elect the farm-optional method, he pays $667 SE tax on $4,360. This tax is partially offset by an earned income credit of $334, resulting in net tax due of $333 ($667 – $334). Under the farm-optional method, Sam reports sufficient earnings for four quarters of social security benefit eligibility (retirement and disability) at an additional cost of $267 ($333 – $66).

Observation. If a nonfarmer, self-employed individual (sole proprietor or partner) has gross nonfarm income of not more than 150% of the sum of the minimum earnings required for a quarter of social security coverage for **each** quarter of the tax year ($1,090 × 4 = $4,360 for 2009), he can report two-thirds of his gross nonfarm income as net earnings from self employment. If the individual's gross nonfarm income is more than 150% of the sum of the minimum earnings required for a quarter of social security coverage for each quarter of the tax year, he can report the sum of the minimum earnings required for a quarter of social security coverage for each quarter of the tax year as his net earnings from self employment.

YEAREND TAX PLANNING SUGGESTIONS FOR FARMERS

- **Income acceleration possibilities:** Sell additional grain/livestock, sealed grain (if election to report as income).
- **Income deceleration possibilities:** Defer grain/livestock sales, sealed grain (if election to report as loan).
- **Expense acceleration possibilities:** Prepay expenses; §179 election to expense.
- **Expense deceleration possibilities:** Postpone expenses; slow depreciation (SL or longer life); capitalize repair costs; capitalize fertilization costs (IRC §180 yearly election to expense).

ISSUE 3: FARM INCOME AVERAGING

Taxpayers engaged in farming or fishing can elect to average current income over three prior base years to obtain the benefit of applying lower income tax rates from those prior years.

ELIGIBLE TAXPAYERS

For income-averaging purposes, a farm business is defined by IRC §263A(e)(4) as the trade or business of farming that involves the cultivation of land or the raising or harvesting of any agricultural commodity. This includes operating a nursery or sod farm; raising or harvesting trees bearing fruit, nuts, or other crops; and raising ornamental trees. However, the instructions for Form 1040, Schedule J, *Income Averaging for Farmers and Fishermen*, provide that a farm business does **not** include contract harvesting of a commodity.

> **Note.** The American Jobs Creation Act of 2004 allowed fishers to use income averaging for taxable years beginning after December 31, 2003. Temporary regulations were adopted on July 21, 2008, and may be relied on for taxable years beginning after July 22, 2008. If a taxpayer farms and fishes, the taxpayer must combine both incomes for averaging purposes. Crew members who are paid a percentage of the catch may also use income averaging.

A taxpayer who has farm income during the tax year as a sole proprietor, a partner in a partnership, or a shareholder in an S corporation may use income averaging without regard to whether the individual was engaged in a farming business in any prior year.[24]

ELIGIBLE INCOME

Elected farm income (EFI), which is averaged over the prior three years, is the amount of taxable income attributable to any farming business that is specifically elected by the taxpayer as subject to income averaging. Any portion of taxable income attributable to farming may be designated as EFI for averaging purposes, but may not exceed the taxpayer's taxable income. Additionally, net capital gain attributable to a farming business may not exceed total net capital gain for the taxpayer.

EFI includes net Schedule F income, gain from the sale or disposition of property (other than land or timber) regularly used by a farmer for a substantial period in a farming business, and the taxpayer's share of net farm income from a partnership, LLC, or S corporation. Treas. Reg. §1.1301-1 provides that wages to a shareholder in an S corporation engaged in farming and a landlord's portion of a crop-share lease may be included in EFI. It does not matter whether the landlord materially participates in the crop production.

> **Note.** After January 1, 2003, a written lease must be entered into **before** the tenant begins farming activities in order to establish the existence of a crop-share lease. This rule may require that existing leases be terminated in accordance with state law, with the tenancy relationship reestablished under the written agreement.

Treas. Reg. §1.1301-1 specifies that EFI includes all income and gains less deductions and losses (including loss carryovers, carrybacks, and net capital loss carryovers) attributable to an individual's farming business. However, the regulation states that income, gain, or loss from "the sale of development rights, grazing rights and other similar rights" is not treated as attributable to a farming business.[25]

24. Prop. Treas. Reg. §1.1301-1(b).

25. Treas. Reg. §1.1301-1(e)(1)(i).

There has been uncertainty about whether EFI for the election year can be negative. On this issue, the 2008 IRS Pub. 225, *Farmer's Tax Guide*, states:

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

Determining Taxable Income

The final regulations state that all allowable deductions, including any NOL, are used to determine taxable income. This is true even if the result is negative. However, any negative amount that provided a benefit in another taxable year must be added back to the base year taxable amount. Therefore, an NOL carried to other years may not be used if it provided a benefit.[26] The regulations offer a safe harbor for the disposition of property after the farming business cessation. The safe harbor provides that if a gain or loss from property disposition is realized after the farming business cessation, such gain or loss is treated as attributable to the farming business if the property is sold within a reasonable time after the business ceases. Sale or other disposition within one year of the farming business cessation is presumed to be within a reasonable time. Whether a sale or other disposition is considered within a reasonable time depends on all the facts and circumstances.[27]

Impact of the Election

The regulations specify that income averaging only affects federal income tax and has no application to employment taxes (FICA, FUTA, SECA). Additionally, in calculating AMT, regular tax liability is determined **without** regard to farm income averaging. Therefore, taxpayers using income averaging receive the full benefit of the lower tax rates. Income tax is determined by allocating EFI to the base years only after all other adjustments and determinations are made.

The regulations allow taxpayers with both ordinary income and capital gain income that are eligible for income averaging to elect to average any combination of the capital gain and ordinary income.[28] If the EFI includes both ordinary income and capital gain income, the regulations provide such income must be allocated in equal portions among the tax brackets of the three prior years. Capital gains that are included in the tax bracket of a prior year do not offset capital losses from that year. They are taxed at the lesser of the capital gains rate or the ordinary income tax rate for the prior year.[29] Net capital losses first offset net capital gains, both farm and nonfarm, before reducing ordinary income.[30] The rule that capital losses can only offset up to $3,000 of ordinary income per year also applies for purposes of EFI calculations.[31] Thus, a taxpayer can elect to carry back only ordinary income or any combination after making these adjustments.

> **Note.** The final regulations permit a taxpayer to make changes or revoke the election on an amended return if the statute has not expired.

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26. Treas. Reg. §1.1301-1(d)(2).
27. Treas. Reg. §1.1301-1(e)(1)(ii)(B).
28. Treas. Reg. §1.1301-1(e)(2)(i).
29. Treas. Reg. §1.1301-1(d)(1).
30. Treas. Reg. §1.1301-1(e)(ii), Examples 3–4.
31. Treas. Reg. §1.1301-1(e)(ii), Example 5.

Example 5. Kevin and Jane are married with no dependent children and use the standard deduction. Kevin's Schedule F income for 2008 is $130,000, and the couple's taxable income is $113,600. In the past, Kevin and Jane reported taxable income in the 10–15% bracket. Taxable income for tax years 2005, 2006, and 2007 was $16,000, $17,000, and $18,000, respectively. Approximately $40,000 of additional taxable income would be needed in each of these years to reach the top of the 15% tax bracket.

Kevin and Jane could elect to average up to $120,000 (an average of $40,000 over the three years) of current farm income or gains and keep the EFI in the 15% bracket. If $48,500 is averaged, that will move all of Kevin and Jane's income that is currently in the 25% bracket down to the 15% bracket ($113,600 taxable income – $48,500 = $65,100, which is the top of the 15% bracket for 2008). This would reduce their current tax liability by $4,850 (10% of $48,500).

Observation. For practical purposes, it generally is advantageous to elect as much farm income as possible in order to reduce the current-year taxable income to the lowest optimal amount. Thus, when the current year becomes a prior year in the future, there will be a greater portion of the 15% bracket available to absorb the farm income of future years.

For Example 5

SCHEDULE J (Form 1040) Department of the Treasury Internal Revenue Service (99)	**Income Averaging for Farmers and Fishermen** ▶ Attach to Form 1040 or Form 1040NR. ▶ See Instructions for Schedule J (Form 1040).	OMB No. 1545-0074 2008 Attachment Sequence No. 20
Name(s) shown on return: Kevin and Jane		Social security number (SSN): 111 11 1111

1	Enter the taxable income from your **2008** Form 1040, line 43, or Form 1040NR, line 40			1	113,600
2	Enter your **elected farm income** (see page J-2). **Do not** enter more than the amount on line 1			2	48,500
3	Subtract line 2 from line 1			3	65,100
4	Figure the tax on the amount on line 3 using the **2008** tax rates (see page J-2)			4	8,969
5	If you used Schedule J to figure your tax for: • 2007, enter the amount from your 2007 Schedule J, line 11. • 2006 but not 2007, enter the amount from your 2006 Schedule J, line 15. • 2005 but not 2006 or 2007, enter the amount from your 2005 Schedule J, line 3. Otherwise, enter the taxable income from your **2005** Form 1040, line 43; Form 1040A, line 27; Form 1040EZ, line 6; Form 1040NR, line 40; or Form 1040NR-EZ, line 14. If zero or less, see page J-2.	5	16,000		
6	Divide the amount on **line 2** by 3.0	6	16,167		
7	Combine lines 5 and 6. If zero or less, enter -0-	7	32,167		
8	Figure the tax on the amount on line 7 using the **2005** tax rates (see page J-4)			8	4,095
9	If you used Schedule J to figure your tax for: • 2007, enter the amount from your 2007 Schedule J, line 15. • 2006 but not 2007, enter the amount from your 2006 Schedule J, line 3. Otherwise, enter the taxable income from your **2006** Form 1040, line 43; Form 1040A, line 27; Form 1040EZ, line 6; Form 1040NR, line 40; or Form 1040NR-EZ, line 14. If zero or less, see page J-6.	9	17,000		
10	Enter the amount from line 6	10	16,167		
11	Combine lines 9 and 10. If less than zero, enter as a negative amount	11	33,167		
12	Figure the tax on the amount on line 11 using the **2006** tax rates (see page J-7)			12	4,220
13	If you used Schedule J to figure your tax for 2007, enter the amount from your 2007 Schedule J, line 3. Otherwise, enter the taxable income from your **2007** Form 1040, line 43; Form 1040A, line 27; Form 1040EZ, line 6; Form 1040NR, line 40; or Form 1040NR-EZ, line 14. If zero or less, see page J-9	13	18,000		
14	Enter the amount from line 6	14	16,167		
15	Combine lines 13 and 14. If less than zero, enter as a negative amount	15	34,167		
16	Figure the tax on the amount on line 15 using the **2007** tax rates (see page J-9)			16	4,343
17	Add lines 4, 8, 12, and 16			17	21,627
18	If you used Schedule J to figure your tax for: • 2007, enter the amount from your 2007 Schedule J, line 12. • 2006 but not 2007, enter the amount from your 2006 Schedule J, line 16. • 2005 but not 2006 or 2007, enter the amount from your 2005 Schedule J, line 4. Otherwise, enter the tax from your **2005** Form 1040, line 44;* Form 1040A, line 28;* Form 1040EZ, line 10; Form 1040NR, line 41;* or Form 1040NR-EZ, line 15.	18	1,674		
19	If you used Schedule J to figure your tax for: • 2007, enter the amount from your 2007 Schedule J, line 16. • 2006 but not 2007, enter the amount from your 2006 Schedule J, line 4. Otherwise, enter the tax from your **2006** Form 1040, line 44;* Form 1040A, line 28;* Form 1040EZ, line 11; Form 1040NR, line 41;* or Form 1040NR-EZ, line 15.	19	1,799		
20	If you used Schedule J to figure your tax for 2007, enter the amount from your 2007 Schedule J, line 4. Otherwise, enter the tax from your **2007** Form 1040, line 44;* Form 1040A, line 28;* Form 1040EZ, line 10; Form 1040NR, line 41;* or Form 1040NR-EZ, line 15.	20	1,921		
	***Do not** include any tax reported on this line from Forms 8814, 4972, or 8889, or from recapture of an education credit or charitable contribution deduction. Also, **do not** include alternative minimum tax from Form 1040A.				
21	Add lines 18 through 20			21	5,394
22	**Tax.** Subtract line 21 from line 17. Also include this amount on Form 1040, line 44 or Form 1040NR, line 41			22	16,233

Caution. Your tax may be less if you figure it using the 2008 Tax Table, Tax Computation Worksheet, Qualified Dividends and Capital Gain Tax Worksheet, or Schedule D Tax Worksheet. Attach Schedule J only if you are using it to figure your tax.

For Paperwork Reduction Act Notice, see Form 1040 or Form 1040NR instructions. Cat. No. 25513Y **Schedule J (Form 1040) 2008**

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Example 6. Joe and Sue had the following income for the three base years and 2008:

2005	($ 50,000) (includes $30,000 NOL from a prior year)
2006	15,000
2007	1,500
2008	150,000

EFI for 2008 is $93,000. Joe and Sue must eliminate the NOL from the base year 2005; therefore, base year income becomes ($20,000).

Base year income plus EFI is as follows:

2005	($20,000)	+	$31,000 ($93,000 ÷ 3 years)	=	$11,000
2006	15,000	+	31,000	=	46,000
2007	1,500	+	31,000	=	32,500

Tax computations are as follows:

Base Year	Base Year Income Adjusted	Share of Farm Income	Income after Share of EFI	Tax Rate	Income Tax with Farm Income Averaging	Income Tax without Farm Income Averaging	Additional Tax Due to EFI
2005	($20,000)	$31,000	$11,000	10%	$1,100	$ 0	$1,100
2006	15,000	31,000	46,000	10/15%	6,145	1,500	4,645
2007	1,500	31,000	32,500	10/15%	4,092	150	3,942

2008 income tax **with** income averaging:

Taxable Income	Less: EFI	Taxable Income after EFI	Tax Rate	Income Tax
$150,000	$93,000	$57,000	10/15%	$ 7,747
Total income tax				$17,434

2008 income tax **without** income averaging:

Taxable Income	Rate	Income Tax
$ 16,050	10%	$ 1,605
49,050	15%	7,358
66,350	25%	16,587
18,550	28%	5,194
$150,000		$30,744

Income Tax Savings: $30,744 – $17,434 = $13,310.

Example 7. Verlin is eligible for income averaging. He elects to apply Schedule J income averaging to $15,000 of income in 2006, $18,000 of income in 2007, and $21,000 of income in 2008. His base income for averaging must reflect the additions which occur from his prior income averaging.

	2003	2004	2005	2006	2007	2008
Base income	$10,000	$10,000	$10,000	$45,000	$58,000	$60,000
EFI 2006	5,000	5,000	5,000	(15,000)		
	$15,000	$15,000	$15,000	$30,000		
EFI 2007		6,000	6,000	6,000	(18,000)	
		$21,000	$21,000	$36,000	$40,000	
EFI 2008			7,000	7,000	7,000	(21,000)
			$28,000	$43,000	$47,000	$39,000

Kiddie Tax

If a farmer elects to use farm income averaging in a year in which he also calculated his tax liability using Schedule J, he uses the tax rate determined after allocating the EFI. For example, the farmer may be in a 25% tax bracket before income averaging but a 15% bracket after income averaging. He will use the 15% bracket to calculate the amount of kiddie tax.

In a base year, kiddie tax is not affected by income averaging.

ISSUE 4: CROP INSURANCE/DISASTER PAYMENTS

THE DEFERRAL ELECTION

A cash-method farmer (including share-rent landlords on the cash method) may elect to postpone reporting insurance proceeds on damaged crops. Federal disaster payments from the year of damage may also be reported in the following year.[32] The deferral election applies to insurance proceeds received as a result of "destruction or damage to crops." In addition, federal disaster payments received as a result of "destruction or damage to crops caused by drought, flood, or any other natural disaster" or the inability to plant crops "because of such a natural disaster" are treated as insurance proceeds received as a result of "destruction or damage to crops."[33] Thus, "prevented planting" payments are eligible for deferral.

When a taxpayer receives both crop insurance and disaster payments in the same taxable year, they must be treated the same way.[34] If crop insurance and disaster payments are received in different years, they may be reported independently.

> **Note.** There is no provision for reporting crop insurance or disaster proceeds in an earlier year than the year of receipt. The only option is to defer crop insurance and/or disaster proceeds to the year after the year of "destruction or damage to crops." Any insurance proceeds received in a prior year and properly deferred must be reported on the following year's Schedule F, line 8d.

32. IRC §451(d); Treas. Reg. §1.451-6.
33. Treas. Reg. §1.451-6(a)(1).
34. IRS Notice 89-55, 1989-1 CB 696.

In order to make the deferral election, the taxpayer must establish that under the taxpayer's "normal business practice," the income from the damaged crop would have been reported in the year after the year of damage or destruction. While the statute does not expressly require a farmer to have a practice of deferring **all** crop income to the following year in order to be eligible to defer receipt of crop insurance or disaster payment, the IRS interprets the statute to require a "substantial amount" of the crop be deferred before the taxpayer is eligible to defer crop insurance or disaster insurance proceeds. The IRS generally interprets the phrase as meaning more than 50%. The legislative purpose allowing this deferral of income is to prevent farmers from having to report income from two years of crops in one calendar year.

