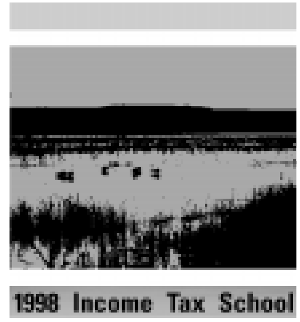
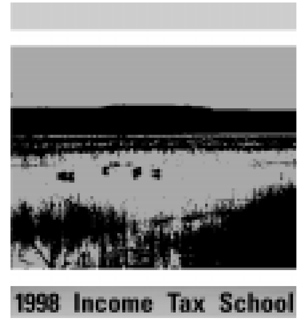


1998 Agricultural Issues



AGRICULTURAL ISSUES

ISSUE 1: INCOME AVERAGING FOR FARMERS

> Special Note: Regulations are nearly finished that will answer the questions raised in this issue. They should be available prior to the tax schools. See page 306 for the questions.

A. IRC §1301

The Taxpayer Relief Act of 1997 allows individuals engaged in a farming business to use income averaging for farm income in 1998, 1999, and 2000. Under this provision, farm producers can elect to apply the tax rates from the three previous years to part or all of their farm income for the year of the election.

The income averaging election applies only to farm income, which includes gain from the sale or disposition of property (other than land) regularly used in the farming business for a *substantial period*. Thus, gains from the sale of breeding livestock and farm machinery reported on Form 4797 qualify as farm income eligible for averaging.

> **Observation.** The term "substantial period" is not defined in the Internal Revenue Code or the committee reports.

> **Practitioner Note.** The Secretary of the Treasury is instructed to prescribe regulations appropriate to carry out this provision and to prescribe the manner in which the election is to be made. The election, once made, will generally be irrevocable.

Example 1-A. *Calvin Cashpoor, a married filing jointly farmer, has financially struggled in his farming operations for several years. However, in 1998, due to the combination of an optimum growing season and excellent commodity prices, Calvin has a very prosperous year. His income for 1995–1998 is as follows*

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Year	Taxable Income	Schedule F Income	Form 4797 Gains Livestock & Machinery
1995	$6,000	$(14,000)	$4,000
1996	$8,000	$(10,000)	$1,500
1997	$11,000	$(8,500)	$2,000
1998	$132,000	$114,000	$3,000

If Calvin does not elect income averaging for 1998, he will have part of his income taxed as high as the 31 percent tax bracket. His overall income tax liability will be $32,346, plus self-employment tax of $11,788.

Calvin elects to average $90,000 of his $117,000 eligible farm income for 1998 (the $90,000 is his "elected farm income"). Thus, he will reduce his income subject to the 1998 rates by $90,000 and subject $30,000 to 1995 rates, $30,000 to 1996 rates, and $30,000 to 1997 rates. His 1998 tax liability is reduced to $19,804, as shown on the Schedule J (Form 1040) in Figure 1. Therefore, income averaging saves Calvin $12,542 of income taxes in 1998.

Figure 1

(Form 1040)

Department of the Treasury
Internal Revenue Service

Farm Income Averaging

► Attach to Form 1040.

► See Instructions for Schedule J (Form 1040).

OMB No. 1545-0074

1998

Attachment Sequence No. 49

Name(s) shown on Form 1040: Calvin Cashpoor

Social security number (SSN): 54 | 61 | 1301

Proof as of 7/13/1998

1	Enter your taxable income from Form 1040, line 39			1	132,000
2	Enter your **elected farm income** (see instructions)			2	90,000
3	Subtract line 2 from line 1. If zero or less, enter -0-			3	42,000
4	Figure the tax on the amount on line 3. Use the 1998 Tax Table, Tax Rate Schedules, or Schedule D, whichever applies			4	6,304
5	Enter the taxable income from your 1995 Form 1040, line 37	5	6,000		
6	Divide the amount on line 2 by 3.0	6	30,000		
7	Add lines 5 and 6	7	36,000		
8	Figure the tax on the amount on line 7. Use the 1995 Tax Rate Schedules or Capital Gain Tax Worksheet, whichever applies			8	5,404
9	Enter the taxable income from your **1996** Form 1040, line 37	9	8,000		
10	Enter the amount from line 6	10	30,000		
11	Add lines 9 and 10	11	38,000		
12	Figure the tax on the amount on line 11. Use the **1996** Tax Rate Schedules or Capital Gain Tax Worksheet, whichever applies			12	5,704
13	Enter the taxable income from your **1997** Form 1040, line 38	13	11,000		
14	Enter the amount from line 6	14	30,000		
15	Add lines 13 and 14	15	41,000		
16	Figure the tax on the amount on line 15. Use the **1997** Tax Rate Schedules or Schedule D, whichever applies			16	6,154
17	Add lines 4, 8, 12, and 16			17	23,566
18	Enter the tax from your **1995** Form 1040, line 38	18	904		
19	Enter the tax from your **1996** Form 1040, line 38	19	1,204		
20	Enter the tax from your **1997** Form 1040, line 39	20	1,654		
21	Add lines 18 through 20			21	3,762
22	Subtract line 21 from line 17. If the result is less than the tax figured from the **1998** Tax Table, Tax Rate Schedules, or Schedule D, also enter on Form 1040, line 40			22	19,804

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Question 1-A.1. *How much self-employment tax will Calvin save in 1998 by electing income averaging?*

Answer 1-A.1. Calvin will pay exactly the same self-employment tax if he elects income averaging as if he does not. The income averaging provision does not apply for self-employment tax purposes or for purposes of the alternative minimum tax. Thus, Calvin will still pay the same self-employment tax of approximately $10,800.

Question 1-A.2. *Assume 1999 is a year with a poor harvest and low commodity prices. Thus, Calvin's Schedule F shows a loss of $10,000, and his taxable income is only $7,000. He has no gains or losses from farming on Form 4797. In 2000, Calvin decides to terminate his farming operations. He is fortunate to find a buyer quickly. The sale of his farming assets and his 2000 Schedule F result in the following income.*

Source of Income		Amount of Income
Schedule F		$(6,000)
Form 4797:		
Farm Land	$ 110,000	
Farm Equipment	$ 65,000	
Breeding Livestock	$ 35,000	$210,000
Total		$204,000

The gain on the farm equipment is §1245 ordinary income, while the gains on the sale of farm land and breeding livestock are §1231 gains. Which assets qualify for averaging, and what is considered to be Calvin's taxable income in 1997 and 1998 prior to the election of averaging for 2000?

Answer 1-A.2. The Schedule F loss, the Form 4797 §1231 gain on the breeding livestock, and the Form 4797 §1245 recapture income on the farm equipment are considered as the farm income eligible for averaging. Therefore, Calvin's farm income eligible for averaging in 2000 is $94,000 ($65,000 + $35,000 – $6,000). Calvin's taxable income for 1997 and 1998 for income averaging purposes is the income as already adjusted for the prior 1998 income averaging election. Thus, the 1997 taxable income prior to the year 2000 averaging is $41,000, and the 1998 taxable income is $42,000.

Question 1-A.3. *Since Calvin will have adjusted taxable income for 1997 of $41,000, for 1998 of $42,000, and for 1999 of only $7,000, can he elect to allocate a larger portion of his year 2000 elected farming income to the year 1999 and a smaller amount to the years 1997 and 1998 in order to "even out" the income allocation?*

Answer 1-A.3 . No. If Calvin elects income averaging for the year 2000 for his farming income, he must allocate the "elected farm income" equally to the tax rates from the three prior years. If Calvin designates $51,000 as elected farm income in 2000, he will reduce his income tax for 2000 from $20,822 (using 1998 rates) to $18,547 (using 1998 income tax rates), as shown on Schedule J in Figure 2. That saves Calvin $2,275 of income taxes.

Figure 2

SCHEDULE J (Form 1040) Department of the Treasury Internal Revenue Service	**Farm Income Averaging** ▶ Attach to Form 1040. ▶ See instructions for Schedule J (Form 1040).	OMB No. 1545-0074 **1998** Attachment Sequence No. **49**
Name(s) shown on Form 1040	Calvin Cashpoor	Social security number (SSN) [illegible]4 61 1301

Proof as of 7/13/1998

1	Enter your taxable income from Form 1040, line 39		94,000
2	Enter your elected farm income (see instructions)		51,000
3	Subtract line 2 from line 1. If zero or less, enter -0-		43,000
4	Figure the tax on the amount on line 3. Use the ~~1998~~ 2000 Tax Table, Tax Rate Schedules, or Schedule D, whichever applies		6,542
* 5	Enter the taxable income from your ~~1995~~ 1997 Form 1040, line 3?	41,000	
6	Divide the amount on line 2 by 3.0	17,000	
7	Add lines 5 and 6	58,000	
8	Figure the tax on the amount on line 7. Use the ~~1995~~ 1997 Tax Rate Schedules or Capital Gain Tax Worksheet, whichever applies		10,891
* 9	Enter the taxable income from your ~~1996~~ 1998 Form 1040, line 39	42,000	
10	Enter the amount from line 6	17,000	
11	Add lines 9 and 10	59,000	
12	Figure the tax on the amount on line 11. Use the ~~1996~~ 1998 Tax Rate Schedules or Capital Gain Tax Worksheet, whichever applies		11,022
* 13	Enter the taxable income from your ~~1997~~ 1999 Form 1040,	7,000	
14	Enter the amount from line 6	17,000	
15	Add lines 13 and 14	24,000	
16	Figure the tax on the amount on line 15. Use the ~~1997~~ 1999 Tax Rate Schedules or Schedule D, whichever applies		3,604
17	Add lines 4, 8, 12, and 16		32,059
18	Enter the tax from your ~~1995~~ 1997 Form 1040, line 38	6,154	
19	Enter the tax from your ~~1996~~ 1998 Form 1040, line 38	6,304	
20	Enter the tax from your ~~1997~~ 1999 Form 1040, line 39	1,054	
21	Add lines 18 through 20		13,512
22	Subtract line 21 from line 17. If the result is less than the tax figured from the 1998 Tax Table, Tax Rate Schedules, or Schedule D, also enter on Form 1040, line 40		18,547

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 25513Y Schedule J (Form 1040) 1998

* These lines are likely to include instructions to adjust the taxable income to reflect income averaging elections in prior years.

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Timber

Income from timber **is not eligible** for the income averaging election, since farming business is defined in I.R.C. §1301(b)(3) by reference to I.R.C. §263A, which does not include timber. For purposes of this definition, Christmas trees that are more than six years old when severed from the roots are treated as timber (**not eligible** for income averaging), whereas Christmas trees that are six years old or less at the time they are severed from their roots are treated as ornamental trees and therefore **are eligible** for income averaging.

Estates and Trusts

Estates and trusts are **specifically excluded** from eligibility to elect income averaging [I.R.C. §1301(b)(2)].

B. ISSUES THAT NEED TO BE ADDRESSED IN THE REGULATIONS

I.R.C. §1301(c) authorizes the Secretary of the Treasury to prescribe regulations to carry out this provision. Several issues need to be covered by those regulations.

1. Character of Income Subject to Prior Year Rates

Will income that is subject to the rates of the previous three years retain its character? If so, can the taxpayer choose which character of income is subject to the prior year rates? Will capital gains be taxed at the rate in effect for the prior year?

Example 1-B. *In 1998, Bob has $80,000 of net Schedule F income and $40,000 of gain on Form 4797 from the sale of cull cows held for 24 months or more.*

Question 1-B.1. *If he makes $60,000 of that income elected farm income subject to the 1995 – 1997 rates, what is the character of the income subject to those rates?*

Answer 1-B.1. Possible answers include:

1. All $60,000 of the elected farm income could be ordinary income, since there is $80,000 Schedule F income in 1998.
2. The $60,000 elected farm income could be allocated between ordinary and capital gains on a pro rata basis. That would allocate $40,000 of the $60,000 as ordinary income and $20,000 as capital gain.
3. $40,000 of the $60,000 could be characterized as capital gain, and the remaining $20,000 as ordinary income.

Can Bob elect the result he wants?

Question 1-B.2. *Assuming the $60,000 of elected farm income is allocated pro rata between ordinary income and capital gains (i.e., $40,000 of ordinary income and $20,000 of capital gains), how are the ordinary income and capital gains in elected farm income allocated among the three prior years?*

Answer 1-B.2. Possible answers include: *The $20,000 subject to each of the prior year's rates is allocated pro rata between ordinary income and capital gains. This method allocates $13,333 to ordinary income and $6,667 to capital gains for each of the prior years.*

1. The $20,000 subject to each of the prior year's rates is allocated pro rata between ordinary income and capital gains. This method allocates $13,333 to ordinary income and $6,667 to capital gains for each of the prior years.
2. Allocate ordinary income first to the earliest years. This method allocates $20,000 of ordinary income to 1995 and 1996 rates and $20,000 of capital gains to 1997 rates.

3. Allocate capital gain first to the earliest years. This method allocates $20,000 of capital gain to 1995 rates and $20,000 of ordinary income to 1996 and 1997 rates.

Can Bob choose how to allocate the capital gain and ordinary income among the prior year rates?

Question 1-B.3. *If capital gain is allocated to 1995 rates and/or 1996 rates, what capital gains rates are used to recalculate the 1995 and/or 1996 income tax?*

Answer 1-B.3. **It is likely** that the old 28% capital gain rate will be used for capital gains subject to 1995 and 1996 rates. I.R.C. §1301 says "the increase in tax imposed by section 1.for each of the 3 prior taxable years." Since the capital gains rates are in I.R.C. §1(h), the rates for the prior year are likely to be applied.

Question 1-B.4. *If capital gain is allocated to 1997 rates, what capital gains rates are used to recalculate the 1997 income tax?*

Answer 1-B.4. **There is very little guidance** on which to base an answer to this question. In Notice 97-59, the IRS set out rules for netting capital gains and losses. Those rules allow losses to be netted first against gains in the highest capital gains rate groups. That gives the taxpayer the greatest benefit from the capital losses that are carried from another group or from another year. If the philosophy of giving the taxpayer the best result is applied to the income averaging rules, the new capital gains rules will be applied to gains carried back to 1997.

Example 1-C. Jennifer had $10,000 of nonrecaptured §1231 losses in 1995, but none in 1996, 1997, or 1998 because the nonrecaptured losses were more than five years old in those years. In 1998, Jennifer has $30,000 of §1231 gains that are carried back to 1995, 1996, and 1997.

Question 1-C.1. *Assuming $10,000 of the §1231 gains are allocated to 1995 rates, are they subject to recapture as ordinary income under the §1231(c) recapture rules?*

Answer 1-C.1. Possible arguments.

1. It could be argued that only I.R.C. §1 rules apply from the 1995 tax year. Since the character of the §1231 gain is converted by I.R.C. §1231(c), the conversion can occur only in 1998. Therefore, there is no conversion in this example.
2. It could also be argued that the 1995 income tax rules apply to the income subject to the 1995 rates. Therefore, the $10,000 of §1231 gain carried to 1995 is converted to ordinary income in this example.

2. Which Taxpayers Qualify for the Income Averaging Provision?

a. I.R.C. §1301(a) says "individual engaged in a farming business." "Individual" is generally used in the Internal Revenue Code to mean a natural person, not a trust, estate, partnership, association, company, or corporation [I.R.C. §7701(a)]. Therefore, on its face, the provision appears to apply only to natural people. However, §1301(b)(2) specifically excludes estates and trusts from the term "individual." Since partnerships, associations, companies, and corporations were not specifically excluded, are they included in the term "individual"? **It does not seem likely that Congress intended to include corporations in this provision and not estates and trusts, so it is more likely that §1301(b)(1) is superfluous and "individual" means only natural people.**

b. Does "individual engaged in a farming business" include individuals who receive farm income that flows through another entity such as a partnership, S corporation, trust, or estate? Since that income retains its character in the hands of the individual taxpayer for purposes of self-employ-

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ment taxes (§1402), the exception to the underpayment penalty in §6654(i), and other provisions, **it is logical to treat an individual who receives farm income from a partnership, S corporation, trust, or estate as an "individual engaged in farming."**

c. Does "individual engaged in a farming business" include land owners who rent their land for use in agricultural production?

If the landowner materially participates in the farming activity and properly reports the income on Schedule F, it is logical to treat the landowner as an individual engaged in farming for purposes of §1301, since those landowners are treated as receiving farm business income for purposes of self-employment taxes (§1402), the exception to the underpayment penalty in §6654(i), soil and water conservation expenses under I.R.C. §175, and other provisions.

If the landowner does not materially participate but receives share rent that is properly reported on Form 4835, it could still be argued that the landowner is engaged in a farming business, since the landowner shares in the risk of the business. Furthermore, a non-materially participating share-lease landowner is treated as being engaged in a farming business for purposes of the soil and water conservation rules under I.R.C. §175 and the estimated tax rules under I.R.C. §6654(i). A rental activity is a trade or business for purposes of the self-employment tax rules of I.R.C. §1402, even though rent from real estate is excepted from that tax.

If the landowner receives cash rent for farmland and properly reports the rent on Schedule E, the landowner **looks less like he or she is engaged in farming since the landowner is not treated as being engaged in farming for purposes of the soil and water conservation expense deduction under I.R.C. §175 or the estimated tax penalty under I.R.C. §6654(i).**

3. What Property Is "Regularly Used in a Farming Business"?

In order for gain from the sale of property to be attributable to a farming business, how much farm use is required to meet the "regularly used in a farming business" requirement of I.R.C. §1301(b)(1)(B)?

Some property that quite clearly meets the requirement includes:

a. Property for which sales or other transfers are reported on Schedule F or Form 4835 (assuming share-rent landowners qualify for the provision).

b. Property for which depreciation and/or §179 deductions are claimed on Schedule F or Form 4835 (assuming share-rent landowners qualify for the provision).

c. Raised breeding and dairy livestock for which sales are reported on Form 4797.

Property that likely meets the requirement includes machinery and other property that is I.R.C. §1231 property, because of its use in a farm business. But what if the property is only partially used in a farm business? Does the business use portion qualify? **Some further definition of "regularly used in a farm business" would be useful.**

4. How Long Is a "Substantial Period"?

In order for gain from the sale of property to be attributable to a farming business, how long must it be held to meet the "substantial period" requirement of I.R.C. §1301(b)(1)(B)? Presumably, all income reported on Schedule F or Form 4835 (assuming share-rent landowners qualify for the provision) is "attributable to a farming business" under I.R.C. §1301(b)(1)(A)(i), and therefore, property for which sales are reported on Schedule F or Form 4835 does not need to meet the "substantial period" requirement of I.R.C. §1301(b)(1)(B). **Therefore, the only property that must meet the substantial period requirement is property for which sales or other transfers are reported on Form 4797.**

Possibilities for the holding period for that property include:

a. The holding period required to report the gain in Part I or Part III of Form 4797. This rule has the advantage of ease of administration, since the property sales are already sorted by this criterion for reporting on Form 4797. It has the disadvantage of not treating all property the same. To be reported in Part I or Part III of Form 4797, cattle and horses are required to be held for 24 months or more [I.R.C. §1231(b)(3)(A)], other livestock is required to be held 12 months or more [I.R.C. §1231(b)(3)(B)] and all other property is required to be held for more than one year [I.R.C. §1231(b)(1)]. The administrative advantage probably outweighs the disadvantage of not treating all property the same.

b. The "more than one year" holding period is required by I.R.C. §1222(3) to qualify the gain or loss for long-term treatment. This rule treats all property the same, but would require sorting out property reported in Part II of Form 4797 that meets the "more than one year" requirement, such as cattle and horses held more than one year but not 24 months or more.

5. Can a Taxpayer Treat Negative Income for the Election Year as "Elected Farm Income"?

Can a taxpayer treat negative income for the election year as "elected farm income" and thereby reduce the amount of taxes paid on income in the previous three years? I.R.C. §1301(b)(1) defines elected farm income as "taxable income." I.R.C. §63(a) defines "taxable income" as gross income reduced by allowed deductions, without any restrictions on reducing taxable income below zero. Therefore, **it appears** that "elected farm income" **could be negative.** However, the I.R.C. §1301(a)(2) requires the "increase in tax imposed by section 1" (from the three prior years) to be added to the tax computed in §1301(a)(1).

Therefore, if a taxpayer had negative elected farm income, he or she would apparently not be allowed to use a reduction in tax liability that results from adding the negative income to the three prior taxable years to reduce the electing year's tax liability. A clear statement of this rule in the regulations would be useful.

