# 1 Agricultural Issues

## Issue 1: Alternative Minimum Tax on Deferred Payment Contracts

### A. 1996 Case and Rulings

*Coohey v. United States,* No. C95-163 (N.D. Iowa, October 21, 1996) and TAM 9640003 (dated December 21, 1995, but released October 4, 1996) hold that income from a deferred payment contract must be reported in the year the commodity is delivered for alternative minimum tax (AMT) purposes. These holdings, which came as a surprise to many farm producers and their income tax preparers, raised the issue of how to report 1996 deferred payment contracts on the producers' 1996 income tax returns. In light of pending legislation, the IRS issued Notice 97-13, IR-97-3, which extended the date for filing Form 3115 for the 1997 tax year until the due date of the 1997 tax return. Therefore, taxpayers did not have to deal with the issue in 1996.

### B. 1997 legislation and case

The Taxpayer Relief Act (TRA) of 1997 repealed I.R.C. §56(a)(6), which was the basis for the IRS position that commodity income could not be deferred for AMT purposes. The change is effective for commodity sales in tax years beginning after 1986. Consequently, farm producers can now use installment reporting of commodity income for both regular and AMT purposes.

In *Loomis v Commissioner,* Docket No. 8748-95, T.C. Memo 1997-381, filed August 20, 1997, the court ruled that the taxpayer did not have to make an AMT adjustment for 1991 installment contracts. The ruling is based on the change made by the Taxpayer Relief Act of 1997.

**Example 1-A.** Bull Kernel has been using deferred payment contracts to market his corn crop since 1988. Under these contracts, he delivered his corn crop to the elevator in one calendar year and received payment for the corn in the following year. For regular income tax purposes, he reported the income in the year he received the payment.

Under TAM 9640003, Bull would have been required to report the corn income in the year the corn was delivered for AMT purposes. Notice 97-13 would have required him to adjust his 1997, 1998, 1999, and delivered for AMT purposes. Notice 97-13 would have required him to adjust his 1997, 1998, 1999, and 2000 AMT income to make up for the AMT income he did not report in 1988 through 1996. He would also have to report income from deferred commodity sales in 1997 and thereafter in the year the commodity is delivered. That would have accelerated the payment of income taxes on the corn sales by one year.

The TRA of 1997 allows Bull to report the corn income in the year he receives the payments for AMT purposes as well as regular income tax purposes. Therefore, he does not have to adjust prior years' AMT income, and he can continue to report commodity income in the year he receives the payments.

## C. Refunds for prior years

Since the change in the statute is effective for tax years after 1986, taxpayers who made an AMT adjustment under §56(a)(6) in 1987 or thereafter can claim a refund for any additional taxes paid as a result of the adjustment **if the tax year is still open.** Tax years are open under I.R.C. §6511(a) until the later of:

1. Three years from the date a timely filed income tax return was filed, or
2. Two years from the date the tax was paid.

**Example 1-B.** Doe Chaff sold her 1996 corn crop under a deferred payment contract in the fall of 1996. For regular income tax purposes, she did not report any of the contract income in 1996. Based on TAM 9640003, she reported an AMT adjustment in 1996 equal to the amount of the contract. The adjustment added $10,000 to her tax liability in 1996.

As a result of the Taxpayer Relief Act of 1997, Doe can file an amended return for 1996 to claim a refund of the additional $10,000 she paid in 1996.

**Practitioner Note.**

Former I.R.C. §56(a)(6) denied installment reporting for AMT purposes for any inventory item or asset held for sale in the ordinary course of business. Therefore, the repeal of §56(a)(6) affects any taxpayer who is allowed to use installment reporting for regular income tax purposes for the sale of inventory or assets held for sale in the ordinary course of business.

# Issue 2: Earned Income Credit

The Welfare Reform Act of 1996 expanded the definition of "disqualified income" to include, among other things, "capital gain net income." The effect of this expansion is to disqualify more taxpayers from claiming the earned income credit. Committee reports indicate that Congress expanded the definition of disqualified income because its purpose is to determine the taxpayer's assets that could be liquidated to pay living expenses instead of receiving the earned income credit. Congress reasoned that gains from the sale of passive investments should be included in the term "disqualified income."

The IRS has interpreted the term "capital gain net income" to include some gains from the sale of assets used in a trade or business, such as land, buildings, equipment, and livestock. The gains that are included by the IRS interpretation are those from the sale of assets that satisfy the holding period requirement of I.R.C. §1231 (more than a year for most assets, 12 months or more for livestock other than cattle and horses, and 24 months for cattle and horses) **and are not subject to the recapture rules of Sections 1245** (depreciation recapture on personal property), 1250 (depreciation recapture on real property),**1252** (recapture of soil and water conservation expenses), 1254 (recapture of depletion), or 1255 (recapture of excluded cost sharing expenses).

**Example 2-A.** Jill sold five cull cows in 1997 for $500 each. The cows were raised, were more than 24 months old, and had a zero basis. The IRS treats the $2,500 of gain as disqualified income. **Since it exceeds the $2,250 limit for 1997, Jill is not eligible for the earned income credit.**

**Example 2-B.** Andy sold five cull cows in 1997 for $500 each. He paid $900 for each of the cows when he purchased them in 1992. He claimed $863 of depreciation on each cow and had an adjusted basis of $37 in each cow when they were sold. Andy's $463 of gain on each cow ($500 - $37) is treated as ordinary income under the depreciation recapture rules of I.R.C. §1245. **Therefore, the IRS does not treat that gain as disqualified income and Andy can claim the earned income credit** (if he otherwise qualifies) even though his gain from sale of the cull cows ($2,315) exceeds the **$2,250 disqualified income limit for 1997.**

**Example 2-C.** Brook culled five heifers from her herd in 1997. The heifers were raised and were less than 24 months old. She sold them for $500 each. Since the heifers were less than 24 months old, they were not §1231 assets. Therefore, the $2,500 of gain from the sale is reported as ordinary income on Form 4797. **The IRS does not treat the gain from these heifers as disqualified income. Therefore, Brook can claim the earned income credit** (if she otherwise qualifies) even though her gain from the sale of the heifers exceeds the $2,250 limit for 1997.

**Example 2-D.** Bruce sold five cull cows in 1997 for $500 each. The cows were raised, were more than 24 months old, and had a zero basis. One month before Bruce sold the cows, he put them in his feed lot to fatten them for market. **Putting the cows in the feedlot converted the cows from being held for breeding to being held for sale in the ordinary course of business.** Therefore, Bruce must report the $2,500 of gain from the sale on Schedule F. The IRS **does not** treat the gain from this sale as disqualified income. Therefore Bruce can claim the earned income credit (if he otherwise qualifies) even though his gain from sale of these cows was greater than the $2,250 limit for 1997.

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**Practitioner Note.**

**Practitioner Note.**

It can be argued that the IRS misinterpreted the 1996 Act by including the gain from the sale of assets used in a trade or business in disqualified income. See *Agricultural Tax Issues and Form Preparation* (1997) by Philip E. Harris, Zoel W. Daughtrey, and C. Allen Bock for the arguments that the IRS interpretation is in error and the IRS response to those arguments.

However, it seems quite clear that the IRS **will not** waver from its position. A change in this position was in the 1997 Tax Act Senate bill but was **removed** by the conference committee from the final bill that passed.

## Issue 3: Real property rented to an entity

### Applicable Law

To understand the role of material participation in the self-employment tax, the self-employment tax rules must be summarized.

- I.R.C. §§1401(a) and 1402(a) and (b) impose the self-employment tax on net income from a taxpayer's trade or business or from a partnership in which the taxpayer is a member.
- I.R.C. §1402(a)(1) excludes rentals received from real estate and from personal property leased with real estate from the self-employment tax with two exceptions:
    1. Rentals received in the course of a trade or business as a real estate dealer, and
    2. Income derived by the owner of land if:
        a. the land is used under an arrangement that provides:
            i. that another individual will produce agricultural or horticultural commodities on the land, and

            ii. the owner of the land will materially participate in the production of the agricultural or horticultural commodities.

        and
        b. there is material participation by the owner of the land with respect to the agricultural or horticultural commodity.

Note the following important points about the above rules:

1. Material participation is an issue only with respect to land used in farming.
2. For rent from land used in farming to be subject to the self-employment tax, there must be both an

## A. Land Rented to Partnership

In *Mizell v. Commissioner*, T.C. Memo 1995-571, the court held that rent paid from a partnership to one of the partners for land that was used for farming is subject to self-employment tax. The court reasoned that the partner's participation in the partnership met the material participation requirement of the exception in I.R.C. §1402(a)(1) and there was the required arrangement.

**Example 3-A.** Charles Kightlinger owns 320 acres of farmland with a set of buildings. He also owns some farm machinery. He rents the land, buildings, and machinery to a partnership in which he, his daughter, and his son are equal partners. He receives $24,000 for the land, $8,000 for the buildings, and $15,000 for the machinery.

Charles must report the $24,000 of rent for the land on a Schedule F and pay self-employment tax on that rent. He does not have to pay self-employment tax on the $8,000 of rent received on the buildings since they are real estate; the rent on them is therefore excluded from self-employment income by §1402(a)(1). The rent on the buildings is not excluded from the real estate exception by the material participation rule since the material participation rule applies only to land.

Charles is likely to be required to pay self-employment tax on the rent received for the machinery since rent on personal property is generally subject to self-employment tax. Charles could argue that this rent falls within the §1402(a)(1) exception for personal property rented with real estate, but the IRS is not likely to follow that position.

## B. Land Rented to a Corporation

In LTR 9637004, dated May 1, 1996, the IRS ruled that rent paid from a corporation to the shareholders for land that was used in farming is subject to self-employment tax. The IRS followed the reasoning in *Mizell* and concluded that the shareholders met the requirements of §1402(a)(1) since they were employees of the corporation.

**Example 3-B.** Dan Nath owns 320 acres of farmland with a set of buildings. He rents the land and buildings to a corporation in which he owns all of the shares. The corporation also employs him. He receives $24,000 for the land, $8,000 for the buildings, and $15,000 for the machinery.

Dan is subject to self-employment tax on the same rent as Charles in Example 3-A above. Therefore, he is subject to self-employment tax for the rent on the land. He is not subject to self-employment tax for the rent on the buildings and is likely to be subject to self-employment tax for the rent on the machinery.

## C. Planning to Avoid Self-Employment Tax on Rent from an Entity

Under the reasoning of *Mizell* and LTR 9637004, avoiding self-employment tax on the rent paid for farmland requires the owner of the land to avoid material participation in the farming operation. One way for the landowner to avoid material participation is to shift ownership of the land to an individual who is not a part of the farming operation.

**Example 3-C.** If Charles in Example 3-A above has a wife who is not involved in the farming operation of the partnership, Charles could give his land and buildings to his wife. His wife could rent the land and buildings to the partnership. Since his wife is not materially participating in the farm business, the rent arguably should not be subject to the self-employment tax.

Another arguable way to avoid material participation by the landowner is to shift ownership of the land to a corporation.

**Example 3-D.** If Dan in Example 3-B above put his land and buildings into a newly created corporation, the land-holding corporation could rent the land and buildings to his existing corporation. The rent arguably should not be subject to self-employment tax.

If Dan made the S election for the new corporation, the rental payments could flow through the corporation to him without being subject to self-employment tax or to double income taxes.

**Practitioner Note.**

If land is put into a corporation to avoid the self-employment tax problems, other tax issues should be considered to make sure putting the land into the corporation does not create more tax liability than it saves. Other tax issues to consider include recognition of gain if the land is taken out of the corporation; the personal holding company tax under §541; special use valuation of assets in a decedent's estate under §2032A; the family business exclusion under §2033A; and installment payment of estate taxes under §6166.

The reason the word *arguably* is used above is that the IRS could take the position that the intermediate business structure is essentially the same as the individual. There are no cases or rulings that directly address this issue in regard to the SE tax issue.

## Issue 4: Disaster Losses and Payments

Natural disasters such as windstorms, droughts, and floods cause property damage that leads to two income tax issues: How much can the taxpayer deduct as a result of the loss? and How much income must be reported as a result of payments received for the damaged property and when must those payments be reported?

## A. Damage to Buildings

Several factors affect the tax consequences of damage to buildings:

1. Purpose for holding the buildings—business or personal
2. Amount of damage to the buildings
3. Whether or not the buildings were insured
4. Income tax basis in the buildings
5. Whether or not the insurance proceeds are used to repair or replace the buildings

**Example 4-A.** Burl Stream owns a farm that is located in an area declared to be a disaster area by the president of the United States in 1997. Burl's 1997 adjusted gross income is $10,000. A tornado destroyed Burl's barn and house on July 20, 1997.

1. The barn was worth $25,000 before the tornado and was insured for its fair market value. Burl used straight-line depreciation on the barn, which had an adjusted basis of $10,000 at the time it was destroyed.
2. Burl's home was purchased on July 10, 1975. It was declared unsafe by the state government, and Burl was ordered to demolish it on August 1, 1997. Burl also lost personal property that was in the house. The property he lost, its value before and after the tornado, income tax basis, insurance reimbursement, and what Burl spent to replace the items are listed below:

| Item | Value Before | Value After | Basis | Insurance Received | Amount Reinvested |
|---|---|---|---|---|---|
| Home | $80,000 | $ 0 | $50,000 | $70,000 | $76,000 |
| Clothing[a] | 3,000 | 200 | 7,000 | 2,500 | 500 |
| Painting[b] | 3,500 | 0 | 2,000 | 3,200 | 0 |

[a] The clothing was not scheduled in the insurance policy.

[b] The painting was scheduled in the insurance policy.

Burl must separate his business casualty gains and losses from his personal casualty gains and losses before he reports them on his tax return. Each item is discussed below.

1. Since the barn was used in a trade or business, a gain or loss resulting from the casualty is reported in Section B of Form 4684. The $15,000 gain on the barn is gain from the sale of property used in a trade or business (§1231 gain). Burl reports the gain on his barn by listing the barn as Property A on line 19 of Form 4684. He enters the $10,000 basis of the barn on line 20 in column A. On line 21, he reports the $25,000 of insurance proceeds. The resulting $15,000 gain is reported on lines 34, 36, and 39 of Form 4684 and is then carried to line 3 of Form 4797, where it is combined with gains and losses from other §1231 property.

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Note that, under TRA of 1997, the depreciation taken on the barn will be unrecaptured §1250 gain and will usually be taxed at a maximum 25% rate, and will not qualify for the reduced capital gain rate in effect for sales or conversions during this period.

2. The loss of a personal residence and personal property in the residence is reported in Section A of Form 4684. Burl calculates his $20,000 gain on the residence and his $1,200 gain on the painting on lines 2 through 4, but he does not report those gains on line 14 because he replaced the property and made the §1033(a) election to postpone the gain. The Revenue Reconciliation Act of 1993 added a new subsection (h) to §1033; it allows Burl to pool the insurance proceeds received for his house and for the personal property that was scheduled in his insurance policy. Therefore, Burl does not have to report the $1,200 gain on his painting even though he did not replace it. He spent more than the $73,200 of insurance proceeds that he received for both the house and the painting on a $76,000 replacement house. (See completed Form 2119 below.)

**Observation.** If Burl had realized a loss on the involuntary conversion of his residence, he could have elected to deduct that loss from his 1996 income because his house was in a declared disaster area, it was rendered unsafe for use as a residence, and he was ordered to demolish it within 120 days of the tornado [I.R.C. §165(k)].

Burl reports the loss he realized on his clothes by reporting his $7,000 basis in the clothes on line 2, the $2,500 insurance proceeds on line 3, the clothes' $3,000 fair market value before the flood on line 5, and their $200 fair market value after the flood on line 6. He reports the $2,800 difference between the fair market value before and after on line 7 and the smaller of that figure and his $7,000 basis on line 8. On line 9 he reports the $300 difference between his loss and the insurance reimbursement he received.

**Observation.** If Burl had realized a gain on the involuntary conversion of his unscheduled personal property, he would not have to recognize that gain [I.R.C. §1033(h)(1)(A)(i)].

Form **4684**

Department of the Treasury
Internal Revenue Service

## Casualties and Thefts

▶ See separate instructions.
▶ Attach to your tax return.
▶ Use a separate Form 4684 for each different casualty or theft.

OMB No. 1545-0177
199~~6~~7
Attachment Sequence No. 26

Name(s) shown on tax return: Burl Stream

Identifying number: 165-04-1033

**SECTION A—Personal Use Property** (Use this section to report casualties and thefts of property **not** used in a trade or business or for income-producing purposes.)

1 Description of properties (show type, location, and date acquired for each):
Property A Personal residence purchased 7/10/75 Route 2, Box 86, Rural, AR
Property B Clothing kept in above residence purchased on various dates
Property C Painting kept in above residence purchased on 12/2/91
Property D

| | | Properties (Use a separate column for each property lost or damaged from one casualty or theft.) | | | |
|---|---|---|---|---|---|
| | | A | B | C | D |
| 2 Cost or other basis of each property | 2 | 50,000 | 7,000 | 2,000 | |
| 3 Insurance or other reimbursement (whether or not you filed a claim). See instructions<br>**Note:** *If line 2 is more than line 3, skip line 4.* | 3 | 70,000 | 2,500 | 3,200 | |
| 4 Gain from casualty or theft. If line 3 is **more than** line 2, enter the difference here and skip lines 5 through 9 for that column. See instructions if line 3 includes insurance or other reimbursement you did not claim, or you received payment for your loss in a later tax year | 4 | 20,000 * | | 1,200 * | |
| 5 Fair market value **before** casualty or theft | 5 | | 3,000 | | |
| 6 Fair market value **after** casualty or theft | 6 | | 200 | | |
| 7 Subtract line 6 from line 5 | 7 | | 2,800 | | |
| 8 Enter the **smaller** of line 2 or line 7 | 8 | | 2,800 | | |
| 9 Subtract line 3 from line 8. If zero or less, enter -0- | 9 | | 300 | | |

| | | |
|---|---|---|
| 10 Casualty or theft loss. Add the amounts on line 9. Enter the total | 10 | 300 |
| 11 Enter the amount from line 10 or $100, whichever is **smaller** | 11 | 100 |
| 12 Subtract line 11 from line 10<br>**Caution:** *Use only one Form 4684 for lines 13 through 18.* | 12 | 200 |
| 13 Add the amounts on line 12 of all Forms 4684 | 13 | 200 |
| 14 Combine the amounts from line 4 of all Forms 4684 | 14 | |
| 15 • If line 14 is **more than** line 13, enter the difference here and on Schedule D. Do not complete the rest of this section (see instructions).<br>• If line 14 is **less than** line 13, enter -0- here and continue with the form.<br>• If line 14 is **equal to** line 13, enter -0- here. Do not complete the rest of this section. | 15 | |
| 16 If line 14 is **less than** line 13, enter the difference | 16 | 200 |
| 17 Enter 10% of your adjusted gross income (Form 1040, line 32). Estates and trusts, see instructions | 17 | 1,000 |
| 18 Subtract line 17 from line 16. If zero or less, enter -0-. Also enter result on Schedule A (Form 1040), line 19. Estates and trusts, enter on the "Other deductions" line of your tax return | 18 | -0- |

**For Paperwork Reduction Act Notice, see page 1 of separate instructions.** Cat. No. 12997O Form 4684 (199~~6~~7)

*This gain is postponed under I.R.C. §1033(a). See the attached statement.

Form 4684 (199~~6~~)7 Attachment Sequence No. 26 Page 2

Name(s) shown on tax return. Do not enter name and identifying number if shown on other side. | Identifying number

**SECTION B—Business and Income-Producing Property** (Use this section to report casualties and thefts of property used in a trade or business or for income-producing purposes.)

**Part I** Casualty or Theft Gain or Loss (Use a separate Part I for each casualty or theft.)

19 Description of properties (show type, location, and date acquired for each):

Property A Barn

Property B

Property C

Property D

| | | Properties (Use a separate column for each property lost or damaged from one casualty or theft.) | | | |
|---|---|---|---|---|---|
| | | A | B | C | D |
| 20 Cost or adjusted basis of each property | 20 | 10,000 | | | |
| 21 Insurance or other reimbursement (whether or not you filed a claim). See the instructions for line 3<br>**Note:** *If line 20 is* **more than** *line 21, skip line 22.* | 21 | 25,000 | | | |
| 22 Gain from casualty or theft. If line 21 is **more than** line 20, enter the difference here and on line 29 or line 34, column (c), except as provided in the instructions for line 33. Also, skip lines 23 through 27 for that column. See the instructions for line 4 if line 21 includes insurance or other reimbursement you did not claim, or you received payment for your loss in a later tax year | 22 | 15,000 | | | |
| 23 Fair market value **before** casualty or theft | 23 | | | | |
| 24 Fair market value **after** casualty or theft | 24 | | | | |
| 25 Subtract line 24 from line 23 | 25 | | | | |
| 26 Enter the **smaller** of line 20 or line 25<br>**Note:** *If the property was totally destroyed by casualty or lost from theft, enter on line 26 the amount from line 20.* | 26 | | | | |
| 27 Subtract line 21 from line 26. If zero or less, enter -0- | 27 | | | | |

28 Casualty or theft loss. Add the amounts on line 27. Enter the total here and on line 29 or line 34 (see instructions). 28

**Part II** Summary of Gains and Losses (from separate Parts I)

| | (a) Identify casualty or theft | | (b) Losses from casualties or thefts<br>(i) Trade, business, rental or royalty property | (ii) Income-producing property | (c) Gains from casualties or thefts includible in income |
|---|---|---|---|---|---|
| | **Casualty or Theft of Property Held One Year or Less** | | | | |
| 29 | | | ( ) | ( ) | |
| | | | ( ) | ( ) | |
| 30 | Totals. Add the amounts on line 29 | 30 | ( ) | ( ) | |
| 31 | Combine line 30, columns (b)(i) and (c). Enter the net gain or (loss) here and on Form 4797, line 15. If Form 4797 is not otherwise required, see instructions | | | 31 | |
| 32 | Enter the amount from line 30, column (b)(ii) here and on Schedule A (Form 1040), line 22. Partnerships, S corporations, estates and trusts, see instructions | | | 32 | |
| | **Casualty or Theft of Property Held More Than One Year** | | | | |
| 33 | Casualty or theft gains from Form 4797, line 34 | | | 33 | |
| 34 | Barn | | ( ) | ( ) | 15,000 |
| | | | ( ) | ( ) | |
| 35 | Total losses. Add amounts on line 34, columns (b)(i) and (b)(ii) | 35 | ( ) | ( ) | |
| 36 | Total gains. Add lines 33 and 34, column (c) | | | 36 | 15,000 |
| 37 | Add amounts on line 35, columns (b)(i) and (b)(ii) | | | 37 | -0- |

38 If the loss on line 37 is **more than** the gain on line 36:

a Combine line 35, column (b)(i) and line 36, and enter the net gain or (loss) here. Partnerships and S corporations see the note below. All others enter this amount on Form 4797, line 15. If Form 4797 is not otherwise required, see instructions 38a

b Enter the amount from line 35, column (b)(ii) here. Partnerships and S corporations see the note below. Individuals enter this amount on Schedule A (Form 1040), line 22. Estates and trusts, enter on the "Other deductions" line of your tax return 38b

39 If the loss on line 37 is **equal to** or **less than** the gain on line 36, combine these lines and enter here. Partnerships, see the note below. All others, enter this amount on Form 4797, line 3 39 15,000

**Note:** *Partnerships, enter the amount from line 38a, 38b, or line 39 on Form 1065, Schedule K, line 7. S corporations, enter the amount from line 38a or 38b on Form 1120S, Schedule K, line 6.*

Form **2119**

Department of the Treasury
Internal Revenue Service

# Sale of Your Home

▶ Attach to Form 1040 for year of sale.

▶ See separate instructions. ▶ Please print or type.

OMB No. 1545-0072

199~~6~~7

Attachment Sequence No. 20

Your first name and initial. If a joint return, also give spouse's name and initial. Last name: Burl Stream

Your social security number: 165 : 04 : 1033

**Fill in Your Address Only If You Are Filing This Form by Itself and Not With Your Tax Return**

Present address (no., street, and apt. no., rural route, or P.O. box no. if mail is not delivered to street address): Route 2, Box 86

Spouse's social security number: : :

City, town or post office, state, and ZIP code: Rural, AR 60001

## Part I Gain on Sale

1 Date your former main home was sold (month, day, year) . . . . . . . . . . . . ▶ **1** 07 / 20 / 97

2 Have you bought or built a new main home? . . . . . . . . . . . . . . . . . . . . . ☒ Yes ☐ No

3 If any part of either main home was ever rented out or used for business, check here ▶ ☐ and see page 3.

| | | | |
|---|---|---|---|
| 4 | Selling price of home. Do not include personal property items you sold with your home . . | 4 | 73,200 |
| 5 | Expense of sale (see page 3) . . . . . . . . . . . . . . . . . . . . . . | 5 | -0- |
| 6 | Subtract line 5 from line 4 . . . . . . . . . . . . . . . . . . . . . . | 6 | 73,200 |
| 7 | Adjusted basis of home sold (see page 3) . . . . . . . . . . . . . . . . . | 7 | 52,000 |
| 8 | **Gain on sale.** Subtract line 7 from line 6 . . . . . . . . . . . . . . . . | 8 | 21,200 |

Is line 8 more than zero?

- Yes ▶ If line 2 is "Yes," you **must** go to Part II or Part III, whichever applies. If line 2 is "No," go to line 9.
- No ▶ Stop and attach this form to your return.

9 If you haven't replaced your home, do you plan to do so within the **replacement period** (see page 1)? . ☐ Yes ☐ No

- If line 9 is "Yes," stop here, attach this form to your return, and see **Additional Filing Requirements** on page 1.
- If line 9 is "No," you **must** go to Part II or Part III, whichever applies.

## Part II One-Time Exclusion of Gain for People Age 55 or Older—By completing this part, you are electing to take the one-time exclusion (see page 2). If you are not electing to take the exclusion, go to Part III now.

10 Who was age 55 or older on the date of sale? . . . . . . . . . . . ☐ You ☐ Your spouse ☐ Both of you

11 Did the person who was 55 or older own and use the property as his or her main home for a total of at least 3 years of the 5-year period before the sale? See page 2 for exceptions. If "No," go to Part III now . . . ☐ Yes ☐ No

12 At the time of sale, who owned the home? . . . . . . . . . . . . . ☐ You ☐ Your spouse ☐ Both of you

13 Social security number of spouse at the time of sale if you had a different spouse from the one above. If you were not married at the time of sale, enter "None" . . . . . . . ▶ **13** : :

14 **Exclusion.** Enter the smaller of line 8 or $125,000 ($62,500 if married filing separate return). Then, go to line 15 . . . . . . . . . . . . . . . . . . . . . . . . . . **14**

## Part III Adjusted Sales Price, Taxable Gain, and Adjusted Basis of New Home

| | | | |
|---|---|---|---|
| 15 | If line 14 is blank, enter the amount from line 8. Otherwise, subtract line 14 from line 8 . . | 15 | 21,200 |
| | • If line 15 is zero, stop and attach this form to your return.<br>• If line 15 is more than zero and line 2 is "Yes," go to line 16 now.<br>• If you are reporting this sale on the installment method, stop and see page 4.<br>• All others, stop and **enter the amount from line 15 on Schedule D, col. (g), line 4 or line 12.** | | |
| 16 | Fixing-up expenses (see page 4 for time limits) . . . . . . . . . . . . . . . | 16 | -0- |
| 17 | If line 14 is blank, enter amount from line 16. Otherwise, add lines 14 and 16 . . . . . . | 17 | -0- |
| 18 | **Adjusted sales price.** Subtract line 17 from line 6 . . . . . . . . . . . . . | 18 | 73,200 |
| 19a | Date you moved into new home ▶ 12/23/97 **b** Cost of new home (see page 4) | 19b | 76,000 |
| 20 | Subtract line 19b from line 18. If zero or less, enter -0- . . . . . . . . . . . | 20 | -0- |
| 21 | **Taxable gain.** Enter the smaller of line 15 or line 20 . . . . . . . . . . . . | 21 | -0- |
| | • If line 21 is zero, go to line 22 and attach this form to your return.<br>• If you are reporting this sale on the installment method, see the line 15 instructions and go to line 22.<br>• All others, **enter the amount from line 21 on Schedule D, col. (g), line 4 or line 12,** and go to line 22. | | |
| 22 | Postponed gain. Subtract line 21 from line 15 . . . . . . . . . . . . . . . | 22 | 21,200 |
| 23 | **Adjusted basis of new home.** Subtract line 22 from line 19b . . . . . . . . . | 23 | 54,800 |

**Sign Here Only If You Are Filing This Form by Itself and Not With Your Tax Return**

Under penalties of perjury, I declare that I have examined this form, including attachments, and to the best of my knowledge and belief, it is true, correct, and complete.

Your signature: Burl Stream Date

Spouse's signature Date

If a joint return, both must sign.

**For Paperwork Reduction Act Notice, see separate instructions.** Cat. No. 11710J Form **2119** (199~~6~~7)

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* U.S. Government Printing Office: 1996-407-330

### Election under I.R.C. §1033(a) to Postpone Gain on Property Lost in a Casualty

Taxpayer elects to defer the gain realized from the involuntary conversion of property due to a tornado on July 20, 1996. The property is located in an area declared to be a disaster area by President Clinton. The $20,000 of gain on a personal residence (Property A on Line 1 of Section A of the attached Form 4684) and $1,200 of gain on a painting (Property C on Line 1 of Section A of the attached Form 4684) are treated as a common fund under I.R.C. §1033(h). As required by I.R.C. §1033(b), the basis of the replacement personal residence purchased on August 18, 1997, is reduced as follows:

| | |
|---|---|
| Purchase price | $76,000 |
| Postponed gain | 21,200 |
| Adjusted basis | $54,800 |

## B. Livestock

Weather conditions can raise two different income tax issues with respect to livestock. One is the gain or loss resulting from the destruction of the livestock. The other is the gain that is realized when livestock are sold because weather conditions destroyed the crop that was to be fed to the livestock.