Note. The IRS substantial-portion test was established in Rev. Rul 74-145.[35] The ruling involved a situation in which the taxpayer had a history of deferring more than 50% of crop income to the following year. The IRS ruled that constituted a substantial portion of the taxpayer's crop income and allowed deferral of all the crop insurance proceeds for the destroyed crop. The 8th Circuit Court of Appeals, affirming the Tax Court, upheld the IRS's position in *Nelson, et al*.[36] In addition, to be eligible for deferral, the court noted that when a farmer sustains damage to multiple crops, the farmer must meet the substantial portion (more than 50%) test for each crop.

Making the Election

As previously mentioned, in order to make the deferral election, the taxpayer must establish that under the taxpayer's normal business practice, the income from the damaged crop would have been reported in a year after the year of damage or destruction. The taxpayer must check the box on line 8c of Schedule F to make the election. In addition, a statement of election to postpone the income must be attached to the taxpayer's Form 1040 for the year the damage occurred. The statement must contain the following information:

- Explanation that the election is being made under IRC §451(d) and Treas. Reg. §1.451-6
- Identification the specific crop or crops destroyed or damaged
- Statement that, under normal business practice, the taxpayer would have included income from the damaged crop in a year following the year of destruction or damage
- Identification of the cause of destruction or damage and the date(s) it occurred
- Amount of payment(s) received and the date each payment was received for each crop
- Name of the insurance carrier or payor from whom the amounts were received
- Name and address of the taxpayer

35. Rev. Rul 74-145, 1974-1 CB 113.

36. *Nelson, et al. v. Comm'r,* TC 568 F.3d 662 (8th Cir. 2009), *aff'g* 130 TC 70 (2008).

The election statement could use the following format:

Attachment to Form 1040

Name(s): ______________________________ SSN/TIN: __________________

Election of Cash-Basis Taxpayer to Defer Reporting of Hail Insurance Proceeds: (Pursuant to Internal Revenue Code §451(d) and Treas. Reg. §1.451-6)

The taxpayer(s) do hereby elect to defer the reporting of hail insurance proceeds received during the tax year as income until the following year during which the crop damaged would ordinarily have been marketed. In support thereof, the following statement is made:

1. The crops damaged or destroyed were:

   Corn Soybeans

2. Under the normal business practice of the taxpayer(s), the income derived from the crops destroyed or damaged would have been reported in the taxable year following the taxable year of the damage.

3. The damage was caused by wind and hail storms on the following dates:

   Corn ________________ Soybeans _______________

   ________________ _______________

   ________________ _______________

4. Payments were received from the following insurance companies in the following amounts:

	Insurance Company	Date Paid	Amount
Corn:	______________________	_________	$___________
	______________________	_________	$___________
	______________________	_________	$___________
Soybeans:	______________________	_________	$___________
	______________________	_________	$___________
	______________________	_________	$___________

An election that is made for a particular tax year is binding, unless the IRS consents to a written request for a change. The decision to defer crop insurance proceeds can be made independently for each year insurance is received.[37]

Observation. An election to defer insurance proceeds may be made on either an original or amended return. This can be important for the taxpayer with lower income in the current year than in the prior year. If any crop insurance or government disaster program payments were received and reported in the prior year without a deferral election, an amended return could be prepared to electively defer that prior year income to the current lower income tax return.

37. Treas. Reg. §1.451-6(b)(2).

Other Points about the Election

If a taxpayer receives insurance proceeds from damage to two or more specific crops and wishes to defer such proceeds, the election to defer is deemed to cover all proceeds attributable to the crops representing a single business. A taxpayer operating two separate farms and maintaining separate books and records for each business may make a separate election for each business.[38]

Note. In the case of insurance carriers that allow deferral of the premium payment by a farmer until harvest, the insurance proceeds issued to the taxpayer often are reduced by the unpaid premium. However, in making the IRC §451 election, **the gross proceeds must be deferred, while the premium expense is allowed as a current deduction.** Importantly, the amount of the Form 1099 received from the insurance carrier must be matched with the proceeds reported by the taxpayer on Schedule F, line 8a, with only the current year taxable portion reported on line 8b.

Government Disaster Payments

USDA agricultural disaster payments are eligible for the election.[39]

Note. Crop insurance proceeds and disaster payments must be combined and reported consistently. A taxpayer cannot pick and choose.

Disaster payments (and crop insurance proceeds) that are received in a year after the year of damage or destruction of the crops are not deferrable. IRC §451(d) provides that proceeds may be deferred to the "year following the taxable year of the destruction or damage."[40]

Deferral of Revenue-Based Insurance Policies

Revenue-based insurance policies include group risk income plans, income protection, revenue assurance, and crop revenue coverage. These plans are based on the gross revenue produced for crops and include both a yield and a price component.

A revenue policy may be viewed as an alternative to multi-peril insurance. It is broader in scope because it covers any revenue losses to the farmer, whether caused by low price, low yield, or a casualty event. Essentially, a farmer sets the contract to guarantee a certain level of revenue, and shortfalls are covered regardless of the event which caused the reduced revenue. The farm's actual production history is utilized to set current coverage, with the policy allowing coverage levels from 50% to 75%. A minimum guarantee is set by a commodity base price, but there can be a second price test at harvest, which can produce a greater guaranteed return.

The IRS ruled that crop insurance programs that provide payments without regard to actual losses (such as for low prices) fall outside of the statutory definition of destruction or damage to crops and **do not qualify for the deferral election.**[41] Accordingly, deferral is not available for any revenue component of crop insurance because such payments are not compensating the taxpayer for destruction to the taxpayer's crops.[42] However, the portion of insurance proceeds attributable to crop destruction or damage is eligible for deferral. The practical problem is properly accounting for insurance proceeds that are paid for production loss versus those paid for price loss. Crop insurance claim reports often provide the loss computation details that are needed to determine if any proceeds are eligible for deferral.

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38. Treas. Reg. §1.451.

39. Rev. Rul. 91-55, 1991-2 CB 321.

40. The Treasury Regulations mirror the statute. Treas. Reg. §1.451-6(a)(1) states, "however, if a taxpayer receives the insurance proceeds in the taxable year following the taxable year of the destruction or damage, the taxpayer shall include the proceeds in gross income for the taxable year of receipt."

41. IRS Notice 89-55, 1989-1 CB 696.

42. See IRS Info 2009-0047 (Jan. 29, 2009).

ISSUE 5: SELECTED IMPORTANT TAX ELECTIONS FOR FARMERS

ELECTION TO FORGO 5-YEAR FARM NOL CARRYBACK

In general, a net operating loss (NOL) can be carried back two years or carried forward 20 years. However, a taxpayer engaged in a farming business can carry back an NOL that is attributable to a federally-declared disaster for three years.[43] Other farm NOLs qualify for a 5-year carryback period.[44]

> **Note.** A farming loss is defined as the amount of any NOL attributable to the income and deductions of a farming business as defined in IRC §263A(e)(4). The farming loss portion of an NOL cannot exceed the taxpayer's NOL for the taxable year. Thus, the taxpayer should include farm capital losses in excess of farm capital gains (Schedule D) only to the extent of the capital loss limitation on Schedule D, and must usually separate business and nonbusiness portions. In addition, the loss must be reduced by the extent that net nonbusiness capital gains reported on Schedule D exceed net "other" nonbusiness deductions reported elsewhere (such as Schedule A).

The entire NOL must first be carried to the earliest of the taxable years to which such loss may be carried, then any remaining NOL may be carried forward for up to 20 years after the NOL year, unless an election is made to waive the entire carryback period.[45] If this election is made, the NOL is only carried forward for up to 20 years or until fully utilized. Any part of the NOL remaining after the 20-year carryforward period cannot be deducted.

> **Note.** A 5-year, rather than 2-year, carryback period was allowable for an NOL that was a qualified Gulf Opportunity (GO) Zone loss. The qualified loss generally was the lesser of the taxpayer's NOL or the aggregate amount of specified deductions taken into account in computing the NOL. Similarly, a taxpayer is eligible for a 5-year carryback if the taxpayer sustains a qualified disaster loss in a federally-declared disaster area after December 31, 2007, or an NOL attributable to qualified disaster-recovery assistance losses or eligible storm losses arising from the 2008 Midwestern disaster area.

A taxpayer may elect out of the 5-year carryback period so that the NOL is subject to the otherwise applicable carryback period (generally two years). The election must be made by the due date, including extensions, for the loss year. If a timely return was filed, it can also be made on an amended return filed within six months of the original return's due date. If the election is made on an amended return, a statement should be attached that says "Filed pursuant to section 301.9100-2" at the top of the statement. If the election is made, the regular NOL rules apply. Also, once the election is made, it is irrevocable for that tax year.[46]

43. IRC §172(b)(1)(F)(ii)(III).

44. IRC §172(b)(1)(G).

45. IRC §172(b)(3).

46. IRC §172(i)(3).

A statement should be attached to the amended return. Following is a sample of the form the attachment to Form 1040 can take concerning a farm taxpayer electing to forgo the 5-year carryback period but retain the 2-year regular NOL carryback period:

Attachment to Form 1040

Name(s): ______________________________ SSN/TIN: __________________

Election to Relinquish Five (5) Year Carryback Period with Respect to Farm Net Operating Loss: Pursuant to Internal Revenue Code §172(i)(3)

BE HEREBY ADVISED, that the taxpayer(s) incurred a net operating loss from farming operations in the amount of $__________ (see attached schedule for computation), for the current taxable year, and is/are entitled to a five (5) year carryback of said loss under the provisions of IRC §172(b)(1)(G).

BE FURTHER ADVISED, that pursuant to IRC §172(i)(3) the taxpayer(s) hereby elect(s) to relinquish the five (5) year carryback period with respect to said net operating loss from farming operations. The taxpayer(s) understand(s) that this election, once made, shall be irrevocable with respect to this net operating loss.

BE FURTHER ADVISED, that the taxpayer(s) is/are **only** relinquishing his/her right to a five (5) year carryback of a loss from farming operations. The taxpayer(s) is/are **not** relinquishing the general two (2) year net operating loss carryback provided by IRC §172(b)(1)(A).

Note. A taxpayer cannot combine the 5-year NOL carryback with an election to treat a disaster loss as incurred in the prior year. If the prior-year return is amended to claim the casualty loss, only the normal NOL carryback period is allowed.

A corporation makes the NOL election on line 11 of Schedule K (Form 1120).

A detailed discussion of NOL carrybacks is found in Chapter 7, Net Operating Losses.

ELECTION TO EXPENSE START-UP COSTS

Start-up expenses must be capitalized unless a taxpayer elects to expense (currently deduct) up to $5,000 of the cost in the tax year in which the taxpayer's trade or business begins and amortize the balance ratably over 180 months.[47] The election is made and the deductions are claimed on a timely-filed return, including extensions, for the tax year in which the trade or business begins. The election applies to start-up expenses paid or incurred after October 22, 2004.

Note. Eligible expenses also include investigatory costs incurred before the taxpayer reaches a final decision to acquire or enter a business (e.g., expenses associated with a general search as to whether to enter a new business and which new business to enter).

47. IRC §195(b)(1). The $5,000 cap is reduced on a dollar-for-dollar basis by the excess of total start-up expenditures over $50,000. Thus, if the cumulative start-up expenses exceed $55,000, no amount is eligible to be currently expensed.

The election is irrevocable and applies to all start-up expenditures related to the active trade or business. The election is made on a statement that is attached to the return. Following is a sample of the statement that is attached to the return:

Statement of Information Substantiating Election to Expense Start-Up Expenses
Pursuant to Internal Revenue Code §195(b)(1)
(After October 22, 2004)

The taxpayer commenced the active conduct of a new trade or business on the ______day of ________, 2009. A description of the nature of said new trade or business is as follows:

Prior to the commencement of said trade or business, the taxpayer incurred certain start-up expenses (whether or not paid) which the taxpayer hereby elects to expense for the taxable year in which active conduct of the trade or business began.

Taxpayer's start-up expenditures are as follows:

Date Incurred	Expense Item	Amount
___________	________________________________	_____________
___________	________________________________	_____________
___________	________________________________	_____________
___________	________________________________	_____________

Note. If the taxpayer filed a timely election for a business, the taxpayer may submit a revised statement with a subsequent tax return to include any additional start-up expenditures that were not included in the original election, as long as those expenditures were treated consistently with other start-up expenses.

ELECTION TO FORGO THE EXCLUSION OF COST-SHARE PAYMENTS

Under certain federal farm programs, especially those designed to provide environmental benefits, the U.S. Department of Agriculture (USDA) covers part of the expense a farmer (including a landlord) incurs for complying with the program. Some cost-sharing amounts can be excluded from income.[48] If the farmer excluded cost-sharing payments from gross income for property disposed of within 20 years, part or all of the excluded payments are taxed as ordinary income. The amount taxed as ordinary income is the lesser of the gain realized on sale of the property or the applicable percentage of the amount of the payment that had been excluded from income. The applicable percentage for the first 10 years after the date payments are received and excluded from income is 100%. Thereafter, the applicable percentage is reduced annually by 10%. After the 19th year, there is no recapture.

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An election can be made to forgo the exclusion of cost-share payments in order to avoid the 20-year potential for recapture under IRC §1255. The election is made by filing a statement with a timely-filed return (including extensions). The election can be made annually.

48. IRC §126.

ELECTION TO EXPENSE FERTILIZER AND OTHER FARMLAND CONDITIONING COSTS

Fertilizer and lime are allowable business deductions. However, if the benefits of the materials are expected to last substantially more than one year, an election must be made to expense the costs.[49] There is no dollar limit on the deductible amount, and the election is not binding for subsequent years. The election is made by entering the costs as a deduction on the taxpayer's return. If the election is not made, costs associated with fertilizer and lime are not currently deductible but are instead capitalized over the period soil fertility is affected. IRS consent is required to revoke the election. If the benefits of the fertilizer are expected to last one year or less, the expense can be deducted in the year paid without an election.

Note. In order to deduct costs associated with fertilizer and lime, the taxpayer must be in the trade or business of farming. Thus, the taxpayer must be either an operator of farmland or a landlord under a crop- or livestock-share lease. In addition, the fertilizer or lime must be applied to land used in farming. Expenditures on land brought into production for the first time are not eligible for the election to deduct the expense currently.

ELECTION TO GROUP RENTAL REAL ESTATE ACTIVITIES — THE PASSIVE LOSS RULES

The passive loss rules apply to activities that involve the conduct of a trade or business in which the taxpayer does not materially participate or in rental activity on a basis which is regular, continuous, and substantial. If the passive loss rules apply, deductions (losses) from passive trade or business activities may not be deducted against other income (nonpassive activity gains), to the extent the deductions exceed income from all passive activities. For farmers, the passive loss rules are likely to apply in situations in which the farmer is a passive investor in a separate business venture apart from the farming operation. In that situation, the losses from the venture cannot be used to offset the income from the farming operation — unless the farmer can group the activities together as a single economic unit for passive loss purposes. If grouping can be done, the farmer's material participation in the farming activity counts as material participation in the passive business, and the losses offset the farming income.

Any reasonable method for making the grouping determination can be utilized, but certain factors are given the greatest weight in determining whether activities should be grouped or kept separate:

1. Similarities or differences in types of businesses
2. Extent of common control
3. Extent of common ownership
4. Geographic location
5. Business interdependencies

Note. The grouping election does not result in income or loss being grouped for SE tax purposes.

49. IRC §180.

The election to group activities is made by filing a statement with the taxpayer's original income tax return for the taxable year. The following is a sample election statement for a grain storage activity.

Attachment to Form 1040

Name(s): ______________________________ SSN/TIN: __________________

Election to Group Activities Pursuant To Treas. Reg. §1.469-4(c)

(Grain Storage Facility)

During the tax year, the taxpayer acquired an interest as an LLC member in ________________________ (TIN: _______________). This entity supplements the taxpayers' sole proprietorship grain farming operation by providing grain storage facilities for the taxpayers' crops.

Accordingly, the taxpayer hereby elects to group the following activities together so that the grouped activities are treated as a single activity for the current tax year and all years thereafter. The following activities are to be grouped together and treated as one activity:

Schedule F

Sole Proprietorship	Grain Farming Operation
Limited LLC Member	Name:______________________ TIN: ______________________

New Court Case

A recent Tax Court case illustrates the application of the passive loss rules and the activities that can be grouped. In *Senra*,[50] the taxpayer was a majority owner in a C corporation that was engaged in retail sales of granite and marble. The taxpayer was materially involved in the operations of the C corporation and received wage income. The taxpayer also was the sole owner of a limited liability company (LLC) that rented a warehouse to the C corporation. The LLC had passive rental losses that flowed through to the taxpayer, and the taxpayer wanted to group his active participation in the C corporation with his passive activities in the LLC for purposes of satisfying the material-participation test of the passive loss rules. However, the Tax Court ruled that Treas. Reg. §1.469-4(d)(5)(ii) limited the aggregation of the activities. The taxpayer argued that the regulation only applied when unrelated activities are grouped, but the Tax Court rejected that argument. Thus, because the rental activities in the LLC were per se passive irrespective of whether the taxpayer materially participated in them, the taxpayer had no passive income and the losses were not deductible.