6. Can the Election Be Made on an Amended Return?

The committee reports and the Joint Committee blue book state that the election is irrevocable, except as provided by the Secretary. Therefore, it appears that the election **cannot be revoked** by the taxpayer. Does that statement mean that the failure to elect is also irrevocable? **Or, could a taxpayer wait until filing the 1999 and/or 2000 tax return to make the election on an amended 1998 tax return?**

C. PLANNING CONSIDERATIONS

The planning considerations depend in part on the answers to the above questions regarding the application of the income averaging rules. However, some rules can be identified regardless of the answers to the above questions.

1. Planning to Minimize Income Tax Rates

In general, income should be leveled as much as possible over the years that are affected by income averaging, that is, 1995 through 2000. However, there may be exceptions, where the increase in taxes from shifting income into a higher bracket in one of the prior years is more than offset by the decrease in taxes from shifting income into a low bracket for the other two prior years. To minimize taxes, the break points for the tax brackets must be considered.

The following tables provide information for comparing the tax rates of the various years.

PERSONAL EXEMPTION DEDUCTION AND STANDARD DEDUCTION

Item	1995	1996	1997	1998
Personal Exemption Deduction	$2,500	$2,550	$2,650	$2,700
Standard Deduction:				
Single	$3,900	$4,000	$4,150	$4,250
Married filing jointly	$6,550	$6,700	$6,900	$7,100
Head of household	$5,750	$5,900	$6,050	$6,250
Married filing separately	$3,275	$3,350	$3,450	$3,550

TOP END OF TAXABLE INCOME TAX BRACKETS

Bracket	1995	1996	1997	1998
Single				
15%	$ 23,350	$ 24,000	$ 24,650	$ 25,350
28%	$ 56,550	$ 58,150	$ 59,750	$ 61,400
31%	$117,950	$121,300	$124,650	$128,100
36%	$256,500	$263,750	$271,050	$278,450
Married filing jointly				
15%	$ 39,000	$ 40,100	$ 41,200	$ 42,350
28%	$ 94,250	$ 96,900	$ 99,600	$102,300
31%	$143,600	$147,700	$151,750	$155,950
36%	$256,500	$263,750	$271,050	$278,450
Head of household				
15%	$ 31,250	$ 32,150	$ 33,050	$ 33,950
28%	$ 80,250	$ 83,050	$ 85,350	$ 87,700
31%	$130,800	$134,500	$138,200	$142,000
36%	$256,500	$263,750	$271,050	$278,450
Married filing separately				
15%	$ 19,500	$ 20,050	$ 20,600	$ 21,175
28%	$ 47,125	$ 48,450	$ 49,800	$ 51,150
31%	$ 71,800	$ 73,850	$ 75,875	$ 77,975
36%	$128,250	$131,875	$135,525	$139,225

TOP END OF SELECTED ADJUSTED GROSS INCOME TAX BRACKETS

Bracket	1995	1996	1997	1998
Married filing jointly, 4 exemptions, standard deduction				
0%	$ 16,550	$ 16,900	$ 17,500	$ 17,900
15%	$ 55,550	$ 57,000	$ 58,700	$ 60,250
28%	$110,800	$113,800	$117,100	$120,200
31%	$160,150	$164,600	$169,250	$173,850
36%	$273,050	$280,650	$288,550	$296,350

Example 1-D. Peter is married, has two children, and files a joint tax return. He had no adjusted gross income in 1995 and 1996. In 1997 his adjusted gross income was $117,100, and in 1998 his adjusted gross income was $90,250.

The first $49,650 ($16,550 × 3) of 1998 farm income that Peter makes elected farm income is taxed at an average of 10.3% (0% + 0% + 31% = 31% ÷ 3). The next $350 ($16,900 – $16,550) is taxed at an average of 15.33% (15% + 0% + 31% = 46% ÷ 3). **Therefore, Peter should elect no more than $49,650 for income averaging, since any greater election would move income from the 15% bracket for 1998 to an average, 15.33% bracket for 1995, 1996, and 1997.**

Observation. One-third of the $49,650 is being moved from the 28% and 15% brackets in 1998 to the 31% bracket for 1997. That increase in taxes is more than offset by the decrease in taxes caused by moving the other two-thirds to the zero brackets for 1995 and 1996.

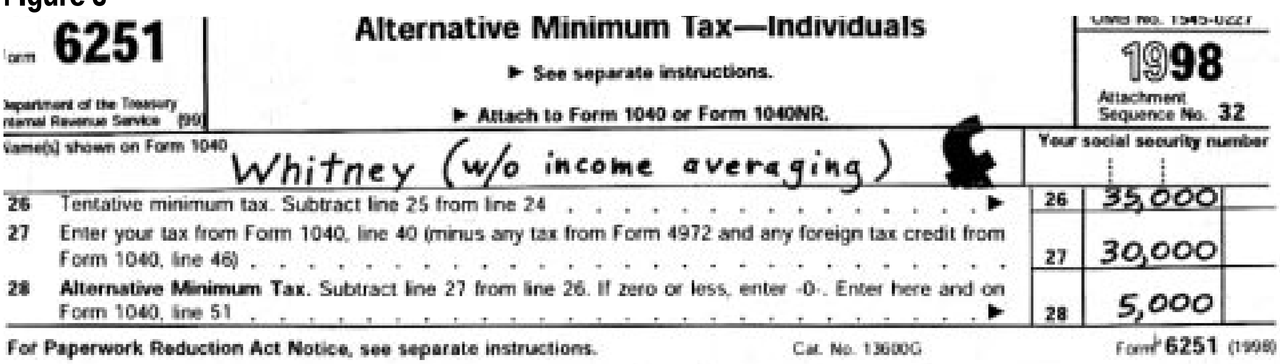
Effect of the Alternative Minimum Tax

Taxpayers should consider the effect of the alternative minimum tax when making the income averaging election. **The committee reports state that this provision does not apply for purposes of the alternative minimum tax under I.R.C. §55.** The draft versions of Form 1040, Schedule J (Form 1040), and Form 6251 appear to apply this comment in a manner that makes income averaging of little benefit for taxpayers who are subject to the alternative minimum tax in the year for which averaging is elected. For those taxpayers, alternative minimum taxes appear to be increased by an amount equal to the decrease in regular taxes caused by income averaging.

Practitioner Caution. At the time of this writing, the instructions for Form 1040 and Form 6251 have not been released. Those instructions may give further guidance on this issue.

Example 1-E. Whitney is not married and had a $35,000 tentative minimum tax (line 26 of Form 6251) for 1998. She had a $30,000 regular tax (line 40 of Form 1040 and line 26 of Form 6251) before income averaging, which resulted in a $5,000 alternative minimum tax (line 27 of Form 6251). See Figure 3.

Figure 3



Form 6251 — Alternative Minimum Tax—Individuals — 1998

► See separate instructions.

► Attach to Form 1040 or Form 1040NR.

Department of the Treasury, Internal Revenue Service (99) — Attachment Sequence No. 32

Name(s) shown on Form 1040: Whitney (w/o income averaging) — Your social security number

26	Tentative minimum tax. Subtract line 25 from line 24 ►	26	35,000
27	Enter your tax from Form 1040, line 40 (minus any tax from Form 4972 and any foreign tax credit from Form 1040, line 46)	27	30,000
28	**Alternative Minimum Tax.** Subtract line 27 from line 26. If zero or less, enter -0-. Enter here and on Form 1040, line 51 ►	28	5,000

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 13600G Form 6251 (1998)

Whitney has enough of her 15% bracket available in 1995, 1996, and 1997 so that if she elects income averaging for $51,000 of her 1998 farm income, her regular tax liability will decrease by $8,160. However, her alternative minimum tax will increase by $8,160, so her total 1998 tax liability does not change. See Schedule J (Form 1040) and Form 6251 in Figure 4.

Figure 4

Farm Income Averaging

(Form 1040)

Department of the Treasury
Internal Revenue Service

▶ Attach to Form 1040.

▶ See Instructions for Schedule J (Form 1040).

OMB No. 1545-0074

1998

Attachment Sequence No. 49

Name(s) shown on Form 1040: Whitney

Social security number (SSN)

22 Subtract line 21 from line 17. If the result is less than the tax figured from the 1998 Tax Table, Tax Rate Schedules, or Schedule D, also enter on Form 1040, line 40	22	21,840

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 25513Y Schedule J (Form 1040) 1998

Form **6251**

Alternative Minimum Tax—Individuals

Department of the Treasury
Internal Revenue Service (99)

▶ See separate instructions.

▶ Attach to Form 1040 or Form 1040NR.

OMB No. 1545-0227

1998

Attachment Sequence No. 32

Name(s) shown on Form 1040: Whitney (with income averaging)

Your social security number

26 Tentative minimum tax. Subtract line 25 from line 24 ▶	26	35,000
27 Enter your tax from Form 1040, line 40 (minus any tax from Form 4972 and any foreign tax credit from Form 1040, line 46)	27	21,840
28 **Alternative Minimum Tax.** Subtract line 27 from line 26. If zero or less, enter -0-. Enter here and on Form 1040, line 51 ▶	28	13,160

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 13600G Form **6251** (1998)

Observation. The $8,160 of additional alternative minimum tax liability could increase Whitney's alternative minimum tax credit by $8,160. Since that credit can be used to offset income tax liability in future years, there is a net positive benefit to making the election. The value of that benefit depends on how far in the future the alternative minimum tax credit can be claimed.

Practitioner Note. It could be argued that the comment in the committee reports regarding application of the income averaging provision to the alternative minimum tax should be applied to the regular tax liability computation under I.R.C. §55(a)(2). Under that interpretation, the alternative minimum tax is not increased by the decrease in regular taxes caused by income averaging. For example, Whitney's regular tax liability would decrease by $8,160, but her alternative minimum tax liability would remain at $5,000 in the previous example.

Effect on Earned Income Credit

The income averaging election apparently has no effect on the earned income credit, since it affects only the tax imposed by I.R.C. §1. However, if a taxpayer shifts income from one year to another to make the best use of the income averaging rules, that shift in income could affect the earned income credit.

Example 1-F. Mary and Gary have two children and file a joint tax return. In November of 1998, they project their 1998 income to be $12,300–all of it from Schedule F (Form 1040). Since they expect significantly more income in 1999 and their income was low in 1995, 1996, and 1997, they decide to accelerate the sale of $20,000 of grain to increase their 1998 income and to use income averaging for 1998. That increase in 1998 income will reduce their earned income credit from $3,756 to zero.

ISSUE 2: SELF-EMPLOYMENT TAX ON CRP PAYMENTS

A. MATERIALLY PARTICIPATING LANDOWNERS

For several years, the IRS has taken the position that Conservation Reserve Program (CRP) payments are subject to self-employment tax if the recipient is materially participating in a farm business. See **Ltr. Rul.** 9637004 (May 1, 1996) and 1997 IRS Pub. 225, *Farmer's Tax Guide*, p. 17. That position was quite widely accepted by tax practitioners and commentators (see Harris, Daughtrey, and Bock, *Agricultural Tax Issues and Form Preparation*, Fall 1997, pp. 28–31). Some courts also agreed with the IRS position. See *Ray v. Commissioner*, T.C. Memo 1996-436, 72 T.C.M. 780 [CCH Dec. 51,572(M)] (1996).

In *Wuebker v. Commissioner*, 110 T.C. No. 31 (June 23, 1998), the court agreed with the taxpayer that CRP payments received by a materially participating farmer are not subject to self-employment tax. In that case, the taxpayers had been farming for approximately 20 years. In 1991 they put 214 acres of their land into the CRP program and continued to farm other land under a sharecrop rental arrangement. Mr. Wuebker used his equipment to establish the required ground cover on the CRP land and performed minimal upkeep on the land each year.

The *Wuebker* court based its decision on its finding that the CRP payments are rental payments. By contrast, the *Ray* court treated the CRP payments the same as other government program payments.

Having determined that the CRP payments are rental payments, the *Wuebker* court then applied I.R.C. §1402. That section imposes the self-employment tax on all trade or business income but excludes, among other things, rental from real estate. Since the CRP payment was found to be rental from real estate, it falls within this exception.

There is an exception to the rental real estate exception under I.R.C. §1402. The exception to the exception is for land that is used in agricultural production if:

1. There is an arrangement calling for the owner's material participation, and
2. The owner materially participates.

The *Wuebker* court concluded that the exception to the exception does not apply to CRP land, because the CRP land is not used in agricultural production. The CRP agreement prohibits the owner from using the land in agricultural production.

Note: The IRS **is not** appealing the *Wuebker* decision. **Practitioners should note** that this decision may affect the qualification of this property for purposes of §§2032A, 2057 and 6166 and estimated tax rules.

Example 2-A. Fred and Ruth put part of their farm into the CRP program and continue to farm the remainder of their land. They received a $8,000 CRP payment in 1998, and they want to report that payment as not subject to the self-employment tax. The CRP payment would be reported on Schedule E (Form 1040).

Practitioner Note. Since the IRS is not appealing *Wuebker*, disclosure is **not necessary** unless Fred and Ruth report the income on Schedule F and rely on **Ray** and **Ltr. Rul.** 9637004.

Figure 5

(Form 1040)

Department of the Treasury
Internal Revenue Service (99)

Supplemental Income and Loss

(From rental real estate, royalties, partnerships, S corporations, estates, trusts, REMICs, etc.)

▶ Attach to Form 1040 or Form 1041. ▶ See Instructions for Schedule E (Form 1040).

OMB No. 1545-0074
1998
Attachment Sequence No. 13

Name(s) shown on return: Fred and Ruth

Your social security number: 200 01 1402

Proof as of 6/23/1998

Part I **Income or Loss From Rental Real Estate and Royalties** Note: *Report income and expenses from your business of renting personal property on Schedule C or C-EZ (see page E-1). Report farm rental income or loss from Form 4835 on page 2, line 39.*

1 Show the kind and location of each **rental real estate property:**

A CRP land in Brighton township

B

C

2 For each rental real estate property listed on line 1, did you or your family use it during the tax year for personal purposes for more than the greater of:
- 14 days, or
- 10% of the total days rented at fair rental value?

(See page E-1.)

	Yes	No
A		X
B		
C		

Income:		Properties A	B	C		Totals (Add columns A, B, and C.)
3 Rents received	3	8,000			3	
4 Royalties received	4				4	
Expenses:						
5 Advertising	5					
6 Auto and travel (see page E-2)	6					
7 Cleaning and maintenance	7					
8 Commissions	8					
9 Insurance	9					
10 Legal and other professional fees	10					
11 Management fees	11					
12 Mortgage interest paid to banks, etc. (see page E-2)	12				12	
13 Other interest	13					
14 Repairs	14					
15 Supplies	15					
16 Taxes	16	1,000				
17 Utilities	17					
18 Other (list) ▶	18					
19 Add lines 5 through 18	19	1,000			19	
20 Depreciation expense or depletion (see page E-2)	20				20	
21 Total expenses. Add lines 19 and 20	21	1,000				
22 Income or (loss) from rental real estate or royalty properties. Subtract line 21 from line 3 (rents) or line 4 (royalties). If the result is a (loss), see page E-3 to find out if you must file **Form 6198**	22	7,000				
23 Deductible rental real estate loss. **Caution:** *Your rental real estate loss on line 22 may be limited. See page E-3 to find out if you must file Form 8582. Real estate professionals must complete line 42 on page 2*	23	( )	( )	( )		

24 **Income.** Add positive amounts shown on line 22. **Do not** include any losses	24	7,000
25 **Losses.** Add royalty losses from line 22 and rental real estate losses from line 23. Enter total losses here	25	( )
26 Total rental real estate and royalty income or (loss). Combine lines 24 and 25. Enter the result here. If Parts II, III, IV, and line 39 on page 2 do not apply to you, also enter this amount on Form 1040, line 17. Otherwise, include this amount in the total on line 40 on page 2	26	7,000

Figure 5

Form **8275** (Rev. March 1998) Department of the Treasury Internal Revenue Service

Disclosure Statement

Do not use this form to disclose items or positions that are contrary to Treasury regulations. Instead, use Form 8275-R, Regulation Disclosure Statement. See separate instructions.

▶ **Attach to your tax return.**

OMB No. 1545-0889

Attachment Sequence No. **92**

Name(s) shown on return: Fred and Ruth

Identifying number shown on return: 200-01-1402

Part I **General Information** (see instructions)

(a) Rev. Rul., Rev. Proc., etc.	(b) Item or Group of Items	(c) Detailed Description of Items	(d) Form or Schedule	(e) Line No.	(f) Amount
1 Ray v. Comm. T.C. Memo 1996-436	CRP payments	Conservation Reserve Payments	Sch. E (Form 1040)	3	8,000
2					
3					

Part II **Detailed Explanation** (see instructions)

1 Taxpayer takes the position that CRP payments are rental income from real estate not used in agricultural production and therefore are not subject to self-employment tax under I.R.C. § 1402(a)(1) as held in Wuebker v. Commissioner 110 T.C. No. 31 (June 23, 1998).

B. NON-MATERIALLY PARTICIPATING LANDOWNERS

Whether or not the *Wuebker* case stands, non-materially participating landowners **are not subject to self-employment tax** on CRP payments. See 1997 IRS Pub. 225, *Farmer's Tax Guide*, p. 17.

Example 2-B. Lorna Buckmaster put her entire farm into the CRP. She paid her neighbor to establish the required ground cover and pays him each year to mow the land. Since Lorna is not materially participating, she is not subject to self-employment tax on the CRP payments.

Example 2-C. If Lorna from the previous example established the ground cover herself and mowed the land each year, **she is still likely to be treated as not materially participating and therefore not subject to the self-employment tax under the IRS position.**

ISSUE 3: SELF-EMPLOYMENT TAX ON RENTAL INCOME

A. 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.

9

I.R.C. §1402(a) reads as follows:

"The term 'net earnings from self-employment' means the gross income derived by an individual from any trade or business carried on by such individual, less the deductions allowed by this subtitle which are attributable to such trade or business, plus his distributive share (whether or not distributed) of income or loss described in §702(a)(8) from any trade or business carried on by a partnership of which he is a member; except that in computing such gross income and deductions and such distributive share of partnership ordinary income or loss–

(1) there shall be excluded rentals from real estate and from personal property leased with the real estate (including such rentals paid in crop shares) together with the deductions attributable thereto, unless such rentals are received in the course of a trade or business as a real estate dealer; except that the preceding provisions of this paragraph shall not apply to any income derived by the owner or tenant of land if

(A) such income is derived under an arrangement, between the owner or tenant and another individual, which provides that such other individual shall produce agricultural or horticultural commodities (including livestock, bees, poultry, and fur-bearing animals and wildlife) on such land, and that there shall be material participation by the owner or tenant (as determined without regard to any activities of an agent of such owner or tenant) in the production or the management of the production of such agricultural or horticultural commodities, and

(B) there is material participation by the owner or tenant (as determined without regard to any activities of an agent of such owner or tenant) with respect to any such agricultural or horticultural commodity;"

In other words, 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:

      1. that another individual will produce agricultural or horticultural commodities on the land, and

      2. 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 preceding 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 *arrangement* providing for the owner's *material participation* and there must be material participation.
3. Only land, not buildings, is subject to the material participation exception.

B. 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 treated the lease and the partnership agreement as one agreement and held that they met the requirement that there be an arrangement calling for material participation. The court also held that the partner's participation in the partnership met the material participation requirement of the exception in I.R.C. §1402(a)(1).

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.

Arguably, he does not have to pay self-employment tax on the $8,000 of rent received on the buildings. The **argument** is that rent on real estate is not subject to self-employment tax unless it falls within one of the exceptions. Since Congress used the term "land" for the exception for agricultural use, **it can be argued** that Congress intended the exception to apply to something different from real estate. That difference could be that only bare land, **and not improvements** on the land, are subject to the exception for agricultural use. This argument is consistent with the Joint Committee on Taxation *General Explanation of the Economic Recovery Tax Act of 1981* discussion of the 6% imputed interest rate for sales of land to family members [I.R.C. §483(e)]. See p. 60 of the *General Explanation.* That discussion interprets the term land to mean only the bare soil and not the depreciable assets on the land. **The counterargument is that under state law, the term "land" includes improvements, and therefore, the rent on the buildings is also subject to self-employment tax.**

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 I.R.C. §1402(a)(1) exception for personal property rented with real estate, **but the IRS is not likely to follow that position.**

C. LAND RENTED TO A CORPORATION

9

In Ltr. Rul. 9637004, dated May 1, 1996, the IRS ruled that cash 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 I.R.C. §1402(a)(1), since they were **employees** of the corporation.

> Note that **Treas. Reg.** §1.1402(a)-4(b)(2) says the rental income must be received by the owner pursuant to "a share-farming or other rental arrangement." That language supports the IRS conclusion that cash rent is subject to the self-employment tax.