### Destruction of the Livestock

Livestock that are used in a trade or business and are destroyed by adverse weather conditions are treated the same as other business property for income tax purposes. Deductible losses are limited to the **lesser** of the taxpayer's basis in the property or the decrease in fair market value of the property. If the taxpayer receives insurance proceeds for the loss, gain is recognized to the extent that the proceeds exceed the basis in the livestock. That gain must be reported as income in the year the proceeds are received unless the taxpayer elects to replace the livestock within two years of the end of the tax year the proceeds are received.

**Example 4-B.** Sally Lamb owns and operates a farm. On May 13, 1997, a flood killed 14 lambs Sally was raising to sell on the slaughter market and two prize ewes Sally had purchased to improve the blood line of her flock. The lambs were not insured. The ewes were purchased in May 1995 for $2,000 each. Sally claimed $300 of depreciation on each ewe in 1995 and $510 of depreciation on each ewe in 1996. Sally had insured the ewes and received $2,250 for each ewe from the insurance company.

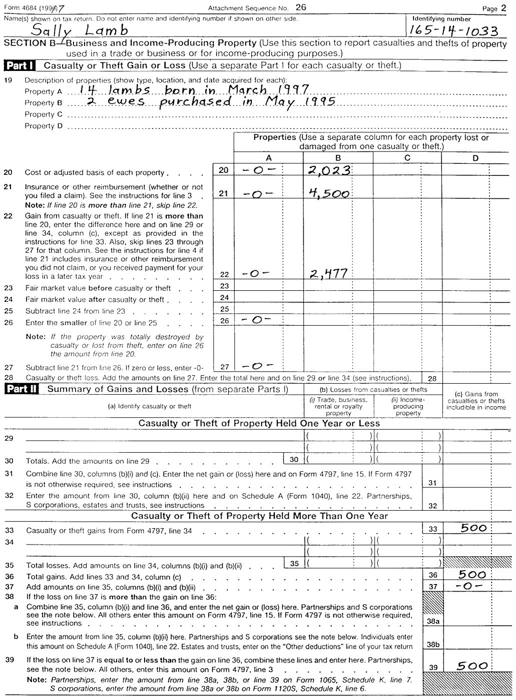
Since the lambs were not insured and had a zero basis, there is no gain or loss to report as a result of the loss of the lambs.

Sally must report a gain from the insurance proceeds received for her ewes. Gain is reported as if she sold each ewe for the $2,250 insurance payment. The gain is reported in Section B of Form 4684 and Part III of Form 4797 as follows:

1. On line 19 of Form 4684, Sally lists the ewes and the date of purchase on line B.
2. On line 20 of Form 4684, Sally reports the $2,023 adjusted basis of the ewes calculated as follows:

| | | |
|---|---|---|
| Purchase price | | $4,000 |
| Less depreciation claimed: | | |
| 1995 | $ 600 | |
| 1996 | 1,020 | |
| 1997 | 357 | |
| Total depreciation | | 1,977 |
| Adjusted basis | | $2,023 |

3. On line 21, Sally reports the $4,500 insurance payment.
4. On line 22, Sally reports the $2,477 gain realized on the ewes.
5. Since the gain on line 22 is subject to the depreciation recapture rules, Sally must complete Part III of Form 4797.
6. Sally reports the $500 of gain from line 34 of Form 4797 on line 33 of Form 4684. The $500 is also reported on lines 36 and 39 of Form 4684 and is carried to line 3 of Form 4797.



Form 4684 (199~~6~~7) Attachment Sequence No. 26 Page 2

Name(s) shown on tax return. Do not enter name and identifying number if shown on other side. Sally Lamb

Identifying number 165-14-1033

**SECTION B—Business and Income-Producing Property** (Use this section to report casualties and thefts of property used in a trade or business or for income-producing purposes.)

**Part I Casualty or Theft Gain or Loss** (Use a separate Part I for each casualty or theft.)

19 Description of properties (show type, location, and date acquired for each):

Property A 14 lambs born in March 1997

Property B 2 ewes purchased in May 1995

Property C

Property D

| | | **Properties** (Use a separate column for each property lost or damaged from one casualty or theft.) A | B | C | D |
|---|---|---|---|---|---|
| 20 Cost or adjusted basis of each property | 20 | -0- | 2,023 | | |
| 21 Insurance or other reimbursement (whether or not you filed a claim). See the instructions for line 3<br>**Note:** *If line 20 is **more than** line 21, skip line 22.* | 21 | -0- | 4,500 | | |
| 22 Gain from casualty or theft. If line 21 is **more than** line 20, enter the difference here and on line 29 or line 34, column (c), except as provided in the instructions for line 33. Also, skip lines 23 through 27 for that column. See the instructions for line 4 if line 21 includes insurance or other reimbursement you did not claim, or you received payment for your loss in a later tax year | 22 | -0- | 2,477 | | |
| 23 Fair market value **before** casualty or theft | 23 | | | | |
| 24 Fair market value **after** casualty or theft | 24 | | | | |
| 25 Subtract line 24 from line 23 | 25 | | | | |
| 26 Enter the **smaller** of line 20 or line 25<br>**Note:** *If the property was totally destroyed by casualty or lost from theft, enter on line 26 the amount from line 20.* | 26 | -0- | | | |
| 27 Subtract line 21 from line 26. If zero or less, enter -0- | 27 | -0- | | | |

28 Casualty or theft loss. Add the amounts on line 27. Enter the total here and on line 29 **or** line 34 (see instructions). 28

**Part II Summary of Gains and Losses** (from separate Parts I)

| (a) Identify casualty or theft | | (b) Losses from casualties or thefts (i) Trade, business, rental or royalty property | (ii) Income-producing property | (c) Gains from casualties or thefts includible in income |
|---|---|---|---|---|
| **Casualty or Theft of Property Held One Year or Less** | | | | |
| 29 | | ( ) | ( ) | |
| | | ( ) | ( ) | |
| 30 Totals. Add the amounts on line 29 | 30 | ( ) | ( ) | |
| 31 Combine line 30, columns (b)(i) and (c). Enter the net gain or (loss) here and on Form 4797, line 15. If Form 4797 is not otherwise required, see instructions | 31 | | | |
| 32 Enter the amount from line 30, column (b)(ii) here and on Schedule A (Form 1040), line 22. Partnerships, S corporations, estates and trusts, see instructions | 32 | | | |
| **Casualty or Theft of Property Held More Than One Year** | | | | |
| 33 Casualty or theft gains from Form 4797, line 34 | 33 | | | 500 |
| 34 | | ( ) | ( ) | |
| | | ( ) | ( ) | |
| 35 Total losses. Add amounts on line 34, columns (b)(i) and (b)(ii) | 35 | ( ) | ( ) | ▨ |
| 36 Total gains. Add lines 33 and 34, column (c) | 36 | | | 500 |
| 37 Add amounts on line 35, columns (b)(i) and (b)(ii) | 37 | | | -0- |
| 38 If the loss on line 37 is **more than** the gain on line 36:<br>a Combine line 35, column (b)(i) and line 36, and enter the net gain or (loss) here. Partnerships and S corporations see the note below. All others enter this amount on Form 4797, line 15. If Form 4797 is not otherwise required, see instructions | 38a | | | |
| b Enter the amount from line 35, column (b)(ii) here. Partnerships and S corporations see the note below. Individuals enter this amount on Schedule A (Form 1040), line 22. Estates and trusts, enter on the "Other deductions" line of your tax return | 38b | | | |
| 39 If the loss on line 37 is **equal to or less than** the gain on line 36, combine these lines and enter here. Partnerships, see the note below. All others, enter this amount on Form 4797, line 3 | 39 | | | 500 |

**Note:** *Partnerships, enter the amount from line 38a, 38b, or line 39 on Form 1065, Schedule K, line 7. S corporations, enter the amount from line 38a or 38b on Form 1120S, Schedule K, line 6.*

Form 4684 (1997) Attachment Sequence No. 26 Page 2

Name(s) shown on tax return. Do not enter name and identifying number if shown on other side.
Sally Lamb

**Identifying number** 165-14-1033

**SECTION B—Business and Income-Producing Property** (Use this section to report casualties and thefts of property used in a trade or business or for income-producing purposes.)

**Part I** Casualty or Theft Gain or Loss (Use a separate Part I for each casualty or theft.)

19 Description of properties (show type, location, and date acquired for each):
Property A 14 lambs born in March 1997
Property B 2 ewes purchased in May 1995
Property C
Property D

| | | Properties (Use a separate column for each property lost or damaged from one casualty or theft.) | | | |
|---|---|---|---|---|---|
| | | A | B | C | D |
| 20 Cost or adjusted basis of each property | 20 | -0- | 2,023 | | |
| 21 Insurance or other reimbursement (whether or not you filed a claim). See the instructions for line 3<br>**Note:** *If line 20 is* ***more than*** *line 21, skip line 22.* | 21 | -0- | 4,500 | | |
| 22 Gain from casualty or theft. If line 21 is **more than** line 20, enter the difference here and on line 29 or line 34, column (c), except as provided in the instructions for line 33. Also, skip lines 23 through 27 for that column. See the instructions for line 4 if line 21 includes insurance or other reimbursement you did not claim, or you received payment for your loss in a later tax year | 22 | -0- | 2,477 | | |
| 23 Fair market value **before** casualty or theft | 23 | | | | |
| 24 Fair market value **after** casualty or theft | 24 | | | | |
| 25 Subtract line 24 from line 23 | 25 | | | | |
| 26 Enter the **smaller** of line 20 or line 25<br>**Note:** *If the property was totally destroyed by casualty or lost from theft, enter on line 26 the amount from line 20.* | 26 | -0- | | | |
| 27 Subtract line 21 from line 26. If zero or less, enter -0- | 27 | -0- | | | |

28 Casualty or theft loss. Add the amounts on line 27. Enter the total here and on line 29 **or** line 34 (see instructions). | 28 |

**Part II** Summary of Gains and Losses (from separate Parts I)

| | (a) Identify casualty or theft | | (b) Losses from casualties or thefts<br>(i) Trade, business, rental or royalty property | (b) Losses from casualties or thefts<br>(ii) Income-producing property | | (c) Gains from casualties or thefts includible in income |
|---|---|---|---|---|---|---|
| | **Casualty or Theft of Property Held One Year or Less** | | | | | |
| 29 | | | ( ) | ( ) | | |
| | | | ( ) | ( ) | | |
| 30 | Totals. Add the amounts on line 29 | 30 | ( ) | ( ) | | |
| 31 | Combine line 30, columns (b)(i) and (c). Enter the net gain or (loss) here and on Form 4797, line 15. If Form 4797 is not otherwise required, see instructions | | | | 31 | |
| 32 | Enter the amount from line 30, column (b)(ii) here and on Schedule A (Form 1040), line 22. Partnerships, S corporations, estates and trusts, see instructions | | | | 32 | |
| | **Casualty or Theft of Property Held More Than One Year** | | | | | |
| 33 | Casualty or theft gains from Form 4797, line 34 | | | | 33 | 500 |
| 34 | | | ( ) | ( ) | | |
| | | | ( ) | ( ) | | |
| 35 | Total losses. Add amounts on line 34, columns (b)(i) and (b)(ii) | 35 | ( ) | ( ) | | ▨ |
| 36 | Total gains. Add lines 33 and 34, column (c) | | | | 36 | 500 |
| 37 | Add amounts on line 35, columns (b)(i) and (b)(ii) | | | | 37 | -0- |
| 38 | If the loss on line 37 is **more than** the gain on line 36: | | | | ▨ | |
| a | Combine line 35, column (b)(i) and line 36, and enter the net gain or (loss) here. Partnerships and S corporations see the note below. All others enter this amount on Form 4797, line 15. If Form 4797 is not otherwise required, see instructions | | | | 38a | |
| b | Enter the amount from line 35, column (b)(ii) here. Partnerships and S corporations see the note below. Individuals enter this amount on Schedule A (Form 1040), line 22. Estates and trusts, enter on the "Other deductions" line of your tax return | | | | 38b | |
| 39 | If the loss on line 37 is **equal to** or **less than** the gain on line 36, combine these lines and enter here. Partnerships, see the note below. All others, enter this amount on Form 4797, line 3 | | | | 39 | 500 |

**Note:** *Partnerships, enter the amount from line 38a, 38b, or line 39 on Form 1065, Schedule K, line 7. S corporations, enter the amount from line 38a or 38b on Form 1120S, Schedule K, line 6.*

Form **4797**

Department of the Treasury
Internal Revenue Service

# 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

199~~6~~7

Attachment
Sequence No. 27

Name(s) shown on return: Sally Lamb

Identifying number: 165-14-1033

| | | | |
|---|---|---|---|
| 1 | Enter here the gross proceeds from the sale or exchange of real estate reported to you for 1996 on Form(s) 1099-S (or a substitute statement) that you will be including on line 2, 11, or 22 | 1 | |

| | | | | |
|---|---|---|---|---|
| 3 | Gain, if any, from Form 4684, line 39 | 3 | ▨ | 500 |
| 4 | Section 1231 gain from installment sales from Form 6252, line 26 or 37 | 4 | ▨ | |

| | | | | |
|---|---|---|---|---|
| 12 | Loss, if any, from line 8 | 12 | | ▨ |
| 13 | Gain, if any, from line 8, or amount from line 9 if applicable | 13 | ▨ | |
| 14 | Gain, if any, from line 33 | 14 | ▨ | 1,977 |
| 15 | Net gain or (loss) from Form 4684, lines 31 and 38a | 15 | | |

Form 4797 (199~~6~~7) Page 2

## Part III Gain From Disposition of Property Under Sections 1245, 1250, 1252, 1254, and 1255

| 21 (a) Description of section 1245, 1250, 1252, 1254, or 1255 property: | (b) Date acquired (mo., day, yr.) | (c) Date sold (mo., day, yr.) |
|---|---|---|
| A 2 ewes | 5/1/95 | 5/13/97 |
| B | | |
| C | | |
| D | | |

| | Relate lines 21A through 21D to these columns ▶ | | Property A | Property B | Property C | Property D |
|---|---|---|---|---|---|---|
| 22 | Gross sales price (**Note:** *See line 1 before completing.*) | 22 | 4,500 | | | |
| 23 | Cost or other basis plus expense of sale | 23 | 4,000 | | | |
| 24 | Depreciation (or depletion) allowed or allowable | 24 | 1,977 | | | |
| 25 | Adjusted basis. Subtract line 24 from line 23 | 25 | 2,023 | | | |
| 26 | Total gain. Subtract line 25 from line 22 | 26 | 2,477 | | | |
| 27 | **If section 1245 property:** | | | | | |
| a | Depreciation allowed or allowable from line 24 | 27a | 1,977 | | | |
| b | Enter the **smaller** of line 26 or 27a | 27b | 1,977 | | | |

**Summary of Part III Gains.** Complete property columns A through D through line 31b before going to line 32.

| | | | |
|---|---|---|---|
| 32 | Total gains for all properties. Add property columns A through D, line 26 | 32 | 2,477 |
| 33 | Add property columns A through D, lines 27b, 28g, 29c, 30b, and 31b. Enter here and on line 14 | 33 | 1,977 |
| 34 | Subtract line 33 from line 32. Enter the portion from casualty or theft on Form 4684, line 33. Enter the portion from other than casualty or theft on Form 4797, line 6 | 34 | 500 |

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

See instructions.

| | | | (a) Section 179 | (b) Section 280F(b)(2) |
|---|---|---|---|---|
| 35 | Section 179 expense deduction or depreciation allowable in prior years | 35 | | |
| 36 | Recomputed depreciation. See instructions | 36 | | |
| 37 | Recapture amount. Subtract line 36 from line 35. See the instructions for where to report | 37 | | |

★ U.S. GOVERNMENT PRINTING OFFICE: 1996-407-382

## Livestock Sold Because of Weather-Related Conditions

If weather-related conditions cause the producer to sell livestock, the gain on sale of the livestock can be postponed.

**Practitioner Note.**

Prior to the Taxpayer Relief Act of 1997, the gain could be postponed only if the sale was due to a drought. The Taxpayer Relief Act of 1997 extends the deferral provisions to sales caused by flooding or other weather-related conditions as well as drought. It applies to sales and exchanges after 1996.

There are two different tax treatments, both of which apply only to weather-related sales in excess of normal business practice. The first treatment applies to draft, breeding, or dairy animals that will be replaced within a two-year period. The second applies to all livestock and allows a one-year postponement of the reporting of the sales proceeds.

### A. Election to Postpone Gain by Purchasing Replacement Animals

1. If livestock (other than poultry) held for any length of time for draft, breeding, or dairy (no sporting) purposes is sold because of weather-related conditions, the gain realized on the sale does not have to be recognized if the proceeds are used to purchase replacement livestock within two years of the end of the tax year of the sale. (Notice that there is no required holding period for this provision as there is for §1231.)
2. The new livestock must be used for the same purpose as the livestock that was sold. For example, dairy cows must be replaced with dairy cows. The taxpayer must show that the weather-related conditions caused the sale of more livestock than would have been sold without the drought conditions. For example, if the farmer normally sells one-fifth of the herd each year, only the sales in excess of one-fifth will qualify for this provision. There is no requirement that the weather-related conditions cause an area to be declared a disaster area by the federal government.
3. The farmer has a basis in the replacement livestock equal to the basis in the livestock sold plus any amount invested in the replacement livestock that exceeds the proceeds from the sale.
4. **How to make the election.** The election to defer the recognition of gain by reducing the basis of the replacement livestock is made by not reporting the deferred gain on the tax return and by attaching a statement to the tax return showing all the details of the involuntary conversion, including:
    a. Evidence of existence of the weather-related conditions that forced the sale or exchange of the livestock
    b. A computation of the amount of gain realized on the sale or exchange
    c. The number and kind of livestock sold or exchanged
    d. The number of livestock of each kind that would have been sold or exchanged under the

**Example 4-C.** Rowdy Drover normally sells 15 cows from his beef herd each year. In 1997, a flood reduced his hay crop so that he did not have enough to carry his normal herd through the winter. Consequently, he sold 35 cows rather than 15 in 1997. He plans to purchase an additional 20 cows in 1998 to replace the extra 20 that were sold.

Only 20 of the cows sold in 1997 qualify for the deferral of gain due to the drought. Rowdy can elect to defer the gain by (1) not reporting the gain on those 20 cows on his 1997 return, and (2) attaching the following statement:

**Election under I.R.C. §1033(e) to Postpone Recognition of Gain from Livestock Sold Because of Drought, Flood, or Other Weather-Related Conditions.** The flood conditions evidenced by the rainfall report attached to this statement caused the taxpayer to sell 35 head of beef cows rather than 15 head in 1997. The raised cows have a zero basis. The 35 cows sold for a total of $20,125. Taxpayer elects to defer the recognition of gain on the 20 extra head that were sold ((20 ÷ 35) × $20,125 = $11,500 of gain) under I.R.C. §1033(e).

If Rowdy reinvests $11,500 in 20 replacement cows in 1998, he will have a zero basis in the replacement cows. If he reinvests more than $11,500 in 20 cows, the excess will be his basis in the cows. If he reinvests less than $11,500 on 20 cows, the excess of $11,500 over the amount reinvested must be reported by amending his 1997 income tax return. If he buys only 19 cows in 1998 and 1999, $575 of gain (for the cow not replaced) must be reported on his amended 1997 return regardless of what he paid for the 19 replacement cows.

Rowdy should report the purchase of qualified replacement cows on his 1998 or 1999 return. If there is additional income for 1997, an amended 1997 return must be filed.

**Observation.** The item-for-item replacement rule does not apply to like-kind exchanges under I.R.C. §1031.

## B. Election to Defer Income to Subsequent Tax Year

I.R.C. §451(e) allows taxpayers to postpone reporting income for one year if the livestock is sold because of weather-related conditions. This election applies to all livestock.

To qualify for this provision, the following provisions must be satisfied:

1. The principal business of the taxpayer must be farming.
2. The taxpayer must use the cash method of accounting.
3. The taxpayer must show that the livestock would normally have been sold in a subsequent year.
4. Weather conditions that caused an area to be declared a disaster area must have caused the sale of livestock. It is not necessary that the livestock be raised or sold in the declared disaster area. The sale can take place before or after an area is declared a disaster area as long as the same disaster

The amount of income that can be postponed is explained in the following example.

**Example 4-D.** Mr. Smith normally sells 100 head of raised beef cattle a year. As a result of a drought, he sells 150 head during 1997. He realizes $45,000 from the sale of the 150 head. On September 7, 1997, as a result of the drought, the affected area was declared a disaster area eligible for federal assistance. The income that Mr. Smith may elect to postpone until 1998 is determined as follows:

$$\frac{\text{Total income from sales}}{\text{Total number sold}} \text{ £ Excess number sold}$$

$$\$45{,}000/150 \text{ head} \times 50 = \$15{,}000$$

Mr. Smith may elect to postpone $15,000 income until 1998. The $30,000 that would have normally been received in 1997 must be reported on his 1997 Schedule F, line 4. The election must be made by the due date of the return (including extensions) for the tax year in which the drought sale occurred. The election is made by attaching a statement to the return that includes the following information:

a. A declaration that the taxpayer is making an election under I.R.C. §451(e)
b. Evidence of the existence of the weather-related conditions that forced the early sale or exchange of the livestock and the date, if known, on which an area was designated as eligible for assistance by the federal government as a result of the weather-related conditions
c. A statement explaining the relationship of the designated disaster area to the taxpayer's early sale or exchange of the livestock
d. The total number of animals sold in each of the three preceding years
e. The number of animals that would have been sold in the taxable year had the taxpayer followed his or her normal business practice in the absence of the weather-related conditions.

**Practitioner Note.**

The number of animals that would have been sold under usual business practices in the absence of the weather-related conditions is determined primarily by the past history of the producer. If the producer generally holds all calves until the year after they are born before selling them, but was forced because of weather-related conditions to sell them in the year born, the proceeds from this sale may be reported in the year following the year of the sale.

f. The total number of animals sold and the number sold on account of weather-related conditions during the taxable year
g. A computation, pursuant to Reg. §1.451-7(e) (the computation shown above), of the amount of income to be deferred for each such classification

## Summary of Weather-Related Sale Rules for Livestock

| | Postpone Gain and Purchase Replacements | Defer Income to Next Tax Year |
|---|---|---|
| What livestock qualifies? | Draft, breeding, or dairy livestock | All livestock |
| Requirement of disaster area declaration? | No | Yes |
| Must livestock be in the disaster area? | No | No |
| Must livestock be sold in the disaster area? | No | No |
| Must weather-related condition have caused the sale? | Yes | Yes |
| Provision applies to: | Sales in excess of normal practice | Sales in excess of normal practice |
| Provision allows: | Deferral of gain by carrying over basis | Postponing recognition of gain by one year |
| Repurchase required? | Yes | No |
| Basis in replacement livestock | Reduced by gain that is deferred | Not applicable |
| Period for replacing | Two years from the end of the taxable year of sale | Not applicable |
| Time limit for making the election | Two years from the end of the taxable year of sale | Due date for return for year of sale |

## C. Revoking an Election to Defer Reporting of Weather-Related Sales of Livestock

**Example 4-E.** In 1996, Bubba Bitterweed disposed of an unusually high number of dairy cows due to drought conditions. On his 1996 tax return, Bubba made an election under I.R.C. §451(e) to include the income from the excess sales of livestock for 1997, the year following the year of actual sale. In 1997, Bubba decided to replace the excess dairy cows sold and asks if he can revoke the §451(e) election and replace the involuntarily converted dairy cows under §1033(e).

According to Letter Rulings 9127012, 9214021, and 9333032, a taxpayer can revoke the §451(e) election only with the consent of the Commissioner. However, all taxpayers in the above rulings were allowed to do so. The taxpayers apparently can also then elect under I.R.C. §1033(e) to replace the involuntarily converted animals within the two-year replacement period. Under §1033(e), all of the details in connection with an involuntary conversion of property at a gain must be reported in the return of the year in which the gain is realized. However, all of those details were also supplied with the original §451(e) election. Therefore, a taxpayer originally electing §451(e) treatment has also complied with the information reporting under §1033(e). Since there is no specific requirement that §1033(e) be elected on a timely filed return (but only that the appropriate information be supplied), a taxpayer can apparently elect §1033(e) treatment on an amended return.

---

**Practitioner Note.**

A letter ruling request may have to be filed to request permission for such a change. Thus, Bubba could likely change his §451(e) election to a §1033(e) election if he files a letter ruling request to do so. Alternatively, the taxpayer might elect to request a determination letter from the District Director. A determination letter is apparently an option when the issue is the replacement of involuntarily converted property under §1033, if the taxpayer has filed a return for the year in which the property was involuntarily converted (Rev. Proc. 95-1, 1995-1 IRB 9). This option would reduce the required user fee to $275, or a savings of $625.

**Example 4-F.** Dolly Dandelion disposed of an abnormally high number of breeding cows in 1996, due to drought conditions. On her 1996 tax return, Dolly made an election under I.R.C. §1033(e) to replace the involuntarily converted animals within the designated two-year time period. In 1997, Dolly decides that she will not replace the cows. However, she would prefer to report the income from the drought sale in 1997, rather than amending her 1996 return, since her marginal tax rate was significantly higher in 1996 than in 1997. Can Dolly revoke the §1033(e) election and elect the one-year deferral of sale reporting under §451(e)?

Apparently, Dolly can **not** revoke the §1033(e) election and adopt a §451(e) election. An election under §451(e) must be made by the due date of the return (including extensions) for the tax year in which the drought sale occurred. Thus, if Dolly did not replace the involuntarily converted cows within the designated time period, she would be required to amend her 1996 tax return and report the sales proceeds in that year.

Therefore, taxpayers who have the opportunity to elect either deferral method need to be careful in making the election. Once §1033(e) treatment is elected and the due date of the return passes, §451(e) treatment is no longer available. If, on the other hand, §451(e) treatment is elected, it may be revoked only with permission, which may require a letter ruling request and a $900 fee. A second option is to request a determination letter, which has a cost of only $275. However, if permission to revoke §451(e) treatment is granted, a §1033(e) election on an amended return would defer any realized gain until the replacement property is sold.

**Revoking a Weather-Related Sale Election**

| **Original Election** | **Can Revoke Original Election?** | **Can Make New Election?** |
|---|---|---|
| One-year deferral [§451(e)] | Yes | Yes; can elect to roll gain to replacements [§1033(e)] |
| **WHY? §1033(e) election can be made on an amended return** | | |
| Roll gain to replacements [§1033(e)] | Yes | No; cannot elect to defer income by one year |
| **WHY NOT? §451(e) election must be made by due date of tax return** | | |

## C. Crops

I.R.C. §451(d) allows a producer who uses the cash method of accounting to elect to postpone the recognition of income for one year if the following requirements are met:

1. The payment is received to compensate destruction of or damage to a crop by a flood, drought, or other natural disaster
2. The payment is either insurance proceeds or a federal disaster payment
3. Under the taxpayer's normal business practice, the income from the crop that was destroyed would have been reported in the year following the year of destruction or damage.

**Practitioner Note.**

The election to postpone reporting the payment as income covers all crops from a farm. However, a separate election must be made for each farming business of a taxpayer.

Under the statutory language, the exception applies to crop insurance proceeds; disaster payments received from the federal government under the Agricultural Act of 1949, as amended; and disaster payments received under the Disaster Assistance Act of 1988 [I.R.C. §451(d)]. Under the regulatory language, the provision applies to **all** federal payments received after December 31, 1973, for losses due to a natural disaster [Reg. §1.451-6(a)].

**Practitioner Note.**

This provision does not allow the taxpayer to accelerate reporting the payment if the payment is received the year after a loss.

## Qualifying for the Exception

To qualify for the exception, a taxpayer must be able to show that, under the taxpayer's normal business practice, the income from the crop for which the payment is received would have been reported **in a year following the receipt of the payment.**

## Two Options for Reporting on Tax Returns

Taxpayers who qualify for this exception have the option of reporting the payment as income in the year it is received or as income in the following year.

The election to postpone reporting the payment as income covers all crops from a farm. A separate election must be made for each farming business of a taxpayer. For purposes of this provision, separate businesses are defined as those for which the taxpayer keeps separate books and is allowed to use different methods of accounting. In general, that requires the businesses to be separate and distinct.

## How to Make the Election

The election must be attached to the return (or amended return) for the tax year in which the payment was received. **The statement must include:**

1. The name and address of the taxpayer
2. A declaration that the taxpayer is making an election under §451(d)
3. Identification of the specific crop or crops destroyed or damaged
4. A declaration that, under the taxpayer's normal business practice, the income derived from the crops that were destroyed or damaged would have been included in his or her gross income for a taxable year following the taxable year of such destruction or damage
5. The cause of destruction or damage of crops and the date or dates on which such destruction or damage occurred
6. The total amount of payments received from insurance carriers, itemized with respect to each specific crop and with respect to the date each payment was received
7. The name(s) of the insurance carrier or carriers from whom payments were received

**Example 4-G.** Daisy Petal normally sells her soybean and cotton crops in the year **after** they are produced. In 1997, flooding damaged her soybean and cotton crops. She had insurance to cover the loss and received a payment from the insurance company of $15,000 for soybeans and $21,000 for cotton in November 1997.