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Note. For more detail on the *Senra* case, see Chapter 13, Rulings and Cases. In addition, see the *Garnett* case, also covered in Chapter 13, for a court decision involving LLC members being classified as limited partners for the passive-activity rules.

50. *Senra v. Comm'r*, TC Memo 2009-79 (Apr. 15, 2009).

ISSUE 6: CONSERVATION RESERVE PROGRAM (CRP)

HISTORICAL OVERVIEW

Questions continue regarding how the income from CRP payments should be reported and whether they are subject to SE tax. The following is a brief synopsis of the relevant caselaw and IRS rulings and other pronouncements on this issue:

- The Tax Court, in *Ray*,[51] held that CRP payments are subject to SE tax when they are received by a materially-participating landowner **and** the payments have a "direct nexus" with the taxpayer's farming operation.
- In a Letter Ruling,[52] the IRS ruled that CRP payments received by taxpayers that leased all their remaining cropland to an S corporation were subject to SE tax.
- In *Wuebker*,[53] the Tax Court concluded the CRP payments received by a materially-participating farmer were rental income from real estate and were exempt from SE tax under IRC §1402(a)(1). As such, the CRP payments were within the statutory exclusion from SE tax as "rents from real estate." In addition, the taxpayer had done little during the tax years at issue to service or maintain the CRP ground, which evidenced a lack of material participation.

> **Note.** The Tax Court distinguished *Wuebker* from *Ray* by pointing out that the issue of equating the CRP payments to rent never arose in *Ray*. The Tax Court further pointed out that a finding that CRP payments are the equivalent of rental income makes the "direct nexus" analysis of *Ray* a moot point.

In 2000, the 6th Circuit reversed the Tax Court's opinion in *Wuebker*.[54] The 6th Circuit determined that the Wuebker's CRP income was subject to SE tax because of a nexus between the Weubker's CRP income and their existing farming activity on land that they rented from others. The 6th Circuit disregarded the statutory argument that CRP payments are "rental payments" and, as such, fell within the statutory exclusion for "rents from real estate."

> **Note.** The 6th Circuit's opinion is binding on taxpayers within the 6th Circuit — Michigan, Ohio, Kentucky, and Tennessee. The opinion is not binding on taxpayers outside the 6th Circuit. For those taxpayers, the Tax Court's *Wuebker* opinion is substantial authority. As such, Form 8275, *Disclosure Statement*, need not be filed by taxpayers outside the 6th Circuit who are not active farmers but receive CRP payments, which they report as not subject to SE tax. There is now better clarity and a different analysis on this issue than in prior years:
>
> - **Outside the 6th Circuit:** *Wuebker* is substantial authority. CRP income is not SE income, even for active farmers.
> - **Inside the 6th Circuit:** CRP income is SE income due to nexus.
> - **Farm Bill Provision:** CRP income is not SE income if the taxpayer receives social security retirement or disability.

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51. *Ray v. Comm'r*, TC Memo 1996-436 (Sep. 25, 1996).
52. Ltr. Rul. 9637004 (May 1, 1996).
53. *Wuebker v. Comm'r*, 110 TC No. 431 (1998).
54. *Wuebker*, 205 F.3d 897 (6th Cir. 2000), *rev'g* 110 TC 431 (1998).

After the Tax Court's *Wuebker* opinion, the IRS did process some early refund claims. However, they soon changed their position and began denying refund claims. The denials stated, "The IRS is not following the *Wuebker* decision. CRP payments are subject to SE tax." The point became moot (at least for taxpayers located within the 6th Circuit) after the reversal by the 6th Circuit. Although the Tax Court's opinion may be followed for taxpayers outside the 6th Circuit, it may ultimately be necessary to proceed to the IRS appeals level and through to the Tax Court.

In 2003, the IRS released another CRP pronouncement. A CCA Letter Ruling[55] involved two different situations. The first involved an active farmer who had bid land into the CRP. The IRS determined that the payments should be included on Schedule F and were subject to SE tax. In the second situation, a nonfarmer acquired land that had previously been enrolled in the CRP. The IRS again concluded that the CRP rents are reported on Schedule F. Importantly, this is the first time that the IRS took the position that CRP rents were subject to SE tax in the absence of the taxpayer's material participation in a farming operation that has some relationship (nexus) to the CRP rents. It is contradictory to all prior IRS rulings on the issue, the 6th Circuit's *Wuebker* opinion, and the Tax Court's *Ray* opinion.

In 2006, the IRS issued Notice 2006-108,[56] in which it announced that it was proposing to issue a revenue ruling that would follow the 2003 CCA Ltr. Rul. and require that all CRP payments be treated as earned income subject to SE tax. The IRS requested comments through March 19, 2007, and it received no comments that agreed with its position. The IRS later announced that it would not issue a revenue ruling and that it would not change its position.

2008 FARM BILL PROVISION

The Congress included a provision in the 2008 Farm Bill, effective for CRP payments made after 2007, amending IRC §1402 to specify that CRP payments are not subject to SE tax if the recipient is receiving social security retirement or disability payments. For these taxpayers, it is irrelevant whether the taxpayer is a materially-participating farmer, files Schedule F, or has reached full retirement age. Unfortunately, the Farm Bill provision does not provide relief from the IRS position for other taxpayers that are not receiving social security payments.

IRS SYSTEMIC PROBLEM

In certain situations, the IRS submission procession may not recognize the exclusion of CRP payments from SE tax. Taxpayers covered by the Farm Bill provision report CRP payments on Schedule F with the amount then reported as a negative amount on Schedule SE, line 1b. Farm profit is reduced by the amount of the CRP payments received. The potential problem is that if the removal of CRP payments reduces net farm profit beneath $400, Schedule SE may not be filed. Schedule F, on the other hand, will likely show a profit. Thus, the processing of the return may trigger a notice being sent for additional SE tax. There presently is no return-processing procedure in place to look for social security or disability payments.

Observation. CRP payments are lumped together with other agricultural program payments on Schedule F. Thus, it is critical for the IRS to identify the correct amount the taxpayer should use to reduce tax liability. Consequently, CRP information should be carefully matched when the reporting documents are processed. Also, taxpayers covered by the Farm Bill provision may find it helpful to always attach the Schedule SE or a separate accounting of CRP payments to the return so that the excluded income can be readily identified. Ultimately, a long-term fix to the problem may be a modification of Schedule F to specifically provide for a separate accounting of CRP payments and making Schedule SE a required document whenever a reduction for CRP rental payments is taken.

55. Ltr. Rul. 200325002 (May 29, 2003).

56. Notice 2006-108, IRB 2006-51 (Dec. 5, 2006).

COMMON CRP SCENARIOS

Following are various common situations that may arise and possible solutions:

Scenario 1. Warren Teed always rented his property on a cash-rent basis prior to putting his land into the CRP. He does not materially participate in the farming of his property.

Solution 1. The CRP income should not be subject to SE tax. Reporting the income on Form 4835, *Farm Rental Income and Expenses*, is appropriate.[57] If Warren was collecting social security retirement or survivor or disability payments, then the Farm Bill provision would apply; the CRP payments are statutorily not subject to SE tax and are reported on Schedule F.

Scenario 2. Brooke Trout rents her property on a crop-share lease. She actively participates but does not **materially** participate. Brooke did not pay SE tax on the lease income prior to putting the land into the CRP.

Solution 2. The answer should be the same as in **Scenario 1.**

Scenario 3. Lou Pole actively farms and pays SE tax on all farm income.

Solution 3. Reporting the income on Schedule F and paying SE tax was the obvious answer prior to the Tax Court's *Wuebker* decision. Given the 6th Circuit's reversal of *Wuebker*, for taxpayers in the 6th Circuit, CRP rents are subject to SE tax if there is a "nexus" between the CRP rents and the taxpayer's participation in existing farming operations. **The *Wuebker* Tax Court Case is substantial authority in all jurisdictions other than the 6th Circuit.**

Scenario 4. Lou from **Scenario 3** instead rents the property on a crop-share basis but materially participates and pays SE tax.

Solution 4. The treatment is the same as for Lou as an active farmer in **Scenario 3.**

BUYING OUT A CRP CONTRACT

The rise in commodity prices in recent years (which has moderated somewhat in recent months) has provided an incentive for some producers to remove land from the CRP. When land subject to an existing CRP contract is sold, a buyer may also consider buying out the remaining years on the contract. Tax issues may arise when CRP land is removed from the program or an existing contract is bought out.

The penalty for breaking a CRP contract is a repayment of all the CRP payments that were paid under the contract, forfeiture of remaining payments due under the contract, payment of interest, and payment of liquidated damages. In addition, the penalty is not deductible.

> **Observation.** If land is removed from the CRP or the contract is bought out in the earlier years of the contract, the penalty is less burdensome. However, the penalty may make such a strategy less feasible in the later years of the contract.

57. See Ltr. Rul. 8822064 (Mar. 7, 1988). Under the facts of the ruling, no tenant was involved and a retired taxpayer's activity did not constitute material participation and the income was not subject to SE tax.

There are two scenarios involving the termination of a CRP contract through the paying back of previous CRP payments.

Scenario 1. The person (or entity) paying back the CRP payments is the same person (or entity) that initially received the payments.

In this situation, the payback of the CRP payments is arguably deductible in the same manner and reported on the same form as the original payments were reported as income. For a farmer that reported the CRP payments on Schedule F, the cost of paying back the rental payments should be taken as a deduction on Schedule F. Arguably, if the CRP payments were received while the farmer was a Schedule F farmer but paying back the CRP contract payments occurs in a year in which the farmer is no longer a Schedule F farmer, the deduction could be taken on Schedule F. In that case, the deduction would generate an active, fully-deductible loss that could be used to offset any other SE income of the taxpayer in that year. Ultimately, if the taxpayer is now reporting on a Form 4835, *Farm Rental Income and Expenses*, and there is sufficient income to absorb the cost of paying back the contract so that there is no passive loss issue and no other SE income, it would make little or no difference whether the taxpayer reported the cost of paying back the CRP as a lone deduction on a Schedule F versus deducting it on a Form 4835 or Schedule E, *Supplemental Income and Loss.*

Note. As a counter to this position, the IRS could assert that the CRP payments are paid back to "free up" the land for active farming for the remaining years of the CRP contract. Accordingly, the IRS could assert that the payback cost should be spread over the remaining life of the contract and allocated to the income gained from those years. Alternatively, if the payback occurs in the early years of the CRP contract, an argument can be made that the taxpayer could amend prior-year tax returns (those within the statute for open tax years) and decrease the income tax and any SE tax.

Scenario 2. The taxpayer, as the seller of the property subject to the CRP contract, pays back the CRP payments and then sells the land to a new owner.

In this situation, the initial question is which party — the seller or the buyer of the land — in effect, paid back the CRP payments. If the seller paid the CRP payments back, the land was thereby released from the contract before the land was sold, and the comments under Scenario 1 apply. If the seller disposes of the entire farming operation and no longer files a Schedule F (and does not file a Schedule E or Form 4835), the seller should consider filing a Schedule F with a lone deduction or loss on it for the payback cost. Another option is for the seller to subtract this payment from the sale proceeds in arriving at a determination of gain on the sale of the real estate, effectively adding it to the taxpayer's basis in computing the gain from the sale of the farm.

Observation. The taxpayer may want to consider having a carryover of grain (or at least a partial operating year) to further justify the filing of a Schedule F and take the CRP payback deduction on that year's Schedule F.

Alternatively, the buyer of the property could decide to break the CRP contract and buy out the CRP payments after the purchase. If the buyer of the land buys out the CRP contract immediately after acquisition of the land, the buyer might be able to argue that this was a cost and expense of producing a crop on ground that was subject to the CRP. Certainly, the argument exists that the CRP buy-out cost should be spread over what would have been the remaining life of the CRP contract and thereby amortized in some fashion. If the buyer does not separate the acquisition of the land transaction from the CRP buy-out costs, the entire amount might be considered a cost of acquisition and therefore not deductible by the buyer until such time as the ground is sold.

Observation. It is important in any farm sale that the purchase agreement specifies what will happen to land that is enrolled in the CRP. If there is a CRP contract in place and the cost of paying back the CRP contract is not negotiated, the seller should have a clause in the contract wherein the buyer agrees to assume the CRP contract, perform under the contract in all respects, and agree to indemnify the seller for any subsequent violation of the CRP contract which results in any charge to the seller. The considerations involved in this situation are no different than negotiating the advanced deficiency payments or counter-cyclical payment made under the farm program when farm ground changes hands.

In summary, when farm ground is removed from the CRP and CRP payments are paid back by the same taxpayer that enrolled the land in the CRP program, the most justifiable tax treatment is an immediate deduction on Schedule F (or wherever the original CRP payments were reported). When CRP ground changes ownership, ending the CRP contract should be negotiated into the sale price. This should be done in a way in which the seller can deduct the CRP payback costs and the buyer does not have to deal with deductibility issues.

When CRP-enrolled land is sold, care should be taken to obtain a written agreement concerning the assumption of the CRP contract by the buyer. A recent federal district court case from Georgia[58] illustrates this point. Under the facts of the case, CRP-enrolled land was sold without any written agreement specifying that the buyer would assume the existing CRP contracts. However, the seller told the Farm Service Agency (FSA) about the sale, that the buyer intended to assume the CRP contracts, and that FSA should direct all subsequent correspondence to the buyer. The buyer did not subsequently complete the necessary paperwork to formally become the successor to the CRP contracts within the 60-day period that the regulations require. As a result, the FSA told the seller that he needed to refund all the annual rental payments (plus interest), all the cost-share payments (plus interest), and pay liquidated damages.

The seller filed an administrative appeal. The USDA National Appeals Division (NAD) determined that the verbal agreement between the parties was ineffective and should have been put in writing. In addition, the NAD noted that the buyer did not obtain FSA approval to succeed to or modify the contracts and that the buyer's cancellation of some of the CRP contracts did not entail the buyer's succession to the remaining contracts. Upon review, the NAD's decision was upheld. After exhausting the administrative appeal process, the seller sought judicial review. However, the court granted the government's motion for summary judgment on all the plaintiff's claims.

58. *Balfour Land Company, L.P. v. U.S.*, No. 7:08-CV-34 (HL), 2009 U.S. Dist. Lexis 52289 (M.D. GA. June 22, 2009).

ISSUE 7: COOPERATIVES AND THE DOMESTIC PRODUCTION ACTIVITIES DEDUCTION[59]

OVERVIEW

In recent months, farmers have been receiving Form 1099-PATR, *Taxable Distributions From Cooperatives*, as well as statements about the pass-through of the domestic production activities deduction[60] (DPAD) from their cooperatives. These forms and statements have generated a number of questions from farmers and their income tax preparers. While the rules are confusing, they can have a significant positive effect on the tax returns of members of cooperatives that elect to pass the DPAD through to its members.

STATUTORY BACKGROUND

IRC §199 allows taxpayers to claim a deduction on their income tax returns based on their net income from most production activities in the United States. The DPAD for tax years beginning in 2007, 2008, and 2009 is limited to the lesser of:

- Six percent of the qualified production activities income (QPAI),
- Six percent of the entity's taxable income without regard to the §199 deduction (modified adjusted gross income for individual taxpayers), or
- Fifty percent of Form W-2 wages paid during the year by the taxpayer.

Note. The 6% rate increases to 9% for tax years beginning after 2009, except that the deduction percentage remains at 6% in 2010 for the oil and gas industry.

QPAI

QPAI equals domestic production gross receipts (DPGR) reduced by the sum of:

- Cost of goods sold allocable to DPGR,
- Other deductions and expenses directly allocable to DPGR, and
- A share of other deductions and expenses not directly allocable to DPGR or another class of income.

Observation. QPAI for many farmers is the sum of net income reported on Schedule F and net gain from the sale of raised livestock reported on Form 4797, *Sales of Business Property*. However, there are exceptions to this general rule.

DPGR

DPGR are receipts derived from the lease, rental, license, sale, exchange, or other disposition of qualifying production property that is **manufactured, produced, grown, or extracted** by the taxpayer in whole or in significant part within the United States.[61] Qualifying activities include cultivating soil, raising livestock, and fishing as well as storage, handling, and other processing (other than transportation activities) of agricultural products.[62]

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59. This material is adapted, with permission, from material prepared by Philip E. Harris and Roger A. McEowen, which is posted on the website for the Center for Agricultural Law and Taxation [www.calt.iastate.edu].

60. IRC §199.

61. IRC §199(c)(4).

62. Treas. Reg. §1.199-3(e)(1).

Wages

For many farmers, the 50% of wages limitation is the determinative factor on their DPAD. Many farmers have little or no paid labor. In addition, wages for which withholding is not required are excluded from Form W-2 wages for this purpose.[63] Consequently, wages paid in commodities, wages paid for agricultural labor to a child of the proprietor that is under age 18 or to a child under age 18 who is the child of all the partners in a partnership, and compensation paid in the form of nontaxable fringe benefits are not considered Form W-2 wages.