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

Rachel is subject to self-employment tax on the same rent as Charles in Example 1. Therefore, she is subject to self-employment tax for the rent on the land. She is not subject to self-employment tax for the rent on the buildings, but is likely to be subject to self-employment tax for the rent on the machinery.

D. LEGISLATIVE PROPOSALS

There are several legislative proposals to fix the self-employment tax on rent problem.

1. The most pro-taxpayer would allow the taxpayer to choose whether or not the rent is subject to self-employment tax. That has the advantage of allowing taxpayers to build social security coverage if they choose.

A Bill

To amend the Internal Revenue Code of 1986 to allow owners of land used to produce agricultural or horticultural commodities to choose whether or not rental income is included in self-employment income.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

Section 1. Self-employment tax on rental income from land used to produce agricultural or horticultural commodities.

a. In General. Section 1402(a)(1) of the Internal Revenue Code of 1986 is amended by inserting "at the election of such individual" after "except that."

b. Effective Date. The amendment made by this section shall apply to taxable years ending after the date of enactment of this Act.

2. Another proposal would remove the agricultural production exception to the real estate exception to the definition of "net earnings from self-employment." It would amend I.R.C. §1402(a)(1) as follows:

(1) there shall be excluded rentals from real estate and from personal property leased with the real estate (including such rentals paid in crop shares) together with the deductions attributable thereto, unless such rentals are received in the course of a trade or business as a real estate dealer; ~~except that the preceding provisions of this paragraph shall not apply to any income derived by the owner or tenant of land if (A) such income is derived under an arrangement, between the owner or tenant and another individual, which provides that such other individual shall produce agricultural or horticultural commodities (including livestock, bees, poultry, and fur-bearing animals and wildlife) on such land, and that there shall be material participation by the owner or tenant (as determined without regard to any activities of an agent of such owner or tenant) in the production or the management of the production of such agricultural or horticultural commodities, and (B) there is material participation by the owner or tenant (as determined without regard to any activities of an agent of such owner or tenant) with respect to any such agricultural or horticultural commodity;~~

3. A third legislative proposal would fix the problem by adding the word "lease" before "arrangement" in I.R.C. §1402(a)(1) so that partnership and employment agreements would not satisfy the material participation requirement.

E. LITIGATION

Several cases have been initiated in North Dakota and Minnesota to litigate the IRS position. Those cases will take several months to get to court and are likely to be consolidated into one case for appeal if they get that far.

The attorney who is handling these cases, Gary Pierce of Grand Forks, North Dakota, is confident that he can convince the court that the exception for material participation in agricultural production does not apply to cash leases. He also argues that a taxpayer's role as partner in a partnership or employee of a corporation **should not be treated** as material participation as a land owner.

F. PLANNING TO AVOID SELF-EMPLOYMENT TAX ON RENT FROM AN ENTITY

1. Avoiding Material Participation

Under the reasoning of *Mizell* and **Ltr. Rul.** 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 to avoid material participation by the landowner 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 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 Rachel in Example 3-B put her land and buildings into a newly created corporation, the land-holding corporation could rent the land and buildings to her existing corporation. Arguably, the rent should not be subject to self-employment tax.*

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

9

If land is put into a corporation to avoid the self-employment tax problems, other tax issues should be considered to make sure that 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 I.R.C. §541; special use valuation of assets in a decedent's estate under I.R.C. §2032A; the family-owned business deduction under I.R.C. §2057; and installment payment of estate taxes under I.R.C. §6166.

Practitioner Note. The word, "arguably," is used in the preceding discussion because it is possible that the IRS would rule that the ownership by a spouse or by a corporation **should be ignored** for purposes of the self-employment tax.

Another option is putting the land in a family limited partnership (FLP) and paying rent to the FLP. However, the IRS **may argue** that material participation in the farm operation by a partner of the FLP makes that partner's share of FLP income subject to self-employment tax.

2. Separating Building Rent from Land Rent

To make it easier to identify the building rent that is "arguably" not subject to the self-employment tax, it is useful to state the building rent separately from the land rent in the lease.

Example 3-E. Lotta Milk has agreed to lease her 200-acre dairy farm to Juana Bee for $100 per acre per year–for a total of $20,000 per year. The lease includes the dairy parlor, feed storage, and other farm buildings. They should agree how much of the rent is for the buildings and state that amount in their lease. For example, they could state that the rent is $75 per acre for the land ($15,000) and $5,000 for the buildings.

Observation. Separate leases for the land and for the buildings do not add much to the income tax argument that the rent on the buildings is not subject to self-employment tax and will increase the legal cost of drafting the leases.

ISSUE 4: CCC MARKETING LOANS AND LOAN DEFICIENCY PAYMENTS

See part C of this Issue for a description of 1998 marketing loans and marketing strategies. This starts on page 327.

Low commodity prices are causing farm producers to use government programs that have not been used in the past few years. As market prices for commodities fall below the marketing assistance loan rates offered by the Commodity Credit Corporation (CCC), producers can realize more income by taking advantage of one or more of the government options. Those options and the income tax consequences are as follows.

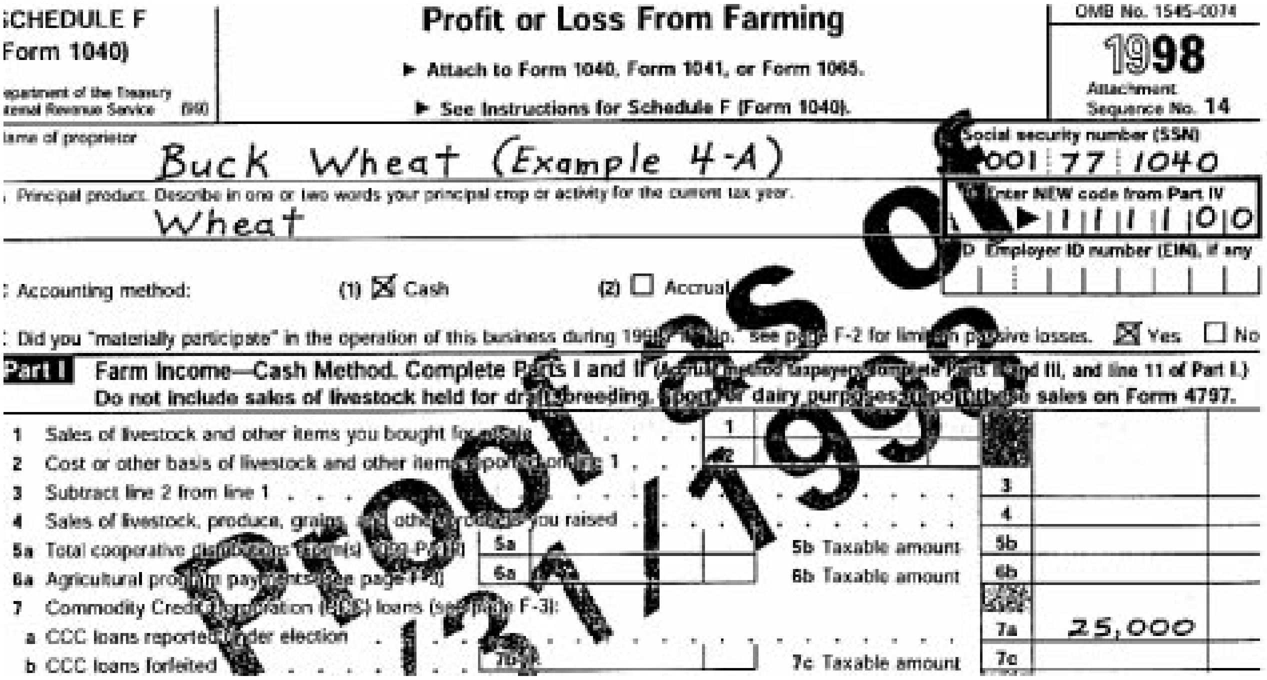
A. CCC NONRECOURSE MARKETING ASSISTANCE LOAN

Instead of selling a commodity, producers can use the commodity as collateral for a nonrecourse loan from the CCC. This option puts cash in the producer's pocket at the time of harvest and lets the producer wait to see whether market prices improve. The loan rate varies by county but is subject to a maximum of 85% of the prior year's rate.

The loan must be reported as income by producers who have made the I.R.C. §77 election in the current year or any previous year.

Example 4-A. Buck Wheat pledged 10,000 bushels of his 1998 wheat harvest as collateral for a $25,000 CCC loan at the rate of $2.50 per bushel. If Buck has made the I.R.C. §77 election to treat CCC loans as income in 1998 **or any previous year,** Buck must report the $25,000 as income on line 7a of his 1998 Schedule F (Form 1040), as shown in Figure 6.

Figure 6



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

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 — 1998 — Attachment Sequence No. 14

Name of proprietor: Buck Wheat (Example 4-A)

Social security number (SSN): 001 77 1040

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

B Enter NEW code from Part IV ► 1 1 1 1 0 0

D Employer ID number (EIN), if any

C Accounting method: (1) ☒ Cash (2) ☐ Accrual

E Did you "materially participate" in the operation of this business during 1998? If "No," see page F-2 for limit on passive losses. ☒ Yes ☐ No

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

1	Sales of livestock and other items you bought for resale	1	
2	Cost or other basis of livestock and other items reported on line 1	2	
3	Subtract line 2 from line 1	3	
4	Sales of livestock, produce, grains, and other products you raised	4	
5a	Total cooperative distributions (Form(s) 1099-PATR) 5a; 5b Taxable amount	5b	
6a	Agricultural program payments (see page F-3) 6a; 6b Taxable amount	6b	
7	Commodity Credit Corporation (CCC) loans (see page F-3):		
a	CCC loans reported under election	7a	25,000
b	CCC loans forfeited 7b; 7c Taxable amount	7c	

Proof as of 1/31/1999

Practitioner Note. Schedule F no longer has a line to check indicating that the taxpayer has made the I.R.C. §77 election. Tax preparers should make a reasonable effort to determine whether the taxpayer has made the §77 election in any prior year.

If the producer has **not** made the I.R.C. §77 election, the CCC loan is treated the same as any other loan—**it is not income when the loan is received.**

9

Example 4-B. If Buck from the previous example has not made the I.R.C. §77 election to treat CCC loans as income, the $25,000 loan is treated the same as any other loan–**it is not income in the year it is received.**

1. If Market Prices Rise above the Loan Rate

If market prices rise above the loan rate, producers will choose to repay the loan, with interest, and then sell the commodity for more than the loan.

The income tax consequences of the sale depend upon whether or not the I.R.C. §77 election has been made.

If the I.R.C. §77 election has been made, the producer has a **basis** in the commodity **equal to the amount of the loan.** That basis is subtracted from the sale price to determine the gain or loss on sale.

Example 4-C. If Buck makes the I.R.C. §77 election, repays the loan (including $1,000 of interest), and sells the wheat for $30,000, he must report the following on Schedule F:

1. The $25,000 loan on line 7a
2. The $30,000 sale price on line 1
3. The $25,000 basis in the wheat on line 2
4. The $5,000 gain on the sale of the wheat on line 3
5. The $1,000 of interest on line 23b

See the Schedule F (Form 1040) in Figure 7.

Practitioner Note. In *Thompson v. Commissioner*, 322 F.2d 122 (5th Cir. 1963), the court held that a taxpayer **who had made the I.R.C. §77 election** did not have to report a loan as income since it was repaid in the same year as the loan was received. In *Isaak v. Commissioner*, 400 F.2d 869 (9th Cir. 1968), the court held that such a taxpayer **does have to report the loan as income.** The IRS is likely to follow the *Isaak* case and require Buck to report the loan as income, as shown in this example.

Figure 7

igure 7

SCHEDULE F (Form 1040)

Department of the Treasury Internal Revenue Service (99)

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

1998

Attachment Sequence No. 14

Name of proprietor: Buck Wheat (Example 4-C)

Social security number (SSN): 001 77 1040

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

B Enter NEW code from Part IV ► 1 1 1 1 1 1 0 0

C Accounting method: (1) [X] Cash (2) [ ] Accrual

D Employer ID number (EIN), if any

E Did you "materially participate" in the operation of this business during 1998? If "No," see page F-2 for limit on passive losses. [X] Yes [ ] No

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

1	Sales of livestock and other items you bought for resale	1	30,000	
2	Cost or other basis of livestock and other items reported on line 1	2	25,000	
3	Subtract line 2 from line 1			3 5,000
4	Sales of livestock, produce, grains, and other products you raised			4
5a	Total cooperative distributions (Form(s) 1099-PATR)	5a	5b Taxable amount	5b
6a	Agricultural program payments (see page F-3)	6a	6b Taxable amount	6b
7	Commodity Credit Corporation (CCC) loans (see page F-3):			
a	CCC loans reported under election			7a 25,000
b	CCC loans forfeited	7b	7c Taxable amount	7c
8	Crop insurance proceeds and certain disaster payments (see page F-3):			
a	Amount received in 1998	8a	8b Taxable amount	8b
c	If election to defer to 1999 is attached, check here ► [ ]		8d Amount deferred from 1997	8d
9	Custom hire (machine work) income			9
10	Other income, including Federal and state gasoline or fuel tax credit or refund (see page F-3)			10
11	**Gross income.** Add amounts in the right column for lines 3 through 10. If accrual method taxpayer, enter the amount from page 2, line 51 ►			11

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

12	Car and truck expenses (see page F-4—also attach Form 4562)	12	25	Pension and profit-sharing plans	25
13	Chemicals	13	26	Rent or lease (see page F-6):	
14	Conservation expenses (see page F-4)	14	a	Vehicles, machinery, and equipment	26a
15	Custom hire (machine work)	15	b	Other (land, animals, etc.)	26b
16	Depreciation and section 179 expense deduction not claimed elsewhere (see page F-5)	16	27	Repairs and maintenance	27
			28	Seeds and plants purchased	28
			29	Storage and warehousing	29
17	Employee benefit programs other than on line 25	17	30	Supplies purchased	30
			31	Taxes	31
18	Feed purchased	18	32	Utilities	32
19	Fertilizers and lime	19	33	Veterinary, breeding, and medicine	33
20	Freight and trucking	20	34	Other expenses (specify):	
21	Gasoline, fuel, and oil	21	a		34a
22	Insurance (other than health)	22	b		34b
23	Interest:		c		34c
a	Mortgage (paid to banks, etc.)	23a	d		34d
b	Other	23b 1,000	e		34e
24	Labor hired (less employment credits)	24	f		34f

35	**Total expenses.** Add lines 12 through 34f ►	35
36	**Net farm profit or (loss).** Subtract line 35 from line 11. If a profit, enter on **Form 1040, line 18,** and ALSO on **Schedule SE, line 1.** If a loss, you MUST go on to line 37 (estates, trusts, and partnerships, see page F-6)	36
37	If you have a loss, you MUST check the box that describes your investment in this activity (see page F-6). • If you checked 37a, enter the loss on **Form 1040, line 18,** and ALSO on **Schedule SE, line 1.** • If you checked 37b, you MUST attach **Form 6198.**	37a [ ] All investment is at risk. 37b [ ] Some investment is not at risk.

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 11346H Schedule F (Form 1040) 1998

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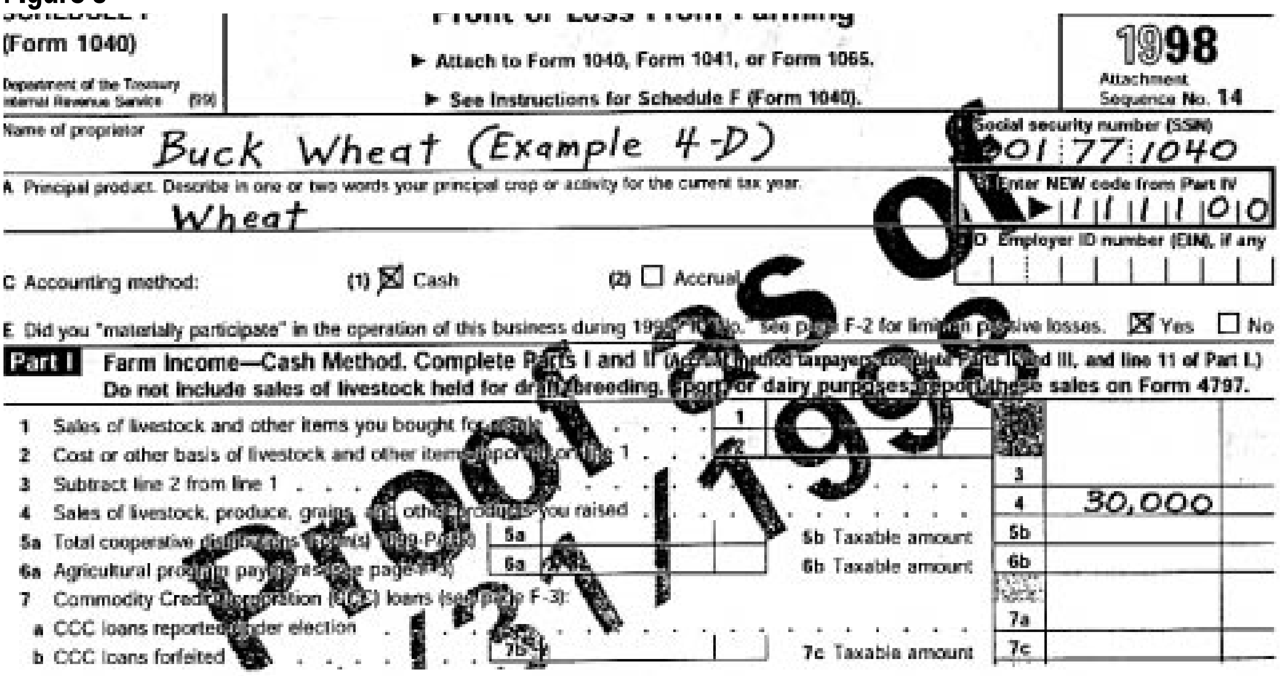
If the I.R.C. §77 election has **not** been made, the producer has no basis in the commodity. Therefore, the full sale price must be reported as income.

Example 4-D. If Buck does not make the I.R.C. §77 election, repays the loan (including $1,000 of interest), and sells the wheat for $30,000 in 1998, he must report the following on Schedule F (Form 1040):

1. The $30,000 sale price on line 4
2. The $1,000 of interest on line 23b

See the Schedule F (Form 1040) in Figure 8.

Figure 8



SCHEDULE F (Form 1040) — Profit or Loss From Farming — 1998

Department of the Treasury, Internal Revenue Service (99)

► Attach to Form 1040, Form 1041, or Form 1065.

► See Instructions for Schedule F (Form 1040).

Attachment Sequence No. 14

Name of proprietor: Buck Wheat (Example 4-D) — Social security number (SSN): 001 : 77 : 1040

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

B Enter NEW code from Part IV ► 111110

C Accounting method: (1) ☒ Cash (2) ☐ Accrual

D Employer ID number (EIN), if any

E Did you "materially participate" in the operation of this business during 1998? If "No," see page F-2 for limit on passive losses. ☒ Yes ☐ No

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

1	Sales of livestock and other items you bought for resale	1
2	Cost or other basis of livestock and other items reported on line 1	2
3	Subtract line 2 from line 1	3
4	Sales of livestock, produce, grains, and other products you raised	4 30,000
5a	Total cooperative distributions (Form(s) 1099-PATR) 5a	5b Taxable amount 5b
6a	Agricultural program payments (see page F-3) 6a	6b Taxable amount 6b
7	Commodity Credit Corporation (CCC) loans (see page F-3):	
a	CCC loans reported under election	7a
b	CCC loans forfeited 7b	7c Taxable amount 7c

Proof as of 12/1/1998

> **Practitioner Note.** If the commodity is not sold until 1999, the producer does not have to report the sale until 1999 and will simply have the commodity on hand at the end of the year with a basis equal to the loan amount (if the §77 election has been made) or zero (if the §77 election has not been made).

2. If Market Prices Do Not Rise above the Loan Rate

If market prices do not rise above the loan rate, producers will choose to redeem the commodity by paying the posted county price (PCP) to the CCC. By making that payment, the producer is no longer obligated on the loan and can keep the difference between the loan rate and the PCP. This option replaces the option of forfeiting the grain to the CCC under the old loan program.

A producer who redeems the commodity by paying the PCP will receive a Form CCC-1099-G from the CCC for the difference between the loan rate and the PCP. That amount must be reported on line 6a of the producer's 1998 Schedule F (Form 1040).