Daisy can postpone reporting the $36,000 of income by attaching the following statement to her 1997 return. She then reports the $36,000 on line 8a of her 1997 Schedule F and excludes it from line 8b. She cannot postpone reporting the payment for one crop unless she postpones reporting the payment for both.

**Election under §451(d) to Postpone**

**Recognition of Crop Insurance Proceeds**

Daisy Petal 000–00–0001
Route 2, Box 2
Bitterweed, MS 38000

The above taxpayer hereby elects to postpone the recognition of the following crop insurance proceeds. The income from the crops for which these proceeds were received would have been included in gross income in a year following the year of distribution or damage under the taxpayer's normal business practice.

| **Crop Destroyed or Damaged** | **Cause** | **Date of Destruction or Damage** | **Payment Received** | **Date of Payment** | **Insurance Carrier** |
|---|---|---|---|---|---|
| Soybeans | Flood | 6/10/97 | $15,000 | 10/15/97 | Crops Ins., Inc. |
| Cotton | Flood | 6/10/97 | $21,000 | 10/15/97 | Crops Ins., Inc. |

**Observation.** Some producers have deferred crop insurance and disaster payments from 1996 to be reported in 1997. Those payments should be reported on line 8d of the 1997 Schedule F (Form 1040).

## Ambiguity in the Election Requirements

Notice 89-55, 1989-20 IRB 134, May 15, 1989, explains the application of I.R.C. §451(d) for many situations but leaves one ambiguity: the treatment of disaster payments and crop insurance payments when they are received for two different crops and the crops are normally marketed in different years by the producer.

1. In **Rev. Rul. 74-145**, 1974-1 C.B. 113, the IRS stated that if a producer normally sold more than 50% of **all** crops in the year following the year of harvest, then **all** insurance payments would be postponed until the following year **if** the §451(d) election is made.
2. Notice 89-55 and §451(d) say that insurance proceeds and disaster payments can be postponed "if the taxpayer establishes that, under its normal business practice, income from the crops would have been reported in the year following the year of destruction or damage." That language can be interpreted as saying that insurance and disaster payments received for crops that are normally marketed in the year of harvest cannot be postponed even if the election is made.

**Example 4-H.** Assume the facts are the same as Example 4-G except that Daisy normally sells her soybeans at harvest time.

Likely tax consequence. Rev. Rul. 74-145 seems to say that the insurance payments received for the cotton and soybeans must be treated the same and would be eligible for the §451(d) election only if the sales from both crops that are normally postponed are more than 50% of the total.

Possible argument. It could be argued that the language of §451(d) does not allow Daisy to postpone reporting the payment received on her soybeans since she normally sells that crop in the year it is harvested. Notice 89-55 does not clarify this issue since it uses the language of the Code but does not specifically overrule Rev. Rul. 74-145.

**Example 4-I.** In 1997 Clay Fields receives $8,000 of crop insurance proceeds due to hail damage on his wheat crop, and also receives $14,000 of disaster payments as a result of drought damage to his corn crop. Can Clay elect to include in income the crop insurance proceeds for his wheat and defer the disaster payment for his corn, since one payment is crop insurance and the other payment is a disaster payment?

No, both crop insurance proceeds and disaster payments must be aggregated in determining whether to defer the income reporting or to include the payment in current year income. Crop disaster payments are specifically identified as equivalent to crop insurance proceeds, and thus both types of payments are to be reported in a consistent manner. Clay must therefore decide between reporting the entire amount of payments ($8,000 + $14,000) in 1996 or deferring both payments to 1998, assuming he meets the requirement of normally selling more than 50% of his crops in the following year.

**Example 4-J.** Assume that Clay Fields, the taxpayer in 4-I, had received the $8,000 of crop insurance proceeds for the wheat loss in his sole proprietorship grain farm and had received the $14,000 of disaster payments for drought damage to corn grown by a farming partnership in which Clay is a 50% partner. The sole proprietorship wheat farm and the partnership corn farm are separate farming businesses and keep separate records. Can Clay elect to include in income the $8,000 of crop insurance proceeds for his wheat, while the partnership farm elects to defer the disaster payment received for corn?

Yes, the two separate farming operations in which Clay participates do not have to make the same election. If a taxpayer has more than one farming business, he or she makes a separate election for each such business. Separate farming businesses are those for which the taxpayer keeps separate books and is allowed to use different methods of accounting.

## Issue 5: Crop Indemnity Payments

As part of the new farm bill, the USDA is expanding the risk management protection offered by the crop insurance programs. These experimental programs, which are in addition to the Actual Production History multi-peril crop insurance, include the Crop Revenue Coverage (CRC), Income Protection Plan (IP), and Revenue Assurance (RA) programs. Producers in some areas can purchase coverage for a limited number of crops. Program availability for the 1997 crop year is given below:

Crop Revenue Coverage (CRC) covers

- Corn in the following states:

| | | |
|---|---|---|
| Colorado | Michigan | Ohio |
| Illinois | Minnesota | Oklahoma |
| Iowa | Missouri | South Dakota |
| Kansas | Nebraska | Texas |

- Cotton in the following states:

| | |
|---|---|
| Arizona | Oklahoma |
| Georgia | Texas (designated counties) |

- Grain sorghum in the following states:

| | |
|---|---|
| Colorado | Nebraska |
| Kansas (designated counties) | Oklahoma |
| Missouri (designated counties) | South Dakota (designated counties) |

- Soybeans in the following states:

| | | |
|---|---|---|
| Illinois | Michigan | Ohio |
| Indiana | Minnesota | Oklahoma |
| Iowa | Missouri | South Dakota |
| Kansas | Nebraska | Texas |

- Spring wheat in the following states:

| | |
|---|---|
| Minnesota | North Dakota (designated counties) |
| Montana (designated counties) | |

- Winter wheat in the following states:

| | |
|---|---|
| Kansas | South Dakota |
| Michigan | Texas |
| Montana (designated counties) | Washington |
| Nebraska | |

### Income Protection Plan covers

- Grain sorghum in Texas (designated counties)
- Soybeans in the following states:

| | |
|---|---|
| Arkansas (designated counties) | Indiana (designated counties) |
| Illinois (designated counties) | |

### Revenue Assurance (RA) covers

- Corn in Iowa
- Soybeans in Iowa

The amount of payments varies by the type of coverage that is purchased by the producer and the type of loss that is incurred. However, for purposes of this income tax discussion, the payments can be divided into two types according to the type of loss:

1. Losses that result from a lower than expected price
2. Losses that result from reduced production due to natural disasters

## Losses That Result from Low Market Price

Payments that compensate the producer for low market prices must be reported as income in the year they are received. No income tax provisions allow that income to be postponed.

**Example 5-A.** Craig White purchased an income protection plan for his 1997 wheat crop. Craig received a $1,500 payment from the plan in 1997 because the harvest price was below the price set in the plan. The $1,500 must be included with other crop income reported on line 4 of Schedule F (Form 1040).

### Losses That Result from Natural Disasters

Losses that result from crop loss due to natural disasters may qualify for the provision that allows taxpayers to postpone reporting income by one year [§451(d)]. That provision is discussed and illustrated in Issue 4 above.

## Issue 6: Like-kind exchange of machinery

I.R.C. §1031 allows taxpayers to postpone recognition of gain on property they relinquish if they trade that property for property that is "like-kind." The gain is postponed by not recognizing the gain realized on the relinquished property and by reducing the basis in the acquired property. Both the relinquished property and the acquired property must be used in a trade or business or held for investment [I.R.C. §1031(a)(1)].

"Like-kind" is interpreted more narrowly for personal property than it is for real property. Regulations issued in 1991 add some clarity to the murky issue of determining whether personal property is like-kind. However, some issues remain unresolved. The regulations add clarity by providing two different safe harbors for determining whether property is like-kind.

### First Safe Harbor

The first safe harbor includes 13 General Asset classes under the depreciation rules set out in Rev. Proc. 87-56, 1987-2 C.B. 674. **Since farm property is not included in those 13 classes, this safe harbor is of no use when farm "personal" property is exchanged.**

### Second Safe Harbor

The second safe harbor includes all the four-digit product classes within Division D of the Standard Industrial Classification codes, set forth in Executive Office of the President, Office of Management and Budget, Standard Industrial Classification Manual (1987) ("SIC Manual"). Any two assets that are listed in the same four-digit product class (other than the miscellaneous classes) are like-kind property.

Since the SIC Manual was written to classify industries rather than products, use of the product classes to find like-kind property is somewhat confusing. The assets being traded by a taxpayer are classified by the industry that manufactures the assets rather than by the taxpayer's industry.

Consequently, farm personal property falls into product classes such as 3423 Hand and Edge Tools, Except Machine Tools and Handsaws; 3425 Saw Blades and Handsaws; 3429 Hardware, Not Elsewhere Classified; and 3523 Farm Machinery and Equipment. (See Appendix B at the end of this chapter for the list of assets included in each of these product classes.)

**Practitioner Note.**

Product classes ending with a 9 are the miscellaneous classes. Therefore, assets in product class 3429 Hardware, Not Elsewhere Classified are not like-kind property with other property in that class.

**Conclusion.** Since most personal property used in a farm business is included in product class 3523 Farm Machinery and Equipment, farmers will generally qualify for I.R.C. §1031 treatment when they exchange farm equipment for farm equipment.

**Observation.** The new rules provide an additional means of showing that two assets are like-kind. The new rules do not change or replace any of the prior law. Therefore, if two assets are not in the same class under the new rules, they are still like-kind property if they were like-kind property under prior law [Treas. Reg. §1.1031(a)-2(a)].

**Example 6-A.** During 1997, Rachel Brown, a sole proprietor, made the following trades:

| Property Transferred | | | | | Property Received | | | |
|---|---|---|---|---|---|---|---|---|
| Item | Unadjusted Basis | Depreciation Claimed | Adjusted Basis | FMV | Item | FMV | Boot Paid | Boot Received |
| Old tractor | $30,000 | $25,000 | $ 5,000 | $10,000 | New tractor | $60,000 | $50,000 | |
| Combine | 57,000 | 35,000 | 22,000 | 40,000 | Corn planter | 25,000 | | $15,000 |
| 1988 car[a] | 14,000 | 7,000 | 7,000 | 4,000 | 1997 car | 20,000 | 16,000 | |

[a]The car was used 50% for business and 50% for personal.

Both the 1988 and the 1997 cars were used 50% in Rachel's farm business; the other 50% was personal use. Rachel claimed depreciation on only the 50% business use.

## Analysis of Trades

**Old tractor for new tractor:** The gain Rachel realized on the exchange of tractors is

| | |
|---|---|
| Trade-in value of old tractor | $10,000 |
| | |

| | |
|---|---|
| Adjusted basis of old tractor | 5,000 |
| Gain realized but not recognized | $5,000 |

The trade qualifies as a like-kind exchange since the property transferred and the property received are both tractors. Therefore, Rachel does not have to recognize any gain on this trade since no boot was received.

**Combine for corn planter:** The gain Rachel realized on the exchange of the combine for the corn planter is

| | |
|---|---|
| Trade-in value of combine | $40,000 |
| Adjusted basis of combine | 22,000 |
| Gain realized | $18,000 |

The trade qualifies as a like-kind exchange since the combine and corn planter are both included in SIC product class 3523 Farm Machinery and Equipment. However, Rachel must recognize gain to the extent she received cash. Therefore, she must recognize $15,000 of gain and can roll $3,000 of gain into the planter.

All of the $15,000 gain that is recognized is ordinary income under the I.R.C. §1245 recapture rules since Rachel claimed $35,000 of depreciation on the combine.

**1988 car for 1997 car:** Since the cars are used partially for business and partially for personal use, the trade must be treated as if each car is two separate assets—one half is a business asset and the other half is a personal asset.

The gain Rachel realized on the business one-half is

| | |
|---|---|
| Trade-in value of one-half | $2,000 |
| Adjusted basis of business one-half | 0 |
| Gain realized but not recognized | $2,000 |

The trade qualifies as a like-kind exchange, so Rachel does not have to report that $2,000 of gain.

The loss Rachel realized on the personal one-half is

| | |
|---|---|
| Trade-in value of one-half | $2,000 |
| Adjusted basis of personal one-half | 7,000 |
| Loss realized but not recognized | $5,000 |

Rachel is not allowed to recognize that loss because it is realized on a personal asset.

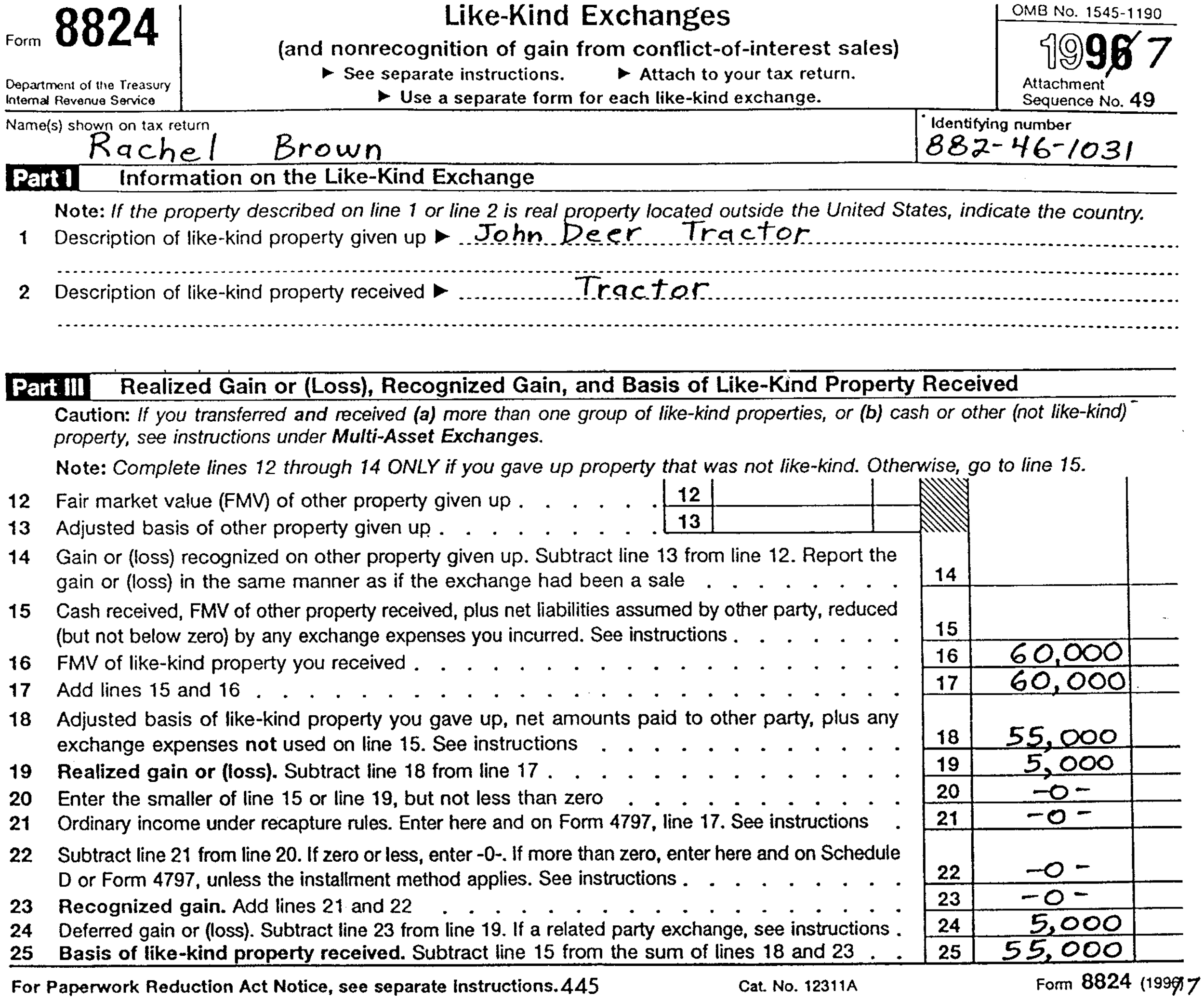
## Reporting Like-Kind Exchanges

The tax-free exchange treatment of I.R.C. §1031 **is not elective.** If an exchange meets the requirements, the taxpayer must postpone reporting the gain or loss realized on the property transferred and adjust the basis of the property received. The transactions in the above example are reported as shown on the following forms.

---

**Practitioner Note.**

The Form 8824 instructions say that it must be filed for the year like-kind exchange property was transferred. If the property was transferred to a related party, Form 8824 must be filed for the two years following the year of the transfer.



Form **8824**
Department of the Treasury
Internal Revenue Service

**Like-Kind Exchanges**
(and nonrecognition of gain from conflict-of-interest sales)
▶ See separate instructions. ▶ Attach to your tax return.
▶ Use a separate form for each like-kind exchange.

OMB No. 1545-1190
199~~6~~7
Attachment Sequence No. 49

Name(s) shown on tax return: Rachel Brown
Identifying number: 882-46-1031

**Part I** **Information on the Like-Kind Exchange**

**Note:** *If the property described on line 1 or line 2 is real property located outside the United States, indicate the country.*

1 Description of like-kind property given up ▶ John Deer Tractor

2 Description of like-kind property received ▶ Tractor

**Part III** **Realized Gain or (Loss), Recognized Gain, and Basis of Like-Kind Property Received**

**Caution:** *If you transferred and received* **(a)** *more than one group of like-kind properties, or* **(b)** *cash or other (not like-kind) property, see instructions under* ***Multi-Asset Exchanges.***

**Note:** *Complete lines 12 through 14 ONLY if you gave up property that was not like-kind. Otherwise, go to line 15.*

| | | | | | |
|---|---|---|---|---|---|
| 12 | Fair market value (FMV) of other property given up | 12 | | | |
| 13 | Adjusted basis of other property given up | 13 | | | |
| 14 | Gain or (loss) recognized on other property given up. Subtract line 13 from line 12. Report the gain or (loss) in the same manner as if the exchange had been a sale | | | 14 | |
| 15 | Cash received, FMV of other property received, plus net liabilities assumed by other party, reduced (but not below zero) by any exchange expenses you incurred. See instructions | | | 15 | |
| 16 | FMV of like-kind property you received | | | 16 | 60,000 |
| 17 | Add lines 15 and 16 | | | 17 | 60,000 |
| 18 | Adjusted basis of like-kind property you gave up, net amounts paid to other party, plus any exchange expenses **not** used on line 15. See instructions | | | 18 | 55,000 |
| 19 | **Realized gain or (loss).** Subtract line 18 from line 17 | | | 19 | 5,000 |
| 20 | Enter the smaller of line 15 or line 19, but not less than zero | | | 20 | -0- |
| 21 | Ordinary income under recapture rules. Enter here and on Form 4797, line 17. See instructions | | | 21 | -0- |
| 22 | Subtract line 21 from line 20. If zero or less, enter -0-. If more than zero, enter here and on Schedule D or Form 4797, unless the installment method applies. See instructions | | | 22 | -0- |
| 23 | **Recognized gain.** Add lines 21 and 22 | | | 23 | -0- |
| 24 | Deferred gain or (loss). Subtract line 23 from line 19. If a related party exchange, see instructions | | | 24 | 5,000 |
| 25 | **Basis of like-kind property received.** Subtract line 15 from the sum of lines 18 and 23 | | | 25 | 55,000 |

**For Paperwork Reduction Act Notice, see separate instructions.** 445 Cat. No. 12311A Form 8824 (199~~6~~7)

Form **8824**

Department of the Treasury
Internal Revenue Service

# Like-Kind Exchanges

(and nonrecognition of gain from conflict-of-interest sales)

▶ See separate instructions. ▶ Attach to your tax return.
▶ Use a separate form for each like-kind exchange.

OMB No. 1545-1190
199~~6~~7
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Name(s) shown on tax return: Rachel Brown

Identifying number: 882-46-1031

## Part I Information on the Like-Kind Exchange

**Note:** *If the property described on line 1 or line 2 is real property located outside the United States, indicate the country.*

1 Description of like-kind property given up ▶ John Deer Tractor

2 Description of like-kind property received ▶ Tractor

## Part III Realized Gain or (Loss), Recognized Gain, and Basis of Like-Kind Property Received

**Caution:** *If you transferred and received (a) more than one group of like-kind properties, or (b) cash or other (not like-kind) property, see instructions under **Multi-Asset Exchanges**.*

**Note:** *Complete lines 12 through 14 ONLY if you gave up property that was not like-kind. Otherwise, go to line 15.*

| | | | | | |
|---|---|---|---|---|---|
| 12 | Fair market value (FMV) of other property given up | 12 | | | |
| 13 | Adjusted basis of other property given up | 13 | | | |
| 14 | Gain or (loss) recognized on other property given up. Subtract line 13 from line 12. Report the gain or (loss) in the same manner as if the exchange had been a sale | | | 14 | |
| 15 | Cash received, FMV of other property received, plus net liabilities assumed by other party, reduced (but not below zero) by any exchange expenses you incurred. See instructions | | | 15 | |
| 16 | FMV of like-kind property you received | | | 16 | 60,000 |
| 17 | Add lines 15 and 16 | | | 17 | 60,000 |
| 18 | Adjusted basis of like-kind property you gave up, net amounts paid to other party, plus any exchange expenses **not** used on line 15. See instructions | | | 18 | 55,000 |
| 19 | **Realized gain or (loss).** Subtract line 18 from line 17 | | | 19 | 5,000 |
| 20 | Enter the smaller of line 15 or line 19, but not less than zero | | | 20 | -0- |
| 21 | Ordinary income under recapture rules. Enter here and on Form 4797, line 17. See instructions | | | 21 | -0- |
| 22 | Subtract line 21 from line 20. If zero or less, enter -0-. If more than zero, enter here and on Schedule D or Form 4797, unless the installment method applies. See instructions | | | 22 | -0- |
| 23 | **Recognized gain.** Add lines 21 and 22 | | | 23 | -0- |
| 24 | Deferred gain or (loss). Subtract line 23 from line 19. If a related party exchange, see instructions | | | 24 | 5,000 |
| 25 | **Basis of like-kind property received.** Subtract line 15 from the sum of lines 18 and 23 | | | 25 | 55,000 |

**For Paperwork Reduction Act Notice, see separate instructions.** 445 Cat. No. 12311A Form 8824 (199~~6~~7)

Form **8824**

Department of the Treasury
Internal Revenue Service

# Like-Kind Exchanges

(and nonrecognition of gain from conflict-of-interest sales)

► See separate instructions. ► Attach to your tax return.
► Use a separate form for each like-kind exchange.

OMB No. 1545-1190

199~~6~~7

Attachment Sequence No. 49

Name(s) shown on tax return: Rachel Brown

Identifying number: 882-46-1031

## Part I Information on the Like-Kind Exchange

**Note:** *If the property described on line 1 or line 2 is real property located outside the United States, indicate the country.*

1 Description of like-kind property given up ► Combine

2 Description of like-kind property received ► Corn Planter

## Part III Realized Gain or (Loss), Recognized Gain, and Basis of Like-Kind Property Received

**Caution:** *If you transferred* **and** *received* **(a)** *more than one group of like-kind properties, or* **(b)** *cash or other (not like-kind) property, see instructions under* ***Multi-Asset Exchanges.***

**Note:** *Complete lines 12 through 14 ONLY if you gave up property that was not like-kind. Otherwise, go to line 15.*

| | | | | | |
|---|---|---|---|---|---|
| 12 | Fair market value (FMV) of other property given up | 12 | | | |
| 13 | Adjusted basis of other property given up | 13 | | | |
| 14 | Gain or (loss) recognized on other property given up. Subtract line 13 from line 12. Report the gain or (loss) in the same manner as if the exchange had been a sale | | | 14 | |
| 15 | Cash received, FMV of other property received, plus net liabilities assumed by other party, reduced (but not below zero) by any exchange expenses you incurred. See instructions | | | 15 | 15,000 |
| 16 | FMV of like-kind property you received | | | 16 | 25,000 |
| 17 | Add lines 15 and 16 | | | 17 | 40,000 |
| 18 | Adjusted basis of like-kind property you gave up, net amounts paid to other party, plus any exchange expenses **not** used on line 15. See instructions | | | 18 | 22,000 |
| 19 | **Realized gain or (loss).** Subtract line 18 from line 17 | | | 19 | 18,000 |
| 20 | Enter the smaller of line 15 or line 19, but not less than zero | | | 20 | 15,000 |
| 21 | Ordinary income under recapture rules. Enter here and on Form 4797, line 17. See instructions | | | 21 | 15,000 |
| 22 | Subtract line 21 from line 20. If zero or less, enter -0-. If more than zero, enter here and on Schedule D or Form 4797, unless the installment method applies. See instructions | | | 22 | -0- |
| 23 | **Recognized gain.** Add lines 21 and 22 | | | 23 | 15,000 |
| 24 | Deferred gain or (loss). Subtract line 23 from line 19. If a related party exchange, see instructions | | | 24 | 3,000 |
| 25 | **Basis of like-kind property received.** Subtract line 15 from the sum of lines 18 and 23 | | | 25 | 22,000 |

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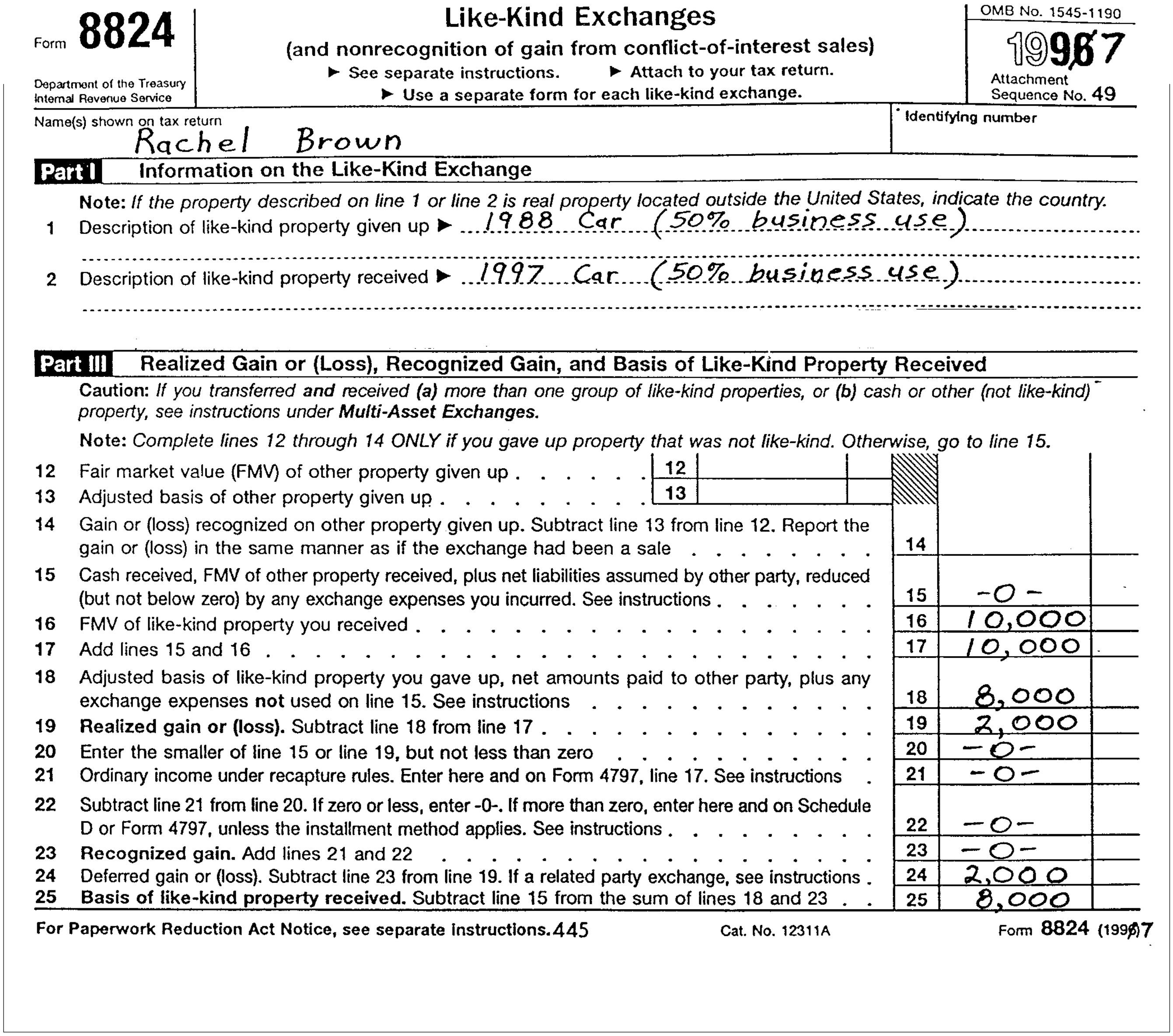


Form **8824**

Department of the Treasury
Internal Revenue Service

**Like-Kind Exchanges**

(and nonrecognition of gain from conflict-of-interest sales)

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

▶ Use a separate form for each like-kind exchange.