> **Note.** For tax years beginning after May 17, 2006, only the wages allocable to DPGR are qualified wages for the 50% of wages limitation.

THE DPAD AND COOPERATIVES

In General

The DPAD can be confusing for members of cooperatives. The DPAD deduction for products sold by a cooperative is calculated at the entity level; the cooperative can elect to pass none, part, or all of the DPAD through to its members based on their patronage.[64] Because of this entity-level calculation, **the deduction on the member's tax return is not limited by the member's adjusted gross income or Form W-2 wages.**

Cooperative's DPAD

A cooperative engaged in marketing agricultural and horticultural products is treated as having produced any products that are produced by its patrons and marketed by the cooperative.[65] In determining the pass-through DPAD, the cooperative's taxable income and QPAI are computed without taking into account any deductions for patronage dividends, per-unit retain allocations (amount paid to patrons for products sold for them which is fixed without regard to the cooperative's net earnings), and nonpatronage distributions under IRC §§1382(b) and (c).[66]

This rule led many cooperatives to take a closer look at how they characterize their payments to members for the members' commodities. This characterization depends on the member's agreement with the cooperative. The IRS was asked to examine several agreements last year and issued five private letter rulings on the subject in 2008.[67] In each of these rulings, the IRS said that the payments a cooperative makes to its members for their commodities are advance per-unit retains payments in money (PURPIM). The cooperatives do not have to deduct those payments from their DPGR to compute their QPAI. The result is that a cooperative's ability to treat the payments for commodities as PURPIM significantly increases the cooperative's QPAI and potentially the DPAD the cooperative can elect to pass through to its members.

63. See Rev. Proc. 2006-22, 2006-22 IRB 1033.

64. IRC §199(d)(3).

65. IRC §199(d)(3)(D); Treas. Reg. §1.199-6(d).

66. IRC §199(d)(3)(C); Treas. Reg. §1.199-6(c).

67. Ltr. Rul. 200838011 (Sep. 19, 2008); Ltr. Rul. 200843015 (Oct. 24, 2008); Ltr. Rul. 200843016 (Oct. 24, 2008); Ltr. Rul. 200843023 (Oct. 24, 2008); Ltr. Rul. 200852022 (Dec. 26, 2008).

Example 8. Ruraltown Farmer's Cooperative is a marketing cooperative that had $5 million in gross receipts in 2008 from the sale of corn its members produced and delivered to it. Ruraltown paid $4 million to its members at the time they delivered the corn and another $500,000 in patronage dividends after the close of the 2008 tax year. Ruraltown also had $500,000 of other expenses, which includes $120,000 of wages.

Historically, Ruraltown treats the payments to its members at the time they deliver corn as payments for the purchase of the corn. However, after reviewing its membership agreement in light of the letter rulings issued by the IRS, Ruraltown concluded that those payments are advance PURPIM. Therefore, it did not deduct these payments from DPGR to compute its QPAI for 2008; and it included these payments in box 3 of the 2008 Forms 1099-PATR it sent to its members.

Because Ruraltown marketed grain produced by its members, all its receipts are DPGR. Consequently, all its expenses are allocable to DPGR, and its QPAI is $4.5 million ($5 million – $500,000).

Note. If Ruraltown's payments to members at the time they delivered corn were purchases of the corn, the $4 million cost of the corn would be an expense that is deducted from the cooperative's DPGR, which would reduce the cooperative's QPAI to $500,000 ($5 million – $500,000 – $4 million).

Ruraltown's DPAD is $30,000, which is computed as the **lesser of:**

- Six percent of its $4.5 million QPAI ($270,000),
- Six percent of its $500,000 taxable income ($30,000), or
- Fifty percent of its $120,000 wages ($60,000).

Observation. Using the PURPIM method could allow taxpayers with low farm income or no qualified wage expense to realize a larger DPAD on their individual income tax returns.

The DPAD of Cooperative Members

The member's deduction is the DPAD of the cooperative that is allocable to the following:

- Patronage dividends paid to the patron in money, a qualified notice of allocation, or other property (except a nonqualified written notice of allocation)
- Per-unit retain allocations that are paid to the patron in qualified per-unit retain certificates

Note. A cooperative must designate the patron's portion of the income allocable to QPAI in a written notice mailed by the cooperative to the patron no later than the fifteenth day of the ninth month following the close of the tax year.[68]

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68. IRC §199(d)(3)(A)(ii).

Example 9. Use the same facts as in **Example 8.** Joe Corngrower, a member of Ruraltown Farmer's Cooperative, marketed 20,000 bushels of corn through Ruraltown in 2008, which was 2% of all the grain Ruraltown marketed that year. Ruraltown elected to pass its entire $30,000 DPAD through to its members and allocated 2% ($600) of it to Joe on Form 1099-PATR, box 6. Joe reports that $600 DPAD on line 21 of his 2008 Form 8903, *Domestic Production Activities Deduction*. Joe can deduct the full $600 regardless of his AGI or Form W-2 wages because a DPAD that is passed through from a cooperative is not subject to the 6% of AGI or 50% of wage limitations on the member's income tax return.

9797 ☐ VOID ☐ CORRECTED

PAYER'S name, street address, city, state, ZIP code, and telephone no. **RURALTOWN COOPERATIVE** **RR 4** **RURALTOWN, IA 44444**	1 Patronage dividends $ **10000.00** 2 Nonpatronage distributions $ 3 Per-unit retain allocations $ **80000.00**	OMB No. 1545-0118 **2008** Form **1099-PATR**	**Taxable Distributions Received From Cooperatives**
PAYER'S federal identification number **11-1111111** / RECIPIENT'S identification number **222-22-2222**	4 Federal income tax withheld $		**Copy A For Internal Revenue Service Center**
RECIPIENT'S name **JOE CORNGROWER**	5 Redemption of nonqualified notices and retain allocations $	6 Domestic production activities deduction $ **600.00**	**File with Form 1096.**
Street address (including apt. no.) **RR 1**		7 Investment credit $	For Privacy Act and Paperwork Reduction Act Notice, see the **2008 General Instructions for Forms 1099, 1098, 5498, and W-2G.**
City, state, and ZIP code **RURALTOWN, IA 44444**	8 Work opportunity credit $	9 Patron's AMT adjustment $	
Account number (see instructions) / 2nd TIN not. ☐	10 Other credits and deductions $		

Form **1099-PATR** Cat. No. 14435F Department of the Treasury - Internal Revenue Service

No Double Counting. The regulations specify that a qualified payment received by a patron of a cooperative is not taken into account by the patron for purposes of §199.[69] Therefore, patronage dividends paid to the patron in money, in a qualified notice of allocation or other property (except a nonqualified written notice of allocation), or in **per-unit retain allocations** that are paid to the patron in qualified per-unit retain certificates are **not included in a member's DPGR.**

It is important to note that this rule excludes the listed items from the member's DPGR whether or not the cooperative elects to pass none, part, or all of its DPAD through to its members. Therefore, the cooperative's election to pass through DPAD to its members has no effect on the members' DPGR.

Example 10. Joe Corngrower, from **Example 9,** cannot include the payments he received from Ruraltown in his DPGR because Ruraltown has characterized those payments as PURPIM and patronage dividends. This is true even if Ruraltown passed none of its DPAD through to its members.

Effect of 5% Safe Harbor. There is no guidance on the interaction of Treas. Reg. §1.199-6(l) (prohibiting double counting) and the safe harbor under Treas. Reg. §1.199-1(d)(3)(i) that allows a taxpayer to treat all receipts as DPGR if less than 5% of the taxpayer's total gross receipts are non-DPGR. This raises a question as to whether a patron who qualifies for the 5% safe harbor can include qualified payments from a cooperative in DPGR because all receipts are included under the safe harbor. An alternative interpretation is that Treas. Reg. §1.199-6(l) overrides the 5% safe harbor and excludes the qualified payments from the patron's DPGR.

In general, a more specific rule takes precedence over a more general rule if the two rules are in conflict. Because Treas. Reg. §1.199-6(l) is the more specific rule in this case, it would seem to take precedence over the 5% safe harbor.

69. Treas. Reg. §1.199-6(l).

Cooperative's DPAD Is Not Reduced. IRC §199(d)(3) and Treas. Reg. §1.199-6 do not explicitly state the effect of a cooperative's election to pass its DPAD through to its patrons. Neither the Code nor the regulations require the cooperative to reduce its DPAD deduction. However, Example 2 of Treas. Reg. §1.199-6(m) allows the cooperative to deduct the full amount of the DPAD that it passed through to its patrons. In addition, the IRS ruled that a cooperative remains entitled to claim the entire §199 deduction on its return (provided that it does not create or increase a patronage tax loss).[70]

IRC §199(d)(3)(B) and Treas. Reg. §1.199-6(b) require the cooperative to reduce the deduction it would otherwise claim against its taxable income under IRC §1382(b) for per-unit retain allocations and patronage dividends by the amount of the DPAD that it elects to pass through to its patrons. This reduction has the same effect on the cooperative's taxable income as reducing the cooperative's DPAD by the amount of the DPAD passed through to the cooperative.

Reporting on Farmers' Tax Returns

Based on the preceding analysis, many of the questions raised by the Form 1009-PATR and DPAD statements that are presently being sent to farmers by cooperatives can be addressed.

Question A. The original 2008 Form 1099-PATR my client received from her cooperative reported $10,000 in box 3, which is the per-unit retain that she received in January 2008 based on the grain she marketed through the cooperative in 2007. An amended 2008 Form 1099-PATR increases the amount reported in box 3 by the $100,000 of grain she delivered in 2008 and for which she was paid in 2008. If this entire amount is reported on line 5b of Schedule F (Form 1040), the grain sales will be included in income twice. How should the amount in box 3 be reported?

Answer A. By reporting the $100,000 the member received for grain sales in box 3 of Form 1099-PATR, the cooperative is stating that the payment for grain is a per-unit retain paid in money (PURPIM). That determination is based on the membership agreement. Because of that determination, the $100,000 from the cooperative for the grain should be included on both lines 5a and 5b of Schedule F.

2	Cost or other basis of livestock and other items reported on line 1	2				
3	Subtract line 2 from line 1				3	
4	Sales of livestock, produce, grains, and other products you raised				4	
5a	Cooperative distributions (Form(s) 1099-PATR)	5a	110,000	5b Taxable amount	5b	110,000
6a	Agricultural program payments (see page F-3)	6a		6b Taxable amount	6b	
7	Commodity Credit Corporation (CCC) loans (see page F-3):					
a	CCC loans reported under election				7a	
b	CCC loans forfeited	7b		7c Taxable amount	7c	
	...proceeds and federal crop disaster payments (see page F-3):					

Note. Reporting the $100,000 for grain as part of the PURPIMs on line 5b of Schedule F (Form 1040) is consistent with the Treas. Reg. §1.199-6(l) statement that those payments are not included in the member's DPGR. Your client's 2008 DPGR does not include the $100,000 she received for the grain.

Question B. This same client received a statement from her cooperative indicating it elected to pass through 60% of its DPAD to its members, and the client's share of the pass-through is $3,600. The $3,600 is reported in box 6 of her 2008 Form 1099-PATR and on line 21 of the client's 2008 Form 8903, *Domestic Production Activities Deduction*. Because that amount is only 60% of the DPAD that the cooperative could have passed through to the client, can 40% of her $100,000 grain sales in her 2008 DPGR be used to calculate her DPAD?

Answer B. **No,** because the cooperative determined that its payments for members' grain are advance payments of PURPIMs, those payments are not included in the members' DPGR regardless of the cooperative's election to pass through some, all, or none of its DPAD.

70. Ltr. Rul. 200838011 (Sep. 19, 2008).

Question C. The taxpayer received a 2008 Form 1099-PATR with $270,000 in box 3. That amount matches the $20,000 he received in PURPIMs in 2008 and $250,000 of his milk checks received in 2007. The $250,000 is reported as milk income on his 2007 income tax return. How should the $270,000 shown in box 3 be reported on his 2008 income tax return?

Some cooperatives calculated the passed-through 2008 DPAD based on the commodities the member delivered in 2007. They then reported the 2007 payments for commodities in box 3 of the 2008 Form 1099-PATR so that it is consistent with the DPAD that is passed through in box 6 of the 2008 Form 1099-PATR. With hindsight, the cooperative agreed that the 2007 payments should have been reported in box 3 of the 2007 Form 1099-PATR. However, the cooperative did not send amended Forms 1099-PATR.

Answer C. To work around this reporting problem, the full $270,000 from box 3 of Form 1099-PATR is reported on line 5a of the 2008 Schedule F, only $20,000 is reported on line 5b. A statement should be attached to the return that indicates the $250,000 was reported as milk income on the client's 2007 income tax return.

If the $250,000 of milk income was included in the client's DPGR to calculate the client's 2007 DPAD, the client should be advised to amend the 2007 tax return in order to report a DPAD that is based on DPGR without the $250,000 of milk income. That is true whether or not the cooperative elected to pass its DPAD through to its members. The cooperative's determination that the 2007 payments for milk are advance payments of PURPIM excludes those payments from the members' DPGR without regard to the cooperative's DPAD pass-through election.

Question D. A client is a member of a cooperative that received a private letter ruling in 2008. The cooperative sent two statements to the client — both in August of 2008. One reported the client's 2007 DPAD, and the other reported his 2008 DPAD. The 2008 Form 1099-PATR shows the DPAD for both years in box 6 as a deduction for the 2008 calendar year. Can the taxpayer take only the 2008 DPAD and file an amended return for 2007 using the 2007 DPAD allocation, or must he take the DPAD for both years in 2008?

Answer D. The statements from the cooperative appear to be inconsistent with the Form 1099-PATR. The taxpayer could request corrected Forms 1099-PATR for both 2007 and 2008. If the cooperative does not provide the corrected forms, the DPAD shown in the statements could be reported on an amended 2007 return and an original 2008 return with a statement attached to each return explaining that the DPAD statements and Forms 1099-PATR did not match.

Question E. Does the 2008 per-unit retain allocation include the grain sold on a deferred payment contract that the cooperative member received in 2009?

Answer E. No. If the cooperative determined that payments to its members for grain are advance PURPIM, the deferred payments received in 2009 are PURPIM in 2009 and should be reported as per-unit retain allocations on the 2009 Form 1099-PATR. If the cooperative determined that payments to its members for grain are grain purchases, the deferred payments are not per-unit retain allocations in either 2008 or 2009. They are grain sales revenue in 2009.

SUMMARY

By itself, the DPAD is complicated and confusing. The tax rules for a cooperative's DPAD are even more complicated, and they are different from the rules that apply to other entities. In addition, the differences among cooperatives adds to the confusion. Some of the more complex issues follow:

1. Payments from cooperatives for members' commodities were traditionally reported by the cooperative and the members as a sale of the commodity to the cooperative. The DPAD rules encourage cooperatives to look more closely at that characterization because of the tax benefits of treating those payments as PURPIM. Many cooperatives concluded those payments are PURPIM and therefore do not have to be subtracted from the cooperative's DPGR to compute their QPAI. Another consequence of that characterization is that the members cannot include the payments they receive from the cooperative in their DPGR when they compute their own DPAD.

2. The cooperative chooses how much, if any, of its DPAD it passes through to its members. The cooperative's choice has no effect on its members' DPGR because members cannot include PURPIM or patronage dividends in their DPGR regardless of the cooperative's choice of how much DPAD is passed through to members.

3. Some cooperatives calculated their 2008 DPAD based on commodities delivered to them in 2007 while others computed their 2008 DPAD based on commodities delivered to them in 2008. The year on which the DPAD is based affects the members of the cooperative because, in most cases, this is the first year the cooperative treated all its payments to its members as PURPIM or patronage dividends. Therefore, it is the first year the members must exclude all payments from the cooperative from their DPGR. Additionally, cooperatives may use a fiscal year instead of a calendar year for their tax reporting; this can create further confusion regarding the amounts reported.

ISSUE 8: UNHARVESTED CROPS

OVERVIEW

The presence of unharvested crops in a decedent's estate raises income tax issues and, if the estate is large enough, estate tax issues. The matter can be complicated if the decedent's farmland was rented and crop rent had accrued but had not yet been received as of the date of the decedent's death.

There are several possible ways to determine the value of unharvested crops.[71]

1. Value the crop by discounting it by the amount of risk involved between the date of death and harvest with the amount of risk associated with the lease.

2. Value the crop by the amount of a loan, secured by the crop that could have been negotiated as of the date of death or other means to determine the investment made in the growing crop.

3. Prorate the allocation of the crop proceeds between the pre-death and post-death periods. It is this pro-rata approach that the IRS utilizes to address both estate tax and income tax issues involving unharvested crops in a decedent's estate. This is the simplest and least beneficial to the decedent's estate.

71. The following possible ways to value an unharvested crop were suggested to the author as a first-year practicing attorney by Donald H. Kelley, then of Kelley, Scritsmier and Byrne in North Platte, NE.