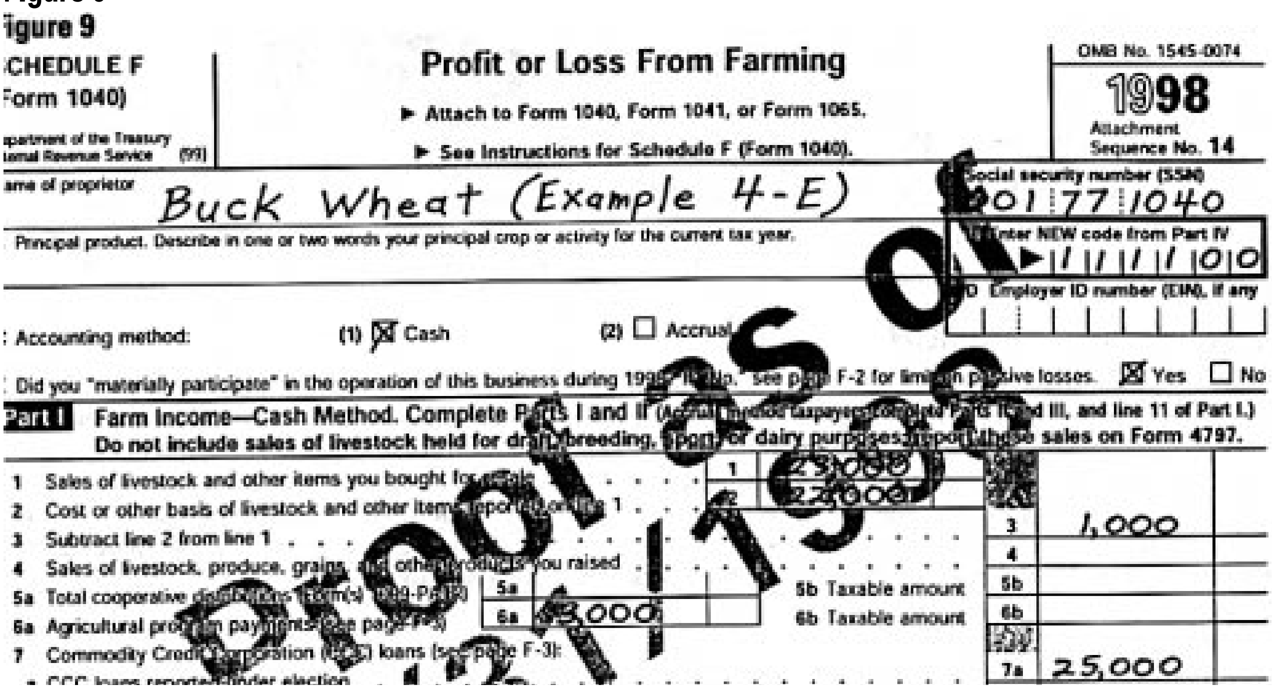
If the producer made the §77 election, the difference between the loan rate and the PCP **is not** reported on line 6b of Schedule F (Form 1040), since the loan has already been reported on line 7a. The producer has a basis in the commodity equal to the PCP.

Example 4-E. If Buck makes the I.R.C. §77 election, redeems the commodity by paying $22,000 to the CCC when the PCP is $2.20 per bushel, and sells the wheat for $23,000, he will receive a Form CCC-1099-G for $3,000 from the CCC, and he must report the following on Schedule F (Form 1040):

1. The $23,000 sale price on line 1
2. The $22,000 basis in the wheat on line 2
3. The $1,000 gain on the sale of the wheat on line 3
4. The $3,000 marketing loan gain from the Form CCC-1099-G on line 6a
5. The $25,000 loan on line 7a

See the Schedule F (Form 1040) in Figure 9.

Figure 9


igure 9

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

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
1998
Attachment Sequence No. 14

Name of proprietor: Buck Wheat (Example 4-E)
Social security number (SSN): 001 77 1040

Principal product. Describe in one or two words your principal crop or activity for the current tax year.
Enter NEW code from Part IV ▶ 1 1 1 1 0 0
Employer ID number (EIN), if any

Accounting method: (1) ☒ Cash (2) ☐ Accrual

Did you "materially participate" in the operation of this business during 1998? If "No," see page F-2 for limit on passive losses. ☒ Yes ☐ No

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

1	Sales of livestock and other items you bought for resale	1	23,000		
2	Cost or other basis of livestock and other items reported on line 1	2	22,000		
3	Subtract line 2 from line 1			3	1,000
4	Sales of livestock, produce, grains, and other products you raised			4	
5a	Total cooperative distributions (Form(s) 1099-PATR)	5a		5b Taxable amount 5b	
6a	Agricultural program payments (see page F-3)	6a	3,000	6b Taxable amount 6b	
7	Commodity Credit Corporation (CCC) loans (see page F-3):				
•	CCC loans reported under election			7a	25,000

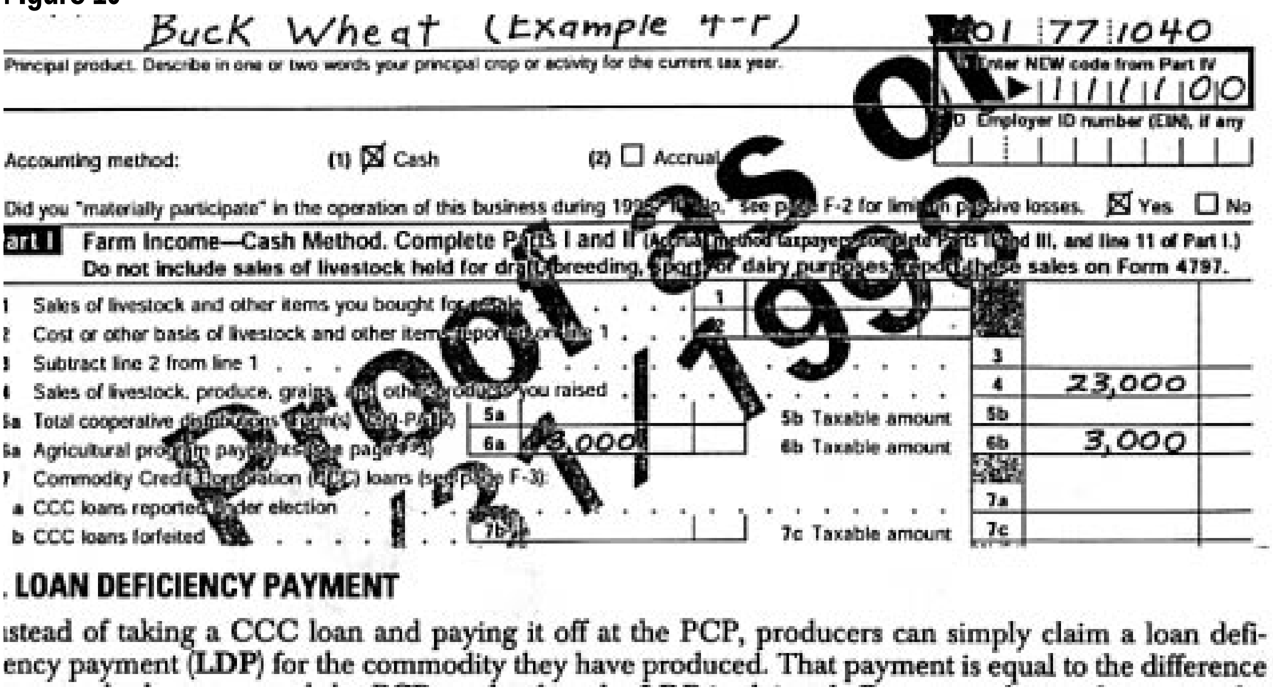
If the producer has not made the §77 election, the difference between the loan rate and the PCP **is** reported on line 6b of Schedule F (Form 1040), since the loan has not been reported on line 7a. The producer has a zero basis in the commodity.

Example 4-F. If Buck does not make the I.R.C. §77 election, redeems the commodity by paying $22,000 to the CCC when the PCP is $2.20 per bushel, and sells the wheat for $23,000, he will receive a Form CCC-1099-G for $3,000 from the CCC, and he must report the following on Schedule F (Form 1040):

1. The $23,000 sale price on line 4
2. The $3,000 marketing loan gain from the Form CCC-1099-G on lines 6a and 6b

See the Schedule F (Form 1040) in Figure 10.

Figure 10


Buck Wheat (Example 4-F) 01 77 1040

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

Enter NEW code from Part IV ▶ 111100

D Employer ID number (EIN), if any

Accounting method: (1) ☒ Cash (2) ☐ Accrual

Did you "materially participate" in the operation of this business during 1998? If "No," see page F-2 for limit on passive losses. ☒ Yes ☐ No

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

1	Sales of livestock and other items you bought for resale	1			
2	Cost or other basis of livestock and other items reported on line 1	2			
3	Subtract line 2 from line 1			3	
4	Sales of livestock, produce, grains, and other products you raised			4	23,000
5a	Total cooperative distributions (Form(s) 1099-PATR)	5a		5b Taxable amount 5b	
6a	Agricultural program payments (see page F-3)	6a	3,000	6b Taxable amount 6b	3,000
7	Commodity Credit Corporation (CCC) loans (see page F-3):				
a	CCC loans reported under election			7a	
b	CCC loans forfeited	7b		7c Taxable amount 7c	

. LOAN DEFICIENCY PAYMENT

nstead of taking a CCC loan and paying it off at the PCP, producers can simply claim a loan defi-
ency payment (LDP) for the commodity they have produced. That payment is equal to the difference

B. LOAN DEFICIENCY PAYMENT

Instead of taking a CCC loan and paying it off at the PCP, producers can simply claim a loan deficiency payment (**LDP**) for the commodity they have produced. That payment is equal to the difference between the loan rate and the PCP on the date the LDP is claimed. Consequently, producers get the same result as if they had taken the loan and paid the PCP rate on the date they claimed the LDP.

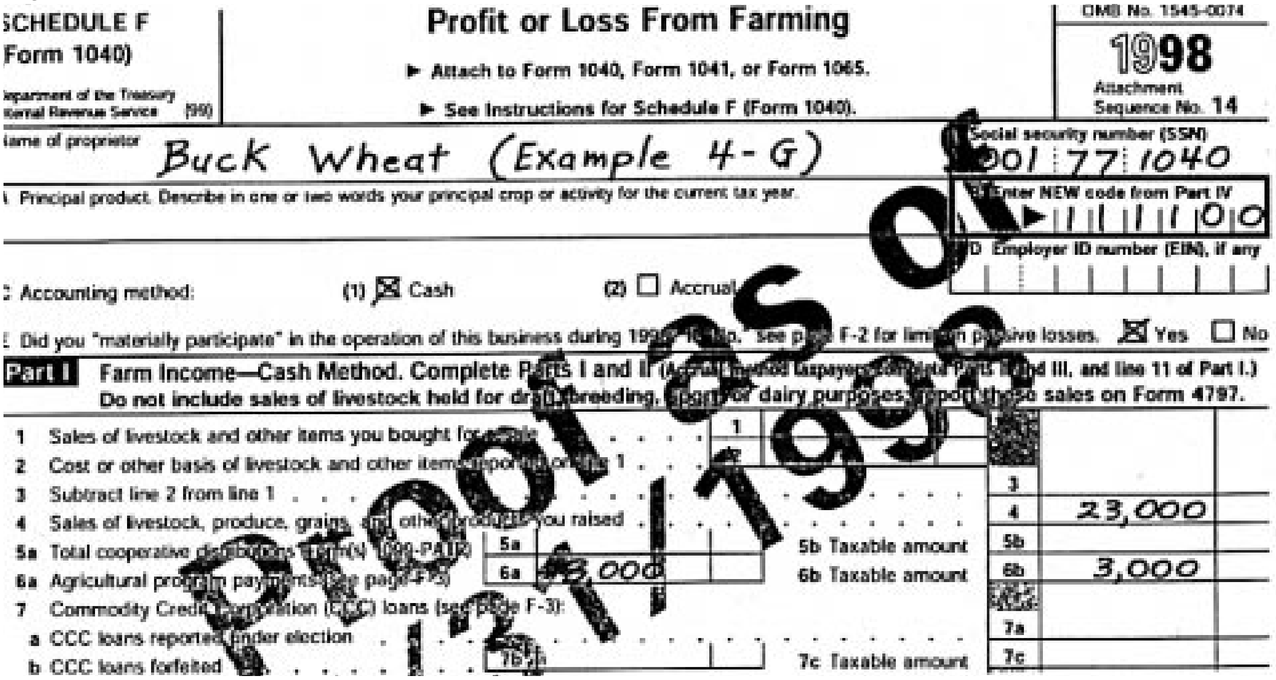
The loan deficiency payment allows producers to reap the benefit of the CCC program even if they have forward contracted their crop or if they sell the crop shortly after harvest. **These producers must collect the LDP between the date of harvest and the date of title transfer.**

Example 4-G. Buck claimed his LDP when the loan rate was $2.50 per bushel and the PCP was $2.20 per bushel instead of taking out a CCC loan. He received a $3,000 LDP from the CCC and a Form CCC-1099-G reporting that $3,000. Buck sold his wheat for $23,000. Buck must report the following on his 1998 Schedule F (Form 1040):

1. The $23,000 sale price on line 4
2. The $3,000 LDP from the Form CCC-1099-G on lines 6a and 6b

See the Schedule F (Form 1040) in Figure 11.

Figure 11



SCHEDULE F (Form 1040)

Department of the Treasury Internal Revenue Service (99)

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

1998

Attachment Sequence No. 14

Name of proprietor: Buck Wheat (Example 4-G)

Social security number (SSN): 001 77 1040

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

B Enter NEW code from Part IV ► 1 1 1 1 0 0

C Accounting method: (1) ☒ Cash (2) ☐ Accrual

D Employer ID number (EIN), if any

E Did you "materially participate" in the operation of this business during 1998? If "No," see page F-2 for limit on passive losses. ☒ Yes ☐ No

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

1	Sales of livestock and other items you bought for resale	1	
2	Cost or other basis of livestock and other items reported on line 1	2	
3	Subtract line 2 from line 1	3	
4	Sales of livestock, produce, grains, and other products you raised	4	23,000
5a	Total cooperative distributions (Form(s) 1099-PATR) 5a	5b Taxable amount 5b	
6a	Agricultural program payments (see page F-3) 6a 3,000	6b Taxable amount 6b	3,000
7	Commodity Credit Corporation (CCC) loans (see page F-3):		
a	CCC loans reported under election	7a	
b	CCC loans forfeited 7b	7c Taxable amount 7c	

C. 1998 MARKETING LOANS AND MARKETING STRATEGIES

by Brad Lubben and Darrel Good[1]

I. MECHANICS OF THE CCC MARKETING ASSISTANCE LOANS AND LOAN DEFICIENCY PAYMENTS

The Federal Agriculture Improvement and Reform Act of 1996 established a nonrecourse marketing assistance loan and loan deficiency payment (LDP) program, administered by the Farm Service Agency (FSA) on behalf of the Commodity Credit Corporation (CCC). The legislation also established maximum average loan rates for commodities covered by the program, with a national average loan rate of $1.89 per bushel for corn, $5.26 per bushel for soybeans, and $3.11 per hundredweight for grain sorghum.

The loan program provides producers an opportunity to put a commodity under loan at the established loan rate and at the CCC interest rate (6.25% for the month of September), or take an LDP in lieu of a loan if the posted county price (PCP) is below the loan rate. The choices a producer will make in the program depend on a number of factors.

First, each county has a different loan rate. Each county also has a different PCP, which is representative of local price levels. The PCP for each county is determined daily from prices published for two established terminals, adjusted by a fixed differential between each terminal and the county. The higher of these two adjusted prices is the PCP for the county. The available LDP is the difference between the county loan rate and the county PCP.

Based on the county PCP, loan and LDP decisions may vary for the producer. If the county PCP is above the county loan rate, an LDP is not available, but the commodity is eligible to be put under loan. If the county PCP is below the county loan rate, a producer can place the commodity under loan or can take an LDP payment in lieu of the loan program. If the commodity is placed under loan, the producer will have another decision to make regarding loan redemption. The basic rule is that the loan

1. Extension Educator and Extension Specialist, respectively, University of Illinois Extension.

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can be redeemed at any time before maturation at the lower of the county PCP or the county loan rate plus interest. The commodity could also be held under loan until maturation and forfeited to the CCC, but the economics of the PCP and loan redemption will encourage against this option.

As a brief explanation of the mechanics of loan redemption, consider three possible scenarios. If the county PCP is below the county loan rate, the loan can be redeemed at the PCP, and all accrued interest is waived. The difference between the PCP and the loan rate is considered a marketing loan gain, and the interest expense is zero. If the county PCP is higher than the county loan rate, but lower than the county loan rate plus accrued interest on the loan, the loan can be redeemed at the PCP. In this case, the interest expense is the difference between the PCP and the loan rate. All accrued interest in excess of this amount is waived. Finally, if the county PCP is above the county loan rate plus accrued interest, the loan can be redeemed at the loan rate plus interest. These three scenarios are demonstrated in the example calculations in §III of this discussion.

There are some general requirements regarding the use of the loan program and the LDP program. First, a producer must have beneficial interest in the commodity to be eligible for the program. This means that a producer cannot request a loan or an LDP once the commodity has been sold. For commodities that have already been forward contracted for harvest delivery or that will be sold upon delivery at harvest, a producer is eligible for an LDP only if a field direct LDP is requested prior to delivery. For commodities that remain in the producer's ownership after harvest time, a loan or an LDP can be requested at any time prior to sale or use of the commodity and before May 31, 1999 (the last date that loans or LDPs are available for 1998 fall-harvested crops). Note that taking the LDP does not require that the crop be sold on the same date, only that the producer be in legal possession of the crop from harvest until the request for an LDP is made. In addition, remember that the LDP is in lieu of a loan. Once an LDP is taken on a crop, the crop is no longer eligible for the loan program. In all cases, production evidence will be required to support the number of bushels on which a LDP payment is received. This evidence may include warehouse receipts, settlement sheets, or FSA measurement services to establish an amount prior to feeding. Measurement services will also be required prior to the entry of any crop into the loan program.

For complete details of the provisions of the marketing assistance loan and the loan deficiency payment programs, one should contact the local county Farm Service Agency office. Once the provisions and mechanics of the program are understood, producers can begin to make decisions about using the loan program and the LDPs based on their situations and on their expectations for market prices.

II. HARVEST-TIME MARKETING STRATEGIES

The marketing decisions by corn and soybean producers during the harvest period of 1998 will depend on a broad range of factors. Most important among these are eligibility for the Commodity Credit Corporation (CCC) loan program; availability of on-farm storage; availability and cost of off-farm storage; previous marketing decisions (e.g. contract sales); the relationship among the county CCC loan rate, the posted county price, and the actual market price for current and future delivery; and expectations about the timing and magnitude of post-harvest changes in prices and spreads. This discussion is an attempt to outline the alternatives that might be considered under varying circumstances in respect to the factors listed above. The alternatives discussed may not exhaust all possible alternatives, but are representative of the decision process that producers must go through.

Consider first the case of corn or soybeans that have been forward contracted (priced) for harvest delivery. Those crops are eligible for loan deficiency payments (LDPs) following harvest and prior to the time the producer loses beneficial interest in the crops (assuming the posted county price is below the county loan rate). Prior to harvest and delivery of the crops on the contract, the producer needs to apply for a field direct LDP. The producer would then provide the Farm Service Agency (FSA) with evidence of delivery on the contract (settlement sheets, etc.). All bushels delivered against the contract would be eligible for the LDP, if any, on the day of delivery. If the contract is filled over several days, each day's deliveries will be assigned the appropriate LDP. Evidence of delivery needs to be submitted to FSA by May 31, 1999.

Depending on the individual situation, producers may have some flexibility about when in the harvest period to deliver crops against the forward contract. For example, on-farm storage could be filled first and the later harvest delivered on contract, or vice versa. The challenge to the producer would be to time the delivery to maximize the LDP payment.

Some crops may have been forward priced for post-harvest delivery (for example, January 1999) and will be stored until the delivery period. During the storage period, those crops are eligible to be placed under loan or to receive an LDP. If a loan is taken, it will have to be repaid prior to delivery on the contract. During the loan period, the producer would repay at either the loan rate plus interest or the posted county price, whichever is lower. If a loan is not taken, the producer can "lock in" the LDP (if available) anytime prior to delivery on the contract. Once again, the challenge is to repay the loan or lock in the LDP when the PCP is at the lowest expected level. Loans can be repaid or LDPs locked in on portions of the crop at different times during the storage period.

For crops which have not been forward priced prior to harvest, the decisions become more complicated. Most important in the decision process are the availability of storage space and expectations about post-harvest price patterns. If a post-harvest recovery in prices is not expected, a producer may sell the crop as harvested and receive the LDP, if any, being paid that day. Once again, the producer must apply for the field direct LDP prior to harvest. The elevator settlement sheet will serve as the basis for determining the date of delivery and quantity delivered. These dates and quantities determine the total LDP received by the producer. This strategy results in a net price equal to the county loan rate, if the PCP is below the loan rate, and equal to the actual market price, if the PCP is above the loan rate.