OMB No. 1545-1190

199~~6~~7

Attachment Sequence No. 49

Name(s) shown on tax return: Rachel Brown

Identifying number:

**Part I** Information on the Like-Kind Exchange

**Note:** *If the property described on line 1 or line 2 is real property located outside the United States, indicate the country.*

1 Description of like-kind property given up ▶ 1988 Car (50% business use)

2 Description of like-kind property received ▶ 1997 Car (50% business use)

**Part III** Realized Gain or (Loss), Recognized Gain, and Basis of Like-Kind Property Received

**Caution:** *If you transferred and received* **(a)** *more than one group of like-kind properties, or* **(b)** *cash or other (not like-kind) property, see instructions under* ***Multi-Asset Exchanges.***

**Note:** *Complete lines 12 through 14 ONLY if you gave up property that was not like-kind. Otherwise, go to line 15.*

| | | | |
|---|---|---|---|
| 12 | Fair market value (FMV) of other property given up | 12 | |
| 13 | Adjusted basis of other property given up | 13 | |
| 14 | Gain or (loss) recognized on other property given up. Subtract line 13 from line 12. Report the gain or (loss) in the same manner as if the exchange had been a sale | 14 | |
| 15 | Cash received, FMV of other property received, plus net liabilities assumed by other party, reduced (but not below zero) by any exchange expenses you incurred. See instructions | 15 | -0- |
| 16 | FMV of like-kind property you received | 16 | 10,000 |
| 17 | Add lines 15 and 16 | 17 | 10,000 |
| 18 | Adjusted basis of like-kind property you gave up, net amounts paid to other party, plus any exchange expenses **not** used on line 15. See instructions | 18 | 8,000 |
| 19 | **Realized gain or (loss).** Subtract line 18 from line 17 | 19 | 2,000 |
| 20 | Enter the smaller of line 15 or line 19, but not less than zero | 20 | -0- |
| 21 | Ordinary income under recapture rules. Enter here and on Form 4797, line 17. See instructions | 21 | -0- |
| 22 | Subtract line 21 from line 20. If zero or less, enter -0-. If more than zero, enter here and on Schedule D or Form 4797, unless the installment method applies. See instructions | 22 | -0- |
| 23 | **Recognized gain.** Add lines 21 and 22 | 23 | -0- |
| 24 | Deferred gain or (loss). Subtract line 23 from line 19. If a related party exchange, see instructions | 24 | 2,000 |
| 25 | **Basis of like-kind property received.** Subtract line 15 from the sum of lines 18 and 23 | 25 | 8,000 |

**For Paperwork Reduction Act Notice, see separate instructions.**445 Cat. No. 12311A Form **8824** (199~~6~~7)

## Subsequent Sale of Property Received in a Like-kind Exchange

Gain that is postponed by a like-kind exchange is recognized on the sale of the asset received in the like-kind exchange. If there was potential depreciation recapture included in the postponed gain, that recapture must also be recognized upon sale of the assets received in the like-kind exchange.

**Example 6-B.** Rachel from Example 6-A used the corn planter in 1997, 1998, and 1999 and then sold it for $24,000. Upon sale of the planter, she must report the following gain:

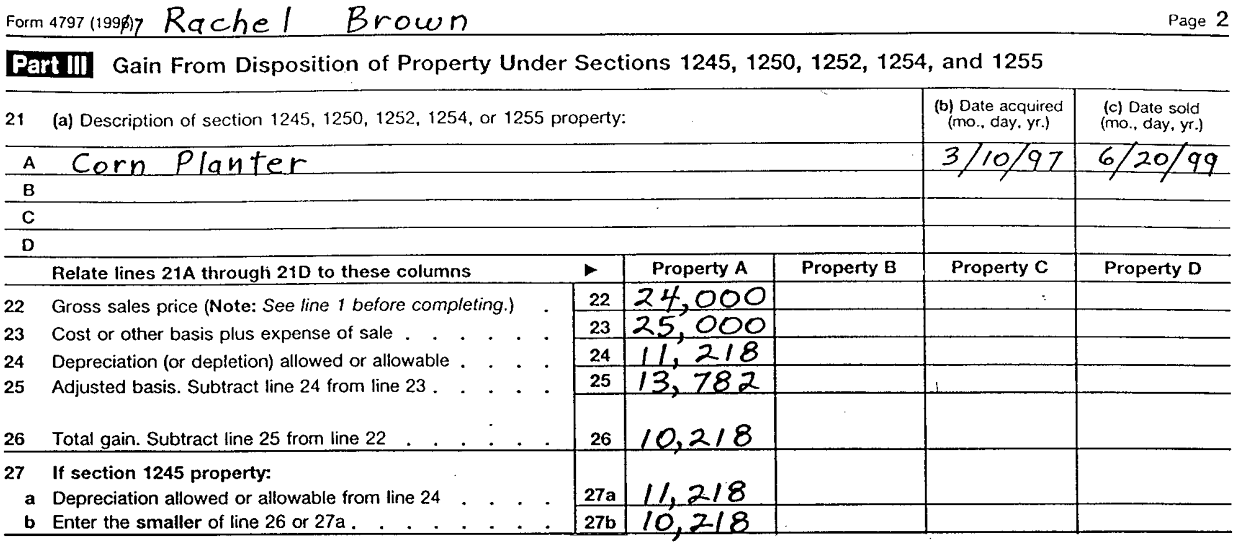
| | | |
|---|---|---|
| Amount realized | | $24,000 |
| Less adjusted basis | | |
| Unadjusted basis | $22,000 | |
| Depreciation | 8,218 | |
| Adjusted basis | | 13,782 |
| Gain realized | | $10,218 |

$8,218 of the gain realized on the planter must be reported as recapture of depreciation on the planter. **The remaining $2,000 of gain realized must also be reported as depreciation recapture** since it is part of the $3,000 of gain rolled over from the combine and would have been reported as depreciation recapture if the gain had been recognized.

The instructions for line 24 of Form 4797 require the taxpayer to include the depreciation claimed on property transferred in a like-kind exchange for the property that is currently being sold. However, the depreciation that must be included from the transferred asset is limited to the gain that is rolled over into the asset acquired, in this case $3,000. Therefore, the depreciation reported on line 24 of Form 4797 is

| | |
|---|---|
| Depreciation on planter | $8,218 |
| Deferred gain from combine | 3,000 |
| Total | $11,218 |

Rachel is also allowed to increase the basis she reports on line 23 of Form 4797 by the $3,000 of gain that was rolled into the planter. (See instructions for line 24 of Form 4797 and Reg. §1.1245-29(e)(4).) That adjustment is necessary to arrive at the appropriate gain on line 26 of Form 4797.

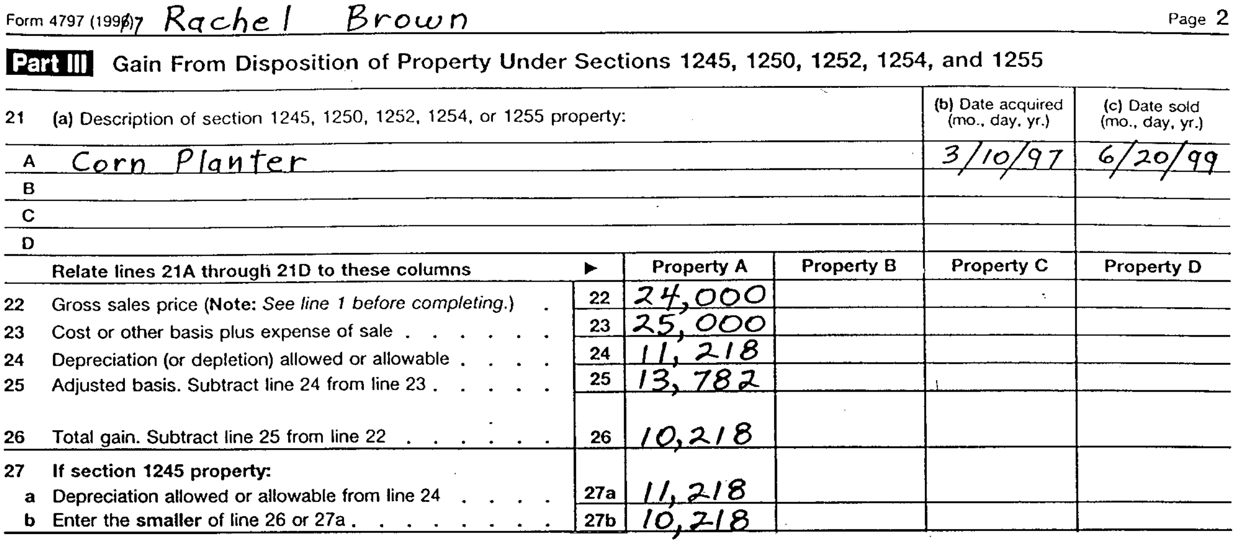


Form 4797 (199~~6~~)7 Rachel Brown — Page 2

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

| | | (b) Date acquired (mo., day, yr.) | (c) Date sold (mo., day, yr.) |
|---|---|---|---|
| 21 | (a) Description of section 1245, 1250, 1252, 1254, or 1255 property: | | |
| A | Corn Planter | 3/10/97 | 6/20/99 |
| B | | | |
| C | | | |
| D | | | |

| Relate lines 21A through 21D to these columns ▶ | | Property A | Property B | Property C | Property D |
|---|---|---|---|---|---|
| 22 Gross sales price (**Note:** *See line 1 before completing.*) | 22 | 24,000 | | | |
| 23 Cost or other basis plus expense of sale | 23 | 25,000 | | | |
| 24 Depreciation (or depletion) allowed or allowable | 24 | 11,218 | | | |
| 25 Adjusted basis. Subtract line 24 from line 23 | 25 | 13,782 | | | |
| 26 Total gain. Subtract line 25 from line 22 | 26 | 10,218 | | | |
| 27 **If section 1245 property:** | | | | | |
| a Depreciation allowed or allowable from line 24 | 27a | 11,218 | | | |
| b Enter the **smaller** of line 26 or 27a | 27b | 10,218 | | | |



Form 4797 (199~~6~~)7 Rachel Brown — Page 2

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

| | | (b) Date acquired (mo., day, yr.) | (c) Date sold (mo., day, yr.) |
|---|---|---|---|
| 21 | (a) Description of section 1245, 1250, 1252, 1254, or 1255 property: | | |
| A | Corn Planter | 3/10/97 | 6/20/99 |
| B | | | |
| C | | | |
| D | | | |

| Relate lines 21A through 21D to these columns ▶ | | Property A | Property B | Property C | Property D |
|---|---|---|---|---|---|
| 22 Gross sales price (**Note:** *See line 1 before completing.*) | 22 | 24,000 | | | |
| 23 Cost or other basis plus expense of sale | 23 | 25,000 | | | |
| 24 Depreciation (or depletion) allowed or allowable | 24 | 11,218 | | | |
| 25 Adjusted basis. Subtract line 24 from line 23 | 25 | 13,782 | | | |
| 26 Total gain. Subtract line 25 from line 22 | 26 | 10,218 | | | |
| 27 **If section 1245 property:** | | | | | |
| a Depreciation allowed or allowable from line 24 | 27a | 11,218 | | | |
| b Enter the **smaller** of line 26 or 27a | 27b | 10,218 | | | |

## Tax Planning for Like-kind Exchanges of Machinery

Gain realized on the sale of farm machinery is not subject to the self-employment tax. Depreciation claimed on the asset received in a like-kind exchange reduces self-employment income. Consequently, it is often to the taxpayer's advantage to sell the asset and recognize the gain on the asset transferred in order to obtain a higher depreciable basis in the asset purchased.

**Example 6-C.** If Rachel from Example 6-A had sold the old tractor for $10,000, she would have reported an additional $5,000 of ordinary income not subject to the self-employment tax on her return. It would also increase her basis in the new tractor by $5,000. If she made the §179 election for that $5,000, she would reduce her taxable income by $5,000 for both income tax and self-employment tax purposes. Therefore, she would save $5,000 × 0.9235 × 15.3% = $706 of self-employment taxes. She would also increase her taxable income by $353 ($706 ÷ 2).

**Observation.** If the taxpayer wants to recognize the gain on the old machinery, the transaction must be set up to avoid triggering the like-kind exchange rules. Since like-kind treatment **is not elective,** the gain will be rolled over if the transaction qualifies as a like-kind exchange.

**Example 6-D.** Clarence Potter owns an old tractor that is worth $10,000. It is fully depreciated. It would be tax-wise for him to sell the old tractor outright and buy a new tractor outright in 1997 rather than to trade the old tractor for a new one. The implement dealer has agreed to buy his old tractor and write him a check for it if he buys the new tractor from the same implement dealer and writes out his check for the purchase price. Is this a sale and purchase or a trade?

This transaction is a trade. Rev. Rul. 61-119 (1961-1 C.B. 395) had identical facts. The IRS stated that this was a nontaxable like-kind exchange even though the dealer and the taxpayer had separate contracts and both treated the transactions separately in their respective books and records. If the transactions are mutually dependent on each other, the IRS views the two "separate transactions" as steps in a single related and dependent transaction.

**Note:** This issue has been litigated. Both the IRS and the courts have placed great reliance on substance over form when dealing with this situation. If the sale and purchase are clearly separate, unrelated, and independent of each other, then Rev. Rul. 61-119 would not apply.

**Example 6-E.** Joe Hinz sells his old tractor to an implement dealer on February 26, 1997, for $10,000. (Joe needed some extra cash to pay his income taxes.) The implement dealer regularly buys old farm implements from farmers to sell at semiannual auction sales held by the dealership in March and October. On March 14, 1997, Joe buys a new planter from the same implement dealer for $18,000, as Joe rented 500 acres of additional farmland on March 1, 1997, and the new landlord expressed concern that Joe's old planter was inadequate. **In this example, the sale and purchase should be interpreted as separate and independent transactions.**

## Issue 7: Unique Agricultural Structures: Depreciation, I.R.C. §179,

## and I.R.C. §1245

Several structures used in agricultural production are affected by special rules that determine the depreciation that can be claimed, whether or not they qualify for expensing under §179, and whether or not they are subject to the §1245 recapture rules. The rules are confusing because they are interrelated but affect the various categories of property in different ways.

The basic rules for each of the provisions are set out below, followed by a table that reports the income tax treatment for purposes of depreciation, §179, and §1245 of several assets used in farming businesses.

## Depreciation

For most assets, the allowable depreciable life and the method of depreciation is determined by the class life of the asset [I.R.C. §168(e)(1)]. The class life of many assets is reported in Table B-2 in Appendix B of IRS Publication 946, *How to Depreciate Property*.

The depreciable life of some assets is prescribed by statute. Examples include:

1. Race horses more than two years old and other horses more than 12 years old are three-year property under I.R.C. §168(e)(3)(A).
2. Automobiles and light general-purpose trucks are five-year property under I.R.C. §168(e)(3)(B).
3. Single purpose agricultural or horticultural structures are 10-year property under I.R.C. §168(e)(3)(D)(i).

Single-purpose agricultural and horticultural structures are defined in I.R.C. §168(i)(13). That definition is very similar to the definition of agricultural and horticultural structures that was used in the (now repealed) investment credit rules. Therefore, cases and rulings that ruled on whether or not an asset was a single-purpose agricultural or horticultural structure for purposes of the investment credit provide good guidance for determining whether an asset qualifies for the 10-year recovery period.

**Practitioner Note.**

Assets that are not single-purpose agricultural or horticultural structures but meet one of the other (now repealed) tests for being investment credit property—such as the storage provision or the integral part of production provision—do not qualify for the 10-year recovery period.

## §1245

Property used in farming is subject to the depreciation recapture rules under I.R.C. §1245 if it can be depreciated and is

1. Personal property (for example, machinery, breeding livestock, and office equipment)

2. Other tangible property other than buildings that are
   a. Used as an integral part of production (for example, tile lines, water wells, and fences), or
   b. Used for the bulk storage of fungible commodities in connection with production (for example, grain bins and fuel tanks)
3. A single-purpose agricultural or horticultural structure (for example, hog confinement facilities)

**Observation.** The §1245 rules and the depreciation rules are interrelated in two ways. First, to be subject to §1245 recapture the property must be depreciable. Second, single-purpose agricultural and horticultural structures are defined for purposes of §1245 by reference to the definition under the depreciation rules.

## §179

I.R.C. §179 is also interrelated to the §1245 rules and the depreciation rules, since among other requirements property must be §1245 property to qualify for the expensing rules of §179. As noted above, the §1245 rules in turn refer to the definition of single-purpose agricultural and horticultural structures. Therefore, an asset that qualifies as a single-purpose agricultural or horticultural structure not only qualifies for the 10-year recovery period but is also §1245 property and meets one of the §179 requirements.

The following table summarizes the relationship of these rules:

| Asset | Qualifies for 10-Year Recovery Period? | Qualifies for §1245? | Qualifies for §179? |
|---|---|---|---|
| Single-purpose | Yes | Yes | Yes |
| Storage facility | No | Yes | Yes |
| Integral part of production | No | Yes | Yes |

The following table reports the MACRS recovery period of several assets used in farming and the authority for that recovery period. It also reports whether or not the asset qualifies for §§179 and 1245 and the reason for qualifying or not qualifying.

| Asset | Depreciation | | I.R.C. §§179 and 1245 | | |
|---|---|---|---|---|---|
| | MACRS Life | Authority | Qualifies? | Reason | Authority |
| Apple storage | 20-year | Table B-2, Class 01.3 | Yes | Storage | Rev. Rul. 74-451, 1974-2 C.B. 10 |
| Barns | 20-year | Table B-2, Class 01.3 | No | Building | Rev. Rul. 66-89, 1966-1 C.B. 7 |
| Citrus trees | 10-year | I.R.C. §168(e)(3)(D)(ii | Yes | Integral | Rev. Rul. 69-249, 1969-1 |

| | | | | | |
|---|---|---|---|---|---|
| | | ) | | | C.B. 31 |
| Drain tile | 15-year | Pub. 225 | Yes | Integral | Rev. Rul. 66-89, 1966-1 C.B. 7 |
| Fences | 7-year | Table B-2, Class 01.1 | Yes | Integral | Rev. Rul. 66-89, 1966-1 C.B. 7 |
| Fish raising facilities | 20-year | Table B-2, Class 01.3 | Yes | Integral | Rev. Rul. 80-341, 1980-2 C.B. 24 |
| Fruit cooling room | 20-year | Table B-2, Class 01.3 | Yes | Integral | *Giannini Packing Corp. v. Commissioner*, 83 T.C. 526 (1984) |
| Gasoline storage tanks | 20-year | Table B-2, Class 01.3 | Yes | Personal property | Rev. Rul. 74-602, 1974-2 C.B. 12, revoking Rev. Rul. 74-152, 1974-1 C.B. 11 |
| Grain storage | 7-year | Table B-2, Class 01.1 | Yes | Storage | *Schuyler Grain Co., Inc. v. Commissioner*, 50 T.C. 265 (1968) |
| Grain storage, flat | 20-year | Table B-2, Class 01.3 | No | Building | *Bundy v. United States*, 87-1 USTC 87,084 (D. Neb. 1986) |
| Greenhouses | 10-year | I.R.C. §168(e)(3)(D)(i) | Yes | Single-purpose | Rev. Rul. 79-343, 1979-2 C.B. 18, modifying Rev. Rul. 66-89, 1966-1 C.B. 7 |
| Hay storage and feeding facility | 10-year | I.R.C. §168(e)(3)(D)(i) | Yes | Single-purpose | *Lesher v. Commissioner*, 73 T.C. 340 (1979) |
| Hog facility | 10-year | I.R.C. §168(e)(3)(D)(i) | Yes | Single-purpose | Rev. Rul. 66-329, 1966-2 C.B. 16, as modified by Rev. Rul. 79-343, 1979-2 C.B. 18. |
| Horse facilities | 10-year | I.R.C. §168(e)(3)(D)(i) | Yes | Single-purpose | |
| Kennel, dog and | | | No | Not live-stock | *McKenzie v.* |

| | | | | | |
|---|---|---|---|---|---|
| cat | | | | | *Commissioner*, 85 T.C. 875 (1985) |
| Macadamia trees | 10-year | I.R.C. §168(e)(3)(D)(ii) | Yes | | Rev. Rul. 71-488, 1971-2 C.B. 60 |
| Manure storage facility | 20-year * | Table B-2, Class 01.3 | Yes | Storage | Rev. Rul. 66-89, 1966-1 C.B. 7 |
| Milk parlor | 10-year | I.R.C. §168(e)(3)(D)(i) | Yes | Single-purpose | LTR 8324009; LTR 8323011 |
| Mushroom beds and conveyors | 7-year | Table B-2, Class 01.1 | Yes | Personal property | Rev. Rul. 66-156, 1966-1 C.B. 11, as modified by Rev. Rul. 79-183, 1979-1 C.B. 44 |
| Onion shed | 20-year | Table B-2, Class 01.3 | No | Building | *Tamura v. United States*, 734 F.2d 470 (9th Cir. 1984) |
| Paved barnyard | 15-year | Table B-2, Class 00.3 | Yes | Integral | Rev. Rul. 66-89, 1966-1 C.B. 7 |
| Peanut storage | 20-year | Table B-2, Class 01.3 | Yes | Storage | Rev. Rul. 71-359, 1971-2 C.B. 61 |
| Potato storage | 20-year | Table B-2, Class 01.3 | Yes | Storage | Rev. Rul. 68-132, 1968-1 C.B. 14, as modified by Rev. Rul. 71-359, 1971-2 C.B. 61; LTR 7107221760A |
| Poultry facilities | 10-year | I.R.C. §168(e)(3)(D)(i) | Yes | Building | *Satrum v. Commissioner*, 62 T.C. 413 (1974) and Rev. Rul. 79-343, 1979-2 C.B. 18, modifying Rev. Rul. 66-89, 1966-1 C.B. 7, but see *Starr Farms v. U.S.*, 447 F. Supp. 580 (W.D. Ark.1977). |
| Stable | 20-year | Table B-2, Class | No | Building | Rev. Rul. 66-89, |

| | | | | | |
|---|---|---|---|---|---|
| | | 01.3 | | | 1966-1 C.B. 7 |
| Storage facility | 20-year | Table B-2, Class 01.3 | Yes | Storage | Rev. Rul. 66-89, 1966-1 C.B. 7 |
| Tobacco storage shed | 20-year | Table B-2, Class 01.3 | Yes | Storage | *Brown and Williamson Tobacco Corp.*, 369 F. Supp. 1283 (W.D. Ky. 1973) |
| Tractor | 7-year | Table B-2, Class 01.1 | Yes | Personal property | Rev. Rul. 72-573, 1972-2 C.B. 12 |
| Warehouse | 20-year | Table B-2, Class 01.3 | No | Building | Rev. Rul. 66-89, 1966-1 C.B. 7 |
| Water wells | 15-year | Table B-2, Class 00.3 | Yes | Integral | Rev. Rul. 66-89, 1966-1 C.B. 7, clarified by Rev. Rul. 72-222, 1972-1 C.B. 17 |

* Depending upon the facts and circumstances, manure storage facilities could be 7- or 10-year property. Also, all storage facilities could be 7-year, depending on the facts and circumstances.

## Issue 8: How to Correct Errors on Depreciation

Rev. Proc. 97-37, I.R.B. 1997-33, July 31, 1997, treats a change in depreciation method as a change in method of accounting and sets out the procedure for getting permission to change a method of accounting. In general, the rules create an incentive for taxpayers to correct errors in their method of accounting before being subject to examination by the IRS. The incentives are created by giving the taxpayer more favorable terms of making the adjustment to the correct method of accounting.

**Example 8-A.** Christine Lamm paid $117,500 in 1995 for a combine for use in her farm business. She properly claimed a $17,500 expense deduction under I.R.C. §179 but erroneously used the 200% declining balance method to depreciate the remaining $100,000 basis. (Christine used Rev. Proc. 97-27 rather than Rev. Proc. 97-37, as she claimed too much depreciation. Rev. Proc. 97-27 is not an automatic consent and does require a user fee of either $900 or $500.) She used the 200% declining balance to depreciate the combine again in 1996.

In 1996, Christine paid $67,500 for a tractor for use in her farm business. She again properly claimed a $17,500 expense deduction under §179 but erroneously claimed 200% declining balance depreciation on the remaining $50,000 basis.

The depreciation Christine claimed and the proper depreciation for 1995 and 1996 are as follows:

| Asset and Year | I.R.C. §179 Deduction | Depreciable Basis | Depreciation Claimed | Proper Depreciation | Difference |
|---|---|---|---|---|---|
| Combine | | | | | |
| 1995 | $17,500 | $100,000 | $14,290 | $10,710 | $3,580 |
| 1996 | 0 | 100,000 | 24,490 | 19,130 | 5,360 |
| Tractor | | | | | |
| 1996 | 17,500 | 50,000 | 7,145 | 5,355 | 1,790 |

Christine purchased another $75,000 of machinery in 1997 and wants to know how she should report depreciation in 1997.

The depreciation Christine can claim in 1997 differs according to the year the property was placed in service.

**Property Placed in Service in 1997 [Machinery—$75,000].** Property placed in service in 1997 must be depreciated using the 150% declining balance method. The improper method claimed on property placed in service in prior years does not require and does not allow Christine to use the improper method for property placed in 1997.

Therefore, she can claim $18,000 as an expense deduction under §179. On the remaining $57,000 of basis, she can claim $57,000 × 10.71% = $6,105 of depreciation.

**Property Placed in Service in 1996 [Tractor—$50,000].** The improper depreciation claimed on property placed in service in 1996 can be corrected by filing an amended return for 1996. Therefore, Christine can file an amended return for 1996 showing $5,355 instead of $7,145 of depreciation. That increases her 1996 income by $1,790.

**Property Placed in Service in 1995 [Combine—$100,000].** Christine has established a method of accounting with respect to the depreciation claimed on the combine placed in service in 1995, since she has used that improper method for two or more years. See §2.01(2) of Rev. Proc. 97-37, 1997-27 I.R.B. 10 (May 27, 1997). Therefore, she is not allowed to correct the error by filing amended returns for 1995 and 1996. Instead, she must seek the permission of the Commissioner to change her method of accounting and follow the Commissioner's requirements for reporting the adjustment to income that results from changing the method of accounting.

**Practitioner Note.**

If the proper method of depreciation is used, only one year is needed to establish a method of accounting.

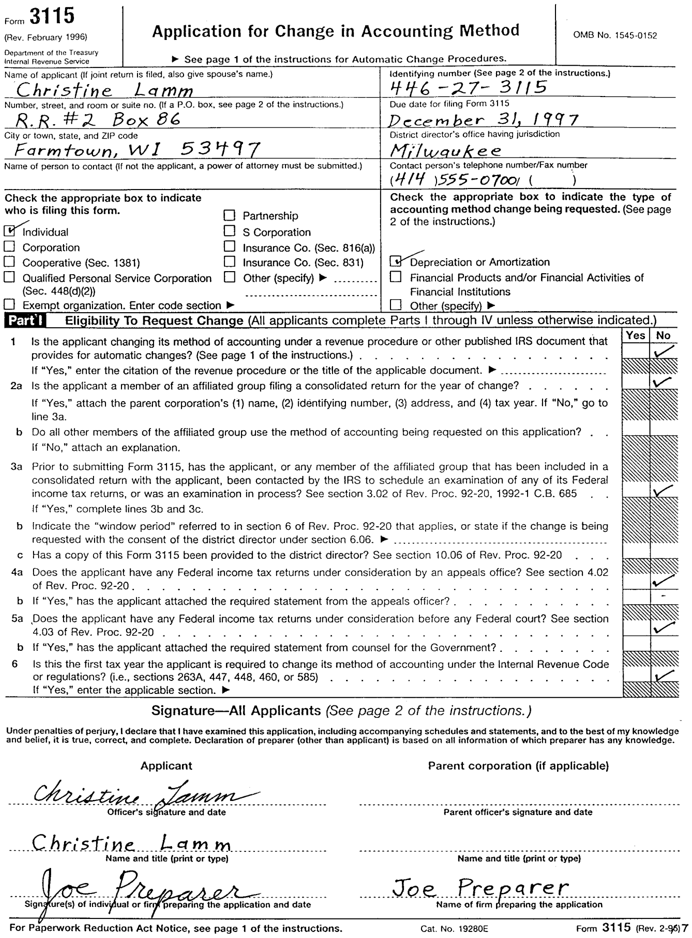
Rev. Proc. 97-37 requires the taxpayer to file Form 3115 by the due date of the return for the tax year for which the taxpayer wants to change the method of accounting. Therefore, Christine must file a Form 3115 and pay the filing fee by April 15, 1998.

The filing fee for Form 3115 is generally $900. However, most taxpayers qualify for a reduced fee of $500 if their gross income is less than $150,000 [Rev. Proc. 97-1, 1997-1 I.R.B. 11].

**Practitioner Note.**

Before Rev. Proc. 97-27 was issued on May 27, 1997, Form 3115 had to be filed within the first 180 days of the tax year for which the change of accounting was requested. Rev. Proc. 97-27 moved that date to the end of the tax year, and Rev. Proc. 97-37 moved it to the due date of the tax return.

The adjustment Christine will make as a result of correcting the depreciation rate on her combine is $3,580 + $5,360 = $8,940. Since the total adjustment is less than $25,000, she can elect to make the entire adjustment in the year of the change instead of the normal four-year adjustment period. See §5.04(3)(a) of Rev. Proc. 97-37. Christine makes that election by checking the "yes" box on line 26 of Form 3115 as shown on the filled-in form below.



Form **3115**
(Rev. February 1996)
Department of the Treasury
Internal Revenue Service

**Application for Change in Accounting Method**

▶ See page 1 of the instructions for Automatic Change Procedures.