CHARACTER OF INCOME AND BASIS ISSUES

General Rule

Under the general rule, property interests of a decedent that the decedent owns at death are valued for estate tax purposes at their FMV as of the decedent's date of death.[72] For income tax basis purposes, the basis of property that is included in a decedent's estate equals the value of the property as of the decedent's date of death.[73] This is generally known as the stepped-up basis rule, although it is also possible that property values could have declined after the date of death. The rule operates to eliminate any taxable gain in the property upon later sale by an heir at the date-of-death value.

Exception

Income in respect of decedent (IRD) property does not receive a step up in basis.[74] IRD is taxable income that is received after a taxpayer died. It is income the taxpayer earns before death, but is not included on the decedent's final income tax return because the taxpayer was not eligible or chose not to collect the income before death. IRD is subject to both income tax and estate tax.

IRD does not receive a stepped-up basis by virtue of being included in the decedent's estate, but **the recipient of the IRD is entitled to an income tax deduction for the federal estate tax that is attributable to the IRD as a result of its inclusion in the decedent's estate.** The deduction occurs in the year the income from IRD property is recognized.[75] The deduction is computed at the average estate tax rate and is determined by the ratio that the value of the items bear to the gross estate. The deduction is allowed regardless of whether the IRD item is used to fund a marital deduction for the surviving spouse (in the estate of the first spouse to die). Thus, in larger estates, it may be a wise practice to fund the marital deduction with IRD items or with property items that are intended to be held by the recipient rather than resold or which have relatively low appreciation.

Application of the IRD Rule

The IRD issue depends on the status of the decedent at the time of death. Two questions are relevant:

1. Was the decedent an operating farmer or a farm landlord?
2. If the decedent was a farm landlord, was the decedent a materially-participating landlord or a nonmaterially-participating landlord?

Operating Farmers and Materially-Participating Landlords. For operating farmers (including a materially-participating farm landlord) unsold livestock, growing crops, and grain inventories are **not** IRD.[76] The rule is the same if the decedent was a landlord under a material-participation lease.[77] Those assets are included in the decedent's gross estate and receive a new basis equal to their FMV as of the decedent's death.[78] No allocation is made between the decedent's estate and the decedent's final income tax return.[79]

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72. IRC §2031.

73. IRC §1014(a)(1).

74. IRC §691.

75. IRC §691(c).

76. Rev. Rul. 58-436, 1958-2 CB 355.

77. Rev. Rul. 64-289, 1964-2 CB 173. While the Code and the Treasury Regulations are unclear on the issue, it appears that the decedent could achieve material participation through an agent.

78. See, e.g., *Estate Of Tompkins v. Comm'r,* 13 TC 1054 (1949). This is the rule for decedents on the cash method. For those on the accrual method, the items would be included in the decedent's closing inventory on the final return.

79. Treas. Reg. §20.2031-1(b).

Nonmaterially-Participating Landlords. For nonmaterially-participating farm landlords that die during a rent period, the issue is more complex. If a cash-basis landlord rents out land under a nonmaterial-participation lease, the landlord normally includes the rent in income when the crop share is reduced to cash or a cash equivalent, not when the crop share is first delivered to the landlord. In this situation, a portion of growing crops or crop shares or livestock that are sold post-death are IRD and a portion are post-death ordinary income to the landlord's estate. That is the result if the crop share is received by the landlord before death but is not reduced to cash until after death. It is also the result if the decedent had the right to receive the crop share and the share is delivered to the landlord's estate and then reduced to cash. In essence, an allocation is made with the portion of the proceeds allocable to the pre-death period (in both situations) being IRD in accordance with a formula set forth in Rev. Rul. 64-289.[80] In these situations, IRD is not incurred until the crop share is sold. However, if the landlord received the crop share and sold it **before** death, the income realized is includable on the landlord's final return and is not IRD.[81]

> **Note.** If the estate sells crops within six months after death, the income from the sale is treated as long-term capital gain if the basis in the crops is not IRD (if the basis in the crops was determined under the IRC §1014 date-of-death FMV rule).[82]

The allocation formula set forth in Rev. Rul. 64-289 splits out the IRD and estate income based on the number of days in the rental period before and after death.

Example 11. On February 4, 2008, Jerry Mander leased his farm to a tenant on a 60/40 crop-share lease (i.e., Jerry gets 40% of the crop and pays for 40% of the expenses). The lease ran from March 1, 2008, through February 28, 2009, and was for the growing of corn and soybeans on Jerry's farm. Jerry died on July 4, 2008. The tenant harvested the corn on October 15 and sold it later the same day for $135,000. The soybeans were harvested on October 7 and stored. The soybeans were later sold on January 27, 2009, for $40,000.

The allocation formula operates as follows: The lease period was for 365 days (March 1 to February 28) and Jerry was alive for 126 of those days. Therefore, 126/365 of the amount that the estate received for the corn is IRD, or $18,641 (40% × $135,000 × (126/365)).

The balance of the amount received by the estate is $35,359 ((40% × $135,000) – $18,641), which is taxable to the estate as ordinary income. The entire amount that the estate received for the soybeans is $16,000 ($40,000 × 40%) which is taxable to the estate as ordinary income.

80. Rev. Rul. 64-289, 1964-2, CB 173 (1964). The formula is directed to decedents who were on the cash method and specifies that for decedents dying during the rent period, only the crop (or livestock share) rents attributable to the rent period ending with the decedent's death are IRD.

81. Ibid.

82. IRC §1223(11). This treatment does not apply to cattle (which must be held for 24 months) or other livestock (which must be held for 12 months) if the animals were used in the decedent's trade or business and were held for draft, breeding, or sporting purposes. Rev. Rul. 75-361, 1975-2 CB 344. The ruling points out that there is no exception under IRC §1223(11) from the special holding period requirements of 24 months for cattle and 12 months for other livestock. See IRC §§1231(b)(3)(A)-(B). However, the holding period requirements do not apply to livestock held for sale, such as nonreplacement calves. This type of livestock, if included in the estate of an active operator or a materially-participating landlord, are classified as property and are entitled to a basis equal to the date of death value, and any resulting gain upon sale is entitled to long-term capital gain treatment.

> **Note.** If Jerry had died **after** the crop shares were sold (but before the end of the rental period), the proceeds would have been reported on Jerry's final return. No proration would have been required.
>
> If Jerry had received his crop share in-kind and held it until death, with the heirs selling it after death, the sale proceeds would be allocated between IRD and ordinary income of the estate under the formula set forth above.
>
> Expenses attributable to IRD items are deducted on Schedule K of Form 706, *United States Estate (and Generation-Skipping Transfer) Tax Return,* and are also deducted on the income tax return of the person or estate when the expense item is paid.

IRD results from crop-share rents of a nonmaterially-participating landlord that are fed to livestock **before** death if the animals are also owned on shares. If the decedent utilized the livestock as a separate operation from the lease, the in-kind crop-share rents (e.g., hay, grain) would be treated as any other asset in the farming operation — included in the decedent's gross estate and entitled to a date-of-death FMV basis.

Crop-share rents fed to livestock after the landlord's death are treated as a sale at the time of feeding[83] with an offsetting deduction.

Deceased Farm Landlords — Crop-Rental Income

Crop rents that have accrued as of the date of the decedent's death but which the decedent did not receive before death are included in the decedent's gross estate.[84] They are not allocated between the estate and the decedent's final income tax return.[85] According to the IRS, a crop rent which is not payable until harvest is included in the decedent's gross estate, to the extent it has accrued, even though the decedent died before harvest. For estate tax valuation purposes, the crop is valued as of the date of death or six months after death if the executor makes an alternate-valuation election.[86]

If an alternate-valuation election is made, any increase in value attributable to crop growth during the 6-month alternate-valuation period is not directly included in the gross estate.[87] Instead, the crop value (for both date-of-death and alternate-valuation purposes) is allocated between the pre-death and post-death period in accordance with a formula. The formula multiplies the crop value by a fraction, the numerator of which is the number of days in the part of the rental period ending with the decedent's date of death, and the denominator is the total number of days in the rental period. When the crop is later sold (or fed to livestock) this formula is applied to the sale proceeds (or the value of the crop on the date of disposition by feeding to livestock) to determine which portion of the crop rental is IRD and which portion is income to the estate.

83. Rev. Rul. 75-11, 1975-1 CB 27.

84. IRC §691(c).

85. Ibid.

86. IRC §2032.

87. Compare Ltr. Rul. 7743007 and Ltr. Rul. 7805008.

ISSUE 9: ASSET ALLOCATION OF A FARM PURCHASE

When a farm is purchased, the buyer and seller often find it desirable to come to an agreement about the allocation of the purchase price among the various components of the farm purchase. This, however, may not fall under the business acquisition rule which provides for setting forth this agreement. In general, Form 8594, *Asset Acquisition Statement Under Section 1060*, will not be required when only a tract of land is purchased from an existing farming operation and does not comprise the entire farming operation. However, the buyer and seller must generally file Form 8594 and both must attach it to their tax returns when the purchase involves a group of assets comprising an existing trade or business of the seller, the buyer, or both.[88]

> **Note.** The concept of trade or business for purposes of the Form 8594 filing requirement applies only to a group of assets if goodwill or going-concern value could, under any circumstance, attach to the assets. In addition, the penalty provisions of IRC §§6271–6274 can be applied to situations in which a Form 8594 was required to be filed but was omitted.

Absent an agreement between the buyer and seller, the buyer must allocate the purchase price to the various assets that are acquired in the transaction. In general, the purchase-price allocation is based on FMVs of the assets acquired. Numerous documents can be used for the purpose of making this determination. For example, insurance policies may specify not only the replacement value of the insured assets, but also their FMVs. Also, the county assessor may maintain data on the value of improvements and buildings on the property for property tax purposes, and appraisers may be contacted for their expert estimation of FMV.

In addition to farm buildings, single-purpose agricultural or horticultural structures, silos, grain bins and machine sheds, consideration should also be given to the extent of fencing and drainage tile on the property. Fencing of moderate age is generally valued at $1 per foot, and tiling in the range of $1–2 per foot.

> **Note.** For drainage tile, the buyer may find it useful to enlist the help of someone either familiar with the purchased property or who has farmed the ground to determine the location and extent of existing tile lines and draw a tile map.

Once the FMVs of the respective items involved in the purchase are compiled, the values can be subtracted from the purchase price of the total property in order to determine the value of the raw underlying nondepreciable farmland.

> **Observation.** In certain situations, this approach may lead to a value placed on the farmland that is unacceptably low. In that event, an FMV appraisal of the farmland should be obtained. The purchase price should then be allocated on a pro-rata FMV basis.

If the purchase-price allocation appears to have been done in a reasonable and rational manner, the IRS usually accepts the allocation. In addition, if the primary issue involves the IRC §1250 property and raw land, the buyer and seller may be able to come to an agreement as to the allocation which is not detrimental to the seller's capital gain treatment of the sale proceeds. In that situation, an agreed-upon allocation should be attempted because an agreement between the parties usually makes it more difficult for the IRS to contest the matter.

88. However, Form 8594 need not be filed for transactions involving like-kind exchanges and transfers of partnership interests.

Example 12. Land Holding, LLC, purchases a 160-acre farm for a total price of $960,000. The property includes a house, machine shed, hog-finishing facility, electrical system, and grain storage for 30,000 bushels. Eighty acres of the farm was recently tiled. Land Holding, LLC, allocates the purchase price as follows with the tax deduction attributes noted:

Land	$725,000	No depreciation, basis addition only
House	60,000	27.5 yrs. depreciation
Machine shed	30,000	20 yrs. depreciation
Hog-finishing facility	90,000	10 yrs. depreciation, eligible for §179 expense
Electrical system	5,000	7 yrs. depreciation, eligible for §179 expense
Grain storage	18,000	7 yrs. depreciation, eligible for §179 expense
80 acres tiled	32,000	15 yrs. depreciation, eligible for §179 expense
Total purchase price	$960,000	

The allocation worksheet and a description showing how the values were obtained should be kept as part of the buyer's permanent records. This will be helpful if the IRS challenges the allocation in an audit.

ISSUE 10: TRADING VERSUS SELLING FARM MACHINERY

OVERVIEW

When farm machinery needs to be replaced, which is the best tax strategy — trading or selling? From a tax standpoint, the answer may depend on numerous factors which should be considered to achieve the optimal tax result.

COMPARING A TRADE WITH A PURCHASE

Income Tax Basis and Depreciation Issues

When an old machine is traded for a replacement machine, the replacement machine has an income tax basis equal to the old machine's basis plus any cash paid (known as boot).[89] If the transaction is structured as an outright purchase, the taxpayer's basis is the amount paid for the new machine.[90]

> **Note.** Because of the basis rules, a purchased machine often has a higher income tax basis in the taxpayer's hands than a machine obtained in a trade. Accordingly, the annual depreciation deductions are higher for purchased machinery than for a machine acquired by trade.

Depreciation Recapture

In order to determine whether a higher basis in a purchased machine generates greater depreciation deductions in future years as compared to tax savings that result in trading a machine, the taxpayer's combined marginal income and SE tax rate and the amount of triggered depreciation recapture on the sale of the used machine must be analyzed. Depreciation is recaptured and taxed at ordinary income rates if the selling price of the used machine is greater than the asset's income tax basis.

Depreciation recapture on the sale of farm machinery is more important in recent years because of the substantial increase in the §179 expense method depreciation election and the reenactment of bonus depreciation available for qualified assets acquired in 2008 and 2009.[91]

89. IRC §1031(d).

90. IRC §1012.

91. IRC §168(k). The bonus first-year depreciation allowance applies to "qualified property" and is claimed in the first year that the property is placed in service by the taxpayer for use in its trade or business or for the production of income. The bonus amount is equal to 50% of the unadjusted depreciable basis of property acquired after Dec. 31, 2007, and before Jan. 1, 2010.

Whether §179 expensing (limited to $250,000 annually for 2008 and 2009) or first-year bonus depreciation is claimed on an asset plays a significant role in determining whether a sale or a trade is the better income tax strategy. Certainly, if a transaction is structured as a trade, the recognition of gain on the sale is deferred, thereby removing the issue of depreciation recapture (which could loom large if either bonus or §179 expense was utilized on the asset). Assets on which either bonus or §179 expensing was utilized that are sold before the end of their recovery lives face artificially lower bases and sustain larger depreciation recapture in the form of higher taxes.

Observation. A §179 expense election can be made **or revoked** on an amended return for a taxable year beginning after 2007 and ending before 2011.[92] The IRS later reaffirmed the point in a Chief Counsel Information letter in which it stated that such an election or revocation can be made without the Commissioner's consent and before the issuance of Treasury Regulations on the matter, and that taxpayers can rely on the guidance provided in Rev. Proc. 2008-54.[93] The ability to make (and especially the ability to revoke) a §179 expense election after the fact provides tremendous planning flexibility for asset acquisitions and dispositions and should be factored into the decision of whether to sell or trade an item of farm machinery.

Impact on SE Income

If a transaction involving the disposition of farm machinery is structured as a sale, no SE tax results. If the transaction qualifies as a like-kind exchange, depreciation claimed on the boot paid for farm machinery received in the exchange reduces SE income by a like amount. Consequently, practitioners must evaluate each proposed transaction to determine if it is in the client's best interest to sell (rather than exchange) the item of machinery, recognize the gain, receive a higher depreciable basis in the new item of machinery, and not incur SE tax on the income from the sale.

Tax Planning Implications

As mentioned above, assets that are sold at a price that exceeds the asset's basis, the gain from depreciation recapture, and capital gain are included in income in the year that the sale proceeds are received. For a traded item, the basis of the replacement asset is the basis of the asset traded plus any boot. This often means lower depreciation deductions in future years. Trading results in a shift of taxable income from the current year to future years. This could be a tax-saving technique if the result is to shift income from a high-tax-bracket year to a year in which the applicable tax bracket is lower. Conversely, a sale of an asset rather than a trade triggers gain in the year of sale.

Note. In some states, sales tax must be paid on the net price of farm machinery that is acquired in a trade. In those states, depending on the amount of boot involved in a trade, the taxpayer needs to consider how the impact of state sales tax affects the decision on how to structure the transaction.

In order to determine the most appropriate tax structure for the disposition of an item of farm machinery, a comparison must be made of the benefit of a higher income tax basis against the near-term depreciation recapture when machinery is sold, along with potential reduction of SE tax.

92. Rev. Proc. 2008-54, 2008-38 IRB 722, Section 7.

93. INFO 2009-0059 (Feb. 17, 2009).

Example 13. Pete and Sandy Moss, a married couple with no children (filing as MFJ) need to replace an old combine with a new one. Assume Pete and Sandy can sell their old combine for $35,000. It has an income tax basis of $0 (original purchase price minus accumulated depreciation). The dealer has agreed to a $40,000 value if the old combine is traded for a new combine. The new combine will cost Pete and Sandy $135,000 if they buy it outright. The cost of the new combine if they acquired it in a trade would be $95,000 cash. Pete and Sandy's marginal income tax rate is 25%. When the self-employment tax is considered, the total marginal rate is 38%.