A second alternative exists for those producers who have storage capacity but are unconvinced of a post-harvest price recovery. A weak harvest basis and a large spread in the futures market would result in a large premium paid for delivering the crops at a later date. If the premium exceeds the cost of storage, the crops could be stored and priced for later delivery. During the storage period the producer could place the crop under loan and subsequently repay the loan or could lock in the LDP anytime during the storage period. As in the example above, the challenge would be to repay the loan or lock in the LDP, if available, when the PCP is lowest.

A third alternative would be to buy put options on deferred futures rather than forward pricing or hedging the stored crop. This would be a more expensive alternative, by the magnitude of the option premium, but it would allow the producer to receive a higher price if futures prices stage a post-harvest rally. The crop could be placed under loan or an LDP accepted anytime during the storage period.

All three of these strategies have merit, regardless of whether the PCP is above or below the loan rate. The first two alternatives, however, would prevent the producer from benefiting from a post-harvest rally, should it occur.

For producers who expect a significant recovery in crop prices following harvest, different strategies will be considered. Anticipation of price recovery implies that the producer will want to retain ownership of the crops beyond harvest. This can be accomplished with storage, where available. If harvest time basis is unusually weak and carrying charges in the futures market remain large, storage is likely the lowest cost alternative for retaining ownership.

During the storage period, the crop can be placed under loan. The loan could be repaid at any time during the loan period. Presumably, that would be done relatively early, perhaps still in the harvest period, if the PCP is below the loan rate, since a post-harvest price recovery is expected. Alternatively, the producer could lock in the LDP, if available, on the stored crop and then continue to store the crop unpriced. The risk of this strategy is that prices do not rally. A decline in prices could result in a net price below the loan rate.

For producers who expect a post-harvest recovery in prices but lack storage capacity, alternative ownership arrangements could be considered. These include delivering the crop on a delayed pricing contract, a basis contract, or a minimum price contract; or selling the crops and buying futures or call options contracts. These alternatives will result in a higher net price compared to harvest sales if the futures market moves higher in the post-harvest period. The increase must be enough to pay options premiums in the case of minimum price contracts or the direct purchase of call options. These alternatives might even be preferred to storage in the unlikely event that the basis is strong at harvest and the futures spreads are small. More likely, a weak basis and large spreads will make these alternatives more expensive than storage. Like storage, the risk of each of these strategies is a subsequent decline in prices.

Crops sold at harvest time, or delivered on a contract that results in a loss of beneficial interest, will not be eligible for the CCC loan program. However, those crops would be eligible for LDP at the time of delivery. The application for field direct LDP must be completed prior to delivery.

For crops unpriced at harvest time, the level of prices and expectations about price recovery will dictate whether the producer wants to sell at harvest or retain ownership. Within the preferred market strategy, the producer will want to take advantage of the marketing loan program if and when the PCP is below the loan rate. Overall marketing strategy, however, should not be built around trying to maximize CCC loan benefits.

III. EXAMPLE CALCULATIONS OF PCPS, LDPS, AND LOAN REDEMPTIONS (USING CHAMPAIGN COUNTY NUMBERS)

Given Information. Base county loan rates are available on the web for each county as a PDF file linked from the following page: http://www.fsa.usda.gov/dafp/psd/loanrate.htm.

Loan rates (Champaign County example):

Corn $1.96

Soybeans $5.45

Terminal markets and differentials are available for each county from the local FSA office.

Differentials (Champaign County example):

	GLF (Gulf)	TKO (Illinois track origination)
Corn	$–0.45	$–0.16
Soybeans	$–0.49	$–0.17

Terminal prices are published daily at 7:00 a.m., available on the Web as a link from the following page: ftp://165.221.16.16/public/RATESP_B/default.htm

September 9, 1998 report

	GLF (Gulf)	TKO (Illinois track origination)
Corn	$2.14	$1.89
Soybeans	$5.64	$5.49

Calculations. The county PCP (September 9, 1998, example) is the higher of the two terminal prices less their respective differentials.

Corn	GLF:	$2.14	–	$0.45	=	$1.69
	TKO:	$1.89	–	$0.16	=	$1.73
	PCP= higher of $1.67 or $1.73 = $1.73					
Soybeans	GLF:	$5.64	–	$0.49	=	$5.15
	TKO:	$5.49	–	$0.17	=	$5.32
	PCP = higher of $5.15 or $5.32 = $5.32					

The LCP available today (September 9, 1998, example) is equal to the basic county loan rate less the county PCP.

Corn	LDP =	$1.96	–	$1.73	=	$0.23
Soybeans	LDP =	$5.45	–	$5.32	=	$0.13

For commodities placed under loan, loan redemptions can be made at the lower of the county PCP or the county rate plus accrued interest. Assume an example of corn placed under the loan and then redeemed six months later (Champaign County example).

Scenarios:	A	B	C
		($bushel)	
A. Loan rate	1.96	1.96	1.96
B. Accrued interest ($1.96 @ 6.25% for six months (approx.))	0.06	0.06	0.06
C. Loan rate plus accrued interest (A + B)	2.02	2.02	2.02
D. PCP	1.80	2.00	2.20
E. Loan repayment rate (lesser of C or D)	1.80	2.00	2.02
F. Interest waived (lesser of (greater of C – D or 0) or B)	0.06	0.02	0.00
G. Interest Paid (B – F)	0.00	0.04	0.06
H. Marketing loan gain (greater of A – E or 0)	0.16	0.00	0.00
I. Net price realized if sold at a market price equal to the PCP (D + H + G)	1.96	1.96	2.14

ISSUE 5: BUSINESS START-UP EXPENSES

I.R.C. §195 allows taxpayers to amortize business start-up expenses over a period of not less than 60 months beginning with the month the business begins. Prior to the enactment of §195, start-up expenses could only be capitalized into the basis of the business and recovered upon sale of the business as a reduction in gain or increase in the loss realized. Congress added §195 to encourage formation of new businesses and decrease controversy and litigation with respect to the proper tax classification of start-up expenditures. Committee Report on P.L. 96-605 (Misc. Revenue Act of 1980).

A. QUALIFIED EXPENSES

To qualify for amortization under I.R.C. §195, an expense must meet both a timing requirement and a character requirement.

1. Timing

The expense must be incurred before the business begins to function as a going concern. These expenses can be divided into two categories.

Investigatory expenses. Investigatory expenses are costs of seeking and reviewing prospective businesses prior to reaching a decision to acquire or enter a business.

Example 5-A. Curtis Tart is thinking about producing cranberries and therefore traveled to several cranberry bogs to learn more about the business. If he begins operating a cranberry bog, he can amortize these investigatory expenses under I.R.C. §195.

Start-up expenses. Start-up or pre-opening expenses are costs that are incurred subsequent to a decision to acquire or establish a particular business and prior to its actual operation.

Example 5-B. Curtis Tart has decided to grow cranberries. He paid $2,000 for one of his employees to learn how to care for the cranberry vines. **Curtis can amortize the $2,000 under I.R.C. §195 beginning with the operation of his business.**

2. Character

The expense must be an expense that would have been deductible had it been incurred by an ongoing business. **Therefore, any expenses that must be capitalized by ongoing businesses cannot be amortized under I.R.C. §195.** Instead, they must be capitalized and, if depreciable, depreciated beginning on the date the business becomes a going concern. **If the expense is not depreciable, it is added to the basis of the business and is recovered when the business is sold, terminated, or transferred.**

Example 5-C. Curtis Tart paid $50,000 for machinery that he will use in his cranberry business that is starting next year. He **cannot** amortize that $50,000 under I.R.C. §195, since the cost would be capitalized and depreciated if it were incurred in an ongoing business. He can depreciate the $50,000 over the useful life of the machinery **beginning with the month he begins his cranberry operation.** See *Fisher v. Commissioner,* 73 TCM 2769 (1998).

B. EXCEPTION FOR CERTAIN EXPENSES

I.R.C. §195(c)(1) excludes interest, taxes, and research and experimental expenditures that are deductible from the definition of start-up expenses. Therefore, these expenses cannot be amortized under I.R.C.§195 but can be deducted under I.R.C. §§163, 164, and 174 respectively if they meet the requirements of those sections.

Example 5-D. In 1998, Sunny Jersey borrowed $100,000 and used the money to pay part of the cost of building a dairy parlor, which she plans to have in operation in 1999. She gave her lender a mortgage on her home to secure the debt. Sunny paid $2000 of interest on the loan in 1998.

Sunny can deduct the $2,000 of interest on her 1998 Schedule A (Form 1040) as home equity interest.

If Sunny had not given the lender a mortgage on her home, **then she would be allowed to amortize the interest** under I.R.C. §195, since the interest **is not** deductible under I.R.C. §163.

Practitioner Note. T**reas. Reg.** §1.163-10T(o)(5) allows a taxpayer to elect to treat debt that is secured by the personal residence as debt not secured by the personal residence. If that election is made, then the interest cannot be deducted as home equity interest and therefore **can be amortized** under I.R.C. §195.

Taxes that are deductible under I.R.C. §164 include:

1. State and local, and foreign, real property taxes
2. State and local personal property taxes
3. State, local, and foreign income, war profits, and excess profits taxes
4. The GST tax imposed on income distributions
5. The environmental tax imposed by section 59A

If any of those taxes are paid to start a business before the business is operating, they can be deducted on Schedule A (Form 1040) but cannot be amortized under I.R.C. §195.

Example 5-E. Sunny Jersey from Example 5-D bought some land in 1998 for her dairy operation and paid $1,000 of property taxes on it in 1998. Sunny is not allowed to amortize that interest under I.R.C. §195, but she can deduct the interest on her 1998 Schedule A (Form 1040).

C. NEW BUSINESS VS. EXPANSION OF EXISTING BUSINESS

The cost of **expanding** an existing business **cannot be amortized** under I.R.C. §195, since those are not start-up expenses. Those expenses are deducted or amortized as any other expense of the business.

Whether activities are expanding an existing business or creating a new business is determined by **how closely the new activity relates** to the existing business activity.

Example 5-F. Rose Burgundy has operated a grape vineyard for several years. She has always sold her grapes on the wholesale market. In 1998, Rose incurred travel expenses and purchased some market research to determine if she could net more income from her grapes by direct marketing them to retailer outlets.

Rose cannot amortize her travel expenses and cost of market research, since she is already in the business of producing and selling grapes. She can deduct them in the year the expenses are incurred.

Example 5-G. If Rose in Example 5-F incurred expenses while investigating making wine out of her grapes, she could not deduct those costs in the year they were incurred. Making wine is a different business from growing and selling grapes. **She could amortize those costs over 60 months beginning with the month her wine-making business began operating.** See *Krebs v. Commissioner*, 63 TCM 2413 (1992).

D. DATE BUSINESS BEGINS OPERATION

To sort out start-up expenses from operating expenses, the date the business begins operation must be determined. In *Reems v. Commissioner*, 67 TCM 2413 (1994), the court quoted the following from *Richmond Television Corp. v. United States*, 345 F. 2d 901, 907 (4th Cir. 1965), to explain the beginning date of a business.

> "The uniform teaching of these several cases is that, even though a taxpayer has made a firm decision to enter into a business and over considerable period of time spent money preparing for entering that business, he still has not "engaged in carrying on any trade or business" within the intendment of § 162(a) until such time as the business has begun to function as a going concern and performed those activities for which it was organized."

Apparently, sales do not have to occur to claim the business is operating. In **Ltr. Rul.** 9047032 (August 27, 1990), the IRS concluded that the date the active business began was the date that the manufacturing process met the required standards, production resulted in products that were ready for sale, and the corporation was ready to receive revenue from the sale of the products. Similarly, in *Cabintaxi Corp. v. Commissioner*, 63 F.3d 614 (1995), the fact that the taxpayer never sold a system for which it had an agreement with the supplier to sell, install and maintain was not strong evidence that it had not begun operation.

On the other hand, some minimal sales are apparently **not enough** to show the business is operating. In *Reems,* the court held that the taxpayer had not started his business of forestry in 1989 because he had sold only two walnut trees for $1,800 and some firewood for $250.

> Farm producers are likely to be treated as starting the business when they began the production cycle by preparing soil for planting a crop, planting trees, purchasing breeding livestock, or purchasing livestock for resale.

By analogy, cases under **Treas. Reg.** §1.162-12, are helpful in sorting out when production begins. In *Maple,* T.C.M. 1968-194, *aff'd* 440 F.2d 1055 (CA-9, 1971), the court distinguished "preparatory" expenses, which are nondeductible capital expenditures, and "developmental expenditures," which are deductible business expenses, if the grower does not elect to capitalize them under **Reg**. 1.162-12. Preparatory expenditures are expenditures incurred prior to raising agricultural commodities or that otherwise enable a grower to begin the growing process (**Rev. Rul. 83-28,** 1983-1 C.B. 47). Developmental expenditures are incurred by a grower so that the growing process may continue in a desired manner. Under **Reg.** §1.162-12, amounts expended to purchase animals are capital investments (or preparatory expenditures), while the purchase of feed and other costs connected with raising livestock may be treated as expense deductions. The court in *Maple* concluded that expenses in the preproductive period are deductible if such expenses are sufficiently similar to the expenses that will be required to maintain the animal or plant when it is productive. In **Duggar,** 71 T.C. 147 (1978), once the taxpayer became the owner of immature animals (Simmental beef calves), he was able to deduct the costs of care and maintenance associated with raising the calves to breeding age.

Example 5-H. Connie Cobb, who is not in the business of farming, plans to start raising corn in the spring of 1999. She paid an accountant to set up her farm records in November of 1998. Connie's business was not operating when she incurred the expense, so she cannot deduct the accountant's fees on her 1998 income tax return. She can amortize the fee over 60 months beginning in the month she begins field work in the spring of 1999.

E. WHAT HAPPENS IF THE BUSINESS NEVER BEGINS?

If the proposed business never begins, then the taxpayer cannot elect to amortize the start-up expenses under I.R.C. §195. If the expenses are start-up costs incurred after the taxpayer decided to start the business, they can be reported as a **capital loss.** See *Delisser v. Commissioner,* 90-2 USTC ¶50,352 (DC Tex 1990). If the expenses are investigatory costs incurred before the taxpayer decided to start a business, the IRS may use the law in effect before I.R.C. §195 was enacted to argue the expenses are **either nondeductible personal expenses or expenses that are not deductible because they were not incurred in the course of a trade or business.** See Committee Report on P.L. 96-605 (Misc. Revenue Act of 1980).

F. MAKING THE ELECTION

> The election to amortize start-up costs under IRC §195 must be made by the due date (including extensions) of the tax return for the year the business becomes active. IRC §195(d)(1). **No retroactive elections are allowed.** See Ltr. Rul. 9615001 (October 17, 1995).

The election is made by **attaching a statement to** the tax return showing the amount of start-up expenses that will be amortized and stating the period (not less than 60 months) over which they will be amortized.

Because it is sometimes difficult to determine the year the business becomes active, the Treasury issued proposed regulations on January 13, 1998, that allow the **election to apply to the year it is made or any subsequent year. Furthermore, once the election is made, the statement can be revised to include any start-up expenditures not included in the original statement.**

Example 5-I. Sam Yellow purchased a corn farm in the fall of 1998 after the crop had been harvested. He paid an attorney $500 to have an LLC formed for his business and he paid an accountant $700 to set up his books. Sam is uncertain whether he has an active business in 1998. Therefore, he files the following election with his 1998 income tax return.

Taxpayer: Sam Yellow
Taxpayer i.d. #195-01-4562

The taxpayer elects to amortize the following costs over a 60 month period beginning on the December 1, 1998 start-up date.

Election to Amortize Start-Up Expenses Under I.R.C. §195

Date	Expense Item	Amount
9/15/98	Attorney's fees for setting up LLC	$ 500
11/2/98	Accountant's fees for setting up books	700
	Total	$1,200

Part VI of Sam's Form 4562 for 1998 is shown in Figure 12.

Figure 12

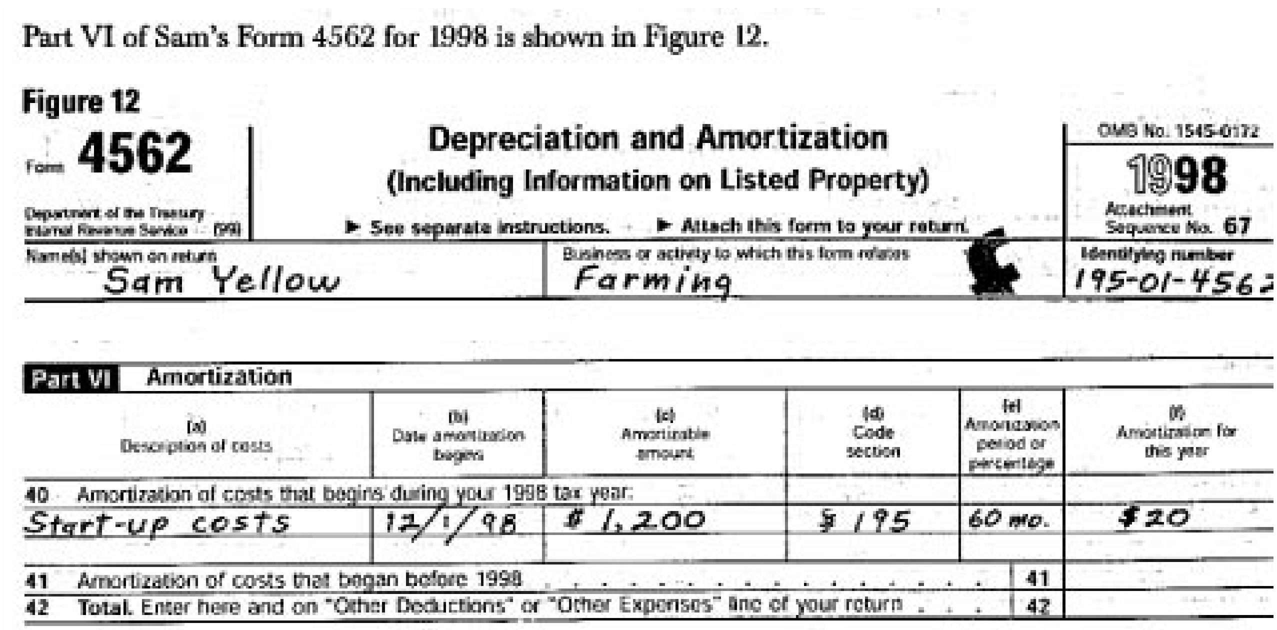
Part VI of Sam's Form 4562 for 1998 is shown in Figure 12.

Figure 12

Form 4562 Depreciation and Amortization (Including Information on Listed Property)
Department of the Treasury Internal Revenue Service (99) ► See separate instructions. ► Attach this form to your return.
OMB No. 1545-0172 1998 Attachment Sequence No. 67

Name(s) shown on return: Sam Yellow | Business or activity to which this form relates: Farming | Identifying number: 195-01-4562

Part VI Amortization

(a) Description of costs	(b) Date amortization begins	(c) Amortizable amount	(d) Code section	(e) Amortization period or percentage	(f) Amortization for this year
40 Amortization of costs that begins during your 1998 tax year:					
Start-up costs	12/1/98	$ 1,200	§ 195	60 mo.	$20
41 Amortization of costs that began before 1998				41	
42 Total. Enter here and on "Other Deductions" or "Other Expenses" line of your return				42	

In 1999 Sam decided his active business began in April of 1999. His previous election is effective for 1999, **but he needs to amend his 1998 income tax return to remove the $20 of amortized start-up cost and file an amended election with his 1999 income tax return to show any additional start-up costs.**

9

Amended Election to Amortize Start-Up Expenses Under I.R.C. §195

Taxpayer: Sam Yellow
Taxpayer i.d. #195-01-4562

The taxpayer elects to amortize the following costs over a 60 month period beginning on the April 1, 1999 start-up date.

Date	Expense Item	Amount
9/15/98	Attorney's fees for setting up LLC	$ 500
11/2/98	Accountant's fees for setting up books	700
2/15/99	Training seminar	600
	Total	$1,800

Sam's amortization is reported on his 1999 Form 4562 as shown in Figure 13.

Figure 13

Form 4562 — Depreciation and Amortization (Including Information on Listed Property)

Department of the Treasury, Internal Revenue Service (99) ► See separate instructions. ► Attach this form to your return.