OMB No. 1545-0152

Name of applicant (If joint return is filed, also give spouse's name.) Christine Lamm

Identifying number (See page 2 of the instructions.) 446-27-3115

Number, street, and room or suite no. (If a P.O. box, see page 2 of the instructions.) R.R. #2 Box 86

Due date for filing Form 3115 December 31, 1997

City or town, state, and ZIP code Farmtown, WI 53497

District director's office having jurisdiction Milwaukee

Name of person to contact (If not the applicant, a power of attorney must be submitted.)

Contact person's telephone number/Fax number (414 )555-0700/ (     )

**Check the appropriate box to indicate who is filing this form.**

☑ Individual
☐ Corporation
☐ Cooperative (Sec. 1381)
☐ Qualified Personal Service Corporation (Sec. 448(d)(2))
☐ Exempt organization. Enter code section ▶
☐ Partnership
☐ S Corporation
☐ Insurance Co. (Sec. 816(a))
☐ Insurance Co. (Sec. 831)
☐ Other (specify) ▶

**Check the appropriate box to indicate the type of accounting method change being requested.** (See page 2 of the instructions.)

☑ Depreciation or Amortization
☐ Financial Products and/or Financial Activities of Financial Institutions
☐ Other (specify) ▶

**Part I Eligibility To Request Change** (All applicants complete Parts I through IV unless otherwise indicated.)

| | | Yes | No |
|---|---|---|---|
| 1 | Is the applicant changing its method of accounting under a revenue procedure or other published IRS document that provides for automatic changes? (See page 1 of the instructions.)<br>If "Yes," enter the citation of the revenue procedure or the title of the applicable document. ▶ | | ✓ |
| 2a | Is the applicant a member of an affiliated group filing a consolidated return for the year of change?<br>If "Yes," attach the parent corporation's (1) name, (2) identifying number, (3) address, and (4) tax year. If "No," go to line 3a. | | ✓ |
| b | Do all other members of the affiliated group use the method of accounting being requested on this application?<br>If "No," attach an explanation. | | |
| 3a | Prior to submitting Form 3115, has the applicant, or any member of the affiliated group that has been included in a consolidated return with the applicant, been contacted by the IRS to schedule an examination of any of its Federal income tax returns, or was an examination in process? See section 3.02 of Rev. Proc. 92-20, 1992-1 C.B. 685<br>If "Yes," complete lines 3b and 3c. | | ✓ |
| b | Indicate the "window period" referred to in section 6 of Rev. Proc. 92-20 that applies, or state if the change is being requested with the consent of the district director under section 6.06. ▶ | | |
| c | Has a copy of this Form 3115 been provided to the district director? See section 10.06 of Rev. Proc. 92-20 | | |
| 4a | Does the applicant have any Federal income tax returns under consideration by an appeals office? See section 4.02 of Rev. Proc. 92-20 | | ✓ |
| b | If "Yes," has the applicant attached the required statement from the appeals officer? | | |
| 5a | Does the applicant have any Federal income tax returns under consideration before any Federal court? See section 4.03 of Rev. Proc. 92-20 | | ✓ |
| b | If "Yes," has the applicant attached the required statement from counsel for the Government? | | |
| 6 | Is this the first tax year the applicant is required to change its method of accounting under the Internal Revenue Code or regulations? (i.e., sections 263A, 447, 448, 460, or 585)<br>If "Yes," enter the applicable section. ▶ | | ✓ |

**Signature—All Applicants** *(See page 2 of the instructions.)*

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

**Applicant**

Christine Lamm
**Officer's signature and date**

Christine Lamm
**Name and title (print or type)**

Joe Preparer
**Signature(s) of individual or firm preparing the application and date**

**Parent corporation (if applicable)**

**Parent officer's signature and date**

**Name and title (print or type)**

Joe Preparer
**Name of firm preparing the application**

**For Paperwork Reduction Act Notice, see page 1 of the instructions.** Cat. No. 19280E Form **3115** (Rev. 2-96)7

## Part II Description of Change

7 Enter the gross receipts for the 4 tax years preceding the year of change. (See page 2 of the instructions.)
$ 320,000 $ 345,000 $ 330,000 $ 360,000

8 Tax year of change begins (month, day, year) ► 1/1/97 and ends (month, day, year) ► 12/31/97

9 Is the applicant applying to change its **overall** method of accounting? Yes ☐ No ✓

If "Yes," check appropriate boxes below to indicate the applicant's present and proposed methods of accounting. Also complete Schedule A on page 3.

**Present method:** ☐ Cash ☐ Accrual ☐ Other (attach description)
**Proposed method:** ☐ Cash ☐ Accrual ☐ Other (attach description)

10 If the applicant is **not** changing its overall method of accounting, attach a description of each of the following:

a The item(s) being changed.
b The applicant's present method for the item being changed.
c The applicant's proposed method for the item being changed.
d The applicant's overall method of accounting.

- **Applicants filing under an automatic change procedure:** Skip lines 11 through 19 and go to line 20.

11 Attach an explanation of the legal basis supporting the proposed change. Include all authority (statutes, regulations, published rulings, court cases, etc.) supporting the proposed change. The applicant is encouraged to include a discussion of any authorities that may be contrary to the proposed change in method of accounting.

12 Attach a statement of the applicant's reasons for the proposed change.

13 Attach a copy of all documents directly related to the proposed change. (See page 2 of the instructions.)

14 Attach an explanation of whether the proposed method of accounting conforms to generally accepted accounting principles (GAAP) and state whether the proposed method will be used for financial accounting purposes, including financial statements. (Insurance companies, see page 2 of the instructions.)

15 Does the applicant assert that its present method is a Category A method as defined in section 3.06 of Rev. Proc. 92-20? Yes ☐ No ☐

If "Yes," attach a statement giving the legal basis for the determination.

16 Is the applicant's present method a "Designated B" method as defined in section 3.09 of Rev. Proc. 92-20? (See page 2 of the instructions.) Yes ☐ No ☐

If "Yes," enter the title of the designating document. ► ..........

17 Attach a description of the applicant's trade or business, operations, goods and services, and any other types of activities generating gross income.

18a Does the applicant have more than one trade or business as defined in Regulations section 1.446-1(d)? Yes ☐ No ✓

b If "Yes," is each trade or business accounted for separately? Yes ☐ No ☐

If "Yes," for each trade or business attach a description of the type of business, the overall method of accounting, whether the business has changed its accounting method in the last 6 years, and whether the business is changing its accounting method as part of this application or as a separate application.

19 Attach a statement addressing whether the applicant has entered (or is considering entering) into a transaction (for example, a reorganization or merger) to which section 381(c)(4) or (5) applies during the tax year of change. Also include in the statement an explanation of any changes in method of accounting that resulted (or will result) from the transaction(s).

## Part III Section 481(a) Adjustment

20 Enter the net section 481(a) adjustment for the year of change. Indicate whether the adjustment is an increase (+) or a decrease (-) in income. ► $ + 8,940

21 Enter the adjustment that would have been required if the requested change had been made for the tax year preceding the year of change. Indicate (+) or (-). ► $ + 3,580 (See page 3 of the instructions.)

22 Is any part of the adjustment attributable to transactions between members of an affiliated group, a controlled group, or other related parties? Yes ☐ No ✓

If "Yes," attach an explanation.

23 Has the adjustment for the year of change been reduced by a pre-1954 amount? Yes ☐ No ✓

24 Enter the number of years the present method has been used by the applicant. ► 2 years (See page 3 of the instructions.)

25 Enter the applicable period over which the applicant proposes to take the adjustment into account. ► 1

26 If the adjustment for the year of change is less than $25,000, does the applicant elect to take the entire adjustment into account in the year of change? Yes ✓ No ☐

27 Enter the NOL, if any, that will expire in the year of change. ► $ -0-

28 Enter the credit carryover, if any, that will expire in the year of change. ► $ -0-

## Part IV Additional Information (Applicants filing under an automatic change procedure, skip Part IV.)

| | | Yes | No |
|---|---|---|---|
| 29 | Has the applicant, predecessor, or related party requested or made a change in accounting method or accounting period in the past 6 years? | | ✓ |
| | If "Yes," attach a description of each change, the year of change, and whether a ruling letter was received. If a ruling letter granting the change was received but the change was not made, include an explanation. | ▨ | ▨ |
| 30 | Does the applicant, predecessor, or related party currently have pending any request for a private letter ruling, a request for change in accounting method or accounting period, or a request for technical advice? | | ✓ |
| | If "Yes," for each such request, indicate the name(s) of the entity, type of request (method, tax year, etc.) and the specific issue in each request. | ▨ | ▨ |
| 31 | Has the applicant attached **Form 2848,** Power of Attorney and Declaration of Representative? (See page 3 of the instructions.) | ✓ | |
| 32 | Does the applicant request a **conference of right** at the IRS National Office if the IRS proposes an adverse response? | ✓ | |
| 33 | Enter the amount of **user fee** attached to this application. ▶ $ 100 (See page 2 of the instructions.) | ▨ | ▨ |
| 34 | If the applicant qualifies for a reduced user fee for identical accounting method changes, has the information required by Rev. Proc. 92-90, 1992-2 C.B. 501, been attached? | | |

## Schedule A—Change in Overall Method of Accounting (If Schedule A applies, Part I must be completed.)

Attach copies of the profit and loss statement (Schedule F (Form 1040) for farmers) and the balance sheet, if applicable, as of the close of the tax year preceding the year of change. On a separate sheet, state the accounting method used when preparing the balance sheet. If books of account are not kept, attach a copy of the business schedules submitted with the Federal income tax return or other return (e.g., tax-exempt organization returns) for that period. If the amounts in Part I, lines 1a through 1g, do not agree with those shown on both the profit and loss statement and the balance sheet, explain the differences on a separate sheet.

## Part I Change in Overall Method (See page 3 of the instructions.)

1 Enter the following amounts as of the close of the tax year preceding the year of change. If none, state "None." Also provide a breakdown of the amounts entered on lines 1a through 1g.

| | | Amount |
|---|---|---|
| a | Income accrued but not received | $ |
| b | Income received or reported before it was earned. Attach a description of the income and the legal basis for the proposed method (See page 3 of the instructions.) | |
| c | Expenses accrued but not paid | |
| d | Prepaid expense previously deducted | |
| e | Supplies on hand previously deducted | |
| f | Inventory on hand previously deducted. Complete Schedule C, Part II | |
| g | Other amounts (specify) ▶ | |
| h | **Net section 481(a) adjustment** (Add lines 1a—1g.) (See page 3 of the instructions.) | $ |

2 Is the applicant also requesting the recurring item exception (section 461(h)) (See page 3 of the instructions.)? ☐ Yes ☐ No

## Part II Change to the Cash Method (See page 3 of the instructions.)

Applicants requesting a change to the cash method must attach the following information.

1 A description of the applicant's investment in capital items and leased equipment used in the trade or business, and the relationship between these items and the services performed by the business.

2 A description of inventory items (items that produce income when sold) and materials and supplies used in carrying out the business.

3 The number of employees, shareholders, partners, associates, etc., and a description of their duties in carrying out the applicant's business.

4 A schedule showing the age of receivables for each of the 4 tax years preceding the year of change.

5 A schedule showing the applicant's taxable income (loss) for each of the 4 tax years preceding the year of change.

6 A profit and loss statement showing the taxable income (loss) based on the cash method for each of the 4 tax years preceding the year of change.

## Schedule D—Change in Reporting Advance Payments and Depreciation/Amortization

### Part I Change in Reporting Advance Payments (See page 4 of the instructions.)

1 If the applicant is requesting to defer advance payment for services under Rev. Proc. 71-21, 1971-2 C.B. 549, attach the following information.

a Sample copies of all service agreements used by the applicant that are subject to the requested change in accounting method. Indicate the particular parts of the service agreement that require the taxpayer to perform services.

b If any parts or materials are provided, explain how the parts or materials relate to the services provided and provide the cost of such parts or materials as an absolute number and a percentage of the contract price.

c If the change relates to contingent service contracts, explain how the contracts relate to merchandise that is sold, leased, installed, or constructed by the applicant and whether the applicant offers to sell, lease, install, or construct without the service agreement.

d A description of the method the applicant will use to determine the amount of income earned each year on contingent contracts and why that method clearly reflects income earned and related expenses in each year.

2 If the applicant is requesting a deferral of advance payments for goods under Regulations section 1.451-5, attach the following information.

a Sample copies of all agreements for goods or items requiring advance payments used by the applicant that are subject to the requested change in accounting method. Indicate the particular parts of the agreement that require the applicant to provide goods or items.

b A statement providing that the entire advance payment is for goods or items. If not entirely for goods or items, a statement that an amount equal to 95% of the total contract price is properly allocable to the obligation to provide activities described in Regulations section 1.451-5(a)(1)(i) or (ii) (including services as an integral part of those activities).

### Part II Change in Depreciation or Amortization (See page 4 of the instructions.)

Applicants requesting approval to change their method of accounting for depreciation or amortization complete this section. Supply this information for each item or class of property for which a change is requested.

**Note:** *If the property has been disposed of before the beginning of the year of change, a method change is not permitted for that property. See* ***Automatic change for section 167 property*** *in the instructions for Part II, Schedule D, on page 4, for information regarding automatic changes under Rev. Proc. 74-11, 1974-1 C.B. 420. Also in Part II, see* ***When Not To File Form 3115*** *for information concerning retroactive elections and election revocations.*

1 Is depreciation for the property figured under Regulations section 1.167(a)-11 (CLADR)? . . . . . . . . ☐ Yes ☑ No
If "Yes," the only changes permitted are under Regulations section 1.167(a)-11(c)(1)(iii).

2 Is any of the depreciation or amortization required to be capitalized under any Code section (e.g., section 263A)? ☐ Yes ☑ No
If "Yes," enter the applicable section ▶ ..........

3 Has a depreciation or amortization election been made for the property (e.g., the election under section 168(f)(1))? ☐ Yes ☑ No
If "Yes," state the election made ▶ ..........

4a To the extent not already provided, describe the property being changed. Include in the description the type of property, the year the property was placed in service, and the property's use in the applicant's trade or business or income-producing activity.

b If the property is residential rental property, did the applicant live in the property before renting it? . . . . ☐ Yes ☐ No

c Is the property public utility property? . . . . . . . . . . . . . . . . . . . . . . . . . . ☐ Yes ☑ No

5 To the extent not already provided in the applicant's description of its present method, explain how the property is treated under the applicant's present method (e.g., depreciable property, inventory property, supplies under Regulations section 1.162-3, nondepreciable section 263(a) property, property deductible as a current expense, etc.).

6 If the property is not currently treated as depreciable or amortizable property, provide the facts supporting the proposed change to depreciate or amortize the property.

7 If the property is currently treated and/or will be treated as depreciable or amortizable property, provide the following information under both the present (if applicable) and proposed methods.

a The Code section under which the property is depreciated or amortized (e.g., section 168(g)).

b If the property is depreciated under section 168, identify the applicable asset class in Rev. Proc. 87-56, 1987-2 C.B. 674. (If none, state so and explain why.) Also provide the facts supporting the asset class under the proposed method.

c The depreciation or amortization method of the property, including the applicable Code section (e.g., 200% declining balance method under section 168(b)(1)).

d The useful life, recovery period, or amortization period of the property.

e The applicable convention of the property.

*U.S. Government Printing Office: 199~~6~~-7 408-698

## Attachment for Form 3115

Christine Lamm
SS# 446-27-3115

## Line 10 information

a. The items being changed are the depreciation claimed in 1995 and 1996 on a combine placed in service in 1995 for use in a farm business.
b. The applicant's present method of depreciating the combine is 200% declining balance over seven years using the half-year convention.
c. The proposed method is the 150% declining balance method over a seven-year period using the half-year convention.
d. The applicant uses the cash-basis method of accounting.

## Line 11 information

I.R.C. §168(b)(2)(B) requires applicant to use the 150% declining balance method, since she is using the asset in the business of farming.

## Line 12 information

Applicant's reason for making this change is to change from an improper to a proper method of accounting.

## Line 14 information

The proposed method conforms to generally accepted methods of accounting and will be used by applicant for all financial accounting purposes.

## Line 17 information

Applicant's business is a grain farm.

## Line 19 information

Applicant has not and is not considering entering into a transaction to which §381(c)(4) or (5) applies.

## Schedule D, line 7 information

| | Present Method | Proposed Method |
|---|---|---|
| a. Code section | §168(a) | §168(a) |
| b. Asset class in Rev. Proc. 87-56 | 01.1 | 01.1 |
| c. Method | 200% DB; §168(b)(1)(a) | 150% DB; §168(b)(2)(B) |
| d. Recovery period | Seven-year | Seven-year |
| e. Applicable convention | Half-year | Half-year |

**Observation.** If Christine had not made the election to make the entire adjustment in the year of the change, she would have spread the $8,940 change evenly over 1997, 1998, 1999, and 2000.

**Example 8-B.** James Fillbach purchased a combine in 1995 for $117,500. He properly claimed $17,500 of I.R.C. §179 expense deduction and used the 150% declining balance rate, but he erroneously used the nine-year recovery period to claim depreciation in 1995 and 1996. (James used Rev. Proc. 97-37, as he claimed less depreciation than allowable. There is an automatic consent and requires no user fee. See Problem 11 in Chapter 2 for more information on Rev. Proc. 97-37.)

In 1996, he paid $67,500 for a tractor and claimed a $17,500 §179 deduction. He claimed the 150% declining balance rate on the remaining $50,000, but he again erroneously claimed the nine-year recovery period.

The depreciation James claimed and the proper depreciation for 1995 and 1996 are as follows:

| Asset and Year | I.R.C. §179 Deduction | Depreciable Basis | Depreciation Claimed | Proper Depreciation | Difference |
|---|---|---|---|---|---|
| Combine | | | | | |
| 1995 | $17,500 | $100,000 | $ 8,330 | $10,710 | $–2,380 |
| 1996 | 0 | 100,000 | 15,280 | 19,130 | –3,850 |
| Tractor | | | | | |
| 1996 | 17,500 | 50,000 | 4,165 | 5,355 | –1,190 |

James purchased another $75,000 of machinery in 1997 and wants to know how he should report depreciation in 1997.

The depreciation James can claim in 1997 differs according to the year the property was placed in service.

**Property Placed in Service in 1997 [Machinery—$75,000].** Property placed in service in 1997 must be depreciated using the 150% declining balance method. The improper recovery period claimed on property placed in service in prior years does not require and does not allow James to use the improper method for property placed in 1997.

Therefore, he can claim $18,000 as an expense deduction under §179. On the remaining $57,000 of basis, he can claim $57,000 × 10.71% = $6,105 of depreciation.

**Property Placed in Service in 1996 [Tractor—$67,500].** The improper depreciation claimed on property placed in service in 1996 can be corrected by filing an amended return for 1996. Therefore, James can file an amended return for 1996 showing $5,355 instead of $4,165 of depreciation. That decreases his 1996 income by $1,190.

**Property Placed in Service in 1995 [Combine—$117,500].** Like Christine in the previous example, James has established a method of accounting with respect to the depreciation claimed on the combine placed in service in 1995, since he has used that improper method for two or more years. See §2.01(2) of Rev. Proc. 97-37, 1997-33 I.R.B. 10 (July 31, 1997). Therefore, he is not allowed to correct the error by filing amended returns for 1995 and 1996. Instead, he must change his method of accounting.

Unlike Christine in the previous example, James has claimed less than the allowable depreciation. That fact allows him to use a more streamlined method of making the change in accounting method. Section 2 of the Appendix to Rev. Proc. 97-37 grants taxpayers who have claimed less than the allowable depreciation automatic consent to change their method of accounting. Therefore, James can follow the instructions for automatic consent changes when he files Form 3115 to claim the underreported depreciation on the combine.

Rev. Proc. 97-37 allows James to make the full adjustment in the year of the change rather than over the four-year period generally required for adjustments resulting from a change in accounting method. Therefore, even if the $25,000 de minimis rule did not apply, James could take the full adjustment in 1997. See the first note in Problem 11 of Chapter 2 for a fuller explanation.

## Issue 9: FSA Recapture of Previously Discharged FmHA Debt

Under the Agricultural Credit Act of 1987 (P.L. 100-233) the Farmers Home Administration (FmHA) discharged some of the debt owed by farm debtors. In exchange for the discharge, some farmers were required to give the FmHA a shared appreciation agreement or a recapture agreement. These agreements allow the FmHA, now a part of the Farm Services Agency (FSA), to recapture part of the debt that was previously discharged, if certain conditions arise. Those conditions are explained in the following excerpt from a letter sent to a producer whose debt was written down.

> Our records indicate that on January 19, 1990, and June 29, 1994, the Farm Service Agency (formerly the Farmers Home Administration) wrote down $721,263.21 and $165,508.73 of your debt. In processing this write-down, you signed a 10-year Shared Appreciation Agreement (SAA) in relation to the real estate you pledged as security for the FSA debt. We have enclosed a copy of your SAA for your reference.
>
> This letter is intended to remind you of your potential obligation to repay all, or a portion, of the debt that FHA wrote down. In accordance with the SAA, you agreed to pay appreciation, if any, in the value of the property up to the amount of the debt write-down. Recapture will be due if the property you pledged as security has appreciated in value when any one of the following events occurs:
>
> 1. 10 years have passed since you signed the SAA.
> 2. Title to the real estate is conveyed.
> 3. Your FSA loans are repaid.
> 4. You cease farming.
>
> If you believe your property has increased in value since your write-down, you will need to consider this

potential liability as you make your future plans. The amount of repayment is 75% of any appreciation if one of the events numbered 2 through 4 above occurs during the first four years of the SAA and 50% of any appreciation if one of the events occurs during the balance of the 10-year period or at the expiration of the SAA. The amount of repayment cannot exceed the amount of debt written down.

**Observation.** The Agricultural Credit Act of 1987 was signed on January 8, 1988, so no agreements under that legislation were entered into in 1987.

The recapture of the debt may have some income tax consequences for the taxpayer.

## Debt Reduction Treated as Discharged Debt at the Time of the Workout

In a letter to the Farmers Home Administration, Peter Scott, Acting Chief Counsel of the Internal Revenue Service, stated that the workout agreement results in discharge of indebtedness income. The letter stated, "Because the SAA [Shared Appreciation Agreement] is fundamentally different from the old debt and is so contingent that it is impossible to estimate whether and when any amount will be paid under the SAA, the SAA is not indebtedness substituted for the amount of the FmHA debt written down."

If the taxpayer treated the debt reduction as discharged debt for income tax purposes at the time of the workout, then a recapture of part or all of the debt reduction will trigger income tax consequences that reverse the effect of treating the debt reduction as discharged debt.

**Example 9-A.** In 1987 Matthew Horton entered into a buy-out agreement with FmHA under which he paid $125,000, and FmHA terminated his obligation to pay his $150,000 farm loan. To get the write-down, Matthew signed a Shared Appreciation Agreement with the terms outlined in the previous excerpt.

When the agreement expired in 1997, his farm was worth $155,000. Therefore, Matthew was required to repay $15,000 of the write-down calculated as follows:

| | |
|---|---|
| Value of farm at end of agreement | $155,000 |
| Value of farm at beginning of agreement | 125,000 |
| Appreciation | $30,000 |
| Recapture percentage | × 50% |
| Recapture amount | $15,000 |

Matthew's records showed the following before the workout agreement:

| | |
|---|---|
| Indebtedness | $175,000 |
| Value of assets | 155,000 |
| Insolvency | $20,000 |
| | |

| | |
|---|---|
| NOL carryover to 1997 | $16,000 |
| Bases in assets | $29,000 |

Matthew treated the $25,000 reduction of indebtedness as discharged debt and therefore properly reported the following tax consequences on his 1987 Form 982.

1. NOLs were reduced by $16,000, and basis was reduced by $4,000 under the insolvency rules.
2. Another $3,000 of discharged debt was not recognized under the insolvency rules, but no attribute reduction was required.
3. **The remaining $2,000 of discharged debt was recognized as income.**

According to the letter written by IRS Acting Chief Counsel Scott, the taxpayer is permitted an adjustment that reverses the tax treatment accorded under I.R.C. §108 if part or all of the debt is repaid. Since $15,000 of the discharged debt was repaid in 1997, the tax consequences of the last $15,000 that was treated as discharged in 1987 must now be reversed. Note: The NOL and basis adjustments were made on his 1988 return, the first year after the year of discharge even though they were reported on the 1987 Form 982. Consequently, Matthew is allowed to claim the following:

1. A deduction against ordinary income for the first $2,000 that was repaid.
2. No adjustment for the next $3,000 that was repaid since there were no tax consequences to that discharge of indebtedness.
3. A $4,000 increase in basis and a $6,000 addition to NOL carryovers for the remaining $10,000 that was repaid.

## Issue 10: Retained Earning Certificates from Bankrupt Cooperatives

### Overview

When a cooperative goes bankrupt, its members are often left with some retained earnings certificates that are worthless. The income tax consequences for the member depend on the income tax treatment of the certificates when they were received.

- If the value of the certificates was taxed at the time the certificates were received, the member has a basis in the certificate equal to the value taxed. When the certificate becomes worthless, that basis can be claimed as a loss.
- If the value of the certificate was not taxed at the time it was received, the taxpayer has no basis in the certificate and therefore has no loss to deduct when it becomes worthless.
- Whether or not a certificate is taxed at the time it is received depends on the type of cooperative and

whether it is a qualified certificate.

The following definitions and examples explain the tax treatment of certificates when they are received and the tax consequences of the certificates becoming worthless.

## Definitions

## Patronage Dividends

**Patronage dividends** are amounts received by patrons of agricultural cooperatives and represent an allocation of the profits of the cooperative. (They are called **patronage refunds** by cooperatives, but I.R.C. §1388(a) uses the term **patronage dividends,** so that term is used throughout the income tax cases and rulings.) If the cooperative is a **selling** or marketing cooperative, the dividends are attributable to products of the farmer-patron that are sold by the cooperative. If the cooperative is a buying cooperative (furnishing various inputs, such as chemicals, feed, fertilizer, etc., to the patrons), the dividends represent rebates to the farmer-patron, resulting from discounts the cooperative receives by buying in bulk.

A patronage dividend, other than investment tax credit, is an amount paid to a patron by a cooperative:

1. on the basis of the quantity or value of business done with or for the patron,
2. under an obligation by the cooperative to pay that amount, and
3. which is determined by reference to the net earnings of the cooperative from business done with or for its patrons [§1388(a)].

Patronage dividends may be received by the farmer in the form of

1. money,
2. qualified written notices of allocation, or
3. nonqualified written notices of allocation.

Patronage dividends in the form of money and qualified written notices of allocation are taxable income to the taxpayer, even though only 20% of the dividend may be in the form of cash.

## Written Notices of Allocation

**Qualified written notices of allocation** are written notices of rights of redemption (however, 20% or more of the patronage dividends must be paid in cash) by the cooperative to each patron. The patronage dividend in excess of cash received is allocated to an equity account on the books of the co-op to be paid to the patron at a later date. The patron thus has **certificates of indebtedness** which he will redeem from the co-op at a later date. In order to remain **qualified,** such notices must be redeemable in cash within 90 days after they are issued, unless the farmer has previously consented to include the face amount of the notices in income at the time he or she receives the notice. A **qualified written notice of allocation** is treated as the equivalent of cash both for purposes of deduction by the co-op and taxation to the patron receiving the dividend.

A **non-qualified written notice of allocation** is not includable in income. Therefore, the patron's basis is zero. When the patron redeems, sells, or otherwise disposes of the notice of allocation, the gain, to the extent that the stated dollar amount in the certificate exceeds its basis, is ordinary income to the patron.

## Per-Unit Retains

**Per-unit retain allocations** are defined as any allocation by a cooperative to a patron with respect to products marketed for him or her, the amount of which is fixed without reference to the net earnings of the organization pursuant to an agreement between the cooperative organization and the patron [§1388(f)]. A **qualified** per-unit retain certificate is included in the patron's income according to either the terms of the certificate or to a prior agreement between the farmer-patron and the cooperative organization. Written notice of allocation amounts are determined by the performance of the cooperative, but the per-unit retain amounts are contracted for between the patron and cooperative prior to the sale of the farm commodity.

Thus, the per-unit retains are not patronage dividends, according to the I.R.C. definition, since per-unit retains are determined by volume of marketing rather than by reference to the cooperative's earnings. In addition, there is no 20% cash distribution required with regard to a per-unit retain allocation. This difference in the source of the income and the manner in which the income is determined is the reason for the difference in terminology—written notice of allocation (purchasing co-op) versus per-unit retain (marketing co-op).

## Qualified Written Notice of Allocation for Farm Supplies

**Question 10-A.** *Barley Brann is a sole proprietor wheat farmer who is a patron of Plains Co-op where he purchases chemicals, fertilizer, and other supplies. During 1997, Barley was allocated $2,800 of patronage dividends, of which $560 (20%) was paid in cash and the other 80% was a qualified written notice of allocation. Barley received a Form 1099-PATR reporting the $2,800 in Box 1. All purchases from Plains Co-op were solely for farm-related supplies. Where does Barley report the patronage dividend, and what amount is taxable?*

**Answer 10-A.** The entire patronage dividend of $2,800 will be reported on both lines 5a and 5b of Schedule F, even though only 20% ($560) was received in cash, since the remaining 80% represents a qualified written notice of allocation (or certificate of indebtedness).

## Qualified Per-Unit Retains for Commodity Sold

**Question 10-B.** *Derry Barnes is a sole proprietor dairy farmer who sells his milk through Dairy Producers Co-op. Derry received a 1997 Form 1099-PATR reporting $4,400 of qualified per-unit retains in Box 3. However, Derry received no cash in 1997. How does Derry report this on Schedule F?*

**Answer 10-B.** The entire qualified per-unit retain allocation is reported on line 5a of Schedule F. Since the per-unit retain is fully taxable, $4,400 is included on line 5b.