The following table shows the reporting of the transaction in two different scenarios:

- **Scenario 1.** A **sale** of the old combine for $35,000, with $135,000 of §179 expense claimed on the new combine purchased
- **Scenario 2.** A **trade** of the old combine and $95,000 of §179 expense claimed on the new combine

	Sale/Purchase	Trade
Gross farm income	$135,000	$135,000
Depreciation	(135,000)	(95,000)
Net farm income	$ 0	$ 40,000
Wage income	83,000	83,000
Form 4797 gains	35,000	0
Total income	$118,000	$123,000
AGI	118,000	120,176
Income tax	17,713	18,256
SE tax	0	5,501
Total federal tax	$ 17,713	$ 23,908

The sale strategy results in $6,195 less tax liability than the trade strategy. Of this amount, $5,652 is SE tax savings produced by smaller net farm income as a result of a larger §179 deduction. In general, a sale followed by a purchase produces less tax liability than a trade until the full amount of the §179 deduction is utilized. See the following forms illustrating the two scenarios.

Ensuring the Desired Tax Treatment of the Transaction. Pete and Sandy must take care to structure their transaction properly to achieve the desired tax treatment. If they want to trigger gain on the disposition of the old combine, the transaction must be structured in a manner to avoid triggering the like-kind exchange rules. Like-kind exchange treatment is not elective. The gain is deferred only if the transaction qualifies as a like-kind exchange. Pete and Sandy must structure the transaction to qualify under the like-kind exchange rules in order to defer treatment of the gain.

If Pete and Sandy strike a deal with the implement dealer under which the dealer agrees to buy their old combine and pay them directly for it, followed by Pete and Sandy buying the new combine from the dealer for the full purchase price, the transaction is still considered a trade and not a sale. In Rev. Rul. 61-119, the IRS ruled that such facts indicated that the sale and purchase are reciprocal and mutually-dependent transactions. Thus, they are governed by IRC §1031 even though the sale and purchase were accomplished by separately-executed contracts and were treated as unrelated transactions by the taxpayer and the dealer for recordkeeping purposes.[94]

94. Rev. Rul. 61-119, 1961-1 CB 395.

If Pete and Sandy want sale rather than trade treatment, they need to ensure that the sale and purchase transactions are clearly separate, unrelated, and independent of each other. This may be accomplished by:

- Utilizing different dealers for the sale and purchase;
- Allowing time to pass (in terms of days or weeks) between the sale and purchase; or
- Purchasing a different type of machinery than the machinery sold and having a nontax reason for the acquisition of the new machinery.

Note. A good example of a court's analysis of whether a sale and purchase are independent transactions can be found in *C. Bean Lumber Transport, Inc.*[95] That case involved the plaintiff's disposition of used trucks and acquisition of new trucks. The plaintiff treated the transaction as a like-kind exchange, but the IRS disagreed. The court ruled that the transaction did **not** qualify as a like-kind exchange primarily because there was no evidence that the cash that the plaintiff received for the used trucks was applied in any way to the financed debt on the new trucks.

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95. *C. Bean Lumber Transport, Inc. v. U.S.*, 68 F.Supp.2d 1055 (W.D. Ark. 1999).

For Example 13 (Sale/Purchase)

Form 1040 Department of the Treasury—Internal Revenue Service
U.S. Individual Income Tax Return 2008 (99) IRS Use Only—Do not write or staple in this space.

For the year Jan. 1–Dec. 31, 2008, or other tax year beginning , 2008, ending , 20 — OMB No. 1545-0074

Label (See instructions on page 14.) **Use the IRS label.** Otherwise, please print or type.

Your first name and initial: Pete	Last name: Moss
Your social security number	123 45 6789
If a joint return, spouse's first name and initial: Sandy	Last name: Moss
Spouse's social security number	987 65 4321
Home address (number and street). If you have a P.O. box, see page 14.	Any Street
Apt. no.	
City, town or post office, state, and ZIP code. If you have a foreign address, see page 14.	Anytown, IA 5000

▲ You **must** enter your SSN(s) above. ▲

Presidential Election Campaign ▶ Check here if you, or your spouse if filing jointly, want $3 to go to this fund (see page 14) ▶ ☐ You ☐ Spouse

Checking a box below will not change your tax or refund.

Filing Status

Check only one box.

1 ☐ Single
2 ☒ Married filing jointly (even if only one had income)
3 ☐ Married filing separately. Enter spouse's SSN above and full name here. ▶
4 ☐ Head of household (with qualifying person). (See page 15.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶
5 ☐ Qualifying widow(er) with dependent child (see page 16)

Exemptions

6a ☒ **Yourself.** If someone can claim you as a dependent, **do not** check box 6a
b ☒ **Spouse**
Boxes checked on 6a and 6b: 2

c **Dependents:**

(1) First name Last name	(2) Dependent's social security number	(3) Dependent's relationship to you	(4) ✓ if qualifying child for child tax credit (see page 17)
			☐
			☐
			☐
			☐

If more than four dependents, see page 17.

No. of children on 6c who:
- lived with you
- did not live with you due to divorce or separation (see page 18)

Dependents on 6c not entered above

d Total number of exemptions claimed — Add numbers on lines above ▶ 2

Income

Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld.

If you did not get a W-2, see page 21.

Enclose, but do not attach, any payment. Also, please use Form 1040-V.

7	Wages, salaries, tips, etc. Attach Form(s) W-2	7	83,000
8a	**Taxable** interest. Attach Schedule B if required	8a	
b	**Tax-exempt** interest. **Do not** include on line 8a — 8b		
9a	Ordinary dividends. Attach Schedule B if required	9a	
b	Qualified dividends (see page 21) — 9b		
10	Taxable refunds, credits, or offsets of state and local income taxes (see page 22)	10	
11	Alimony received	11	
12	Business income or (loss). Attach Schedule C or C-EZ	12	
13	Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ ☐	13	
14	Other gains or (losses). Attach Form 4797	14	35,000
15a	IRA distributions — 15a; **b** Taxable amount (see page 23)	15b	
16a	Pensions and annuities — 16a; **b** Taxable amount (see page 24)	16b	
17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E	17	
18	Farm income or (loss). Attach Schedule F	18	
19	Unemployment compensation	19	
20a	Social security benefits — 20a; **b** Taxable amount (see page 26)	20b	
21	Other income. List type and amount (see page 28)	21	
22	Add the amounts in the far right column for lines 7 through 21. This is your **total income** ▶	22	118,000

Adjusted Gross Income

23	Educator expenses (see page 28)	23	
24	Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ	24	
25	Health savings account deduction. Attach Form 8889	25	
26	Moving expenses. Attach Form 3903	26	
27	One-half of self-employment tax. Attach Schedule SE	27	
28	Self-employed SEP, SIMPLE, and qualified plans	28	
29	Self-employed health insurance deduction (see page 29)	29	
30	Penalty on early withdrawal of savings	30	
31a	Alimony paid **b** Recipient's SSN ▶	31a	
32	IRA deduction (see page 30)	32	
33	Student loan interest deduction (see page 33)	33	
34	Tuition and fees deduction. Attach Form 8917	34	
35	Domestic production activities deduction. Attach Form 8903	35	
36	Add lines 23 through 31a and 32 through 35	36	0
37	Subtract line 36 from line 22. This is your **adjusted gross income** ▶	37	118,000

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see page 88. Cat. No. 11320B Form **1040** (2008)

For Example 13 (Sale/Purchase)

Form 1040 (2008) **PETE AND SANDY MOSS** **123-45-6789** Page **2**

Tax and Credits

38	Amount from line 37 (adjusted gross income)	38	118,000
39a	Check if: ☐ **You** were born before January 2, 1944, ☐ Blind. ☐ **Spouse** was born before January 2, 1944, ☐ Blind. Total boxes checked ▶ 39a		
b	If your spouse itemizes on a separate return or you were a dual-status alien, see page 34 and check here ▶ 39b ☐		
c	Check if standard deduction includes real estate taxes or disaster loss (see page 34) ▶ 39c ☐		
40	**Itemized deductions** (from Schedule A) **or** your **standard deduction** (see left margin)	40	10,900
41	Subtract line 40 from line 38	41	107,100
42	If line 38 is over $119,975, or you provided housing to a Midwestern displaced individual, see page 36. Otherwise, multiply $3,500 by the total number of exemptions claimed on line 6d	42	7,000
43	**Taxable income.** Subtract line 42 from line 41. If line 42 is more than line 41, enter -0-	43	100,100
44	**Tax** (see page 36). Check if any tax is from: a ☐ Form(s) 8814 b ☐ Form 4972	44	17,713
45	**Alternative minimum tax** (see page 39). Attach Form 6251	45	0
46	Add lines 44 and 45 ▶	46	17,713
47	Foreign tax credit. Attach Form 1116 if required	47	
48	Credit for child and dependent care expenses. Attach Form 2441	48	
49	Credit for the elderly or the disabled. Attach Schedule R	49	
50	Education credits. Attach Form 8863	50	
51	Retirement savings contributions credit. Attach Form 8880	51	
52	Child tax credit (see page 42). Attach Form 8901 if required	52	
53	Credits from Form: a ☐ 8396 b ☐ 8839 c ☐ 5695	53	
54	Other credits from Form: a ☐ 3800 b ☐ 8801 c ☐ ____	54	
55	Add lines 47 through 54. These are your **total credits**	55	
56	Subtract line 55 from line 46. If line 55 is more than line 46, enter -0- ▶	56	17,713

Standard Deduction for—
- People who checked any box on line 39a, 39b, or 39c **or** who can be claimed as a dependent, see page 34.
- All others:

Single or Married filing separately, $5,450

Married filing jointly or Qualifying widow(er), $10,900

Head of household, $8,000

Other Taxes

57	Self-employment tax. Attach Schedule SE	57	
58	Unreported social security and Medicare tax from Form: a ☐ 4137 b ☐ 8919	58	
59	Additional tax on IRAs, other qualified retirement plans, etc. Attach Form 5329 if required	59	
60	Additional taxes: a ☐ AEIC payments b ☐ Household employment taxes. Attach Schedule H	60	
61	Add lines 56 through 60. This is your **total tax** ▶	61	17,713

Payments

62	Federal income tax withheld from Forms W-2 and 1099	62	8,970
63	2008 estimated tax payments and amount applied from 2007 return	63	
64a	**Earned income credit (EIC)**	64a	
b	Nontaxable combat pay election 64b		
65	Excess social security and tier 1 RRTA tax withheld (see page 61)	65	
66	Additional child tax credit. Attach Form 8812	66	
67	Amount paid with request for extension to file (see page 61)	67	
68	Credits from Form: a ☐ 2439 b ☐ 4136 c ☐ 8801 d ☐ 8885	68	
69	First-time homebuyer credit. Attach Form 5405	69	
70	Recovery rebate credit (see worksheet on pages 62 and 63)	70	
71	Add lines 62 through 70. These are your **total payments** ▶	71	8,970

If you have a qualifying child, attach Schedule EIC.

Refund

72	If line 71 is more than line 61, subtract line 61 from line 71. This is the amount you **overpaid**	72	
73a	Amount of line 72 you want **refunded to you.** If Form 8888 is attached, check here ▶ ☐	73a	
b	Routing number ▶ c Type: ☐ Checking ☐ Savings		
d	Account number		
74	Amount of line 72 you want **applied to your 2009 estimated tax** ▶ 74		

Direct deposit? See page 63 and fill in 73b, 73c, and 73d, or Form 8888.

Amount You Owe

75	**Amount you owe.** Subtract line 71 from line 61. For details on how to pay, see page 65 ▶	75	8,743
76	Estimated tax penalty (see page 65) 76		

Third Party Designee

Do you want to allow another person to discuss this return with the IRS (see page 66)? ☒ **Yes.** Complete the following. ☐ **No**

Designee's name ▶ **Preparer** Phone no. ▶ ( ) Personal identification number (PIN) ▶

Sign Here

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Joint return? See page 15. Keep a copy for your records.

Your signature | Date | Your occupation **Farmer** | Daytime phone number ( )

Spouse's signature. If a joint return, **both** must sign. | Date | Spouse's occupation **Homemaker**

Paid Preparer's Use Only

Preparer's signature | Date | Check if self-employed ☐ | Preparer's SSN or PTIN

Firm's name (or yours if self-employed), address, and ZIP code | EIN | Phone no. ( )

Form **1040** (2008)

12

For Example 13 (Sale/Purchase)

SCHEDULE F (Form 1040)
Department of the Treasury Internal Revenue Service (99)

Profit or Loss From Farming

▶ Attach to Form 1040, Form 1040NR, Form 1041, Form 1065, or Form 1065-B.
▶ See Instructions for Schedule F (Form 1040).

OMB No. 1545-0074
2008
Attachment Sequence No. 14

Name of proprietor	Social security number (SSN)
Pete Moss	123 45 6789
A Principal product. Describe in one or two words your principal crop or activity for the current tax year. Grain	B Enter code from Part IV ▶ 1 1 1 1 0 0
C Accounting method: (1) ☒ Cash (2) ☐ Accrual	D Employer ID number (EIN), if any

E Did you "materially participate" in the operation of this business during 2008? If "No," see page F-3 for limit on passive losses. ☒ Yes ☐ No

Part I Farm Income—Cash Method. Complete Parts I and II (Accrual method. Complete Parts II and III, and Part I, line 11.) Do not include sales of livestock held for draft, breeding, sport, or dairy purposes. Report these sales on Form 4797.

1	Sales of livestock and other items you bought for resale	1		
2	Cost or other basis of livestock and other items reported on line 1	2		
3	Subtract line 2 from line 1		3	
4	Sales of livestock, produce, grains, and other products you raised		4	135,000
5a	Cooperative distributions (Form(s) 1099-PATR)	5a	5b Taxable amount 5b	
6a	Agricultural program payments (see page F-3)	6a	6b Taxable amount 6b	
7	Commodity Credit Corporation (CCC) loans (see page F-3):			
a	CCC loans reported under election		7a	
b	CCC loans forfeited	7b	7c Taxable amount 7c	
8	Crop insurance proceeds and federal crop disaster payments (see page F-3):			
a	Amount received in 2008	8a	8b Taxable amount 8b	
c	If election to defer to 2009 is attached, check here ▶ ☐		8d Amount deferred from 2007 8d	
9	Custom hire (machine work) income		9	
10	Other income, including federal and state gasoline or fuel tax credit or refund (see page F-4)		10	
11	**Gross income.** Add amounts in the right column for lines 3 through 10. If you use the accrual method to figure your income, enter the amount from Part III, line 51 ▶		11	135,000

Part II Farm Expenses—Cash and Accrual Method.
Do not include personal or living expenses such as taxes, insurance, or repairs on your home.

12	Car and truck expenses (see page F-5). Also attach **Form 4562**		25	Pension and profit-sharing plans	
13	Chemicals		26	Rent or lease (see page F-6):	
14	Conservation expenses (see page F-5)		26a	Vehicles, machinery, and equipment	
15	Custom hire (machine work)		26b	Other (land, animals, etc.)	
16	Depreciation and section 179 expense deduction not claimed elsewhere (see page F-5)	135,000	27	Repairs and maintenance	
17	Employee benefit programs other than on line 25		28	Seeds and plants	
18	Feed		29	Storage and warehousing	
19	Fertilizers and lime		30	Supplies	
20	Freight and trucking		31	Taxes	
21	Gasoline, fuel, and oil		32	Utilities	
22	Insurance (other than health)		33	Veterinary, breeding, and medicine	
23	Interest:		34	Other expenses (specify):	
23a	Mortgage (paid to banks, etc.)		34a		
23b	Other		34b		
24	Labor hired (less employment credits)		34c		
			34d		
			34e		
			34f		

35	**Total expenses.** Add lines 12 through 34f. If line 34f is negative, see instructions ▶	35	135,000
36	**Net farm profit or (loss).** Subtract line 35 from line 11. Partnerships, see page F-7. • If a profit, enter the profit on both **Form 1040, line 18,** and **Schedule SE, line 1a;** on **Form 1040NR, line 19;** or on **Form 1041, line 6.** • If a loss, you **must** go to line 37.	36	
37	If you have a loss, you **must** check the box that describes your investment in this activity (see page F-7). • If you checked 37a, enter the loss on both **Form 1040, line 18,** and **Schedule SE, line 1a;** on **Form 1040NR, line 19;** or on **Form 1041, line 6.** • If you checked 37b, you **must** attach **Form 6198.** Your loss may be limited.	37a ☐ All investment is at risk. 37b ☐ Some investment is not at risk.	

For Paperwork Reduction Act Notice, see page F-7 of the instructions. Cat. No. 11346H **Schedule F (Form 1040) 2008**

For Example 13 (Sale/Purchase)

Form **4797**

Department of the Treasury
Internal Revenue Service (99)

Sales of Business Property
(Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2))
▶ Attach to your tax return. ▶ See separate instructions.