~~1998~~ 99 — Attachment Sequence No. 67

Name(s) shown on return: Sam Yellow | Business or activity to which this form relates: Farming | Identifying number: 195-01-4562

Part VI Amortization

(a) Description of costs	(b) Date amortization begins	(c) Amortizable amount	(d) Code section	(e) Amortization period or percentage	(f) Amortization for this year
40 Amortization of costs that begins during your 1998 tax year:					
Start-up Costs	4/1/99	$1,800	§ 195	60 mo.	$270
41 Amortization of costs that began before 1998				41	
42 **Total.** Enter here and on "Other Deductions" or "Other Expenses" line of your return				42	

ISSUE 6: CASUALTY GAINS AND LOSSES

Natural disasters such as windstorms, droughts, and floods cause property damage that leads to two income tax issues:

1. How much can the taxpayer deduct as a result of the loss?
2. How much income must be reported as a result of payments received for the damaged property and when must those payments be reported?

I. 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.

A. 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 6-A. Sally Lamb owns and operates a farm. On May 13, 1998, 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 1996 for $2,000 each. Sally claimed $300 of depreciation on each ewe in 1996 and $510 of depreciation on each ewe in 1997. 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.
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. Part III of Form 4797 sorts the $2,477 of gain into $1,977 of depreciation recapture and $500 of §1231 gain.
6. Since I.R.C. §1245 overrides all other provision in Subtitle A–Income Taxes, the depreciation recapture is not netted against casualty losses from business and income, producing property [I.R.C. §1245(a)(1)].
7. The $500 of §1231 gain is netted against business casualty losses from §1231 property. Therefore, Sally reports the $500 of gain from line 32 of Form 4797 on line 33 of Form 4684. Since there are no casualty losses in this example, the $500 is also reported on lines 36 and 39 of Form 4684 and is carried to line 3 of Form 4797.

Sally's Forms 4684 and 4797 are shown in Figure 14.

9

Figure 14

Form **4797**

Department of the Treasury
Internal Revenue Service (99)

Sales of Business Property

(Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2))

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

OMB No. 1545-0184

1997

Attachment Sequence No. **27**

Name(s) shown on return: Sally Lamb

Identifying number: 165-01-1033

1 Enter here the gross proceeds from the sale or exchange of real estate reported to you for 1997 on Form(s) 1099-S (or a substitute statement) that you will be including on line 2, 10, or 20 . . . 1

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

(a) Description of property	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Gross sales price	(e) Depreciation allowed or allowable since acquisition	(f) Cost or other basis, plus improvements and expense of sale	(g) GAIN or (LOSS) for entire year. Subtract (f) from the sum of (d) and (e)	(h) 28% RATE GAIN or (LOSS) * (see instr. below)
2							

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		
5	Section 1231 gain or (loss) from like-kind exchanges from Form 8824	5		
6	Gain, if any, from line 32, from other than casualty or theft	6		
7	Combine lines 2 through 6 in columns (g) and (h). Enter gain or (loss) here, and on the appropriate line as follows:	7	500	

Partnerships—Enter the gain or (loss) on Form 1065, Schedule K, lines 6a and 6b. Skip lines 8, 9, 11, and 12 below.

S corporations—Report the gain or (loss) following the instructions for Form 1120S, Schedule K, lines 5 and 6. Skip lines 8, 9, 11, and 12 below, unless line 7, column (g) is a gain and the S corporation is subject to the capital gains tax.

All others—If line 7, column (g) is zero or a loss, enter that amount on line 11 below and skip lines 8 and 9. If line 7, column (g) is a gain and you did not have any prior year section 1231 losses, or they were recaptured in an earlier year, enter the gain or (loss) in each column as a long-term capital gain or (loss) on Schedule D and skip lines 8, 9, and 12 below.

8	Nonrecaptured net section 1231 losses from prior years (see instructions)	8		
9	Subtract line 8 from line 7. If zero or less, enter -0-. Also enter on the appropriate line as follows (see instructions):	9		

S corporations—Enter only the gain in column (g) on Schedule D (Form 1120S), line 14, and skip lines 11 and 12 below.

All others—If line 9, column (g) is zero, enter the gain from line 7, column (g) on line 12 below. If line 9, column (g) is more than zero, enter the amount from line 8, column (g) on line 12 below, and enter the gain or (loss) in each column of line 9 as a long-term capital gain or (loss) on Schedule D.

* Corporations (other than S corporations) should not complete column (h). Partnerships and S corporations must complete column (h). All others must complete column (h) only if line 7, column (g), is a gain. 28% rate gain or loss includes all gains and losses in column (g) from sales, exchanges, or conversions (including installment payments received) either (a) before 5/7/97 or (b) after 7/28/97 for assets held more than 1 year but not more than 18 months.

Part II Ordinary Gains and Losses

10 Ordinary gains and losses not included on lines 11 through 17 (include property held 1 year or less):

11	Loss, if any, from line 7, column (g)	11	
12	Gain, if any, from line 7, column (g) or amount from line 8, column (g) if applicable	12	
13	Gain, if any, from line 31	13	1,977
14	Net gain or (loss) from Form 4684, lines 31 and 38a	14	
15	Ordinary gain from installment sales from Form 6252, line 25 or 36	15	
16	Ordinary gain or (loss) from like-kind exchanges from Form 8824	16	
17	Recapture of section 179 expense deduction for partners and S corporation shareholders from property dispositions by partnerships and S corporations (see instructions)	17	
18	Combine lines 10 through 17 in column (g). Enter gain or (loss) here, and on the appropriate line as follows:	18	1,977

a For all except individual returns: Enter the gain or (loss) from line 18 on the return being filed.

b For individual returns:

(1)	If the loss on line 11 includes a loss from Form 4684, line 35, column (b)(ii), enter that part of the loss here and on line 22 of Schedule A (Form 1040). Identify as from "Form 4797, line 18b(1)." See instructions	18b(1)	
(2)	Redetermine the gain or (loss) on line 18, excluding the loss, if any, on line 18b(1). Enter here and on Form 1040, line 14	18b(2)	1,977

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 13086I Form **4797** (1997)

Figure 14

Form **4797**

Department of the Treasury
Internal Revenue Service (99)

Sales of Business Property

(Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2))

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

OMB No. 1545-0184

1997

Attachment Sequence No. **27**

Name(s) shown on return: Sally Lamb

Identifying number: 165-01-1033

1 Enter here the gross proceeds from the sale or exchange of real estate reported to you for 1997 on Form(s) 1099-S (or a substitute statement) that you will be including on line 2, 10, or 20 1

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

(a) Description of property	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Gross sales price	(e) Depreciation allowed or allowable since acquisition	(f) Cost or other basis, plus improvements and expense of sale	(g) GAIN or (LOSS) for entire year. Subtract (f) from the sum of (d) and (e)	(h) 28% RATE GAIN or (LOSS) * (see instr. below)
2							

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		
5 Section 1231 gain or (loss) from like-kind exchanges from Form 8824	5		
6 Gain, if any, from line 32, from other than casualty or theft	6		
7 Combine lines 2 through 6 in columns (g) and (h). Enter gain or (loss) here, and on the appropriate line as follows:	7	500	

Partnerships—Enter the gain or (loss) on Form 1065, Schedule K, lines 6a and 6b. Skip lines 8, 9, 11, and 12 below.

S corporations—Report the gain or (loss) following the instructions for Form 1120S, Schedule K, lines 5 and 6. Skip lines 8, 9, 11, and 12 below, unless line 7, column (g) is a gain and the S corporation is subject to the capital gains tax.

All others—If line 7, column (g) is zero or a loss, enter that amount on line 11 below and skip lines 8 and 9. If line 7, column (g) is a gain and you did not have any prior year section 1231 losses, or they were recaptured in an earlier year, enter the gain or (loss) in each column as a long-term capital gain or (loss) on Schedule D and skip lines 8, 9, and 12 below.

8 Nonrecaptured net section 1231 losses from prior years (see instructions)	8		
9 Subtract line 8 from line 7. If zero or less, enter -0-. Also enter on the appropriate line as follows (see instructions):	9		

S corporations—Enter only the gain in column (g) on Schedule D (Form 1120S), line 14, and skip lines 11 and 12 below.

All others—If line 9, column (g) is zero, enter the gain from line 7, column (g) on line 12 below. If line 9, column (g) is more than zero, enter the amount from line 8, column (g) on line 12 below, and enter the gain or (loss) in each column of line 9 as a long-term capital gain or (loss) on Schedule D.

* Corporations (other than S corporations) should not complete column (h). Partnerships and S corporations must complete column (h). All others must complete column (h) only if line 7, column (g), is a gain. 28% rate gain or loss includes all gains and losses in column (g) from sales, exchanges, or conversions (including installment payments received) **either (a) before 5/7/97 or (b) after 7/28/97** for assets held more than 1 year but not more than 18 months.

Part II Ordinary Gains and Losses

10 Ordinary gains and losses not included on lines 11 through 17 (include property held 1 year or less):

11 Loss, if any, from line 7, column (g)	11	
12 Gain, if any, from line 7, column (g) or amount from line 8, column (g) if applicable	12	
13 Gain, if any, from line 31	13	1,977
14 Net gain or (loss) from Form 4684, lines 31 and 38a	14	
15 Ordinary gain from installment sales from Form 6252, line 25 or 36	15	
16 Ordinary gain or (loss) from like-kind exchanges from Form 8824	16	
17 Recapture of section 179 expense deduction for partners and S corporation shareholders from property dispositions by partnerships and S corporations (see instructions)	17	
18 Combine lines 10 through 17 in column (g). Enter gain or (loss) here, and on the appropriate line as follows:	18	1,977

a For all except individual returns: Enter the gain or (loss) from line 18 on the return being filed.

b For individual returns:

(1) If the loss on line 11 includes a loss from Form 4684, line 35, column (b)(ii), enter that part of the loss here and on line 22 of Schedule A (Form 1040). Identify as from "Form 4797, line 18b(1)." See instructions	18b(1)	
(2) Redetermine the gain or (loss) on line 18, excluding the loss, if any, on line 18b(1). Enter here and on Form 1040, line 14	18b(2)	1,977

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 13086I Form **4797** (1997)

9

Figure 14

Form 4797 (1997)

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

19 (a) Description of section 1245, 1250, 1252, 1254, or 1255 property:	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)
A 2 ewes	5/1/96	5/13/97
B		
C		
D		

These columns relate to the properties on lines 19A through 19D. ▶		Property A	Property B	Property C	Property D
20 Gross sales price (**Note:** *See line 1 before completing.*)	20	4,500			
21 Cost or other basis plus expense of sale	21	4,000			
22 Depreciation (or depletion) allowed or allowable	22	1,977			
23 Adjusted basis. Subtract line 22 from line 21	23	2,023			
24 Total gain. Subtract line 23 from line 20	24	2,477			
25 **If section 1245 property:**					
a Depreciation allowed or allowable from line 22	25a	1,977			
b Enter the **smaller** of line 24 or 25a	25b	1,977			
26 **If section 1250 property:** If straight line depreciation was used, enter -0- on line 26g, except for a corporation subject to section 291.					
a Additional depreciation after 1975 (see instructions)	26a				
b Applicable percentage multiplied by the **smaller** of line 24 or line 26a (see instructions)	26b				
c Subtract line 26a from line 24. If residential rental property or line 24 is not more than line 26a, skip lines 26d and 26e	26c				
d Additional depreciation after 1969 and before 1976	26d				
e Enter the **smaller** of line 26c or 26d	26e				
f Section 291 amount (corporations only)	26f				
g Add lines 26b, 26e, and 26f	26g				
27 **If section 1252 property:** Skip this section if you did not dispose of farmland or if this form is being completed for a partnership.					
a Soil, water, and land clearing expenses	27a				
b Line 27a multiplied by applicable percentage (see instructions)	27b				
c Enter the **smaller** of line 24 or 27b	27c				
28 **If section 1254 property:**					
a Intangible drilling and development costs, expenditures for development of mines and other natural deposits, and mining exploration costs (see instructions)	28a				
b Enter the **smaller** of line 24 or 28a	28b				
29 **If section 1255 property:**					
a Applicable percentage of payments excluded from income under section 126 (see instructions)	29a				
b Enter the **smaller** of line 24 or 29a (see instructions)	29b				

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

30 Total gains for all properties. Add property columns A through D, line 24	30	2,477
31 Add property columns A through D, lines 25b, 26g, 27c, 28b, and 29b. Enter here and on line 13	31	1,977
32 Subtract line 31 from line 30. 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, column (g), and if applicable, column (h)	32	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)
33 Section 179 expense deduction or depreciation allowable in prior years	33		
34 Recomputed depreciation. See instructions	34		
35 Recapture amount. Subtract line 34 from line 33. See the instructions for where to report	35		

B. 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.

1. Election to Postpone Gain by Purchasing Replacement Animals. 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.)

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.

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.

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:**

1. Evidence of existence of the weather-related conditions that forced the sale or exchange of the livestock
2. A computation of the amount of gain realized on the sale or exchange
3. The number and kind of livestock sold or exchanged
4. The number of livestock of each kind that would have been sold or exchanged under the usual business practice in the absence of the weather-related condition

Example 6-B. Rowdy Drover normally sells 15 cows from his beef herd each year. In 1998, a flood reduced his hay crop, so he did not have enough to carry his normal herd through the winter. **Consequently, he sold 35 cows rather than 15 in 1998**. He plans to purchase an additional 20 cows in 1999 to replace the extra 20 that were sold.

Only 20 of the cows sold in 1998 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 1998. 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 = $11,500of gain) under I.R.C. §1033(e).

If Rowdy reinvests $11,500 in 20 replacement cows in 1999, 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 1998 income tax return. If he buys only 19 cows in 1999 and 2000, $575 of gain (for the cow not replaced) must be reported on his amended 1998 return, regardless of what he paid for the 19 replacement cows.

Rowdy should report the purchase of qualified replacement cows on his 1999 or 2000 return. If there is additional income for 1998, an amended 1998 return must be filed.

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

2. 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 caused the sale.

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

Example 6-C. Mr. Smith normally sells 100 head of raised beef cattle a year. As a result of a drought, he sells 150 head during 1998. He realizes $45,000 from the sale of the 150 head. On September 7, 1998, 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 1999** is determined as follows:

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

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

Mr. Smith may elect to postpone $15,000 income until 1999. The $30,000 that would have normally been received in 1998 must be reported on his 1998 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:

1. A declaration that the taxpayer is making an election under I.R.C. §451(e)
2. 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
3. A statement explaining the relationship of the designated disaster area to the taxpayer's early sale or exchange of the livestock
4. The total number of animals sold in each of the three preceding years
5. 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.

6. The total number of animals sold and the number sold on account of weather-related conditions during the taxable year
7. 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

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

Example 6-D. In 1997, Bubba Bitterweed disposed of an unusually high number of dairy cows due to drought conditions. On his 1997 tax return, Bubba made an election under I.R.C. §451(e) to include the income from the excess sales of livestock for 1998, the year following the year of actual sale. In 1998, Bubba decided to replace the excess dairy cows sold and asks whether he can revoke the §451(e) election and replace the involuntarily converted dairy cows under §1033(e).

According to Ltr. Ruls. 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. The national office does not issue a letter ruling on the replacement of involuntarily converted property, whether or not the property has been replaced, if the taxpayer has already filed a return for the taxable year in which the property was converted. However, the district director may issue a determination letter in this case. **Rev. Proc. 98-1,** 1998-1 I.R.B. 7. Thus, Bubba could likely change his §451(e) election to a §1033(e) election if he files a determination letter request to do so. **The fee for a determination letter is $275.**

Example 6-E. Dolly Dandelion disposed of an abnormally high number of breeding cows in 1997, due to drought conditions. On her 1997 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 1998, Dolly decides that she will not replace the cows. However, she would prefer to report the income from the drought sale in 1998, rather than amending her 1997 return, since her marginal tax rate was significantly higher in 1997 than in 1998. Can Dolly revoke the §1033(e) election and elect the one-year deferral of sale reporting under §451(e)?

Apparently, Dolly cannot 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 1997 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 requires a determination letter request and a **$275 fee.** 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.		

II. 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.

A. 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.

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B. 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.

C. 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 6-F. Daisy Petal normally sells her soybean and cotton crops in the year after they are produced. In 1998, 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 1998.

Daisy can postpone reporting the $36,000 of income by attaching the following statement to her 1998 return. She then reports the $36,000 on line 8a of her 1998 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	6/10/98	$15,000	10/15/98	Crops Ins., Inc.
Cotton	Flood	6/10/98	$21,000	10/15/98	Crops Ins., Inc.

Observation. Some producers have deferred crop insurance and disaster payments from 1997 to be reported in 1998. Those payments should be reported on line 8d of the 1998 Schedule F (Form 1040).

9

D. 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 6-G. Assume the facts are the same as Example 6-F 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 6-H. In 1998 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 1998 or deferring both payments to 1999, assuming he meets the requirement of normally selling more than 50% of his crops in the following year.

Example 6-I. Assume that Clay Fields, the taxpayer in Example 6-H, 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.

III. 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 6-J. 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 1998. Burl's 1998 adjusted gross income is $10,000. A tornado destroyed Burl's barn and house on July 20, 1998.

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, 1998. 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 in the following table

.

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.

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.

Observation. If Burl had realized a loss on the involuntary conversion of his residence, he could have elected to deduct that loss from his 1997 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.

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 — 1997 — 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. **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	12	200
Caution: *Use only one Form 4684 for lines 13 through 18.*		
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). • If line 14 is less than line 13, enter -0- here and continue with the form. • 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 33). 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-

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. **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. **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 (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 14. 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 32	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 14. 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, column (g) and the net 28% rate gain or (loss), if applicable, in column (h)	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.*

9

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, 1998. 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, 1998, is reduced as follows:

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

ISSUE 7: SALE OF FARM WITH A PRINCIPAL RESIDENCE

The new I.R.C. §121, effective for sales of residences after May 6, 1997, increases the incentive for owners of farms to claim that land around the personal residence is a part of the residence rather than a part of the farm. By claiming more of the land is a part of the personal residence, more gain can be attributed to the personal residence and therefore excluded from income under the $250,000 or $500,000 exclusion.

INDICIA OF PERSONAL USE

Since the facts and circumstances of each case determine whether land is a part of the farm business or a part of the residence, there are **several factors** that can help or hurt the taxpayer's argument that land is residential.

1. **Use of the property.** The actual use of the property is the most significant factor. To show the property is residential, it should be used only for bona fide residential purposes such as **hiking, fishing, horseback riding, scenic enjoyment, hunting, or appreciating nature.** Any use of the land for an activity that benefits the farming business gives the IRS an argument that the land is not residential.
2. **Reporting mortgage interest and real estate taxes.** To show residential use, mortgage interest and real estate taxes on the property should be reported on **Schedule A** (Form 1040). Reporting these expenses on Schedule F (Form 1040) indicates the land is used in the farm business. Similarly, reporting these expenses on Schedule E (Form 1040) or Form 4835 indicates the land is held for the production of income rather than for residential use.
3. **Classification for local property tax purposes.** If the local taxing authority has a different classification for farming and residential property, **the taxpayer should claim the residential classification.** Claiming the farming classification to get a lower real estate tax rate could bar the taxpayer from claiming the I.R.C. §121 exclusion.

Example 7-A. I. M. Sierra has owned and operated a 2,000 acre ranch in South Dakota for 20 years. He lives on the ranch and uses 57 acres of hilly woodland next to his house only for hunting, hiking and bird watching. I. M. reports the real estate taxes for the 57 acres on his Schedule A (Form 1040). In 1998, I. M. sells the ranch for $2 million. His basis and gain on each of the segments of the ranch are as follows:

Segment	Amount Realized	Basis	Gain
Home and 1 acre	$ 100,000	$ 40,000	$ 60,000
Woodland (57 acres)	75,000	20,000	55,000
Remaining 1,942 acres	1,825,000	740,000	1,085,000
Total	$2,000,000	$ 800,000	$1,200,000

I. M. can claim the I.R.C. §121 exclusion for the $60,000 gain on the home and 1 acre and the $55,000 gain on the 57 acres of woodland. He cannot claim the exclusion on any of the $1,085,000 gain on the remainder of the ranch.

Example 7-B. Assume that I. M. in Example 7-A boarded horses on his ranch and used the 57 acres to graze his own horses that are **used for pleasure and not as a part of his ranching business.**

I. M. should still be able to claim the I.R.C. §121 exclusion for the $55,000 of gain on the 57 acres, but he must be careful never to use the 57 acres to graze boarded horses, and he must be able to prove the separate uses of the ranch and the 57 acres. See *James D. Schlicher* (T.C. Memo 1997-37).