## Nonqualified Per-Unit Retains for Commodity Sold

**Question 10-C.** *Milo Hull, a sole proprietor rice farmer, in 1997 received an allocation of $3,200 from the local rice producers cooperative in the form of non-qualified per-unit retains for the year 1997. The rice co-op also distributed to Milo $3,900 in cash as payment of non-qualified retains for the year 1995 and issued a Form-PATR showing $3,900 in Box 5. How does Milo report this on Schedule F?*

**Answer 10-C.** The redemption of non-qualified retains shown in Box 5 of 1099-PATR is reported on line 5a and 5b of Schedule F, resulting in a taxable amount of $3,900. The non-qualified per-unit retains of $3,200 for 1997 will not be reported on Schedule F until received in cash.

## Qualified Written Notice of Allocation for Equipment Purchased

**Question 10-D.** *Cherry Bloom, a fruit grower, buys her farm machinery from Equipment Supply Cooperative. In 1997 she received a $400 patronage distribution from Equipment Supply Cooperative, consisting of $80 cash and $320 of certificates of indebtedness that were qualified written notices of allocation. This patronage refund was based on the purchase of a $10,000 planter and a $30,000 tractor in 1996. How does Cherry report the patronage distribution from Equipment Supply Cooperative?*

**Answer 10-D.** Code §1385(a) requires a member of a cooperative to report patronage dividends (distributions) and per-unit retain allocations in income unless they are excluded by I.R.C. §1385(b), which excludes patronage distributions that are (1) taken into account as an adjustment to basis, or (2) attributable to personal expenses.

The $400 distribution from the Equipment Supply Cooperative is reported on the Form 1099-PATR but is not included in income. Instead, Cherry must reduce the basis of the items she purchased during the year for which the patronage dividend was given. Since Cherry's patronage refund was based on the purchase of a $10,000 planter and a $30,000 tractor in 1996, she must reduce the basis of the planter by $100 and the basis of the tractor by $300 as of the beginning of 1997. Cherry should report the $400 shown on the form 1099-PATR from the Equipment Supply Company on line 5a of Schedule F but should omit it from the amount reported on line 5b.

## Loss from Qualified Written Notice of Allocation

**Question 10-E.** *What are the tax consequences to a farmer-patron of a cooperative if the cooperative incurs and allocates a loss to the patrons?*

**Answer 10-E.** **Rev. Rul. 70-64** (1970-1 CB 36) ruled that losses incurred by members of an agricultural cooperative upon the redemption of qualified written notices of allocation were **ordinary losses** deductible in the year of redemption. The IRS noted that the farmer joined the cooperative to facilitate business, that the dividend was in the course of that business, and that, therefore, an ordinary rather than a capital loss should occur. Such losses should be reported on Schedule F, line 34—Other Expense, using the tax benefit rationale that the original patronage dividend was reported on Schedule F and, therefore, the tax benefit rationale that the original patronage dividend was reported on Schedule F and, therefore, was subject to self-employment tax. Therefore, the compensating loss should also be reported on Schedule F.

**Practitioner Note.**

When the farmer-patron receives a notice of loss allocation relating to prior years' patronage dividends included in income, he or she should make sure that the unpaid prior year dividends reported are sufficient to absorb the loss and then reduce his or her **certificates of indebtedness,** or qualified written notices, accordingly on his or her financial records.

## Cancellation of Marketing Credits

**Rev. Rul. 70-407** (1970-2 CB 52) involved the question of whether losses resulting from the cancellation of marketing credits were deductible. The ruling involved a cotton farmer who was a member of a cooperative that followed the custom of paying cash advances to patrons with respect to cottonmarketed. The patrons included the cash advances as well as any patronage dividends from the cooperative, paid in money or qualified written notices of allocation, in their gross income in the taxable year in which it was received.

In a year subsequent to the year in question, the co-op sustained a loss and offset the amount due from the patron against his outstanding marketing credits in the order issued until the full amount of the indebtedness due from each patron was offset. **The marketing credits that were canceled (offset) were qualified written notices of allocation.** If a patron did not have sufficient outstanding marketing credits to cover the excess cash advances, the balance that was due to the co-op was carried on the co-op's books to be offset against future marketing credits to be earned by the patron.

The IRS determined that, since the credits and advances and withdrawal of credits all occurred in the ordinary course of business, the losses sustained should be classified as ordinary losses.

## Member Assessments

Another situation a patron may encounter is when the cooperative incurs an operating loss and then assesses the patrons specified amounts in order to underwrite the loss. Are the assessments made by the patron under this circumstance a capital contribution, a loan, or a deductible loss? This issue was addressed in Letter Ruling 9128007 and concerned a grain elevator co-op which incurred operational losses. The co-op could not recoup those losses through higher charges because its rates were controlled by the lessor. The co-op's losses, instead, were covered by equitable assessments on its members. The assessments prevented a net operating loss. The patrons deducted assessments paid to the co-op.

In **technical advice,** the IRS ruled that patrons were allowed to deduct as ordinary and necessary business expenses the equitable assessments the co-op made on its members to cover operating losses.

The IRS pointed out that the assessments were in agreement with the fundamental characteristic of a cooperative **operating at cost.** Just as patrons, rather than the cooperative, are entitled to the gains resulting from business conducted on behalf of the patrons, the patrons should also bear the risk of loss from such business.

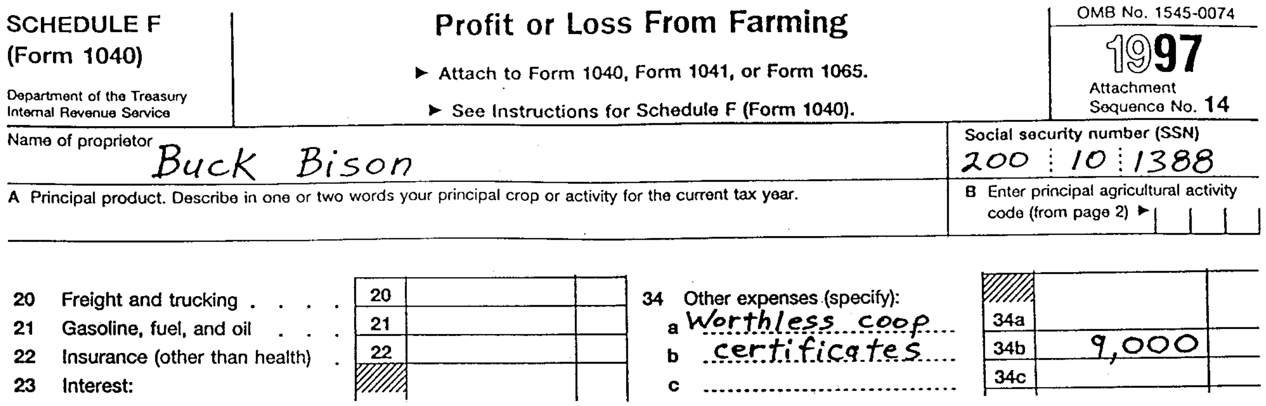
## Bankruptcy of the Cooperative

If the certificates of indebtedness become worthless because the cooperative is bankrupt, the owner of the certificates can claim a deduction equal to his or her basis in the certificate.

**Question 10-F.** *Assume Big Valley Co-op had allocated the following patronage dividends in the form of qualified written notices of allocation to Buck Bison: $2,800 in 1994, $2,900 in 1995, and $3,300 in 1996. Big Valley Co-op went bankrupt in 1997 and the certificates of indebtedness became worthless. How should Buck report this loss?*

**Answer 10-F.** Buck can claim a loss equal to his basis in the certificates of indebtedness. The loss would be reported on Schedule F, Part 2, line 34, as other expense, since the original patronage dividend was reported on Schedule F and subject to self-employment tax.

Buck's bases in the certificates are the amounts he reported in income as they were received—$2,800 in 1994, $2,900 in 1995, and $3,300 in 1996.



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

Profit or Loss From Farming
► Attach to Form 1040, Form 1041, or Form 1065.
► See Instructions for Schedule F (Form 1040).

OMB No. 1545-0074
1997
Attachment
Sequence No. 14

Name of proprietor: Buck Bison

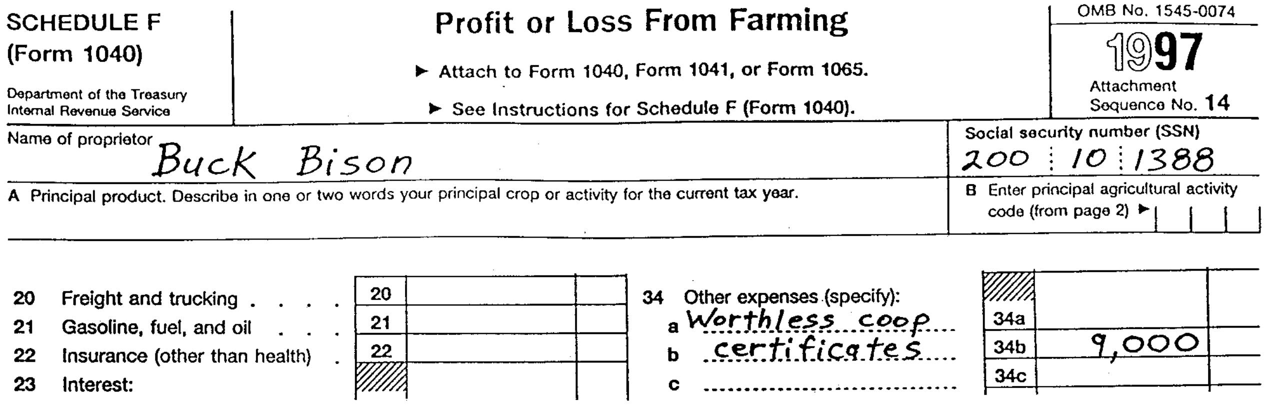
Social security number (SSN): 200 : 10 : 1388

A Principal product. Describe in one or two words your principal crop or activity for the current tax year.

B Enter principal agricultural activity code (from page 2) ►

20 Freight and trucking . . . . 20
21 Gasoline, fuel, and oil . . . 21
22 Insurance (other than health) . 22
23 Interest:

34 Other expenses (specify):
a Worthless coop ........ 34a
b certificates ........ 34b 9,000
c ........ 34c



SCHEDULE F
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**Profit or Loss From Farming**
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OMB No. 1545-0074
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Name of proprietor Buck Bison

Social security number (SSN) 200 : 10 : 1388

A Principal product. Describe in one or two words your principal crop or activity for the current tax year.

B Enter principal agricultural activity code (from page 2) ►

| | | | | | |
|---|---|---|---|---|---|
| 20 Freight and trucking . . . . | 20 | | 34 Other expenses (specify): | ▨ | |
| 21 Gasoline, fuel, and oil . . . | 21 | | a Worthless coop | 34a | |
| 22 Insurance (other than health) . | 22 | | b certificates | 34b | 9,000 |
| 23 Interest: | ▨ | | c | 34c | |

**Question 10-G.** *Assume Big Valley Co-op had allocated the same patronage dividends as in Question 10-F but in the form of* **non-qualified written notices of allocation.** *Big Valley Co-op went bankrupt in 1997, and the certificates of indebtedness became worthless. How should Buck report this loss?*

**Answer 10-G.** Buck cannot claim a loss since he had a **zero basis** in the certificates of indebtedness.

## Issue 11: Allocation of Purchase Price on Purchase of Improved Farmland

I.R.C. §1060 requires taxpayers to allocate the purchase price of a group of assets among the assets in the group and report that allocation on Form 8594 if

1. The assets constitute a trade or business in the hands of either the seller or the buyer, or
2. If under any circumstances, goodwill or going concern value could attach to the assets.

**Observation.** I.R.C. §1060 does not explicitly require the seller and buyer to use the same allocation of purchase price. However, both parties to the transaction must report the name and identification number of the other party on Form 8564. Therefore, the IRS can easily compare the allocations of the two parties and use a disparity between the allocations to challenge one or both of the allocations.

If the parties to a sale agree in writing to an allocation of the purchase price among the assets, both parties must use that allocation for income tax purposes **unless** one of the following occurs.

1. The IRS successfully challenges the allocation (I.R.C. §1060(a)(2)), or
2. One of the parties can show mistake, undue influence, fraud, or duress.

**Example 11-A.** Brandy Whine sold a farm with buildings on it to Whiskey Barrel for $100,000. Brandy had rented the farm to a producer up until the time of sale. Brandy and Whiskey made no allocation of the purchase price among the assets. The depreciation claimed, adjusted income tax basis, and assessed value of the land and buildings for local property taxes were as follows:

| | Depreciation Claimed | Adjusted Basis | Assessed Value |
|---|---|---|---|
| Land | -0- | $ 20,000 | $ 60,000 |
| Loafing shed | $ 6,000 | 5,000 | 12,000 |
| Machine shed | 7,000 | 3,000 | 8,000 |
| Total | $13,000 | $ 28,000 | $ 80,000 |

If the assessed values for property taxes accurately reflect relative fair market value, those assessed values can be used to prorate the total sales price among the assets. That allocation is as follows:

| | Factor | | Total Purchase Price | | Allocated Purchase Price |
|---|---|---|---|---|---|
| Land | $60,000/$80,000 | × | $100,000 | = | $75,000 |
| Loafing shed | 12,000/$80,000 | × | 100,000 | = | 15,000 |
| Machine shed | 8,000/$80,000 | × | 100,000 | = | 10,000 |

An accurate allocation is important because the character of the gain from each of the assets may differ. In this example, the gain on each asset is characterized as follows:

| | Allocated Purchase Price | | Adjusted Basis | | Total Gain | | §1245 Gain | | §1231 Gain |
|---|---|---|---|---|---|---|---|---|---|
| Land | $75,000 | – | $20,000 | = | $55,000 | – | -0- | = | $55,000 |
| Loafing shed | 15,000 | – | 5,000 | = | 10,000 | – | 6,000 | = | 4,000 |
| Machine shed | 10,000 | – | 3,000 | = | 7,000 | – | 7,000 | = | -0- |

**Example 11-B.** Johnny Walker retired from farming and sold his farm to Burgundy Mash for $500,000 on March 1, 1997. The sale included land, buildings, machinery, livestock, a milk base, and the entire inventory needed to operate the farm. Johnny and Burgundy made no allocation of the purchase price among the assets.

Since Johnny used the assets in a trade or business, the transaction is subject to I.R.C. §1060, and both Johnny and Burgundy must file Form 8594.

I.R.C. §1060 and the instructions for Form 8594 require the buyer and seller to use the residual method of allocating the purchase price among assets. That is done by first categorizing each asset into one of five classes. The assets included in each class are as follows:

| | **Description of Assets** | **Example 11-B Assets** |
|---|---|---|
| Class I | Cash, demand deposits, and other similar accounts in banks, savings and loan associations, and other depository institutions | None |
| Class II | Certificates of deposit, U.S. Government securities, readily marketable stock or securities, and foreign currency | None |
| Class III | All tangible and intangible assets that are not Class I, Class II, Class IV, or Class V assets; examples are furniture and fixtures, land, buildings, equipment, and accounts receivable. | Land, buildings, machinery, livestock, and inventory |
| Class IV | Section 197 intangibles, except those in the nature of goodwill and going concern value | Milk base |
| Class V | Section 197 intangibles in the nature of goodwill and going concern value | Going concern value |

After the assets are placed in the above classes, the purchase price is allocated first to the Class I assets, then to the Class II assets, and so on. However, no more than the fair market value can be allocated to any class other than Class V.

Johnny hired an appraiser to determine the fair market value of each of the assets in this sale. His tax preparer provided the adjusted basis for each asset. That information is reported as follows:

| **Asset** | **Adjusted Basis** | **Fair Market Value** |
|---|---|---|
| ***Class III assets*** | | |
| Land | $100,000 | $250,000 |
| Buildings | | |
| Barn | 30,000 | 50,000 |
| Silo | 5,000 | 10,000 |
| Machinery | | |
| Tractor | 12,000 | 30,000 |
| Planter | 7,000 | 10,000 |
| Livestock | | |
| Dairy cows | -0- | 50,000 |
| Youngstock | -0- | 20,000 |
| Feed Inventory | | |
| Silage | -0- | 20,000 |
| Corn | -0- | 40,000 |
| ***Total of Class III assets*** | | $480,000 |
| Class IV assets | | |
| Milk base | 8,000 | 12,000 |
| Total of all assets | | $492,000 |

Based on the above appraised values, Johnny allocates $480,000 of the purchase price to Class III assets and $12,000 to the Class IV asset. The $8,000 residual is allocated to the Class V asset, going concern value.

**Observation.** If there is less purchase price to be allocated to a class than the fair market value of the assets in that class, the purchase price is pro rated among the assets in the class according to the fair market value of the assets in that class.

**Example 11-C.** Assume the same facts as in Example 11-B except that the appraised value of the barn is $120,000 rather than $50,000. Consequently, the total appraised value of Class III assets is $550,000.

Johnny and Burgundy must now allocate all of the $500,000 sale price to the Class III assets according to their fair market value. Since the total fair market value exceeds the total sale price, the sale price allocated to each asset is $500/$550, or 91%, of its fair market value.

None of the purchase price is allocated to the milk base or going concern value since there is no residual to be allocated to Class IV and Class V assets.

**Practitioner Note.**

A memo from Paul Kugler, assistant Chief Counsel for the IRS, dated November 12, 1996, concludes that tobacco and peanut allotments are not I.R.C. §197 intangibles since they are an "interest in land." The memo recognizes that the allotments can be transferred separately from the land to which they are attached, but cites several cases that treat the allotments as interests in land. See *McClung v. Thompson,* 401 F.2d 253 (8th Cir. 1968); *Bryant v. Peckinpaugh,* 400 S.E.2d 201 (Va. 1991) (tobacco); and *Combustion Engineering, Inc. v. Norris,* 217 S.E.2d 813 (Ga. 1980) (peanuts).

**Practitioner Note.**

For asset acquisitions that occurred before February 14, 1997, there were only four classes of assets. Classes I and II were the same as in the five classes discussed above. Class IV included assets in the nature of goodwill and going concern value. Class III included all other assets. Therefore, the assets that are in Class IV of the five classes were in Class III of the four classes.

## Issue 12: Exclusion of Cost Sharing Payments Under I.R.C. §126

Generally, cost-sharing payments received from the government must be reported on the "Agricultural program payments" line on Schedule F (Form 1040).

Some cost-sharing payments qualify for an exception to the above rule of treating cost-sharing payments as income. The exception applies only if the following requirements are met.

1. The cost-sharing payment must be for capital expenditures. If the payment is for an expense that can be deducted in the current year such as a soil and water conservation expense, the payment must be reported as income. While the deduction will offset the income for purposes of net Schedule F (Form 1040) income, inclusion of the payment will increase gross income from farming for purposes of the two-thirds test for a taxpayer to qualify as a farmer for purposes of the estimated tax payments. If the payment is a rental payment to the farmer rather than a reimbursement for a capital expenditure, the payment cannot be excluded under this exception.
2. The payment must not substantially increase the taxpayer's gross receipts from the property that was improved. An increase in gross receipts is substantial if it exceeds the greater of
    a. 10% of the average annual gross receipts derived from the property for the three years prior to the improvement, or

    b. An amount equal to $2.50 times the number of affected acres.

3. The Secretary of Agriculture must certify that the payment was made primarily for conserving soil and water resources, protecting or restoring the environment, improving forests, or providing a habitat for wildlife.

The following federal programs have been certified by the Secretary of Agriculture:

- The rural abandoned mine program authorized by the Surface Mining Control and Reclamation Act of 1977.
- The water bank program authorized by the Water Bank Act.
- The emergency conservation measures program authorized by Title IV of the Agricultural Credit Act of 1978.
- The agricultural conservation program authorized by the Soil Conservation and Domestic Allotment Act.
- The Great Plains conservation program authorized by §16 of the Soil Conservation and Domestic Policy Act, except for payments for practices GP-17 and GP-28.
- The forestry incentives program authorized by §4 of the Cooperative Forestry Assistance Act of 1978.
- The watershed protection and flood prevention program, a small-watershed program, authorized by the Watershed Protection and Flood Prevention Act.
- The experimental rural clean water program, a small-watershed program, authorized by the Agriculture, Rural Development, and Related Agencies Appropriations Acts for fiscal years 1980 and 1981, for payments made for approved conservation practices after February 20, 1980, to projects that qualify as small watersheds. A small watershed is a watershed or subwatershed that does not exceed 250,000 acres and does not include any single structure providing more than 12,500 acre-feet of floodwater detention or more than 25,000 acre-feet of total capacity.

**Several state programs have been approved by the Secretary of Agriculture:**

- Under §126, the amount included in income is the value of the §126 improvement reduced by the taxpayer's share of the cost of the improvement and reduced by the excludable portion.
- The value of the §126 improvement is the fair market value of the improvement multiplied by the following fraction: The numerator is the total cost of the improvement minus

    1. The portion of the government payment that is not for conservation purposes,
    2. The portion of the government payment that is compensation to the taxpayer for services, and
    3. The amount that the taxpayer can claim as a current deduction; the denominator is the total cost of the improvement.

- The excludable portion is the present value of the greater of

    1. 10% of the average annual gross receipts from the affected property for the last three years or
    2. $2.50 per acre.

- If part or all of a cost-sharing payment is excluded under this provision, part or the entire amount excluded may be treated as ordinary income under a recapture rule similar to the §1245 and §1250 recapture rules. The recapture rules for excluded cost-sharing payments are set out in §1255. The recapture is reported on Form 4797.
-

Under these recapture rules, all the excluded payments must be reported as ordinary income to the extent that there is gain upon sale of the property within 10 years of receiving the payment.

- Gain in excess of the excluded payment is treated as capital gain.
- If the property is sold more than 10 years after the payment is received, then only a portion of the excluded payment will be treated as ordinary income. The portion is a percentage determined by reducing 100% by 10% for each year or part of a year the property is held more than 10 years. Therefore, a sale in the eleventh year would cause the lesser of 90% of the excluded payment or the gain realized to be treated as ordinary income. If the sale occurs in the twentieth year or thereafter, no portion of the gain will be recaptured as ordinary income.
-

The taxpayer can avoid the recapture by electing to include the excludable portion in income. If that election is made, the taxpayer must report the payment received or the economic benefit of the improvement as income in the year it is received. The election must be made by the due date (including extensions) of the tax return for the year in which the payment is received.

**Example 12-A.** Oscar Paterson spent $40,000 to build a soil conservation project on his 80-acre farm. The project increased the value of Oscar's property by $30,000 and was worth $10,000 to landowners downstream. His state government paid him $16,000 under a cost-sharing program. Oscar had average annual gross receipts of $36,000 for the past three years from his farm. The Secretary of Agriculture certifies that 100% of the $16,000 cost-share payment was primarily for the purpose of protecting the environment.

How much of the cost-sharing payment can Oscar exclude from income under §126?

- Following the formula in Temp. Reg. §16A.126-1(g), Oscar first calculates the "value of the section 126 improvement" by multiplying the "value of the improvement" ($30,000) by the "section 126 cost" ($40,000) and dividing by the cost of the improvement ($40,000).
- Therefore, the "value of the section 126 improvement" is $30,000.
- From that amount Oscar subtracts the "excludable portion" and his $24,000 share of the cost of the improvement. The "excludable portion" is the present fair market value of the greater of
    1. $3,600 (10% of $36,000), or
    2. $200 ($2.50 × 80 acres).

- Therefore Oscar must calculate the present fair market value of $3,600. To do that, he divides $3,600 by his opportunity cost of capital, which he estimates to be 8%. Therefore, his excludable portion is $45,000 ($3,600 ÷ 0.08).

The formula is applied as follows:

| | |
|---|---|
| Value of the §126 improvement | $30,000 |
| Less excludable portion | –45,000 |
| Less Oscar's contribution | –24,000 |
| Amount included in income | $ -0- |

**Observation.** The present fair market value will vary with the opportunity cost of capital. If Oscar had used 12% as the opportunity cost of capital, the present fair market value would have declined to $30,000.

**Observation.** If Oscar's income from the farm had been $2,000 or less, he could have used the $2.50 per acre amount to determine the excludable portion. The present fair market value of $200 at 8% interest is $2,500. Therefore, Oscar would have to report income of

| | |
|---|---|
| Value of the §126 improvement | $30,000 |
| Less excludable portion | –2,500 |
| Less Oscar's contribution | –24,000 |
| Amount included in income | $3,500 |

# Issue 13: Reducing Income in High Years: Pre-paid Expense Rules

**Practitioner Note.**

Because the I.R.C. §464 rules are designed to prevent taxpayers who are not farmers from using a farm to shelter income, they have little effect on bona fide farmers. Consequently, for most farmers, the effective limit on deducting prepaid expenses is the rules under Rev. Rul. 79-229, 1979-2 C.B. 210, discussed below.

## Prepaid Expenses and Deposits under Rev. Rul. 79-229

Rev. Rul. 79-229, 1979-2 C.B. 210 sets out three tests that must be met in order to deduct the cost of a supply purchased in the current taxable year that will be used in the subsequent taxable year.

1. The expenditure must be a payment for the purchase of a supply rather than a deposit,
2. The prepayment must be made for a business purpose and not merely for tax avoidance, and
3. The deduction of such costs in the taxable year of prepayment must not result in a material distortion of income.

Rev. Rul. 79-229 explains each of these three tests as follows.

## Deposits

Whether a particular expenditure is a deposit or a payment depends on the facts and circumstances of each case. When it can be shown that the expenditure is not refundable and is made pursuant to an enforceable sales contract, it will not be considered a deposit. The following factors, although not all-inclusive, are indicative of a deposit rather than a payment:

- The absence of specific quantity terms,
- The right to a refund of any unapplied payment credit at the termination of the contract [see *Lillie v. Commissioner*, 45 T.C. 54 (1965), aff'd per curiam, 370 F.2d 562 (9th Cir. 1966)],
- The treatment of the expenditure as a deposit by the seller, and
- The right to substitute other goods or products for the feed ingredients specified in the contract. However, a provision permitting substitution of ingredients for the purpose of varying the particular feed mix to accommodate the current diet requirements of the livestock for which the feed was purchased will not be considered indicative of a deposit.

The fact that adjustment is made to the contract price to reflect market value at the date of delivery is not, standing alone, conclusive of a deposit.

## Business Purpose

The second test requires that the prepayment must be made for a valid business purpose and not merely for tax avoidance.

Generally, the factor that distinguishes the earlier court decisions allowing a deduction for prepaid feed costs from those disallowing the deduction is the acquisition of, or the reasonable expectation by the taxpayer of receiving, some business benefit as a result of the prepayment. See *Ernst v. Commissioner*, 32 T.C. 181 (1959), acq., 1959-2 C.B. 4; *Cravens v. Commissioner*, 272 F.2d 895 (10th Cir. 1959); *Shippy v. United States*, 308 F.2d 743 (8th Cir. 1962), aff'd, 199 F. Supp. 842 (W.D. S. Dak. 1961); and*Lillie v. Commissioner*.

Examples of business benefits include, but are not limited to,

1. Fixing maximum prices,
2. Securing an assured feed supply, or
3. Securing preferential treatment in anticipation of a feed shortage.

Whether the prepayment was a condition normally imposed by the seller as an independent arm's-length transaction and whether such condition was otherwise meaningful should also be taken into account in determining whether there was a business purpose for the prepayment.

However, in each of the preceding cases in which a business purpose was found, the taxpayers were traditional farmers and had a significant capital investment in agricultural assets in addition to the feed and animals involved. For this reason, the courts concluded that a business purpose existed when the entire farming business was benefited.

When the transaction in question is carried out in the context of closely held investor-oriented groups, which are usually formed to take advantage of syndicated tax shelter schemes, there is little if any capital investment in assets other than the feed. Generally, the "prepaid" feed is pledged as security to purchase the cattle to be fed. Consequently, the Service will look carefully at the substantive purpose behind such transactions to determine the motives behind them. A motive based on the federal income tax advantages of prepayment of feed costs and the consequent deferral of resulting income is not a valid business purpose.

The business practice of prepayment does not necessarily refute the existence of a primary tax avoidance purpose or a material distortion.

## Distortion of Income

The fact that the first two tests are satisfied does not automatically mean that the expenditure will be deductible in the year paid.  A deferral of the deduction may be necessary to clearly reflect the taxpayer's income. The legitimate use of the cash or accrual methods of accounting does not encompass certain tax shelter techniques, and thus the presence of such techniques supports the exercise of the Service's broad administrative authority to disallow such practices through the timing discretion provided in §§446(b), 451, and 461 of the Code.

Section 461 and the regulations thereunder control the time for the allowance of deductions and provide, in part, that the amount of any allowable deduction shall be taken for the taxable year that is proper under the method of accounting used in computing taxable income. The timing authority in §461 is therefore subject to the clear reflection of income requirement contained in §446(b) [see *Burck v. Commissioner*, 533 F.2d 768 (2d Cir. 1976); *Cole v. Commissioner*, 64 T.C. 1091 (1975); and *Sandor v. Commissioner*, 62 T.C. 469 (1964), aff'd per curiam, 536 F.2d 874 (9th Cir. 1976)].

Section 446(b) of the Code provides, in part, that if the method of accounting used by the taxpayer does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income.