OMB No. 1545-0184
2008
Attachment Sequence No. 27

Name(s) shown on return: **Pete and Sandy Moss**
Identifying number: **123-45-6789**

1	Enter the gross proceeds from sales or exchanges reported to you for 2008 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20 (see instructions)	1	

Part I **Sales or Exchanges of Property Used in a Trade or Business and Involuntary Conversions From Other Than Casualty or Theft—Most Property Held More Than 1 Year** (see instructions)

2 (a) Description of property	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Gross sales price	(e) Depreciation allowed or allowable since acquisition	(f) Cost or other basis, plus improvements and expense of sale	(g) Gain or (loss) Subtract (f) from the sum of (d) and (e)

3	Gain, if any, from Form 4684, line 45	3	
4	Section 1231 gain from installment sales from Form 6252, line 26 or 37	4	
5	Section 1231 gain or (loss) from like-kind exchanges from Form 8824	5	
6	Gain, if any, from line 32, from other than casualty or theft	6	
7	Combine lines 2 through 6. Enter the gain or (loss) here and on the appropriate line as follows:	7	
	Partnerships (except electing large partnerships) and S corporations. Report the gain or (loss) following the instructions for Form 1065, Schedule K, line 10, or Form 1120S, Schedule K, line 9. Skip lines 8, 9, 11, and 12 below.		
	Individuals, partners, S corporation shareholders, and all others. If line 7 is zero or a loss, enter the amount from line 7 on line 11 below and skip lines 8 and 9. If line 7 is a gain and you did not have any prior year section 1231 losses, or they were recaptured in an earlier year, enter the gain from line 7 as a long-term capital gain on the Schedule D filed with your return and skip lines 8, 9, 11, and 12 below.		
8	Nonrecaptured net section 1231 losses from prior years (see instructions)	8	
9	Subtract line 8 from line 7. If zero or less, enter -0-. If line 9 is zero, enter the gain from line 7 on line 12 below. If line 9 is more than zero, enter the amount from line 8 on line 12 below and enter the gain from line 9 as a long-term capital gain on the Schedule D filed with your return (see instructions)	9	

Part II **Ordinary Gains and Losses** (see instructions)

10 Ordinary gains and losses not included on lines 11 through 16 (include property held 1 year or less):

11	Loss, if any, from line 7	11	( )
12	Gain, if any, from line 7 or amount from line 8, if applicable	12	
13	Gain, if any, from line 31	13	35,000
14	Net gain or (loss) from Form 4684, lines 37 and 44a	14	
15	Ordinary gain from installment sales from Form 6252, line 25 or 36	15	
16	Ordinary gain or (loss) from like-kind exchanges from Form 8824	16	
17	Combine lines 10 through 16	17	35,000
18	For all except individual returns, enter the amount from line 17 on the appropriate line of your return and skip lines a and b below. For individual returns, complete lines a and b below:		
a	If the loss on line 11 includes a loss from Form 4684, line 41, column (b)(ii), enter that part of the loss here. Enter the part of the loss from income-producing property on Schedule A (Form 1040), line 28, and the part of the loss from property used as an employee on Schedule A (Form 1040), line 23. Identify as from "Form 4797, line 18a." See instructions	18a	
b	Redetermine the gain or (loss) on line 17 excluding the loss, if any, on line 18a. Enter here and on Form 1040, line 14	18b	35,000

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 13086I Form **4797** (2008)

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For Example 13 (Sale/Purchase)

Form 4797 (2008) PETE AND SANDY MOSS 123-45-6789 Page 2

Part III **Gain From Disposition of Property Under Sections 1245, 1250, 1252, 1254, and 1255** (see instructions)

19 (a) Description of section 1245, 1250, 1252, 1254, or 1255 property:	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)
A Combine (old)	7/01/00	7/01/08
B		
C		
D		

These columns relate to the properties on lines 19A through 19D. ▶		Property A	Property B	Property C	Property D
20 Gross sales price (**Note:** *See line 1 before completing.*)	20	35,000			
21 Cost or other basis plus expense of sale	21	81,633			
22 Depreciation (or depletion) allowed or allowable	22	81,633			
23 Adjusted basis. Subtract line 22 from line 21	23				
24 Total gain. Subtract line 23 from line 20	24	35,000			
25 **If section 1245 property:**					
a Depreciation allowed or allowable from line 22	25a	81,633			
b Enter the **smaller** of line 24 or 25a	25b	35,000			
26 **If section 1250 property:** If straight line depreciation was used, enter -0- on line 26g, except for a corporation subject to section 291.					
a Additional depreciation after 1975 (see instructions)	26a				
b Applicable percentage multiplied by the **smaller** of line 24 or line 26a (see instructions)	26b				
c Subtract line 26a from line 24. If residential rental property **or** line 24 is not more than line 26a, skip lines 26d and 26e	26c				
d Additional depreciation after 1969 and before 1976	26d				
e Enter the **smaller** of line 26c or 26d	26e				
f Section 291 amount (corporations only)	26f				
g Add lines 26b, 26e, and 26f	26g				
27 **If section 1252 property:** Skip this section if you did not dispose of farmland or if this form is being completed for a partnership (other than an electing large partnership).					
a Soil, water, and land clearing expenses	27a				
b Line 27a multiplied by applicable percentage (see instructions)	27b				
c Enter the **smaller** of line 24 or 27b	27c				
28 **If section 1254 property:**					
a Intangible drilling and development costs, expenditures for development of mines and other natural deposits, and mining exploration costs (see instructions)	28a				
b Enter the **smaller** of line 24 or 28a	28b				
29 **If section 1255 property:**					
a Applicable percentage of payments excluded from income under section 126 (see instructions)	29a				
b Enter the **smaller** of line 24 or 29a (see instructions)	29b				

Summary of Part III Gains. Complete property columns A through D through line 29b before going to line 30.

30 Total gains for all properties. Add property columns A through D, line 24	30	35,000
31 Add property columns A through D, lines 25b, 26g, 27c, 28b, and 29b. Enter here and on line 13	31	35,000
32 Subtract line 31 from line 30. Enter the portion from casualty or theft on Form 4684, line 39. Enter the portion from other than casualty or theft on Form 4797, line 6	32	0

Part IV **Recapture Amounts Under Sections 179 and 280F(b)(2) When Business Use Drops to 50% or Less** (see instructions)

		(a) Section 179	(b) Section 280F(b)(2)
33 Section 179 expense deduction or depreciation allowable in prior years	33		
34 Recomputed depreciation (see instructions)	34		
35 Recapture amount. Subtract line 34 from line 33. See the instructions for where to report	35		

Form **4797** (2008)

For Example 13 (Sale/Purchase)

Form **4562** Department of the Treasury Internal Revenue Service (99)

Depreciation and Amortization
(Including Information on Listed Property)

▶ See separate instructions. ▶ Attach to your tax return.

OMB No. 1545-0172 **2008** Attachment Sequence No. 67

Name(s) shown on return	Business or activity to which this form relates	Identifying number
Pete and Sandy Moss	Schedule F / Form 4835 - Grain	123-45-6789

Part I Election To Expense Certain Property Under Section 179
Note: *If you have any listed property, complete Part V before you complete Part I.*

1	Maximum amount. See the instructions for a higher limit for certain businesses	1	$250,000
2	Total cost of section 179 property placed in service (see instructions)	2	135,000
3	Threshold cost of section 179 property before reduction in limitation (see instructions)	3	$800,000
4	Reduction in limitation. Subtract line 3 from line 2. If zero or less, enter -0-	4	0
5	Dollar limitation for tax year. Subtract line 4 from line 1. If zero or less, enter -0-. If married filing separately, see instructions	5	250,000

	(a) Description of property	(b) Cost (business use only)	(c) Elected cost
6	7-year combine (new)	135,000	135,000
7	Listed property. Enter the amount from line 29	7	0

8	Total elected cost of section 179 property. Add amounts in column (c), lines 6 and 7	8	135,000
9	Tentative deduction. Enter the **smaller** of line 5 or line 8	9	135,000
10	Carryover of disallowed deduction from line 13 of your 2007 Form 4562	10	0
11	Business income limitation. Enter the smaller of business income (not less than zero) or line 5 (see instructions)	11	250,000
12	Section 179 expense deduction. Add lines 9 and 10, but do not enter more than line 11	12	135,000
13	Carryover of disallowed deduction to 2009. Add lines 9 and 10, less line 12 ▶	13	0

Note: *Do not use Part II or Part III below for listed property. Instead, use Part V.*

Part II Special Depreciation Allowance and Other Depreciation (Do not include listed property.) (See instructions.)

14	Special depreciation allowance for qualified property (other than listed property) placed in service during the tax year (see instructions)	14	
15	Property subject to section 168(f)(1) election	15	
16	Other depreciation (including ACRS)	16	

Part III MACRS Depreciation (Do not include listed property.) (See instructions.)

Section A

17	MACRS deductions for assets placed in service in tax years beginning before 2008	17	
18	If you are electing to group any assets placed in service during the tax year into one or more general asset accounts, check here ▶ ☐		

Section B—Assets Placed in Service During 2008 Tax Year Using the General Depreciation System

(a) Classification of property	(b) Month and year placed in service	(c) Basis for depreciation (business/investment use only—see instructions)	(d) Recovery period	(e) Convention	(f) Method	(g) Depreciation deduction
19a 3-year property						
b 5-year property						
c 7-year property						
d 10-year property						
e 15-year property						
f 20-year property						
g 25-year property			25 yrs.		S/L	
h Residential rental property			27.5 yrs.	MM	S/L	
			27.5 yrs.	MM	S/L	
i Nonresidential real property			39 yrs.	MM	S/L	
				MM	S/L	

Section C—Assets Placed in Service During 2008 Tax Year Using the Alternative Depreciation System

20a Class life					S/L	
b 12-year			12 yrs.		S/L	
c 40-year			40 yrs.	MM	S/L	

Part IV Summary (See instructions.)

21	Listed property. Enter amount from line 28	21	
22	**Total.** Add amounts from line 12, lines 14 through 17, lines 19 and 20 in column (g), and line 21. Enter here and on the appropriate lines of your return. Partnerships and S corporations—see instr.	22	135,000
23	For assets shown above and placed in service during the current year, enter the portion of the basis attributable to section 263A costs	23	

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 12906N Form **4562** (2008)

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For Example 13 (Sale/Purchase)

12/31/2008 **2008 Federal Summary Depreciation Schedule** **Page 1**

Pete and Sandy Moss **123-45-6789**

No.	Description	Date Acquired	Date Sold	Cost / Basis	Bus. Pct.	Cur. 179/ SDA	Prior 179/ SDA/ Depr.	Method	Life	Current Depr.
	Schedule F / Form 4835 - Grain									
1	Combine (Old)	07/01/00	07/01/08	81,633			81,633	150DB HY	7	0
2	Combine (New)	07/01/08		135,000		135,000		150DB HY	7	0
	Total			216,633		135,000	81,633			0
	Total Depreciation			216,633		135,000	81,633			0
	Grand Total Depreciation			216,633		135,000	81,633			0
	Depreciation Assests Sold			81,633		0	81,633			0
	Depr Remaining Assests			135,000		135,000	0			0

For Example 13 (Trade)

Form 1040 Department of the Treasury—Internal Revenue Service
U.S. Individual Income Tax Return 2008 (99) IRS Use Only—Do not write or staple in this space.

For the year Jan. 1–Dec. 31, 2008, or other tax year beginning , 2008, ending , 20 OMB No. 1545-0074

Label (See instructions on page 14.) Use the IRS label. Otherwise, please print or type.	Your first name and initial: Pete	Last name: Moss	Your social security number: 123 45 6789
	If a joint return, spouse's first name and initial: Sandy	Last name: Moss	Spouse's social security number: 987 65 4321
	Home address (number and street). If you have a P.O. box, see page 14.: Any Street	Apt. no.	You **must** enter your SSN(s) above.
	City, town or post office, state, and ZIP code. If you have a foreign address, see page 14.: Anytown, IA 5000		Checking a box below will not change your tax or refund.

Presidential Election Campaign ▶ Check here if you, or your spouse if filing jointly, want $3 to go to this fund (see page 14) ▶ ☐ You ☐ Spouse

Filing Status
Check only one box.

1 ☐ Single
2 ☒ Married filing jointly (even if only one had income)
3 ☐ Married filing separately. Enter spouse's SSN above and full name here. ▶
4 ☐ Head of household (with qualifying person). (See page 15.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶
5 ☐ Qualifying widow(er) with dependent child (see page 16)

Exemptions

6a ☒ **Yourself.** If someone can claim you as a dependent, **do not** check box 6a
b ☒ Spouse
Boxes checked on 6a and 6b: 2

c Dependents:

(1) First name Last name	(2) Dependent's social security number	(3) Dependent's relationship to you	(4) ✓ if qualifying child for child tax credit (see page 17)
			☐
			☐
			☐
			☐

If more than four dependents, see page 17.

No. of children on 6c who:
- lived with you
- did not live with you due to divorce or separation (see page 18)

Dependents on 6c not entered above

d Total number of exemptions claimed — Add numbers on lines above ▶ 2

Income

Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld.

If you did not get a W-2, see page 21.

Enclose, but do not attach, any payment. Also, please use **Form 1040-V**.

7	Wages, salaries, tips, etc. Attach Form(s) W-2		7	83,000
8a	**Taxable** interest. Attach Schedule B if required		8a	
b	**Tax-exempt** interest. **Do not** include on line 8a	8b		
9a	Ordinary dividends. Attach Schedule B if required		9a	
b	Qualified dividends (see page 21)	9b		
10	Taxable refunds, credits, or offsets of state and local income taxes (see page 22)		10	
11	Alimony received		11	
12	Business income or (loss). Attach Schedule C or C-EZ		12	
13	Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ ☐		13	
14	Other gains or (losses). Attach Form 4797		14	
15a	IRA distributions 15a	b Taxable amount (see page 23)	15b	
16a	Pensions and annuities 16a	b Taxable amount (see page 24)	16b	
17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E		17	
18	Farm income or (loss). Attach Schedule F		18	40,000
19	Unemployment compensation		19	
20a	Social security benefits 20a	b Taxable amount (see page 26)	20b	
21	Other income. List type and amount (see page 28)		21	
22	Add the amounts in the far right column for lines 7 through 21. This is your **total income** ▶		22	123,000

Adjusted Gross Income

23	Educator expenses (see page 28)	23			
24	Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ	24			
25	Health savings account deduction. Attach Form 8889	25			
26	Moving expenses. Attach Form 3903	26			
27	One-half of self-employment tax. Attach Schedule SE	27	2,826		
28	Self-employed SEP, SIMPLE, and qualified plans	28			
29	Self-employed health insurance deduction (see page 29)	29			
30	Penalty on early withdrawal of savings	30			
31a	Alimony paid b Recipient's SSN ▶	31a			
32	IRA deduction (see page 30)	32			
33	Student loan interest deduction (see page 33)	33			
34	Tuition and fees deduction. Attach Form 8917	34			
35	Domestic production activities deduction. Attach Form 8903	35			
36	Add lines 23 through 31a and 32 through 35			36	2,826
37	Subtract line 36 from line 22. This is your **adjusted gross income** ▶			37	120,174

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see page 88. Cat. No. 11320B Form **1040** (2008)

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For Example 13 (Trade)

Form 1040 (2008) **PETE AND SANDY MOSS** **123-45-6789** Page **2**

Tax and Credits

38	Amount from line 37 (adjusted gross income)	38	120,174
39a	Check if: ☐ **You** were born before January 2, 1944, ☐ Blind. ☐ **Spouse** was born before January 2, 1944, ☐ Blind. **Total boxes checked** ▶ **39a**		
b	If your spouse itemizes on a separate return or you were a dual-status alien, see page 34 and check here ▶ 39b ☐		
c	Check if standard deduction includes real estate taxes or disaster loss (see page 34) ▶ 39c ☐		
40	**Itemized deductions** (from Schedule A) **or** your **standard deduction** (see left margin)	40	10,900
41	Subtract line 40 from line 38	41	109,274
42	If line 38 is over $119,975, or you provided housing to a Midwestern displaced individual, see page 36. Otherwise, multiply $3,500 by the total number of exemptions claimed on line 6d	42	7,000
43	**Taxable income.** Subtract line 42 from line 41. If line 42 is more than line 41, enter -0-	43	102,274
44	**Tax** (see page 36). Check if any tax is from: a ☐ Form(s) 8814 b ☐ Form 4972	44	18,256
45	**Alternative minimum tax** (see page 39). Attach Form 6251	45	0
46	Add lines 44 and 45 ▶	46	18,256
47	Foreign tax credit. Attach Form 1116 if required	47	
48	Credit for child and dependent care expenses. Attach Form 2441	48	
49	Credit for the elderly or the disabled. Attach Schedule R	49	
50	Education credits. Attach Form 8863	50	
51	Retirement savings contributions credit. Attach Form 8880	51	
52	Child tax credit (see page 42). Attach Form 8901 if required	52	
53	Credits from Form: a ☐ 8396 b ☐ 8839 c ☐ 5695	53	
54	Other credits from Form: a ☐ 3800 b ☐ 8801 c ☐ ______	54	
55	Add lines 47 through 54. These are your **total credits**	55	
56	Subtract line 55 from line 46. If line 55 is more than line 46, enter -0- ▶	56	18,256

Standard Deduction for—
- People who checked any box on line 39a, 39b, or 39c **or** who can be claimed as a dependent, see page 34.
- All others:

Single or Married filing separately, $5,450

Married filing jointly or Qualifying widow(er), $10,900

Head of household, $8,000

Other Taxes

57	Self-employment tax. Attach Schedule SE	57	5,652
58	Unreported social security and Medicare tax from Form: a ☐ 4137 b ☐ 8919	58	
59	Additional tax on IRAs, other qualified retirement plans, etc. Attach Form 5329 if required	59	
60	Additional taxes: a ☐ AEIC payments b ☐ Household employment taxes. Attach Schedule H	60	
61	Add lines 56 through 60. This is your **total tax** ▶	61	23,908

Payments

62	Federal income tax withheld from Forms W-2 and 1099	62	8,970	
63	2008 estimated tax payments and amount applied from 2007 return	63		
64a	**Earned income credit (EIC)**	64a		
b	Nontaxable combat pay election 64b			
65	Excess social security and tier 1 RRTA tax withheld (see page 61)	65		
66	Additional child tax credit. Attach Form 8812	66		
67	Amount paid with request for extension to file (see page 61)	67		
68	Credits from Form: a ☐ 2439 b ☐ 4136 c ☐ 8801 d ☐ 8885	68		
69	First-time homebuyer credit. Attach Form 5405	69		
70	Recovery rebate credit (see worksheet on pages 62 and 63)	70		
71	Add lines 62 through 70. These are your **total payments** ▶	71		8,970

If you have a qualifying child, attach Schedule EIC.