Example 7-C. Assume that I. M. in Example 7-A used the 57 acres of wooded land as part of his ranching operation and claimed the mortgage interest and real estate taxes on the 57 acres as an expense on his Schedule F (Form 1040). Can he convert the 57 acres to personal use and claim the I.R.C. §121 exclusion on the gain when he sells those acres?

If I. M. does not use the 57 acres in his farm business for two years and does not claim the mortgage interest and real estate taxes on his Schedule F (Form 1040) for two years, **he arguably should** be able to claim the I.R.C. §121 exclusion on the gain from those 57 acres when he sells the ranch. See *Roy v. Commissioner,* (T.C. Memo 1995-23).

Example 7-D. Assume I. M. in Example 7-A put his whole ranch up for sale but sold all but the 57 acres to one buyer on May 1, 1998, and the 57 acres of woodland to another buyer on October 15, 1998.

The $55,000 of gain on the 57 acres of woodland arguably should still qualify for the I.R.C. §121 exclusion. See *Bogley v. Commissioner,* 263 F.2d 746 (4th Cir. 1959); **Rev. Rul. 76.541,** 1976-2 CB 246).

EFFECT OF I.R.C. §280A(C)(6)—RENTING TO EMPLOYER

I.R.C. §280A(c)(6) disallows the deduction of any expenses for a personal residence that is rented to the owner's employer. That denial of a deduction will apparently qualify the property for the I.R.C. §121 exclusion. The instructions for the 1997 Form 2119 state that gain from sale of the part of a residence that was rented out or used for business can be reported on Form 2119 if the taxpayer was not allowed to deduct expenses for that part of the home.

Practitioner Note. Form 2119 will not be used, beginning with the 1998 tax year, since the gain on sale of most personal residences is not recognized.

Example 7-E. Apple Blossom owns a home on five acres that are adjacent to the apple orchard for which she works. Her employer pays her $1,000 per month to store apples, apple bins, and equipment on her property.

Since she is receiving rent from her employer for property that is adjacent to her dwelling, she is likely to be prohibited from deducting expenses for the rental use of her property. Since the rental use is 15 days or more each year, she is not allowed to exclude the rental income under I.R.C. §280A(g). See *Roy v. Commissioner,* T.C. Memo 1998-125 (March 31, 1998).

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Example 7-F. Assume Apple Blossom in Example 7-E sells her home and five acres in 1998 for $200,000. She realized a gain of $25,000 on the home and a gain of $100,000 on the land. She meets the ownership requirements of I.R.C. §121.

Apple Blossom should be allowed to exclude not only the $25,000 of gain on her home but also the $100,000 of gain on the land, since the 1997 Form 2119 instructions allow her to include the gain from the land with the gain from her home.

EFFECT OF GOVERNMENT PROGRAMS

Since land that is placed in a government program such as the Conservation Reserve Program (CRP) is subject to restrictions and produces income, it apparently does not qualify for the I.R.C. §121 exclusion. See *Beckwith v. Commissioner,* TC Memo 1964-254.

Example 7-G. Lazy Landowner owns a home on 80 acres of land. 38 acres of the land are in the CRP program and the remainder are woods that Lazy uses for recreation. In 1998, Lazy sold the land and home. He realized a gain of $90,000 on the CRP land and a gain of $125,000 on the home and the rest of the land.

Lazy can exclude the $125,000 of gain on the home and the rest of the land, but he cannot exclude the gain on the 38 acres in the CRP.

EFFECT OF I.R.C. §183 HOBBY LOSS RULES

I.R.C §183 treats all activities for which deductions are not allowed under I.R.C. §162 or I.R.C. §212 as "activities not engaged in for profit" and limit the deductions of expenses from those activities to the income from those activities. Therefore, if an activity is subject to the hobby loss limitations, it is by definition not a trade or business or an activity for profit.

If property adjacent to a taxpayer's home is determined to be a hobby activity under I.R.C. §183, it could be argued that the property is therefore a part of the taxpayer's residence for purposes of the I.R.C. §121 exclusion. Although the statute does not specifically state that property not used for a trade or business or for the production of income is personal-use property, by default, that is apparently the category it falls into. If the property is adjacent to the taxpayer's home, the taxpayer has a strong argument that the land qualifies for the I.R.C. §121 exclusion. See Rev. Rul. 82-26, 1982-1 CB 114.

EFFECT OF I.R.C. §1031 LIKE-KIND EXCHANGE RULES

Property used in a trade or business or held for investment qualifies for the like-kind exchange rules of I.R.C. §1031 if the property is exchanged for property of like-kind. **A farm owner's personal residence on the farm does not qualify for the like-kind exchange rules, because it is neither used in the trade or business nor held for investment.**

If a farm owner exchanges the farm for other real property that is used in a trade or business or is held for the production of income, all of the gain realized on the exchange will escape recognition under either the like-kind exchange rules (if the value of the replacement property is high enough) or under the I.R.C. §121 exclusion. However, gain that is excluded under I.R.C. §121 will increase the basis in the replacement property whereas gain deferred under the like-kind exchange rules will not.

ISSUE 8: CONSERVATION EASEMENTS

New tax rules, effective beginning in 1998, make donating a conservation easement even more attractive than under prior law. Donations after 1997 qualify the donor for **four** tax benefits:

1. No gain has to be recognized on the transfer of the easement.
2. The value of the gift can be claimed as an income tax deduction,
3. The value of the gift can be claimed as a gift tax deduction, and
4. The donor's estate can be reduced by up to 40% of the remaining value of the property.

TAXPAYER RELIEF ACT OF 1997

The Taxpayer Relief Act of 1997 added a provision that allows an estate to exclude up to 40% of the value of the interest retained in land from which a conservation easement has been donated to a government unit or an organization that qualifies for tax deductible contributions under I.R.C. §501(c)(3).

Observation. To qualify for the exclusion, the landowner must donate the conservation easement during his or her life. However, the exclusion applies to the interest retained in the property at the time of death.

There are several rather technical details that must be observed in applying this provision.

Reduction in the 40% "Applicable Percentage." The 40% applicable percentage is reduced by 2% for each percentage point the value of the conservation easement falls below 30% of the value of the land without the easement and reduced by the value of any development rights retained by the landowner.

Example 8-A. Conrad Conservationist donated a conservation easement to his local Land Trust Commission. The value of the easement was $220,000. The value of the land before the easement was donated was $1.3 million. Conrad retained the right to develop one corner of the property. That development right is worth $300,000.

If Conrad's estate elects the conservation exclusion, its applicable percentage is calculated as follows:

Value of conservation easement	$ 220,000
Value without easement	$1,300,000
Less value of retained development rights	300,000
Remaining value of property	1,000,000
Conservation easement as percent of remaining value	22%
Amount conservation easement percentage is below 30%	8%
Shortfall x 2	× 2
Amount to subtract from 40%	16%
Applicable percentage (40% – 16%)	24%

Retained Development Rights. The value of retained development rights are not eligible for the exclusion unless the beneficiaries and heirs who have an interest in the property agree to extinguish those rights. The agreement can apply to part or all of the rights, but only the rights that the heirs agree to extinguish can be included in the exclusion calculation.

Example 8-B. If Conrad's heirs in the previous example do not agree to extinguish the development rights that Conrad retained, the 24% applicable percentage is applied to the value Conrad retained without the value of the retained development rights. Therefore, the exclusion amount is 24% × $1,000,000 = $240,000 (subject to the maximum discussed below).

If Conrad's heirs agree to extinguish the development rights, then the applicable percentage changes as well as the value of the retained rights to which it applies. The applicable percentage becomes:

Value of conservation easement		$ 220,000
Value without easement	$1,300,000	
Less value of retained development rights	-0-	
Remaining value of property		1,300,000
Conservation easement as percent of remaining value		17%
Amount conservation easement percentage is below 30%		13%
Shortfall x 2		x 2
Amount to subtract from 40%		26%
Applicable percentage (40% – 16%)		14%

The value of the retained rights become $1,300,000. Therefore, the exclusion amount is 14% × $1,300,000 = $182,000 (subject to the maximum discussed below).

Observation. The election to extinguish the development rights reduced the exclusion amount because the reduction in the applicable percentage was greater than the increase in the retained value. This is probably not the result Congress intended.

Exclusion Limitation. The exclusion is limited to a maximum as shown in the following table:

For estates of decedents dying in:	The exclusion limitation is:
1998	$100,000
1999	200,000
2000	300,000
2001	400,000
2002 or thereafter	500,000

Location of the property. To qualify for the exclusion, at the time of the decedent's death, the property must be located:

1. Within 25 miles of a metropolitan area as defined by the Office of Management and Budget. A metropolitan area includes metropolitan statistical areas (MSAs), consolidated metropolitan statistical areas (CSMAs), and primary metropolitan statistical areas (PMSAs). These areas are defined in terms of entire counties, except in the six New England states, where they are defined in terms of cities and towns. Effective June 30, 1998, there are 259 MSAs, 19 CSMAs, and 76 PSMAs. See OMB Bulletin No. 98-06 (June 23, 1998), which is available on the OMB homepage at **http://www.census.gov/population/www/estimates/metrodef.html,** for the list of metropolitan areas.
2. Within 25 miles of a national park or wilderness area designated as part of the National Wilderness System.
3. Within 10 miles of an Urban National Forest as designated by the Forest service.

Debt-Financed Property. The exclusion only applies to equity in debt-financed property.

Example 8-C. Darwin Debtor borrowed $500,000 to purchase land, from which he later donated a conservation easement. At the time of his death, the debt was paid down to $300,000, and the value of his retained interest (without development rights) was $700,000. The value eligible for multiplying by the applicable percentage is $400,000.

Ownership and Donation. The property must have been owned by the decedent or a member of the decedent's family at all times during the three-year period before the decedent's death. The donation of the conservation easement must have been made by the decedent, a member of the decedent's family, the executor of the decedent's estate or the trustee of the trust holding the land no later than the date of the election.

Basis of Property. To the extent the value of land is excluded from the taxable estate, the basis of such land acquired at death is a carryover basis. Therefore, if 40% of the value of property is excluded, then 40% of the decedent's basis will be carried over and 60% of the value of the property will receive a date of death value basis.

Example 8-D. Barry Basis paid $200,000 for land from which he later donated a conservation easement. The conservation easement was valued at 30% of the value of the property without the easement. Therefore, Barry's basis in the interest he retained is 70% of $200,000 = $140,000.

If 40% of the $250,000 retained value is excluded from Barry's estate under the conservation exclusion, then the basis in the retained interest is calculated as follows:

Carryover basis (40% of $140,000)	$ 56,000
Date of death value basis (60% of $250,000)	150,000
Basis in property acquired at death	$206,000

EXAMPLES OF TAX SAVINGS

Example 8-E. Lucy Landowner owns farmland that is within 25 miles of a metropolitan area. Her local Land Trust Commission would like to acquire a conservation easement on the land to manage development in the area. The land is worth $500,000 before the easement is transferred. The easement is worth $200,000 and the land without the easement is worth $300,000. Lucy has owned the land for 30 years and has a $50,000 income tax basis in the land. Lucy is single and has $150,000 of adjusted gross income and $120,000 of taxable income each year, which places her in the 31% marginal income tax bracket. She is expected to live past 2005 and is likely to have an estate worth $1.25 million, which places her in the 41% marginal estate tax bracket.

If Lucy sells the conservation easement to the Land Trust Commission for $200,000, she will have to report $150,000 ($200,000 – $50,000) of capital gain on her income tax return. Lucy will have to pay $30,000 ($150,000 × 20%) of federal income tax on that gain, leaving her $170,000 of after-tax proceeds from the sale. She will also have a zero basis in the land without the conservation easement. Therefore, if she later sells the rest of her interest in the land, she will have to report the entire sale price as capital gain and pay income taxes at the rate of 20% on that gain.

By contrast, if Lucy donates the conservation easement to the Land Trust Commission, she will get the following income, gift, and estate tax benefits.

1. **She will not have to report any gain on the sale of the easement,** which will save her $30,000 ($150,000 × 20%) of federal income tax.
2. **She will be allowed to claim a $200,000 charitable contribution deduction on her income tax return.** That deduction can be used to reduce her taxable income by $45,000 (30% of her adjusted gross income) each year for the current year and the next three tax years. She can claim the remaining $20,000 as a deduction in the fourth tax year after the current year. Those deductions will reduce her federal income taxes by a total of $62,000 ($200,000 × 31%).

3. **She can claim a gift tax exclusion of $200,000, which means her gift will neither cause her to pay any gift taxes nor reduce her lifetime exclusion.** This $200,000 reduction in the value of her estate will reduce her federal estate taxes by $82,000 ($200,000 × 41%).
4. **Her estate will be allowed to exclude** $120,000 (40% of $300,000) **from the value of her estate,** which would reduce her federal estate taxes by $49,200 ($120,000 × 41%).

In summary, by making a gift of the easement, Lucy forgoes the $200,000 of sale proceeds, but saves $223,200 ($30,000 + $62,000 + $82,000 + $49,200) in federal income, gift and estate taxes. Therefore, Lucy's heirs have $23,200 more than they would have if Lucy had sold the easement.

Note: The tax savings are not as dramatic for taxpayers who are in income tax brackets and estate tax brackets that are lower than Lucy's in the above example. However, most taxpayers save some taxes, which reduces the cost of donating a conservation easement even if it does not fully offset that cost.

Example 8-F. Fred Farmer owns farmland that is within 25 miles of a metropolitan area. His local Land Trust Commission would like to acquire a conservation easement on the land to manage development in the area. The land is worth $500,000 before the easement is transferred. The easement is worth $200,000, and the land without the easement is worth $300,000. Fred has owned the land for 30 years and has a $50,000 income tax basis in the land. Fred is married and has $75,000 of adjusted gross income and $65,000 of taxable income each year, which places him in the 28% marginal income tax bracket. He is expected to live past 2005 and is likely to have an estate worth $750,000, which is less than the $1 million lifetime exemption available beginning in 2006, so there will be no estate taxes due on his death.

If Fred sells the conservation easement to the Land Trust Commission for $200,000, he will have to report $150,000 ($200,000 – $50,000) of capital gain on his income tax return. Fred will have to pay $30,000 ($150,000 × 20%) of federal income tax on that gain, leaving him $170,000 of after-tax proceeds from the sale. He will also have a zero basis in the land without the conservation easement. Therefore, if he later sells the rest of his interest in the land, he will have to report the entire sale price as capital gain and pay federal income taxes at the rate of 20% on that gain.

By contrast, if Fred donates the conservation easement to the Land Trust Commission, he will get the following income tax benefits.

1. He will not have to report any gain on the sale of the easement, which would save him $30,000 ($150,000 × 20%) of federal income tax.
2. He will be allowed to claim a $200,000 charitable contribution deduction on his income tax return. That deduction can be used to reduce his taxable income by $22,500 (30% of his adjusted gross income) each year for the current year and the next five tax years. He cannot claim the remaining $65,000 ($200,000 – ($22,500 × 6)) as a deduction, since the carryover of charitable contribution deductions is limited to five years. Those deductions will reduce his federal income taxes by a total of $37,800 ($135,000 × 28%).
3. He can claim a gift tax exclusion of $200,000, which means his gift will neither cause him to pay any gift taxes nor reduce his lifetime exclusion. This $200,000 reduction in the value of his estate will not reduce his gift and estate taxes since his estate is already under the $1 million that can pass tax free in 2006 and later years.
4. His estate will be allowed to exclude $120,000 (40% of $300,000) from the value of his estate. This reduction will not reduce his estate tax, since his estate is already under the $1 million that can pass tax-free in 2006 and later years.

In summary, by making a gift of the easement, Fred forgoes the $200,000 of sale proceeds, but saves $67,800 ($30,000 + $37,800) in federal income taxes. Therefore, Fred's $200,000 donation cost him $132,200 in after-tax dollars.

QUALIFIED FAMILY-OWNED BUSINESS DEDUCTION FOR ESTATE TAX PURPOSES

[See the 1997 Act chapter].

ISSUE 9: HOLDING PERIOD FOR LIVESTOCK

The Taxpayer Relief Act of 1997 created a 28% midterm tax rate for capital assets that were held more than one year but not more than 18 months. The 1997 Act did not change the definition of long-term capital gain. It simply added a new rate for capital assets that met the long term definition (more than one year) but did not meet the more than 18 month requirement. Since net I.R.C. §1231 gain is treated as long-term capital gain, the new rules raise questions about the holding period of livestock under I.R.C. §1231.

> **Practitioner Note.** The 1998 Act has repealed the 18 month holding period effective for tax years ending after December 31, 1997. Therefore, the question only applies to sales of §1231 assets after May 6, 1997, and in a tax year ending on December 31, 1997, or before.

The §1231 rules require livestock other than cattle and horses to be held 12 months or more in order to be treated as §1231 assets. Cattle and horses must be held for 24 months or more to be treated as §1231 assets. The 1997 Act did not amend §1231. Consequently, the holding period to qualify livestock for long-term capital gains was not changed. Gain that qualifies for long-term capital gain treatment must be sorted into gain that meets the 18-month holding period requirement and gain that does not. Since cattle and horses must be held 24 months or more to be §1231 assets, all §1231 gain from the sale of cattle and horses qualifies for the 20% (or 10%) capital gains rate.

Gain from the sale of other livestock sold after May 6, 1997, and in a tax year ending on or before December 31, 1997, is subject to the 28% capital gains rate if the livestock was held for 12 months or more but not more than 18 months.

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Example 9-A. Gary Herder has a farrow-to-finish hog operation and a herd of beef cows. He is a cash-basis, calendar-year taxpayer. In 1997, he sold the following raised breeding livestock after May 6. Gary has a net §1231 gain for the year.

Item	Age	Sale Price
1. Gilts	11 months	$400
2. Sows	17 months	$450
3. Sows	20 months	$500
4. Heifers	23 months	$800
5. Cows	5 years	$900

Gary also sold the following purchased breeding livestock in 1997, after May 6.

Item	Holding Period	Unadjusted Basis	Depreciation	Adjusted Basis	Sales Price	Gain
6. Sows	20 months	$ 900	$ 700	$200	$ 600	$400
7. Cows	4 years	$1,500	$1,200	$300	$1,100	$800

The treatment of each of the above items is as follows:

1. The raised gilts that were held for 11 months are not §1231 assets because they were held less than 12 months. Therefore the $400 gain realized on the sale of the gilts is ordinary income reported in Part II of Form 4797.

2. The raised sows that were held for 17 months are §1231 assets. Therefore, the $450 of gain is treated as long-term gain but it is subject to the 28% midterm capital gains rates because the sows were not held more than 18 months.
3. The raised sows that were held for 20 months are §1231 assets. Therefore, the gain realized on the sale of the sows is treated as long-term gain and qualifies for the 20% (or 10%) rate since the sows were held for more than 18 months.
4. The raised heifers that were held for 23 months are not §1231 assets because they were held less than 24 months. Therefore, the $800 gain on the heifers is ordinary income reported in Part II of Form 4797.
5. The raised cows that were held for 5 years are §1231 assets. Therefore, the $900 gain on the raised cows is long-term capital gain and it qualifies for the 20% (10%) rate.
6. The purchased sows are §1231 assets, but all of the $400 of gain is ordinary income because of the I.R.C. §1245 depreciation recapture rules.
7. The purchased cows are §1231 assets, but all of the $800 of gain is ordinary income because of the I.R.C. §1245 depreciation recapture rules.

Observation. If the above sales had been made in 1998, all of the §1231 gain would qualify for the 20% (10%) long-term capital gains rate.

ISSUE 10: TAXATION OF AGRICULTURAL LABOR

Hiring employees subjects a farm operator to a myriad of state and federal regulations and reporting requirements. For many of the rules, there are de minimis exceptions that exempt most of the smaller farm operations. However, as farms increase in size and hire more employees, more of the requirements will apply.

I. REPORTING REQUIREMENTS

A. Who Are Employees?

Generally, employees are defined either under common law or under special statutes for certain situations.

Employee Status under Common Law. Anyone who performs services for a farmer is the farmer's employee if the farmer can control what will be done and how it will be done. This is so even when the farmer gives the employee freedom of action. What matters is that the farmer has the right to control the details of how the services are performed. See **Pub. 15-A,** Employer's Supplemental Tax Guide, for more information on how to determine whether an individual providing services is an independent contractor or an employee.

An employer is responsible for withholding and paying employment taxes for his or her employees. The employer is also required to file employment tax returns. These requirements do not apply to independent contractors.