Furthermore, §1.461-1(a)(1) of the regulations provides that an expenditure resulting in the creation of an asset having a useful life extending substantially beyond the close of the taxable year may not be deductible, or may be deductible only in part, for the taxable year in which made. Thus, although a taxpayer using the cash receipts and disbursements method of accounting generally can deduct expenses in the year paid, the taxpayer cannot do so if the allowance of a deduction in that year will produce a material distortion of income [see *Commissioner v. Boylston Market Association*, 131 F.2d 966 (1st Cir. 1942) and *Lovejoy v. Commissioner*, 18 B.T.A. 1179 (1930)]. This rule applies equally to persons engaged in the business of farming [*Clement v. United States*, 580 F.2d 422 (Ct. Cl. 1978)].

Some of the factors to be considered in determining whether the deduction results in a material distortion of income include but are not limited to

- The useful life of resulting assets during and beyond the taxable year paid (Rev. Rul. 68-643, 1968-2 C.B. 76) (the relationship of the amount of the prepaid expenditure in question to the projected magnitude of the business in a subsequent year should therefore be considered; see *Cole*),
- The materiality of the expenditure in relation to the taxpayer's income for the year (*Clement*),
- The purpose for paying in advance [*Baird v. Commissioner*, 68 T.C. 115 (1978)],
- The customary, legitimate business practice of the taxpayer in conducting livestock operations,
- The amount of the expenditure in relation to past purchases and the time of the year the expenditure was made, and
- Whether the taxes paid by a taxpayer consistently deducting prepaid feed costs over a period of years are reasonably comparable to the taxes that would have been paid had the same taxpayer consistently not paid in advance.

## Context of Rev. Rul. 79-229

It is important to remember that Rev. Rul. 79-229 was written before the passive activity rules of I.R.C. §469 were enacted. The rules in Rev. Rul. 79-229 were directed primarily at tax shelters. Consequently, courts have at times been quite liberal in applying the rules to bona fide farmers.

## Issue 14: Lessor/Lessee Issues from the Farm Bill

The 1996 Farm Bill provides for diminishing payments to landowners and their tenants over a seven-year period. The payments are called Production Flexibility Contract (PFC) payments and are based on the crop acreage base for the land.

In general, PFC payments are divided between the owner of the land and the lessee according to their respective share of the crop that is produced on the land. Therefore, the farm bill may induce landowners to shift from a cash lease to a share lease in order to be eligible for part of the program payments.

Shifting to a share lease will affect the landowner's self-employment taxes and social security benefits only if the landowner also begins to materially participate (for self-employment tax purposes) in the farm business. If the landowner begins to materially participate, then the landowner's share of the farm income and deductions must be reported on Schedule F (Form 1040) and the net income will be subject to self-employment tax. The net income will also become part of the landowner's earned income for purposes of calculating social security benefits.

**Example 14-A.** Mildred owns 320 acres of farmland. She is retired and is drawing social security benefits. For several years, she has rented the land to George under annual cash leases. In order to be eligible to receive PFC payments, Mildred decides to rent her land under a share lease. She wanted to have a say in management decisions so she made the lease a material participation lease.

Mildred's share of income and expenses must be reported on Schedule F (Form 1040). Her net income is subject to the self-employment tax and is treated as earned income when calculating her social security benefits.

### Retirement After Entering Production Flexibility Contract

A producer who enters into a Production Flexibility Contract will receive all of the payments under the contract. If he or she later retires and rents the land to another producer, the PFC payments will be divided according to the division of the crops under the lease. A cash lease will result in all of the PFC payments going to the tenant. A crop share lease will result in the PFC payments being divided between the landowner and the tenant. If the landowner materially participates in the farming operation, his or her share of the PFC payments will be subject to the self-employment tax.

## Issue 15: Hobby Loss Issues

The hobby loss rules of I.R.C. §183 are designed to prevent a taxpayer from deducting the cost of his or her toys. They do that by limiting a taxpayer's deductions unless the taxpayer can show that he or she entered into an activity to make a profit.

### Presumption

I.R.C. §183(d) presumes the taxpayer entered into an activity for profit if the activity shows a profit in three out of five years. If the activity is breeding, training, showing, or racing horses, the presumption arises if there is a profit in two out of seven years. If the taxpayer meets the threshold for the presumption, the IRS has the burden of proving the lack of a profit motive. As a practical matter, the IRS seldom tries to overcome the presumption. However, note that under I.R.C. §183(e)(3) the taxpayer must elect to have the presumption apply, which may create several undesirable results for the taxpayer. See I.R.C. §183(e)(4). Therefore, if the activity shows a profit in three out of five years (two out seven years for horse activities) the taxpayer generally (but not always) will be allowed to treat the activity as a trade or business and deduct all of the expenses incurred in the activity.

### Nine Factors

If the taxpayer does not meet the threshold for the presumption, he or she has the burden of showing that he or she entered into the activity with a profit motive. The regulations provide nine factors to show a profit motive:

1. **Manner in which the taxpayer carries on the activity.** The fact that the taxpayer carries on the activity in a businesslike manner and maintains complete and accurate books and records may indicate that the activity is engaged in for profit. Similarly, where an activity is carried on in a manner substantially similar to other activities of the same nature which are profitable, a profit motive may be indicated. A change of operating methods, adoption of new techniques, or abandonment of unprofitable methods in a manner consistent with an intent to improve profitability may also indicate a profit motive.
2. **The expertise of the taxpayer or his advisors.**Preparation for the activity by extensive study of its accepted business, economic, and scientific practices, or consultation with those who are expert therein, may indicate that the taxpayer has a profit motive where the taxpayer carries on the activity in accordance with such practices. Where a taxpayer has such preparation or procures such expert advice, but does not carry on the activity in accordance with such practices, a lack of intent to derive profit may be indicated unless it appears that the taxpayer is attempting to develop new or superior techniques which may result in profits from the activity.
3. **The time and effort expended by the taxpayer in carrying on the activity.** The fact that the taxpayer devotes much of his or her personal time and effort to carrying on an activity, particularly if the activity does not have substantial personal or recreational aspects, may indicate an intention

taxpayer may intend to derive a profit from the operation of the activity and may also intend that, even if no profit from current operations is derived, an overall profit will result when appreciation in the value of land used in the activity is realized, since income from the activity together with the appreciation of land will exceed expenses of operation. See, however, Reg. §1.183-1(d) for the definition of an activity in this connection.

5. **The success of the taxpayer in carrying on other similar or dissimilar activities.** The fact that the taxpayer has engaged in similar activities in the past and converted them from unprofitable to profitable enterprises may indicate that he or she is engaged in the present activity for profit, even though the activity is presently unprofitable.
6. **The taxpayer's history of income or losses with respect to the activity.** A series of losses during the initial or start-up stage of an activity may not necessarily be an indication that the activity is not engaged in for profit. However, where losses continue to be sustained beyond the period which is customarily necessary to bring the operation to profitable status, such continued losses, if not explainable as due to customary business risks or reverses, may be indicative that the activity is not being engaged in for profit. If losses are sustained because of unforeseen or fortuitous circumstances which are beyond the control of the taxpayer, such as drought, disease, fire, theft, weather damages, other involuntary conversions, or depressed market conditions, such losses would not be an indication that the activity is not engaged in for profit. A series of years in which net income was realized would of course be strong evidence that the activity is engaged in for profit.
7. **The amount of occasional profits, if any, which are earned.** The amount of profits in relation to the amount of losses incurred and in relation to the amount of the taxpayer's investment and the value of the assets used in the activity may provide useful criteria in determining the taxpayer's intent. An occasional small profit from an activity generating large losses or from an activity in which the taxpayer has made a large investment would not generally be determinative that the activity is engaged in for profit. However, substantial profit, though only occasional, would generally be indicative that an activity is engaged in for profit, where the investment or losses are comparatively small. Moreover, an opportunity to earn a substantial ultimate profit in a highly speculative venture is ordinarily sufficient to indicate that the activity is engaged in for profit even though losses or only occasional small profits are actually generated.
8. **The financial status of the taxpayer.** The fact that the taxpayer does not have substantial income or capital from sources other than the activity may indicate that an activity is engaged in for profit. Substantial income from sources other than the activity (particularly if the losses from the activity generate substantial tax benefits) may indicate that the activity is not engaged in for profit especially if there are personal or recreational elements involved.
9. **Elements of personal pleasure or recreation.** The presence of personal motives in carrying on of an activity may indicate that the activity is not engaged in for profit, especially where there are recreational or personal elements involved. On the other hand, a profit motivation may be indicated where an activity lacks any appeal other than profit. It is not, however, necessary that an activity be engaged in with the exclusive intention of deriving a profit or with the intention of maximizing profits. For example, the availability of other investments which would yield a higher return or which would be more likely to be profitable is not evidence that an activity is not engaged in for profit. An activity will not be treated as not engaged in for profit merely because

If a taxpayer does not satisfy the three- of five-year (two- of seven-year) threshold for the presumption and cannot meet the burden of proof using the nine factors, then expenses from the activity are limited to the income from the activity.

## Deductibility Ordering Rules

If the hobby expenses exceed the amount of gross income generated by the activity, the expenses must be deducted against the gross income in the following order:

| | |
|---|---|
| Tier 1. | Expenses that may be deducted even though they are not incurred in a trade or business (e.g., itemized deductions such as taxes, interest, and casualty losses). If interest expense is incurred in the hobby activity, it would be considered personal interest and subject to the rules of Code §163(h), which generally disallows a deduction for personal interest, subject to the phase-in limitations. |
| Tier 2. | Other expenses of the hobby activity that could have been deducted if they had been incurred in a for-profit activity, but which do not reduce the tax basis of any of the assets used in the hobby (e.g., feed, veterinary services, etc.). |
| Tier 3. | The expenses of the hobby activity that could have been deducted if incurred in a for-profit activity and that reduce the basis of the hobby's assets (e.g., depreciation on fixed assets used in the hobby [Reg. §1.183-1(b)]. |

To the extent the expenses are taken as deductions against the gross income of the activity, they are deductions from AGI and are deductible if the taxpayer has itemized deductions in excess of the standard deduction. The Tier 1 expenses are reported on the appropriate lines of Schedule A. The Tier 2 and Tier 3 expenses allocated to the hobby are treated as miscellaneous itemized deductions and are deductible only to the extent that they exceed two percent of AGI.

The hobby income limitation is applied first. Then, the 2% of AGI floor is applied. The 50% disallowance for meal and entertainment expenses [under I.R.C. §274(n)] must be taken into account prior to the application of both the hobby income limitation and the 2% of AGI floor. The 2% of AGI floor is simply a computational limit to be applied after the otherwise allowable deductions are determined and aggregated.

**Example 15-A.** E.Z. Rider, a local doctor, derives $4,000 of hobby income in 1997 from the breeding and sale of Appaloosa horses. His expenses from the operation (which was determined to be a hobby after an audit of E.Z.'s 1994 return) are as follows:

| Expenses | Amount |
|---|---:|
| Property taxes | $900 |
| Feed | 5,000 |
| Veterinarian bills | 900 |
| Advertising | 400 |
| Depreciation expense | 3,000 |

E.Z.'s AGI (before the horse-breeding activity) for 1997 is $150,000, and he has $2,600 of other miscellaneous itemized deductions that are subject to the two percent of AGI floor.

**Question 15-A.** *What are the allowable deductions for this hobby activity?*

**Answer 15-A.** Using the required ordering rules [under Treas. Reg. §1.183-1(b)(1)], E.Z.'s allowable hobby deductions are determined as follows:

| | |
|---|---|
| Gross hobby income | $4,000 |
| Amounts deductible without regard to profit motive: Property taxes | (900) |
| Remaining hobby income that can be offset by other hobby expenses | 3,100 |

E.Z.'s Tier 2 hobby expenses (for feed, veterinarian bills, and advertising) total $6,300. These expenses are deductible

1. Only to the extent of the remaining hobby income of $3,100, and
2. Only to the extent that, when aggregated with other miscellaneous itemized deductions, they exceed 2% of AGI. This 2% floor is calculated as follows

| | |
|---|---|
| Miscellaneous itemized deductions from hobby (after hobby income limitation) | $3,100 |
| Other miscellaneous itemized deductions | 2,600 |
| Aggregate of miscellaneous itemized deductions | 5,700 |
| Less 2% of AGI (2% × $154,000) | (3,080) |
| Allowable miscellaneous itemized deductions | 2,620 |

E.Z. is thus allowed a miscellaneous itemized deduction of $2,620 after applying both the hobby income limitation and the 2% of AGI floor. The amount of miscellaneous itemized deductions actually allowed for the hobby activity is computed as follows:

($3,100 ÷ $5,700) × $2,620 = $1,425

Instead of being able to reduce his hobby income to zero, the limitation on miscellaneous deductions has resulted in E.Z.'s having net taxable income from his hobby of $1,675 ($4,000 income less $900 of property taxes and $1,425 of other hobby expenses). The 2% of AGI floor has thus penalized E.Z. because his hobby expenses were not, in fact, deductible to the extent of hobby income. There is no provision for carryover of disallowed hobby expenses.

E.Z. also must take into account the phase-out of otherwise allowable itemized deductions which are reduced in 1997 by the lesser of (1) 3% of excess AGI over $121,200 or (2) 80% of the amount of itemized deductions for the tax year.

Medical expenses, casualty losses, investment interest expenses, and gambling losses are excluded from the phase-out. Thus, in 1997, under the facts above E.Z. would likely lose $864 ($28,800 × 3%) of itemized deductions, which would result in an additional disallowance of hobby expenses.

**Question 15-B.** *Assume that E.Z.'s other itemized deductions consist of $5,100 of taxes, $9,000 of home mortgage interest expenses, and $5,000 of charitable contributions. To what extent are the hobby deductions limited by the phase-out of itemized deductions?*

## Answer 15-B

| **Other Itemized Deductions** | **Amount** |
|---|---:|
| State and local taxes | $5,100 |
| Hobby property taxes | 900 |
| Interest | 9,000 |
| Charitable contributions | 5,000 |
| Hobby miscellaneous deductions | 1,425 |
| Other miscellaneous deductions | 1,195 |
| Tentative itemized deductions | 22,620 |
| Less phase-out disallowance | (864) |
| Allowable itemized deductions | 21,756 |

Therefore, hobby deductions are further reduced as follows—

| **Property Taxes** |
|---|
| $864 × ($900 ÷ $21,756) = $36 |
| **Miscellaneous Hobby Deductions** |
| $864 × ($1,425 ÷ $21,756) = $57 |

Actual deductible hobby expenses are as follows:

| | |
|---|---:|
| Property taxes | $900 |
| Less Phase-out disallowance | (36) |
| **Deductible property taxes** | 864 |
| Miscellaneous itemized hobby deductions | 6,300 |
| Less income limitation disallowance | (3,200) |
| Less 2% of AGI disallowance | (1,675) |
| Less phase-out disallowance | (57) |
| **Allowable miscellaneous hobby deductions** | 1,368 |
| **Total allowable hobby expenses** | 2,232 |

**Question 15-C.** *What is E.Z.'s taxable income resulting from the hobby activity?*

## Answer 15-C

| | |
|---|---:|
| Gross hobby income | $4,000 |
| Deductible hobby expenses | (2,232) |
| | |

| | |
|---|---|
| **Taxable hobby income** | 1,768 |

**Question 15-D.** *How is the tentative depreciation expense of $3,000 treated, considering that it is a disallowed Tier 3 expense due to the income limitations?*

**Answer 15-D.** The tentative depreciation of $3,000 does not result in a basis adjustment to the depreciable assets. Basis of depreciable hobby assets is adjusted only by the amount of depreciation actually allowed under §183 [Reg. §1.183–1(b)(3)]. Since no depreciation is allowed under §183 in this situation, there is no basis adjustment.

**Question 15-E.** *Assume that the tentative depreciation expense of $3,000 consists of depreciation on the following assets:*

| | |
|---|---|
| Barn | $1,000 |
| Horses | 1,500 |
| Tractor | 500 |
| **Total** | **3,000** |

*Assume further that gross income from the activity has increased, so that $2,000 of the depreciation is allowed, after considering all limitations. How is the allowed depreciation allocated among the assets?*

**Answer 15-E.** The depreciation allowed is allocated among the assets in proportion to the deduction which would have been allowable if the activity were engaged in for profit [Reg. §1.183–1(b)(3)].

| | | |
|---|---|---|
| Barn | ($1,000 ÷ $3,000) × $2,000 | $667 |
| Horses | ($1,500 ÷ $3,000) × $2,000 | 1,000 |
| Tractor | ($500 ÷ $3,000) × $2,000 | 333 |
| **Total allowed depreciation** | | **2,000** |

**Note:** Although not specifically addressed in the regulations, it would appear that depreciation disallowed by the 2% of AGI limitation or the phase-out of itemized deductions limit would reduce the basis of the underlying property just as allowed depreciation would.

## Suggested Action Plan for §183

Exhibit 1 (following) is useful in translating the nine regulation factors into an action plan to minimize the exposure to an IRS attack under §183. (Exhibit 1 is adapted from Daughtrey, Bunn, and Burkel, "Farm Business or Farm Hobby: Separating the Grain from the Chaff," *Journal of Agricultural Taxation and Law,* Fall 1986, pp. 187–207.)

**Exhibit 1. Action Plan Subfactors Indicative of a Profit Motive of the Nine Regulation Factors**

| Regulation Factors* | Action Plan Subfactors |
|---|---|
| 1. Manner in which taxpayer carries on the activity | a. Operate farm in businesslike manner.<br>b. Maintain acceptable financial books and records.<br>c. Change operating methods to try to improve farm profitability.<br>d. Operate farm in manner similar to other comparable farming enterprises.<br>e. Maintain a separate bank account.<br>f. Engage in advertising and promotion and/or select a formal business name.<br>g. Belong to farm-related association or commodity group. |
| 2. Expertise of the taxpayer or his advisers | a. Solicit preentry advice and follow it.<br>b. Have prior experience or conduct extensive study.<br>c. Solicit postentry advice and follow it. |
| 3. Time and effort expended by the taxpayer in carrying on the activity | a. Allocate significant time to the farm operation.<br>b. Employ a competent manager.<br>c. Withdrawal from another occupation to attend to the farm operation.<br>d. Perform physical work on the farm. |
| 4. Expectation that the assets used in the activity may appreciate in value | a. Expect farm property to appreciate in value.<br>b. Appraisal values indicate that the farm property has increased in value. |
| 5. Success of the taxpayer in carrying on other similar or dissimilar activities | a. Prior experience in similar, successful business activities.<br>b. Prior record of losses in similar business activities. |
| 6. Taxpayer's history of income or losses with respect to the activity | a. Losses continue beyond start-up period.<br>b. Whether magnitude of losses is decreasing or increasing.<br>c. Whether losses extend over a long period of years.<br>d. Losses are due to circumstances beyond the taxpayer's control. |

| | |
|---|---|
| | taxpayer's control. |
| 7. Amount of occasional profits earned, if any | a. Have occasional but significant profits.<br>b. Have small losses in relation to value of assets used in the farming activity.<br>c. Have opportunity for substantial profit in highly speculative venture. |
| 8. Financial status of the taxpayer | a. Have substantial nonfarm income.<br>b. Have substantial nonfarm assets.<br>c. Have significant tax savings from farm losses. |
| 9. Elements of personal pleasure or recreation | a. Have recreation facilities on farm.<br>b. Receive significant personal pleasure from farm activities.<br>c. Whether personal use assets are separately accounted for. |
| 10. Other factors | a. Was farming operation sold or discontinued due to lack of profit?<br>b. Is residence located on farm?<br>c. Is residence considered a lavish facility?<br>d. Are relatives employed in farm operations?<br>e. Have additional capital for improvements and repairs been invested? |

*This exhibit was constructed upon analysis of the material of Burns and Groomer, "An Analysis of tax Court Decisions That Assess the Profit Motive of Farming-Oriented Operations," *J. Am. Tax'n A.*23–29 (Fall 1983); Robinson, "Tax Court Classification of Activities Not Engaged in for Profit," *J. Am. Tax'n A.*7–21 (Fall 1983); Kersten, "How to Prove a Profit Motive in Horse Breeding," 5*J. Agric. Tax'n. & L.*331–353 (1984).

## One Activity or More?

**Definition of Activity.** In order to determine whether and to what extent §183 and the regulations thereunder apply, the activity or activities of the taxpayer must be ascertained. For instance, where the taxpayer is engaged in several undertakings, each of these may be a separate activity, or several undertakings may constitute one activity. In ascertaining the activity or activities of the taxpayer, all the facts and circumstances of the case must be taken into account. Generally, the most significant facts and circumstances in making this determination are the degree of organizational and economic interrelationship of various undertakings separately or together in a trade or business or in an investment setting, and the similarity of various undertakings.

Generally, the Commissioner will accept the characterization by the taxpayer of several undertakings either as a single activity or as separate activities. The taxpayer's characterization will not be accepted, however, when it appears that his characterization is artificial and cannot be reasonably supported under the facts and circumstances of the case. If the taxpayer engages in two or more separate activities, deductions and income from each separate activity are not aggregated either in determining whether a particular activity is engaged in for profit or in applying §183. Where land is purchased or held primarily with the intent to profit from increase in its value, and the taxpayer also engages in farming on such land, the farming and the holding of the land will ordinarily be considered a single activity only if the farming activity reduces the net cost of carrying the land for its appreciation in value. Thus, the farming and holding of the land will be considered a single activity only if the income derived from farming exceeds the deductions attributable to the farming activity which are not directly attributable to the holding of the land (that is, deductions other than those directly attributable to the holding of the land such as interest on a mortgage secured by the land, annual property taxes attributable to the land and improvements, and depreciation of improvements to the land) [Reg. §1.183–1(d)].

**Recent Judicial Guidance.** In *Lawrence T. Hoyle, Jr.* (T.C. Memo 1994-592) the court determined that petitioner's activities, including the holding of the property to benefit from its appreciation, were all part of a single activity. The court found that each of Hoyle's operational activities was organizationally and economically interrelated. Farming, hunting, crabbing, riding lessons, horse boarding, game-bird-breeding, and thoroughbred horse racing occurred at one location and were all part of Hoyle's plan to find sources of revenue. The same accountant maintained tax records for all of the farming operations. The use of different checking accounts was not controlling. The holding of the land was not treated separately, since Hoyle's primary intent was clearly to operate a farm, not to benefit from land appreciation.

*Trilby Pederson* (T.C. Memo 1994–555) operated a tax and accounting business, focusing mostly on preparing tax returns. In 1982, Pederson began boarding, conditioning, and selling horses and competing in endurance horse riding. There are no monetary awards offered in endurance horse riding. Pederson deducted the horse activity expenses as advertising and promotional expenses of her tax return preparation business. The court ruled that the horse activity was a separate activity, noting that Pederson failed to establish that "any of her colleagues in the endurance horse world were also clients of her tax preparation business."

## Issue 16: Uniform Capitalization as it Applies to Fruit and Nurseries: Replanting Costs

### Uniform Capitalization Rules

Compliance with the UNICAP rules set forth in §263A requires the capitalization of certain direct and indirect costs incurred in the production of farming property [§263A(b)(1)]. Simply speaking, UNICAP required the capitalization—as opposed to expensing and deducting—of direct and indirect production costs incurred during the preproductive period of an orchard, grove, or vineyard (OGV) with a preproductive period greater than two years. During the productive period of the OGV, previously capitalized production costs and current production costs become deductible business expenses through depreciation and cost of goods sold. However, farmers not required to use an accrual method of accounting may elect to avoid the capitalization requirements of I.R.C. §263A.

## Exception for Replanting Costs

The cost of replanting an orchard, grove, or vineyard (OGV) in years after the initial planting is covered in §263A(d)(2). An exception to the capitalization rules is provided for the cost of replanting edible crops following loss or damage due to freezing, drought, disease, pests, or casualty. The exception applies to replanting on the same property or on other land within the United States, for an**acreage** up to the amount of the original planting.

## Analysis

Section 263A(d)(2) **only** removes the replanting venture from the uniform capitalization rules. It apparently does not convert capital costs, such as the cost of rootstock, budding stock, grafting costs, and seedlings, into deductible expenses. This section only affects those costs that would be capitalized under the uniform capitalization rules, such as the developmental costs of irrigating, cultivating, pruning, fertilizing, and spraying. The full scope of these costs is not clear.

The Committee Reports for the Tax Reform Act of 1996 (P.L. 99-514), Act §803, state

> The bill provides that if a farmer experiences loss or damage to a grove, orchard, or vineyard as a result of freezing temperatures, disease, drought, pests, or casualty, the capitalization requiremennts of section 278(a) and (b) do not apply to **otherwise deductible costs of replanting,** cultivating, maintaining, or developing the grove, orchard, or vineyard... (Emphasis added.)

Former Code §278 required the capitalization of **all** costs of citrus and almond groves for the first four years beginning with planting and **all** costs of any grove, orchard, or vineyard in which fruits and nuts are grown and held by a farm syndicate, for the period prior to commercial production. This section was repealed by §803(b)(6) of the 1986 Act.

Prior to §278, planting costs were capitalized, but developmental costs were expensed, according to most authorities [*Estate of Richard R. Wilbur*, 43 T.C. 322 (1964); *Maple v. Commissioner*, 440 F.2d 1055 (9th Cir. 1971); *Wagner Mills, Inc. v. Commissioner*, 530 F.2d 827 (6th Cir. 1976); and Revenue Ruling 83-28 (1983-1 C.B. 47)]. However, other authorities [*Ashworth v. United States*, 71-2 USTC ¶9710 (S.D. Ill. 1971)] required the capitalization of developmental costs. It appears that the repeal of §278 would restore the validity of the preceding cases and revenue ruling; the cases are not in total agreement.

## The Key Question

The key question regarding replanting costs is the scope of costs covered by the replanting question. Does the exemption from the capitalization rules apply only to the developmental expenses or is the exemption sufficiently broad to include **all** costs of replanting, including those associated with initial planting?

## Letter Ruling 9547002

As indicated in the previous paragraphs, there is currently some uncertainty regarding the issue of what is included in "replanting costs." Guidance has been provided in **Letter Ruling 9547002,** but some tax practitioners disagree with the conclusions.

In that ruling, the IRS rejected the taxpayer's position that §263A(d)(2) provided an exception from capitalization for all of its costs (that is, the vineyard's replacement costs and the preproductive period expenses), stating "we believe the exception from capitalization set forth in section 263A(d)(2) is limited to preproductive period expenses of the plants." According to the IRS, "the legislative history clearly indicates that the special rule...is intended to except only preproductive period expenses from capitalization, and that the vineyard replacement costs are not within this exception." Consequently, it concluded, the costs of vines, vinestock, fumigation, trellises, and irrigation and drainage systems remain subject to capitalization under the general principles of §263A.

**Example 16-A.** Granny Smith's apple orchard was destroyed by a hail storm in 1996. She did not replant this tract of land. In 1997 Granny purchased a new tract of land in an area less subject to freezing temperatures and planted a new orchard. She planted the same acreage as the old orchard (50 acres). Her costs for the first year were as follows:

| Cost Description | Per Acre | Total |
|---|---|---|
| Land preparation | $150 | $7,500 |
| Trees | 580 | 29,000 |
| Planting, wrapping, treatment | 470 | 23,500 |
| Irrigation system | 350 | 17,500 |
| Cultural practices (fertilization, spraying, irrigation, labor, etc.) | 450 | 22,500 |
| Interest expense | 150 | 7,500 |
| Total costs | 2,150 | 107,500 |

**Question 16-A.** *What is the amount of the replanting costs that is exempt from the uniform capitalization rules?*

**Answer 16-A.** The exception of §263A(d)(2) for replanting costs only removes the replanting activity from the uniform capitalization rules. It apparently does not convert capital costs such as the planting into deductible expenses. It affects only those costs that would be capitalized under §263A. The latitude of these costs has not been clearly defined. Thus, apparently only the developmental costs (fertilizer, pesticides, depreciation, etc.) would be deductible under the replanting rules. Costs of plants and budding, irrigation system installation, trellises, etc., would be capitalized.

Based on the reasoning in the preceding paragraph, Granny could deduct the costs associated with cultural practices ($22,500), the interest expense ($7,500), and the depreciation on the irrigation system and farm equipment (not calculated). Thus, her total developmental costs that would be exempt from §263A for the first year would be $32,500 + depreciation. Granny would be required to capitalize the land preparation ($7,500), the costs of trees ($29,000) and their planting ($23,500), and the costs of the irrigation system ($17,500). Thus, Granny's total capitalized cost would be $60,000 for the apple orchard and $17,500 for the irrigation system.

**Question 16-B.** *Over what period of time would Granny be required to depreciate the capitalized cost ($60,000) of her new orchard and the irrigation system?*

**Answer 16-B.** The answer depends on whether Granny has already made an election under §263A as to the treatment of preproduction period costs. If she purchased the original apple orchard prior to §263A or if the orchard was already productive when she acquired it, she has not yet had to make an election.

A taxpayer who has not yet made an election as to the treatment of preproductive costs may select either the 10-year recovery period or the 20-year alternate MACRS life. According to **Notice 87-76,** a taxpayer can make a timely election for the **first tax year** that begins after December 31, 1986, **in which the taxpayer produces property with a preproductive period of more than two years.** This first year after December 31, 1986, in which UNICAP property is produced may be either the 1987 year or a **later** year if no preproductive expenses have been incurred in any intervening years after 1986. The farmer is not subject to the UNICAP rules if no preproductive expenses have been incurred. Once preproductive expenses are actually incurred, the farmer will then be subject to the UNICAP rules and will have to make a UNICAP election.

Since the replanting costs that Granny has incurred are exempt from §263A, she apparently still does not have to make an election to expense or to capitalize preproductive period costs.