Refund

Direct deposit? See page 63 and fill in 73b, 73c, and 73d, or Form 8888.

72	If line 71 is more than line 61, subtract line 61 from line 71. This is the amount you **overpaid**	72	
73a	Amount of line 72 you want **refunded to you.** If Form 8888 is attached, check here ▶ ☐	73a	
▶ b	Routing number ▶ c Type: ☐ Checking ☐ Savings		
▶ d	Account number		
74	Amount of line 72 you want **applied to your 2009 estimated tax** ▶ 74		

Amount You Owe

75	**Amount you owe.** Subtract line 71 from line 61. For details on how to pay, see page 65 ▶	75	14,938
76	Estimated tax penalty (see page 65) 76		

Third Party Designee

Do you want to allow another person to discuss this return with the IRS (see page 66)? ☒ **Yes.** Complete the following. ☐ **No**

Designee's name ▶ **Preparer** Phone no. ▶ ( ) Personal identification number (PIN) ▶

Sign Here

Joint return? See page 15. Keep a copy for your records.

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Your signature | Date | Your occupation **Farmer** | Daytime phone number ( )

Spouse's signature. If a joint return, **both** must sign. | Date | Spouse's occupation **Homemaker**

Paid Preparer's Use Only

Preparer's signature ▶ | Date | Check if self-employed ☐ | Preparer's SSN or PTIN

Firm's name (or yours if self-employed), address, and ZIP code ▶ | EIN | Phone no. ( )

Form **1040** (2008)

For Example 13 (Trade)

SCHEDULE F (Form 1040)
Department of the Treasury Internal Revenue Service (99)

Profit or Loss From Farming

▶ Attach to Form 1040, Form 1040NR, Form 1041, Form 1065, or Form 1065-B.
▶ See Instructions for Schedule F (Form 1040).

OMB No. 1545-0074
2008
Attachment Sequence No. 14

Name of proprietor: **Pete Moss**
Social security number (SSN): **123-45-6789**

A Principal product. Describe in one or two words your principal crop or activity for the current tax year. **Grain**
B Enter code from Part IV ▶ **111100**
C Accounting method: (1) ☒ Cash (2) ☐ Accrual
D Employer ID number (EIN), if any
E Did you "materially participate" in the operation of this business during 2008? If "No," see page F-3 for limit on passive losses. ☒ Yes ☐ No

Part I Farm Income—Cash Method. Complete Parts I and II (Accrual method. Complete Parts II and III, and Part I, line 11.) Do not include sales of livestock held for draft, breeding, sport, or dairy purposes. Report these sales on Form 4797.

1	Sales of livestock and other items you bought for resale	1			
2	Cost or other basis of livestock and other items reported on line 1	2			
3	Subtract line 2 from line 1			3	
4	Sales of livestock, produce, grains, and other products you raised			4	135,000
5a	Cooperative distributions (Form(s) 1099-PATR)	5a		5b Taxable amount 5b	
6a	Agricultural program payments (see page F-3)	6a		6b Taxable amount 6b	
7	Commodity Credit Corporation (CCC) loans (see page F-3):				
a	CCC loans reported under election			7a	
b	CCC loans forfeited	7b		7c Taxable amount 7c	
8	Crop insurance proceeds and federal crop disaster payments (see page F-3):				
a	Amount received in 2008	8a		8b Taxable amount 8b	
c	If election to defer to 2009 is attached, check here ▶ ☐		8d Amount deferred from 2007	8d	
9	Custom hire (machine work) income			9	
10	Other income, including federal and state gasoline or fuel tax credit or refund (see page F-4)			10	
11	**Gross income.** Add amounts in the right column for lines 3 through 10. If you use the accrual method to figure your income, enter the amount from Part III, line 51 ▶			11	135,000

Part II Farm Expenses—Cash and Accrual Method. Do not include personal or living expenses such as taxes, insurance, or repairs on your home.

12	Car and truck expenses (see page F-5). Also attach **Form 4562**		25	Pension and profit-sharing plans	
13	Chemicals		26	Rent or lease (see page F-6):	
14	Conservation expenses (see page F-5)		26a	Vehicles, machinery, and equipment	
15	Custom hire (machine work)		26b	Other (land, animals, etc.)	
16	Depreciation and section 179 expense deduction not claimed elsewhere (see page F-5)	95,000	27	Repairs and maintenance	
17	Employee benefit programs other than on line 25		28	Seeds and plants	
18	Feed		29	Storage and warehousing	
19	Fertilizers and lime		30	Supplies	
20	Freight and trucking		31	Taxes	
21	Gasoline, fuel, and oil		32	Utilities	
22	Insurance (other than health)		33	Veterinary, breeding, and medicine	
23	Interest:		34	Other expenses (specify):	
23a	Mortgage (paid to banks, etc.)		34a		
23b	Other		34b		
24	Labor hired (less employment credits)		34c		
			34d		
			34e		
			34f		

35	**Total expenses.** Add lines 12 through 34f. If line 34f is negative, see instructions ▶	35	95,000
36	**Net farm profit or (loss).** Subtract line 35 from line 11. Partnerships, see page F-7. • If a profit, enter the profit on both **Form 1040, line 18,** and **Schedule SE, line 1a;** on **Form 1040NR, line 19;** or on **Form 1041, line 6.** • If a loss, you **must** go to line 37.	36	40,000
37	If you have a loss, you **must** check the box that describes your investment in this activity (see page F-7). • If you checked 37a, enter the loss on both **Form 1040, line 18,** and **Schedule SE, line 1a;** on **Form 1040NR, line 19;** or on **Form 1041, line 6.** • If you checked 37b, you **must** attach **Form 6198.** Your loss may be limited.	37a ☐ All investment is at risk. 37b ☐ Some investment is not at risk.	

For Paperwork Reduction Act Notice, see page F-7 of the instructions. Cat. No. 11346H **Schedule F (Form 1040) 2008**

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For Example 13 (Trade)

SCHEDULE SE (Form 1040) Department of the Treasury Internal Revenue Service (99)	**Self-Employment Tax** ▶ Attach to Form 1040. ▶ See Instructions for Schedule SE (Form 1040).	OMB No. 1545-0074 2008 Attachment Sequence No. 17
Name of person with **self-employment** income (as shown on Form 1040) Pete Moss	Social security number of person with **self-employment** income ▶	123 ⁝ 45 ⁝ 6789

Who Must File Schedule SE

You must file Schedule SE if:

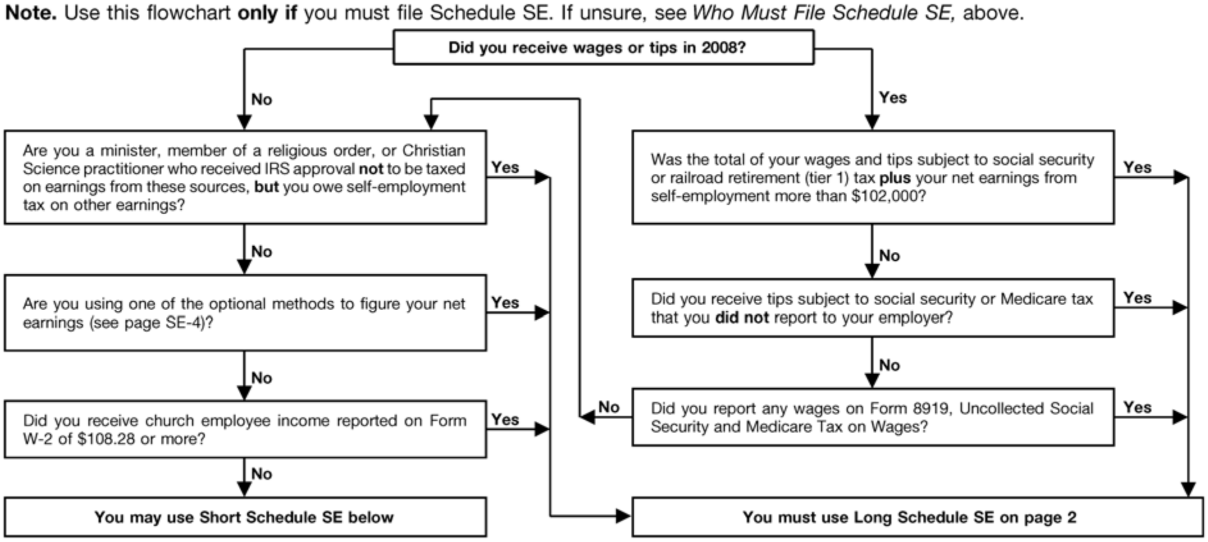
- You had net earnings from self-employment from **other than** church employee income (line 4 of Short Schedule SE or line 4c of Long Schedule SE) of $400 or more, **or**
- You had church employee income of $108.28 or more. Income from services you performed as a minister or a member of a religious order **is not** church employee income (see page SE-1).

Note. Even if you had a loss or a small amount of income from self-employment, it may be to your benefit to file Schedule SE and use either "optional method" in Part II of Long Schedule SE (see page SE-4).

Exception. If your only self-employment income was from earnings as a minister, member of a religious order, or Christian Science practitioner **and** you filed Form 4361 and received IRS approval not to be taxed on those earnings, **do not** file Schedule SE. Instead, write "Exempt—Form 4361" on Form 1040, line 57.

May I Use Short Schedule SE or Must I Use Long Schedule SE?

Note. Use this flowchart **only if** you must file Schedule SE. If unsure, see *Who Must File Schedule SE,* above.



Section A—Short Schedule SE. Caution. Read above to see if you can use Short Schedule SE.

1a	Net farm profit or (loss) from Schedule F, line 36, and farm partnerships, Schedule K-1 (Form 1065), box 14, code A	1a	40,000
b	If you received social security retirement or disability benefits, enter the amount of Conservation Reserve Program payments included on Schedule F, line 6b, or listed on Schedule K-1 (Form 1065), box 20, code X	1b	( )
2	Net profit or (loss) from Schedule C, line 31; Schedule C-EZ, line 3; Schedule K-1 (Form 1065), box 14, code A (other than farming); and Schedule K-1 (Form 1065-B), box 9, code J1. Ministers and members of religious orders, see page SE-1 for types of income to report on this line. See page SE-3 for other income to report	2	
3	Combine lines 1a, 1b, and 2	3	40,000
4	**Net earnings from self-employment.** Multiply line 3 by 92.35% (.9235). If less than $400, **do not** file this schedule; you do not owe self-employment tax ▶	4	36,940
5	**Self-employment tax.** If the amount on line 4 is: • $102,000 or less, multiply line 4 by 15.3% (.153). Enter the result here and on **Form 1040, line 57.** • More than $102,000, multiply line 4 by 2.9% (.029). Then, add $12,648 to the result. Enter the total here and on **Form 1040, line 57**	5	2,652
6	**Deduction for one-half of self-employment tax.** Multiply line 5 by 50% (.5). Enter the result here and on **Form 1040, line 27** — 6 — 2,826		

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 11358Z **Schedule SE (Form 1040) 2008**

For Example 13 (Trade)

Form **4562** Department of the Treasury Internal Revenue Service (99)

Depreciation and Amortization
(Including Information on Listed Property)
► See separate instructions. ► Attach to your tax return.

OMB No. 1545-0172 **2008** Attachment Sequence No. 67

Name(s) shown on return	Business or activity to which this form relates	Identifying number
Pete and Sandy Moss	Schedule F / Form 4835 - Grain	123-45-6789

Part I Election To Expense Certain Property Under Section 179
Note: *If you have any listed property, complete Part V before you complete Part I.*

1	Maximum amount. See the instructions for a higher limit for certain businesses	1	$250,000
2	Total cost of section 179 property placed in service (see instructions)	2	95,000
3	Threshold cost of section 179 property before reduction in limitation (see instructions)	3	$800,000
4	Reduction in limitation. Subtract line 3 from line 2. If zero or less, enter -0-	4	0
5	Dollar limitation for tax year. Subtract line 4 from line 1. If zero or less, enter -0-. If married filing separately, see instructions	5	250,000

6 (a) Description of property	(b) Cost (business use only)	(c) Elected cost
7-year combine (new)	95,000	95,000

7	Listed property. Enter the amount from line 29	7	0
8	Total elected cost of section 179 property. Add amounts in column (c), lines 6 and 7	8	95,000
9	Tentative deduction. Enter the **smaller** of line 5 or line 8	9	95,000
10	Carryover of disallowed deduction from line 13 of your 2007 Form 4562	10	0
11	Business income limitation. Enter the smaller of business income (not less than zero) or line 5 (see instructions)	11	218,000
12	Section 179 expense deduction. Add lines 9 and 10, but do not enter more than line 11	12	95,000
13	Carryover of disallowed deduction to 2009. Add lines 9 and 10, less line 12 ►	13	0

Note: *Do not use Part II or Part III below for listed property. Instead, use Part V.*

Part II Special Depreciation Allowance and Other Depreciation (Do not include listed property.) (See instructions.)

14	Special depreciation allowance for qualified property (other than listed property) placed in service during the tax year (see instructions)	14	
15	Property subject to section 168(f)(1) election	15	
16	Other depreciation (including ACRS)	16	

Part III MACRS Depreciation (Do not include listed property.) (See instructions.)

Section A

17	MACRS deductions for assets placed in service in tax years beginning before 2008	17	
18	If you are electing to group any assets placed in service during the tax year into one or more general asset accounts, check here ► ☐		

Section B—Assets Placed in Service During 2008 Tax Year Using the General Depreciation System

(a) Classification of property	(b) Month and year placed in service	(c) Basis for depreciation (business/investment use only—see instructions)	(d) Recovery period	(e) Convention	(f) Method	(g) Depreciation deduction
19a 3-year property						
b 5-year property						
c 7-year property						
d 10-year property						
e 15-year property						
f 20-year property						
g 25-year property			25 yrs.		S/L	
h Residential rental property			27.5 yrs.	MM	S/L	
			27.5 yrs.	MM	S/L	
i Nonresidential real property			39 yrs.	MM	S/L	
				MM	S/L	

Section C—Assets Placed in Service During 2008 Tax Year Using the Alternative Depreciation System

(a) Classification of property	(b)	(c)	(d)	(e)	(f)	(g)
20a Class life					S/L	
b 12-year			12 yrs.		S/L	
c 40-year			40 yrs.	MM	S/L	

Part IV Summary (See instructions.)

21	Listed property. Enter amount from line 28	21	
22	**Total.** Add amounts from line 12, lines 14 through 17, lines 19 and 20 in column (g), and line 21. Enter here and on the appropriate lines of your return. Partnerships and S corporations—see instr.	22	95,000
23	For assets shown above and placed in service during the current year, enter the portion of the basis attributable to section 263A costs	23	

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 12906N Form **4562** (2008)

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For Example 13 (Trade)

12/31/2008 **2008 Federal Summary Depreciation Schedule** **Page 1**

Pete and Sandy Moss **123-45-6789**

No.	Description	Date Acquired	Date Sold	Cost / Basis	Bus. Pct.	Cur. 179/ SDA	Prior 179/ SDA/ Depr.	Method	Life	Current Depr.
	Schedule F / Form 4835 - Grain									
1	Combine (Old)	07/01/00	07/01/08	81,633			81,633	150DB HY	7	0
2	Combine (New)	07/01/08		95,000		95,000		150DB HY	7	0
	Total			176,633		95,000	81,633			0
	Total Depreciation			176,633		95,000	81,633			0
	Grand Total Depreciation			176,000		85,000	81,633			0
	Depreciation Assests Sold			81,633		0	81,633			0
	Depr Remaining Assests			95,000		95,000	0			0