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IRS GIVES ON EIC

— by Neil E. Harl*

A major obstacle to claiming the earned income credit has been the IRS position that "disqualified income" for purposes of the earned income credit included Section 1231 gains. That IRS stance assured that gains from the sale of dairy and breeding animals, as two of the more prominent items, would preclude many farm taxpayers from being eligible for the earned income credit.

On November 10, 1998, Rev. Rul. 98-56 was issued which signaled a 180 degree shift in the IRS position.

The statutory language

The key question, all along, has been whether Section 1231 gains were properly includible in "disqualified income." The earned income credit statute specifies that "disqualified income" includes "capital gain net income." The statute further states that "capital gain net income" is as defined in Section 1222 of the Internal Revenue Code. Section 1222, in turn, defines "capital gain net income" as "the excess of the gains from the sales or exchanges of capital assets over the losses from such sales or exchanges." That passage focuses attention on the meaning of "capital assets." Section 1221 of the Internal Revenue Code defines "capital assets" as all assets except for five specifically enumerated exceptions. Section 1221(2) excludes property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or real property used in his trade or business. Such income should not count toward the $2300 threshold (for 1998) that can disqualify a taxpayer from the earned income credit.

The problem

Notwithstanding the clear statutory guidance in the matter, IRS in its taxpayer publication and some of the software companies took the position that gains from Section 1231 assets are included in "capital gain net income." The obvious conclusion is that Section 1231 gains from the sale of breeding stock, dairy cows, land used in the business, or machinery are not included in the definition of "capital gain net income." Such income should not count toward the $2300 threshold (for 1998) that can disqualify a taxpayer from the earned income credit.

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were to be included as capital gain net income for purposes of determining the amount of disqualified income. The IRS position was apparently based on the fact that net gains from Section 1231 assets are treated as capital gains for income tax purposes.

**The new IRS position**

In *Rev. Rul. 98-56*, IRS stated that "gain that is treated as long-term capital gain under § 1231(a)(1) is not disqualified income for purposes of § 32(i)." The news release accompanying the revenue ruling stated that taxpayers "who were otherwise eligible to claim the EITC on their 1996 or 1997 returns—but had too much investment income because of Form 4797 calculations—should claim a refund by filing an amended return on Form 1040X for each year that the new calculation lowers their investment income below the limit for that year."

**In conclusion**

It is not clear what caused IRS to change its position. Legislation had been introduced to amend I.R.C. § 32 to provide specifically that Section 1231 gains or losses from the sale of livestock would not be included in disqualified income. However, that legislation was not enacted into law.

Regardless of the reason or reasons for the shift in position, it is good news for low income farmers.

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**FOOTNOTES**

2. I.R.C. § 32(i)(2).
5. I.R.C. § 32(i)(2).
8. Id.
10. See I.R.C. § 1221.
11. Id.
12. I.R.C. § 1222(2).
17. See Harl, "Treasury Position on Section 1231 Gains and the Earned Income Credit," 8 Agric. L. Dig. 73 (1997).
18. Id.
19. Id.
21. Id.
23. Id.