Therefore, Granny could use the 10-year life under normal MACRS rules rather than being required to adopt the 20-year life dictated by the Alternative Depreciation System. If, in a later year, Granny does plant additional acreage to trees or vines, at that time, she can make the election to expense preproductive costs (and adopt ADS for that year and subsequent years) or to capitalize the preproductive costs and retain the ability to use normal MACRS depreciation for farm assets (150% declining balance rate over the general recovery period.)

For the irrigation system, Granny has not made an election under §263A, or if she has made the election to capitalize preproduction costs, she would use the 150% DB method and a seven-year life. If Granny has made a prior election to expense preproductive period costs, she would be required to use straight-line depreciation over a 10-year life for the irrigation system.

## Issue 17: Limited Entrepreneurs

Any taxpayer who owns an interest in a farming activity and does not actively participate in the farming activity is at risk of being classified as a limited entrepreneur. The consequences of that classification are that the farm business may be classified as a tax shelter, which in turn may result in

1. The farm business being required to use accrual accounting, and
2. Losses from the farm business not being allowed as a deduction on the owner's tax return.

## Who Is a Limited Entrepreneur?

A limited entrepreneur is a person with an interest in an enterprise (other than as a limited partner) who does not **actively participate** in the management of the enterprise [I.R.C. §464(e)(2)].

Prop. Reg. §1.464-2(a)(3) states that the determination of whether a person actively participates in the management or operation of a farming enterprise depends on the facts and circumstances of each case.

Factors that tend to indicate **active participation** include participating in the decisions involving the operation or management of the farm, actually working on the farm, living on the farm, and hiring and discharging employees (as opposed to serving only as the farm manager).

Factors that tend to indicate a **lack** of active participation include lack of control of the management and operation of the farm, having authority only to discharge the farm manager, having a farm manager who is an independent contractor rather than an employee, and having limited liability for farm losses.

## Effect of Being a Limited Entrepreneur

The effect of being a limited entrepreneur is the risk of causing the farm business to be classified as a farming syndicate. The term **farming syndicate** includes a partnership or any enterprise other than a C corporation if more than 35% of the losses during any period are allocable to limited entrepreneurs [I.R.C. §464(c)].

There are two separate consequences of being a farming syndicate:

1. Farming syndicates are treated as tax shelters under I.R.C. §448 and are therefore prohibited from using cash accounting.
2. Losses from farming syndicates cannot be deducted when calculating alternative minimum taxable income.

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**Practitioner Note.**

An individual is **not treated as a limited entrepreneur if**

(a) The individual owns an interest and has actively participated in the farming business for a period of not less than five years, or

(b) The individual's principal residence is on a farm that is operated by the enterprise in which the individual owns an interest, or

(c) The activity of the enterprise in which the individual owns an interest is the further processing of livestock that was raised in a farming activity in which the individual actively participates, or

(d) The individual's principal business activity involves active participation in the management of another farming business, or

(e) The individual is a member of the family of an individual who meets one of the requirements of (a) through (d) above with respect to the enterprise. The family of an individual includes only his brothers and sisters, spouse, ancestors, and lineal descendants.

**Example 17-A.** Angus Herd owns an interest in two different tax shelter farm activities: Longhorn Shelter and Beefalo Shelter. He does not materially participate in either shelter. Longhorn Shelter yields a net loss, on the accrual basis, of $40,000 in 1997. Beefalo Shelter yields a net gain, on the accrual basis, of $30,000 in 1997.

Assuming Angus has no other passive activities, he will have to suspend his net $10,000 loss for 1997 under the passive activity rules when he calculates his regular taxable income. By contrast, when Angus calculates his AMTI, he cannot net the loss from Longhorn Shelter with the gain from Beefalo Shelter. Consequently, he must enter the $30,000 portion of the loss from Longhorn Shelter that was allowed in calculating regular taxable income on line 14l of Form 6251.

**Example 17-B.** Ben Hadd owns an interest in Ostrich Shelter and materially participates in the business carried on by Ostrich Shelter. Ostrich Shelter is a limited partnership that meets the definition of a tax shelter farm activity. In 1997, Ben's share of Ostrich Shelter's accrual basis loss is $10,000.

The loss from Ostrich Shelter is not treated as a passive loss when calculating regular taxable income since Ben materially participates in Ostrich Shelter`s business. However, that loss cannot be deducted when calculating AMTI since Ostrich Shelter is a tax shelter farm activity. Therefore, Ben must include the $10,000 on line 14l of Form 6251.

## Issue 18: Timber Issues: Tax Consequences of Cutting Options

If the owner of timber holds the timber for sale in the ordinary course of a business, gain on sale will be taxed as ordinary income unless the owner

1. Disposes of the timber while retaining an economic interest so that I.R.C. §631(b) applies, or
2. Cuts standing timber and elects to treat it as a sale or exchange under I.R.C. §631(a).

By contrast, the owner of a small woodlot is usually not holding the timber primarily for sale as part of a business. Therefore, the owner does not have to worry about selling the timber in a manner that avoids having it taxed as ordinary income. Therefore, he or she is free to choose the method of sale that is most beneficial and/or convenient.

Because it is relatively simple, most owners of small woodlots use the lump-sum method of selling timber. In a lump-sum sale, the owner sells standing timber for a fixed price agreed on in advance. Generally, the value is determined by estimating the volume of usable wood products from standing timber. The sale may cover a given acreage, certain species, or diameter classes.

**Example 18-A.** A taxpayer made a lump-sum sale of timber for $37,500. Sale costs were $2,250. The timber was located on a tract of land purchased 20 years ago for $30,000. At the time of purchase, $20,000 was allocated to the cost of land and $10,000 to the cost of merchantable timber. Gain or loss is computed as follows:

| | |
|---|---:|
| Sales receipts | $37,500 |
| Less cost of sale | 2,250 |
| Less cost of timber | 10,000 |
| Gain | $25,250 |

Assuming the timber was held the appropriate time, the gain of $25,250 is long-term capital gain income. Sales receipts, costs, and gain are reported on Schedule D.

The federal tax liability for this sale, assuming a marginal tax rate of 20% for federal taxes, was as follows:

| | |
|---|---:|
| Taxable gain | $25,250 |
| Taxes due (20% marginal tax rate) | $5,050 |

## Selective Cutting

The small woodlot owner can sell the timber under a contract that calls for selective cutting and still get capital gains treatment, if the timber is held for investment.

Unfortunately, the Internal Revenue Code definition outlining the difference between timber held as an investment and timber held for use in a trade or business is not clear. Factors considered in determining this difference are

1. The purpose for which the timber was acquired, whether for sale or investment
2. The number, continuity, and frequency of sales
3. The promotional activity of the seller with reference to sales
4. The extent or substantiality of the transaction

(Source: *A Guide to Federal Income Tax for Timber Owners.* Agriculture Handbook No. 708, U.S. Department of Agriculture, Oct. 1995.)

Frequent sales, high-income sales, or timber business sales can make the lump-sum timber sale classification a liability to the taxpayer. However, disposing of timber under a sell-as-cut contract or classification a liability to the taxpayer. However, disposing of timber under a sell-as-cut contract or personally cutting the timber may allow the taxpayer to treat the proceeds as capital gains. In these cases, timber is included within a special tax category of business property subject to capital gains treatment. Since the owner is declaring that he or she is in the timber business, the question of whether timber is held for sale to customers never arises as it does in lump-sum sales.

## Establishing the Basis of the Timber

At the time land with a timber stand is purchased, the taxpayer should allocate the purchase price between the land and the timber to establish the income tax basis in the timber. **Form T is designed to report that allocation.**

If the basis of the timber was not established at the time of purchase, the basis will have to be determined by working backward from current information. William C. Siegel lists the following methods for determining the basis of timber after the fact in his *Tax Practitioner Workshops Forestry Taxation Textbook* (1993, pp. 13 and 14):

a. The fair market value of comparable land may be found in such places as property tax records, consulting foresters' files, and in public foresters' records. Timber process can also be found in this manner, or by consulting published price reports for the year(s) in question.
b. Current timber stands may be projected backward by a forester to determine the volume of merchantable timber existing on the date of acquisition.
c. For the property in question, a separate fair market value for each of the property's significant assets should be determined. The total purchase price or other basis should then be apportioned in proportion to these values among the various accounts.
d. It would be prudent to estimate the potential tax savings to compare with the estimated cost of retroactively establishing accounts before proceeding.
e. Depletion deductions attributable to timber harvested prior to establishing accounts, and not taken at that time, are lost except as can be reflected on amended tax returns.

Siegel illustrates one of the methods with the following example on pages 15 and 94 of his textbook:

**Example 18-B. Retroactive Basis Determination.** In 1997 Mr. Brown plans to harvest timber from a 50-acre tract that was purchased 10 years ago for $35,000. Brown did not prepare any records at the time of purchase. The tract is presently stocked with approximately 300,000 board feet (300 MBF) (6 MBF/acre) and compares closely to stands in the vicinity that grow 200 board feet per acre per year. A consulting forester advised Brown that prices in his area averaged $150 per MBF for similar-quality timber in 1987. Several real estate brokers showed bare timberland values that averaged $200 per acre in Brown's vicinity in 1987. How can Brown establish a timber basis for depletion?

In order to establish a basis in his timber retroactively, Brown must know the timber volume and prices and fair market value for the land asset at the time of purchase. Timber volume in 1987 would have been 200 MBF at the estimated rate of growth. (300 MBF – (200 BF/acre/year × 50 acres × 10 years)). Average timber prices were $150 per MBF for a $30,000 (200 MBF × $150 per MBF) estimated market price. Brown's land was valued at $200 per acre ($10,000 total) giving an overall tract value of $40,000. This valuation suggests that Brown got a bargain; however, the original purchase ($35,000) is allocated in the same proportions that each account bears to the total fair market value at that time. Therefore, the timber basis would be $26,250, and the land basis would be $8,750.

| Account | Fair Market Value | % of FMV | Purchase Price | 1987 Allocation of Purchase to Basis |
|---|---|---|---|---|
| Land | $10,000 | 25 | $35,000 | $8,750 |
| Timber | 30,000 | 75 | 35,000 | 26,250 |
| Total | $40,000 | 100 | | $35,000 |

If Brown sells all of the merchantable timber, he can deduct $26,250 as recovery of basis (depletion).

Other procedures that adequately establish the fair market value of the land and timber assets on the date of acquisition will also work. A key test for the results is their reasonableness for the facts given in each case. In addition, the cost of establishing the basis retroactively should be balanced against the expected tax savings from the recovery of invested capital by this procedure.

# Issue 19: Christmas Trees

## Age of Christmas Trees Affects Tax Rules That Apply

The age of Christmas trees at the time they are cut affects the tax treatment of the cost of raising the trees and which tax rules apply to the proceeds from the sale of the trees.

If the trees are more than six years old at the time they are cut, they are defined as timber under I.R.C. §631, and, therefore, most of the tax rules discussed in Issue 18 apply.

If the trees are six years old or less at the time they are cut, they are not treated as timber under I.R.C. §631, and they are subject to the I.R.C. §263A uniform capitalization rules.

**Practitioner Note.**

The age of a tree is measured from the date the seed is planted. Therefore, if a producer buys two-year-old seedlings, the two years is included in the age of the tree.

**Observation.** Christmas trees grown in the Southern United States are often cut at six years of age or less. Christmas trees grown in the Northern United States are often cut at more than six years of age.

## Trees More Than Six Years Old When Cut

## Treatment of Gain on Sale

As noted above, Christmas trees that are more than six years of age when they are cut are treated as timber for purposes of I.R.C. §631. Therefore, if the owner of Christmas trees is an investor, the gain will be treated as capital gains under I.R.C. §1221.

**Example 19-A.** Sally Investor loaned $100,000 to Joe Grower and received a mortgage on Joe's Christmas tree farm as collateral. After paying $25,000 of the principal, Joe defaulted on the loan and Sally repossessed the farm. Sally allocated her $75,000 basis in the repossessed farm as follows:

| | |
|---|---|
| Basis in trees | $25,000 |
| Basis in land | 50,000 |
| Total | $75,000 |

The trees were more than six years old and ready for harvest, so Sally paid a cutter $3,000 to harvest the trees and sold them for $30,000 in a lump-sum sale to a local retailer.

Sally's gain on the sale is

| | |
|---|---|
| Amount realized | $30,000 |
| Less basis | –25,000 |
| Less cost of sale | –3,000 |
| Gain on sale | $2,000 |

That gain is capital gain under I.R.C. §1221 since Sally is an investor and is not in the business of raising and selling Christmas trees.

If the owner of the Christmas trees is in the business of raising and selling trees, then the gain will be reported in one of the three ways discussed in Issue 18 above:

1. All of the gain is ordinary income unless the sales contract qualifies under I.R.C. §631(b) or the taxpayer elects to report the sale under I.R.C. §631(a).

**Example 19-B.** Gary Grainger raises Christmas trees for sale in the wholesale market and harvests the trees when they are seven years old. He uses the cash method of accounting, which allows him to deduct his operating expenses in the year they are incurred. However, the cost of establishing the trees must be capitalized and recovered at the time he sells the trees.

In 1997, Gary sold 10,000 trees for $40,000. His basis in the trees is $15,000. Gary computes his gain as follows:

| | |
|---|---|
| Amount realized | $40,000 |
| | |

| | |
|---|---|
| Less basis | 15,000 |
| Less cost of cutting | 2,000 |
| Gain on sale | $23,000 |

Gary does not qualify for reporting the gain under I.R.C. §631(b) and did not make the election to report the gain under I.R.C. §631(a). Therefore, all of the gain is ordinary income and is subject to the self-employment tax.

2. If the owner retains an economic interest in the trees, then all of the gain is capital gain under I.R.C. §631(b).

**Practitioner Note.**

It is difficult for the owner of Christmas trees to qualify for I.R.C. §631(b) because there is no contract between the parties by virtue of which the customer had both a right and an obligation to cut timber [*Ah Pah Redwood Co. v. Commissioner,* 251 F.2d 163 (9th Cir. 1957); *Jantzer v. Commissioner,* 284 F.2d 348 (9th Cir. 1960); and *Patterson v. Belcher,* 302 F.2d 289 (5th Cir. 1962), opinion amended and reh. den., 305 F.2d 557, cert. den., 371 U.S. 921 (1962)].

In the case of "choose-and-cut" contracts, the Christmas tree owner retains all rights and interest in the standing timber. Consequently, the customer never acquires title to, an economic interest in, or a contract right to cut any timber. By the act of cutting a tree, the customer acquires both the right and the obligation to purchase the cut tree. The transaction between the Christmas tree owner and the customer is, therefore, a present sale of a cut Christmas tree rather than a sale of standing timber.

Accordingly, income from the sale of the Christmas trees is ordinary income to the taxpayer.

3. If the Christmas tree owner elects to report the gain under I.R.C. §631(a), then the difference between the value of the trees at the beginning of the tax year and the basis in the trees is I.R.C. §1231 gain and the difference between the sale price and the value at the beginning of the tax year is ordinary income.

**Example 19-C.** If Gary Grainger in the previous example elected to report his gain under I.R.C. §631(a), part of the gain is treated as I.R.C. §1231 gain. To determine the gain that is allocated between ordinary income and §1231 gain, Gary must determine the value of the trees at the beginning of the tax year in which they are cut.

Assume that Gary can show the value of the trees to be $3.20 on January 1, 1997. The $23,000 of gain is then allocated as follows:

| **Calculation of I.R.C. §1231 Gain** | |
|---|---|
| Value on January 1, 1997 | |
| 10,000 trees × $3.20 per tree | $32,000 |
| Less basis | 15,000 |
| | |

| | |
|---|---|
| I.R.C. §1231 gain | $17,000 |
| **Calculation of Ordinary Income** | |
| Amount realized from sale | $40,000 |
| Less value on January 1, 1997 | –32,000 |
| Less cost of cutting | –2,000 |
| Ordinary income | $6,000 |

**Observation.** As the results of Examples 19-A and 19-C illustrate, Christmas tree owners can dramatically reduce their ordinary income by making the I.R.C. §631(a) election.

## Uniform Capitalization Rules

If the Christmas trees are more than six years old when they are harvested, they are not subject to the capitalization of preproduction expense rules [I.R.C. §§263A(c)(5)(A) and (e)(4)(B)].

## Trees Six Years Old or Less When Cut

## Treatment of Gain on Sale

If Christmas trees are six years old or less when they are cut, they are not treated as timber under I.R.C. §631. Therefore, neither §631(b) nor §631(a) reporting can be used. Consequently, if the tree owner is in the business of raising and selling trees, all of the gain on sale is ordinary income.

**Example 19-D.** If the trees that Sally Investor repossessed in Example 19-A had been six years old or less, she would still report her gain as capital gain since she held the trees as an investment rather than as inventory in a trade or business.

**Example 19-E.** If the trees Gary Grainger sold in Example 19-C had been six years old or less, he would not be allowed to make the §631(a) election. Consequently, all of his gain must be reported as ordinary income as it was in Example 19-B.

## Uniform Capitalization Rules

If the Christmas trees are six years old or less when they are harvested, they are subject to the capitalization of preproduction expense rules [I.R.C. §§263A(c)(5)(A) and (e)(4)(B)]. Under those rules, all costs of raising the trees must be added to the basis of the trees rather than deducted as they are incurred, unless the taxpayer elects out of the rules.

If the taxpayer elects out of the rules, there are two consequences:

1. When the trees are sold, an amount equal to the costs that would have been capitalized is subject

to the I.R.C. §1245 recapture rules.

**Observation.** This rule is of no consequence for a taxpayer who is in the business of raising trees since all of the gain from sale of trees is ordinary income before the recapture rules are applied. The recapture rules do not convert ordinary income subject to the self-employment tax into ordinary income not subject to the self-employment tax.

2. The taxpayer is required to use the alternative depreciation (ADS) method (straight line over the class life) for depreciating all assets used in the farm business.

**Example 19-F.** Assume that Gary Grainger from Example 19-C cut and sold his trees when they were five years old. His cost of raising his trees was $1,200 per year and he did not elect out of the uniform capitalization rules.

Since the trees are cut at six years of age or less, Gary cannot make the I.R.C. §631(a) election and he is not allowed to deduct the $1,200 annual cost of raising the trees. Consequently, his ordinary income upon sale of the trees is as follows:

| | | |
|---|---|---|
| Amount realized on sale | | $40,000 |
| Less basis | | |
| Establishment costs | $15,000 | |
| Annual costs (5 × $1,200) | 6,000 | –21,000 |
| Less cost of cutting | | –2,000 |
| Ordinary income | | $17,000 |

## Issue 20: I.R.C. §2032A Examples

I.R.C. §2032A allows an estate to value land used in a trade or business at its use value rather than at its fair market value if certain requirements are met. This provision is especially useful to farm families who own land near an urban area. Without the provision, they would have to pay estate taxes on the development value of the land, which could be several times the value of the land in a farming operation.

**Practitioner Note.**

Since 1983, the limit on the amount the estate can be reduced is $750,000. Beginning in 1999, the $750,000 limit will be increased by an inflation adjustment.

This estate tax provision is one of the most complex provisions in the Internal Revenue Code. It is beyond the scope of these materials to discuss all of those complexities. The following discussion and examples illustrate some of those issues.

## Pre-Death Considerations

There are several requirements the decedent must meet prior to death in order for the estate to be eligible for the election.

## Material Participation

Generally, the decedent or a member of the decedent's family must materially participate in the farm business for five out of the eight years prior to death [I.R.C. §2032A(b)(1)(C)].

**Disability or Retirement.** If the decedent was retired or disabled at the time of death, then the material participation requirement is met if the decedent or a member of the decedent's family materially participated for five of the eight years ending on the date of disability or retirement [I.R.C. §2032A(b)(4)].

**Surviving Spouse.** If the decedent is the surviving spouse of a decedent who met the requirements of §2032A on the date of his or her death, then the surviving spouse is treated as materially participating if he or she actively participates in the farm business [I.R.C. §2032A(b)(5)].

## 50% Test

One of the threshold requirements for using the special use valuation rules is that 50% or more of the decedent's gross estate consist of property that is used in the trade or business and is passed to a member of the decedent's family [I.R.C. §2032A(b)(1)(A)]. For purposes of this test, the gross estate and the value of assets are reduced by any debt that is owed.

**Example 20-A.** On his date of death, Dennis Sandora owned the following assets:

| Assets | Gross Estate | Farm Assets |
|---|---:|---:|
| Tract 1 | $261,000.00 | $261,000.00 |
| Tract 2 | 256,000.00 | 256,000.00 |
| Tract 3 | 1,000.00 | 1,000.00 |
| Cooperative stock | 405.00 | 405.00 |
| Grain in storage | 30,719.41 | 30,719.41 |
| Checking account | 92,694.35 | 65,199.00 |
| Other assets | 602.280.69 | 0.00 |
| Total | $1,244,099.45 | $614,323.41 |

Since the farm assets are only 49.3790% of the total estate ($614,323.41 ÷ $1,244,099.45) the estate does not qualify for special use valuation.

---

**Observation.** There is considerable room for argument about how much of the checking account should be treated as a farm asset. Notice that in the above example, if the other $7,727 of the checking account is treated as a farm asset, the estate meets the 50% requirement. See *Estate of Mapes v. Commissioner,* 99 T.C. 27 (1992).

## 25% Test

Another requirement of the special use valuation rules is that 25% or more of the decedent's gross estate consist of real property that is used in the trade or business and passes to a member of the decedent's family [I.R.C. §2032A(b)(1)(B)].

**Example 20-B.** Dennis' estate from the previous example meets the 25% test since the value of his real property used in farming is $518,000, which is 41.6365% ($518,000 ÷ $1,244,099.45) of the gross estate.

## Special Use Valuation of Qualified Property

The special use valuation rules provide two different methods for determining the special use value of real property.

**Capitalization of Gross Cash Rents.** One method of valuing the property is to capitalize the gross cash rent of the property to be valued. To use this method, the property must have been used in farming, and there must be comparable land that is rented for cash to establish the market rental rate for the property.

This method of valuing the property requires two pieces of information:

1. The average annual gross cash rent for comparable land used for farming purposes reduced by the average annual state and local taxes for such comparable land.
2. The average annual effective rate for all new Federal Land Bank loans.

"Average annual" means the average of the five calendar years before the date of death.

**Example 20-C.** Carla Hewitt owned 320 acres of land that she used in a farming business until her death in 1997. Her will bequeathed the land to her daughter, who will continue to use it in a farm business. Carla's estate made the special use valuation election.

The annual rent for comparable land for the last five years minus the property tax was as follows:

| Year | Rent |
|---|---|
| 1992 | $90 |
| 1993 | 92 |
| 1994 | 93 |
| 1995 | 95 |
| | |

| | |
|---|---|
| 1996 | 97 |
| Total | $467 |

Therefore, the average is $467 ÷ 5 = $93.40

The Farm Credit Bank interest rate for the St. Paul district 1997 deaths (the district in which Carla's property is located) is 8.39 [see Rev. Rul. 97-13].

The special use value is then calculated by dividing the average rent by the interest rate.

$93.40 ÷ 8.39% = $1,113.20 per acre special valuation

**Five-Factor Formula.** Any estate can use the five-factor formula to value the qualified property. This formula must be used for property that was not used in farming and for property used in farming for which there are no comparable rental values for the capitalization of rent method discussed above.

Under this method, the following factors are used to determine the value of qualified real property:

1. The capitalization of income which the property can be expected to yield,
2. The capitalization of fair rental value,
3. The assessed land value in a state which provides a use value assessment law for farmland,
4. Comparable sales of other farmland in the same geographical area far enough removed from a metropolitan or resort area so that nonagricultural use is not a significant factor in the sales price, and
5. Any other factors that fairly value the farm.

In *Estate of Hughan v. Commissioner,* TC Memo 1991-275, the court applied the five-factor formula by averaging the value determined under the three factors that were available in that case. The capitalization of fair rental value (factor 2 above) was not available since the land was used for an orchard and there were no rental rates available for comparable orchard land. There were no other factors that fairly valued the property (factor 5 above).

The values determined under the other three factors were as follows:

| | |
|---|---|
| Capitalization of income | $197,830 |
| Assessed land value | 215,012 |
| Comparable sales | 242,006 |

Therefore, the average of those three, $218,283, is the special use value of the property.

## Post-Death Considerations

## Qualified Use

If a qualified heir who receives an interest in the property that is specially valued does not meet the post-death requirements for 10 years, part or all of the tax savings can be recaptured.

One of those requirements is that the specially valued property be used in a qualifying business. Prior to the Taxpayer Relief Act of 1997, an heir other than the decedent's spouse was required to use the property in a farm business in which the heir materially participated or to rent it on a share crop basis to a farming operation in which another member of the family materially participated.

The Taxpayer Relief Act of 1997 allows the heir as well as surviving spouse to rent the qualifying property under a cash lease to a farming operation in which a member of the family materially participates.

### Tax Lien

The IRS has a lien on the specially valued property for the 10-year period after death. The taxpayer must take action to remove that lien when the 10-year period expires.

## Issue 21: Divorce Issues

**Example 21-A.** Steve and Sandra Knop married in 1984. At the time of their marriage, Steve had purchased his parents' farm on a land contract. Steve's parents urged him to enter into a prenuptial agreement to insure that the farm would stay in the family in the event of a divorce. Consequently, Steve and Sandy entered into an agreement that included the following provisions:

In the event of a marriage dissolution, the property owned by Steve and Sandy at that time will be divided as follows:

a. Each party would first be allocated property equal in value to the value of property he or she brought to the marriage, increased by the consumer price index for the years between 1984 and the year of the marriage dissolution. For purposes of this provision, Steve and Sandra agree that the value of property brought to the marriage is as follows:

| | ***Value of Asset Allocated to:*** | |
|---|---|---|
| **Asset** | **Sandra** | **Steve** |
| Equity in land contract | | $35,000 |
| Livestock | | 25,000 |
| Machinery | | 55,000 |
| Stocks | $12,000 | 500 |
| Personal assets | 9,000 | 1,200 |
| Bank accounts | 4,500 | 700 |
| Total | $25,500 | $117,400 |

b. After allocating property as provided in paragraph a, the value of the remaining property will be divided equally between Steve and Sandra.

c. To satisfy the value of property going to Steve and Sandra under paragraphs a and b, Steve's share will first be satisfied out of farming assets. If his share is less than the value of the farming assets, he will be given the first right to buy the remaining farm assets at the value used to compute the total value of assets.

At the time of their marriage dissolution in 1997, Steve and Sandra owned the following assets:

| **Asset** | **Adjusted Basis** | **Value** |
|---|---|---|
| Equity in land contract | $260,000 | $350,000 |
| Home | 125,000 | 250,000 |
| Livestock | 0 | 125,000 |
| Machinery | 50,000 | 205,000 |
| Stocks | 11,000 | 15,000 |
| Personal assets | 43,000 | 32,000 |
| Bank accounts | 3,500 | 3,500 |
| Total | $492,500 | $980,500 |

Steve's and Sandra's respective shares of the assets are as follows:

| | | **Sandra** | **Steve** |
|---|---|---|---|
| Value brought to marriage | | $25,500 | $117,400 |
| Consumer price index | | ×1.42 | ×1.42 |
| Value allocated to each | | $36,210 | $166,708 |
| One-half of remainder | | | |
| Total value | $980,500 | | |
| Less CPI allocations | 202,918 | | |
| Remainder | $777,582 | $388,791 | $388,791 |
| Total allocated to each | | $425,001 | $555,499 |

Steve obtained a loan in order to purchase the farm assets in excess of his share of the total assets. The resulting division of assets is as follows:

| **Asset** | **Sandra** | **Steve** |
|---|---|---|
| Equity in land contract | | $350,000 |
| Home | 250,000 | |
| Livestock | | 125,000 |
| Machinery | | 205,000 |
| Stocks | 15,000 | |
| | | |

| | | |
|---|---|---|
| Personal assets | 32,000 | |
| Bank accounts | 3,500 | |
| Cash from Steve to Sandra | 124,501 | –124,501 |
| Total | $425,001 | $555,499 |

**Practitioner Note.**

Since Steve used all of the loan proceeds to buy farm assets, he can deduct the interest paid on the loan on his Schedule F.

After the division of the property, Sandra sold the home for $252,000.

The income tax consequences of these transactions are as follows. Under I.R.C. §1041, the transfers of property between Steve and Sandra do not trigger recognition of gain or loss. The basis of the property remains the same in the hands of the recipient as it had before the transfer.

**Observation.** For income tax purposes, it does not matter whether the property was owned jointly or by one of the spouses individually before the division since the basis will carry over to the recipient of the property without recognition of gain or loss, regardless of previous ownership.

Therefore, before the sale of the home, Steve and Sandra owned assets with the following bases.

| **Steve's Assets** | **Basis** | **Value** |
|---|---|---|
| Equity in land contract | $260,000 | $350,000 |
| Livestock | 0 | 125,000 |
| Machinery | 50,000 | 205,000 |
| Total | $310,000 | $680,000 |
| **Sandra's Assets** | **Basis** | **Value** |
| Home | $125,000 | $250,000 |
| Stocks | 11,000 | 15,000 |
| Personal assets | 43,000 | 32,000 |
| Bank accounts | 3,500 | 3,500 |
| Total | $182,500 | $300,500 |

Since Sandra sold the home after May 6, 1997, she is allowed the $250,000 exclusion of gain under the Taxpayer Relief Act of 1997. Therefore, she does not have to report any gain as a result of that sale.

**Observation.** Notice that Steve ended up with assets with a potential gain of $680,000 – $310,000 = $370,000, while Sandra ended up with only $15,000 – $11,000 = $4,000 of potential gain on the stocks.