In general, a taxpayer is an employer of farmworkers if his or her employees:

1. Raise or harvest agricultural or horticultural products on a farm.
2. Work in connection with the operation, management, conservation, improvement, or maintenance of the farm and its tools and equipment.
3. Handle, process, or package any agricultural or horticultural commodity if the taxpayer produced over half of the commodity (for a group of more than 20 operators, all of the commodity).
4. Do work related to cotton ginning, turpentine, or gum resin products.
5. Do housework in the taxpayer's private home if it is on a farm that is operated for profit. (Taxes for household employees may be reported separately.)

For this purpose, the term "farm" includes stock, dairy, poultry, fruit, fur-bearing animal, and truck farms, as well as plantations, ranches, nurseries, ranges, greenhouses, or other similar structures used primarily for the raising of agricultural or horticultural commodities, and orchards.

Farmwork **does not include** reselling activities that do not involve any substantial activity of raising agricultural or horticultural commodities, such as a retail store or a greenhouse used primarily for display or storage.

B. Employment Taxes

Cash wages paid to employees for farmwork are subject to social security and Medicare taxes. If the wages are subject to social security and Medicare taxes, they are also subject to income tax withholding. Cash wages include checks, money orders, etc. Do not count the value of food, lodging, and other noncash items.

Commodity Wages. Commodity wages are not cash and are not subject to social security and Medicare taxes or income tax withholding.

However, noncash payments, including commodity wages, are treated as cash payments if the substance of the transaction is a cash payment. Most commodity wage payments are! [See the discussion in last year's book.] These payments are subject to social security and Medicare taxes and income tax withholding.

Family Members. Generally, the wages paid to family members who are employees are subject to social security and Medicare, and income tax withholding, and FUTA tax. **However, certain exemptions may apply for a child, spouse, or parent of the taxpayer.**

Child of Employer. The services of a child under the age of 18 who works for his or her parent in a trade or business are not subject to social security and Medicare taxes. If these services are for work other than in a trade or business, such as domestic work in the parent's private home, they are not subject to social security and Medicare taxes until the child reaches 21.

The services of a child under the age of 21 who works for his or her parent (whether or not in a trade or business) are not subject to FUTA tax.

These rules apply even if the child is paid wages for nonfarm work. Wages for these services are not subject to social security and Medicare or federal unemployment taxes. However, the wages for nonfarm work may still be subject to income tax withholding.

One Spouse Employed by the Other. The services of an individual who works for his or her spouse in a trade or business are subject to social security and Medicare taxes, but not FUTA tax. However, the services of one spouse employed by another in other than a trade or business, such as domestic service in a private home, are not subject to social security and Medicare taxes or FUTA tax.

Covered Services of Child or Spouse. Wages for the services of a child or spouse are subject to income tax withholding and social security, Medicare, and FUTA taxes, if he or she works for:

1. A corporation, even if it is controlled by the child's parent or the individual's spouse.
2. A partnership, even if the child's parent is a partner, unless **each** partner is a parent of the child.
3. A partnership, even if the individual's spouse is a partner.
4. An estate, even if it is the estate of a deceased parent.

In these situations, the child or spouse is considered to work for the corporation, partnership, or estate, not the parent or other spouse.

> **Practitioner Note.** Wages to a child of a sole proprietor or to a person who is a child of all partners in a partnership or all members of an LLC are not subject to social security and Medicare. Report these wages on Form W-2 with no tax showing in the social security and Medicare boxes. Do not report them on a Form 1099.

Share Farmers and Alien Workers. Social security and Medicare taxes do not apply to wages paid to share farmers or to alien workers admitted under section 101(a)(15)(H)(ii)(a) of the Immigration and Nationality Act on a temporary basis to perform agricultural labor (H-2(A) workers).

C. Social Security and Medicare Taxes

> Generally, farmers must withhold social security and Medicare taxes on all cash wage payments to employees.

The $150 Test or the $2,500 Test. All cash wages paid to an employee during the year for farmwork are subject to social security and Medicare taxes and income tax withholding if **either** of the two tests below is met:

1. Cash wages are paid to an employee of $150 or more in a year for farmwork (count all cash wages paid on a time, piecework, or other basis). The $150 test applies separately to each farmworker employed. If a family of workers is employed, each member is treated separately. Do not count wages paid by other employers.
2. The total an employer pays for farmwork (cash and noncash) to all employees is $2,500 or more during the year.

> **Exceptions.** The $150 and $2,500 tests **do not apply** to the following situations:

1. Wages paid to a farmworker who receives less than $150 in annual cash wages are not subject to social security and Medicare taxes, or income tax withholding, even if the employer pays $2,500 or more in that year to all farmworkers, if the farmworker:
   - **a.** Is employed in agriculture as a hand-harvest laborer,
   - **b.** Is paid piece rates in an operation that is usually paid on a piece-rate basis in the region of employment,
   - **c.** Commutes daily from his or her home to the farm, and
   - **d.** Had been employed in agriculture less than 13 weeks in the preceding calendar year. Amounts paid to these seasonal farmworkers, however, count toward the $2,500-or-more test to determine whether wages paid to other farmworkers are subject to social security and Medicare taxes.

2. Cash wages paid a household employee are counted in the $2,500 test, **but are not subject to social security and Medicare taxes unless the employer has paid the worker $1,100 or more in cash wages in 1998.**

D. Income Tax Withholding

Farmers and crew leaders must withhold Federal income tax from the wages of farmworkers if they are subject to social security and Medicare taxes. The amount to withhold is figured on gross wages without taking out social security and Medicare taxes, union dues, insurance, or other deductions.

Form W-4. To know how much income tax to withhold from employees' wages, the employer should have a **Form W-4,** Employee's Withholding Allowance Certificate, on file for each employee. Use Form W-4 only to determine income tax withholding. It has no effect on social security, Medicare, state income tax, or any other form of withholding.

E. Deposit Requirements

Generally, employers must deposit both the employer and employee social security and Medicare taxes and income tax withheld (minus any advance earned income credit payments) during the year by mailing or delivering a check, money order, or cash to an authorized financial institution or Federal Reserve bank. However, some employers are required to deposit by electronic funds transfer.

Exception to deposit requirement. An employer may make payments with Form 943 instead of depositing if:

- His or her net tax liability for the year (line 11 on Form 943) is less than $500, or
- He or she is making a payment in accordance with the **Accuracy of deposits rule.** This amount may be $500 or more. **Caution:** Only monthly schedule depositors, defined below, are allowed to make this payment with the return.

Electronic Deposit Requirement. If the employer's total deposits of social security, Medicare, and withheld income taxes were more than $50,000 in 1996, he or she must make electronic deposits for **all** depository tax liabilities that occur after 1997. If an employer was required to deposit by electronic funds transfer in prior years, he or she must continue to do so in 1998. The **Electronic Federal Tax Payment System** (EFTPS) must be used to make electronic deposits.

F. When to Deposit

The rules for determining when to deposit Form 943 taxes classify employers as either a **monthly schedule depositor** or a **semiweekly schedule depositor.** The terms "monthly schedule depositor" and "semi-weekly schedule depositor" **do not** refer to how often the business pays its employees, or how often the employer is required to make deposits. The terms identify which set of rules must be followed when the employer incurs a tax liability. The deposit schedule an employer must use for a calendar year is determined from the total taxes reported on Form 943 (line 9) for the lookback period, discussed below.

1. If **$50,000 or less** of Form 943 taxes were reported for the lookback period, the employer is a monthly schedule depositor.
2. If **more than $50,000** of Form 943 taxes were reported for the lookback period, the employer is a semiweekly schedule depositor.

Lookback Period. The lookback period is the second calendar year preceding the current calendar year. For example, the lookback period for 1998 is 1996.

Monthly Deposit Schedule. If the total tax reported on Form 943 for the lookback period is $50,000 or less, the employer is a monthly schedule depositor for the current year. He or she must deposit Form 943 taxes on payments made during a calendar month by the 15th day of the following month.

Deposits on Banking Days Only . If a deposit is required to be made on a day that is not a banking day, the deposit is considered timely if it is made by the next banking day. In addition to Federal and state bank holidays, Saturdays and Sundays are treated as nonbanking days. For example, if a deposit is required to be made on Friday, but Friday is not a banking day, the deposit is considered timely if it is made by the following Monday (if Monday is a banking day).

$500 Rule. If an employer accumulates less than $500 of Form 943 taxes (reduced by any advance EIC payments) during the year (line 11 of Form 943), no deposits are required. He or she may pay the tax with Form 943.

Example 10-A. Roland Schmidt owns and operates a farm as a sole proprietor. He has one full time employee, who works 50 hours per week 50 weeks of the year and is paid a total of $25,000 per year. He also hires seasonal labor, which varies each year. In 1996, he hired 10 different workers, who worked a total of 800 hours spread over 20 different days during a five-week period. They were paid on an hourly basis and earned a total of $4,000. In 1997, he hired 4 different workers, who worked a total of 700 hours spread over 30 different days during a seven-week period. They were paid on an hourly basis and earned a total of $4,200. He expects to hire about 750 hours of seasonal labor in 1998.

Question 10-A1. *Are the workers Roland hired employees or independent contractors?*

Answer 10-A1. There are not enough facts given to give a definitive answer to this question. However, it is likely that Roland's full-time, permanent worker is an employee. Whether his part-time seasonal workers are employees or independent contractors is determined by the worker classification rules discussed in the What's New chapter. Since farm producers closely supervise the work of seasonal workers, many of them are employees.

For purposes of this example, we will assume that all of Roland's workers are classified as employees.

Question 10-A2. *Are wages paid to Roland's workers subject to FICA tax?*

Answer 10-A2. Yes, Roland meets the $2,500 total payroll threshold for being subject to FICA taxes. Therefore, all of the wages he pays to all of his workers are subject to FICA taxes. The exception for hand harvesters does not apply, because he does not pay his workers on a piece rate basis.

Roland must withhold 6.20% of the wages for the employee's share of Old Age, Survivors and Disability Insurance (OASDI) **and** pay his 6.20% share of OASDI on the wages. Since all of the wages are below the $62,700 wage base for 1998, all of the wages are subject to OASDI.

Roland must also withhold 1.45% of the wages for the employee's share of Hospital Insurance **and** pay his 1.45% share of Hospital Insurance on the wages. There is no wage base for this portion of the FICA, so all wages are subject to this tax.

Practitioner Note. Payment of noncash wages for agricultural labor is not subject to FICA tax under I.R.C. §3121(a)(8)(A).

Question 10-A3. *Is Roland required to withhold federal income taxes from the wages he pays?*

Answer 10-A3. Yes, withholding federal income taxes is required on agricultural wages with only limited exceptions. The exceptions follow the FICA tax liability rules. Therefore, if wages are exempt from FICA taxes, they are also exempt from federal income tax withholding [I.R.C. §3401(a)(2)]. For example, noncash wages that are not subject to FICA taxes are also not subject to federal income tax withholding.

Circular A, *Agricultural Employer's Tax Guide* (IRS Pub. 51) has a lot of useful information on employment taxes, including the federal income tax withholding tables.

Practitioner Note. Roland should have each employee sign a Form W-4 when he or she begins work. If Roland does not have a Form W-4 on file for a particular employee, he should withhold from that employee's wages as if the employee were single with no withholding allowances.

Question 10-A4. *How often is Roland required to make a federal employment tax deposit?*

Answer 10-A4 . Roland must deposit federal employment taxes monthly, since his employment taxes are more than $500 for 1998 and were not more $50,000 in his lookback period (1996).

If an agricultural employer's employment taxes are **less than $500 for the year,** he or she can pay the entire amount with the employment tax return for the year.

If an agricultural employer's employment taxes in the lookback period (the calendar year two years prior to the current year) are **more than $50,000,** then the employer must deposit employment taxes twice a week during the current year.

Regardless of the above rules, on any day that the employment taxes are $100,000 or more, the employer must deposit them by the close of the next banking day.

Question 10-A5. *Is Roland required to pay federal unemployment taxes (FUTA) on the wages he pays to his workers?*

Answer 10-A5. No, Roland is not required to, pay FUTA, because he meets neither of the following threshold requirements.

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1. He did not pay cash wages of $20,000 or more in any calendar quarter in 1996 or 1997.
2. He did not employ 10 or more farm workers during some portion of the day for at least 1 day during 20 different weeks in 1996 or 1997.

Question 10-A6. *What other rules and regulations may affect Roland?*

Answer 10-A6. Other rules and regulations that may affect farm employers include:

1. Worker's compensation laws. These rules vary by state.
2. Occupational Safety and Health Act.
3. Federal Immigration Reform and Control Act
4. Labor union rules
5. EPA Worker Protection Standard for Agricultural Pesticides
6. Migrant and Seasonal Worker Protection Act

Practitioner Note. A Form I-9 must be filed for all new workers.

II. NONTAXABLE FRINGE BENEFITS

Farm operators can provide several fringe benefits for employees that are not taxable income to the employees.

A. Health and accident plans

Health and accident insurance provided to employees can be claimed as a deduction by the employer on Schedule F (Form 1040) [I.R.C. §162(a)(1)] and **does not** have to be included in the employee's income [I.R.C. §105(b)].

Example 10-B. Sandy Land owns and operates a farm. Sandy has a health and accident plan that provides health insurance for employees. Sandy can deduct the cost of health and accident insurance for her employees, and her employees do not have to include the value of the insurance in their income.

1. Discrimination. I.R.C. §105 makes a distinction between

1. Health and accident insurance purchased from a third party (an insured plan) and
2. A health and accident plan under which the employer simply reimburses the employees' medical expenses (a self-insured plan)

An insured health plan is one in which there is a real shift of financial risk to an unrelated third party, such as an insurance carrier. Self-insured plans are subject to nondiscrimination requirements.

If the employer provides health or accident insurance (an insured plan), **there are no nondiscrimination requirements.** The employer can provide the insurance to one or more employees and may provide different coverage to different employees [**Treas. Reg.** §1.105-5(a)].

If the employer **provides** a self-insured medical reimbursement plan, the plan must be in writing and must meet nondiscrimination requirements set out in §105(h). Under those rules, the following employees may be excluded from the plan:

1. Employees who have not completed three years of service.
2. Employees who have not attained age 25.
3. Part-time or seasonal employees.
    a. **Part-time** is defined as under 25 hours per week, but if other employees with similar work have substantially more hours, then the part-time employee may work up to (but not including) 35 hours per week.
    b. **Seasonal** is defined as under seven months per year, but if other employees with similar work have substantially more months, then the seasonal employee may work up to (but not including) nine months per year.
4. **Employees represented by a collective bargaining agreement** in which health benefits were the subject of good faith bargaining.
5. **Employees who are nonresident aliens and who receive no earned income from the employer** that constitutes income from a source within the United States.

2. Family Members

I.R.C. §105 includes insurance for an employee's family, even if a member of that family is the employer. **Rev. Rul.** 71-588 provides that a taxpayer operating a business as a sole proprietorship can employ his or her spouse, provide health insurance that covers the spouse-employee and the family of the spouse-employee (including the taxpayer), and deduct the cost as a business expense. See also Ltr. Rul. 9409006.

Example 10-C. Sandy's health and accident plan in Example 10-A includes health insurance for the family members of her employees. If Sandy employs her husband, Clay, the plan includes coverage for Sandy as a member of Clay's family. Therefore, Sandy can deduct 100% of the cost of health insurance as a business expense.

Sandy must file all the forms applicable to her employment of Clay. Therefore, she must file Forms W-2, W-3, and 943, but she should not include the cost of Clay's health insurance as taxable compensation since it is not subject to income tax or FICA tax.

Observation. If Sandy claims the cost of health insurance provided to Clay and his family as a Schedule F deduction, she cannot claim the health insurance deduction on line 26 of Form 1040, nor can she include the cost of the health insurance as a Schedule A (Form 1040) deduction.

3. Plan Requirements. **It is not necessary to have a written plan if the health and accident benefits are provided through a third-party insurer** [**Treas. Reg.** §1.105-5(a)]. **However, self-insured medical plans must have a written plan document that describes the reimbursements that will be provided** [**Treas. Reg.** §1.105-11(b)(1)].

4. Reimbursement to Employees. According to **Rev. Rul.** 61-146, 1961-2 C.B. 25, it would appear that an employer can reimburse an employee for the health insurance costs the employee pays directly. **However, the employee must submit proof of prior payment of the health insurance premiums and proof that the insurance is in force.** Furthermore, the employer's payment to the employee must be stated to be in reimbursement for the employer's share of the health insurance premiums. A direct payment of the health insurance premiums by the employer in this case would appear to simplify the record-keeping task.

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5. Period of Coverage. If the employer is **contractually bound** to provide benefits to the employee, the plan can cover expenses that were incurred after the plan was in place for an **illness or injury that occurred before the plan was in effect** [**Treas. Reg.** §1.105-5(a)].

The regulations are not as clear on the issue of covering **expenses that were incurred before the plan was in place.**

- A **proposed regulation** for cafeteria plans under I.R.C. §125 states, “Reimbursements of expenses incurred prior to or after the specified period of coverage will not be excluded under §105(b)” [Prop. Reg. §1.125-1, Q&A 17]. It is not clear whether this prohibition of covering expenses incurred prior to the existence of the plan is an I.R.C. §105 rule that applies to all I.R.C. §105 plans or whether it is a prohibition that applies only when an I.R.C. §105 plan is used within an I.R.C. §125 cafeteria plan.
- *American Family Mutual Insurance Co. v. United States*, 93 TNT 2-12 (W.D. Wis., 1992), dealt with an I.R.C. §105 plan that was part of an I.R.C. §125 plan. Judge Crabb concluded that payments for expenses incurred prior to the adoption of the plan were not excluded under I.R.C. §105. In reaching that conclusion, she reasoned that allowing taxpayers to exclude reimbursements of expenses incurred before the plan was in place would allow post hoc discrimination, since employees could choose how much of their salary would be placed in their medical reim-

bursement account after they knew the amount of the expenses. She apparently saw no distinction between an I.R.C. §105 plan that is in an I.R.C. §125 cafeteria plan and one that is not, since she cited authority that dealt with I.R.C. §105 plans that were not in an I.R.C. §125 cafeteria plan. For example, she summarized **Rev. Rul.** 71-403, 1971-2 C.B. 91, as follows: "If the plan is unenforceable, it must be made known to employees prior to the time of illness or injury to be valid; if the plan is enforceable, it must simply be in existence prior to the time an employee incurs an expense as a result of the illness." [See also *Seidel v. Commissioner,* 30 TCM 1021 (1971).]

- It **could be argued** that there is less danger of post hoc discrimination when the I.R.C. §105 plan is not in an I.R.C. §125 plan, and therefore there is no need to prohibit retroactive payments of expenses. Such an argument may be successful in court, but the IRS is likely to challenge such a position.

Example 10-D. Bruce Callum operates a sole proprietorship farming business. His only employees are his wife, Betty, and Clarence Spencer, who is unrelated. Betty and Clarence have each worked 40 hours per week for Bruce's farm business for several years, and they are each paid $25,000 per year.

On November 1, 1998, Bruce adopted a written plan to reimburse employees for their medical expenses. The plan includes the nondiscriminatory rules required by I.R.C. §105(h)(3). The plan requires Bruce to reimburse his employees for medical expenses up to $10,000 per year, including medical insurance. The plan covers medical expenses that were incurred on or after the later of:

1. January 1, 1998, or
2. The date the employee became employed by Bruce.

Question 10-D1. *Can Bruce deduct reimbursements of medical expenses Betty and Clarence incurred on or after January 1, 1998, and before November 1, 1998?*

Answer 10-D1. Yes, the reimbursement is an ordinary and necessary expense under I.R.C. §162.

Question 10-D2. *Can Betty and Clarence exclude from income the reimbursements they receive for medical expenses incurred on or after January 1, 1998, and before November 1, 1998?*

Answer 10-D2. Judge Crabb's concern about **post hoc** payment of medical expenses in *American Family Mutual Insurance Co.* could arguably apply to these facts. If so, the IRS may argue and a court may agree that the expenses are not excluded under I.R.C. §105.

However, *American Family Mutual Insurance Co.* deals with a different set of facts than this example. A court could interpret the I.R.C. §105 rules to allow Betty and Clarence to exclude the reimbursements, since Bruce's I.R.C. §105 plan is not part of an I.R.C. §125 plan.

6. Name on the Insurance Policy

Example 10-E. Susan Carlson operates a farm business as a sole proprietor. Her husband, Ben, works part-time for her in the farm business. Susan plans to adopt an I.R.C. §105 plan beginning on January 1, 1998. Susan currently carries medical insurance for the family under a policy that is issued in her name. Because of preexisting conditions, a new policy in Ben's name would have a higher annual premium. Therefore, Susan would like to include in her medical reimbursement plan reimbursement of Ben's payment of the premiums on the policy in Susan's name.

Question 10-E1. *Will such reimbursements be excluded from income under I.R.C. §105?*

Answer 10-E1. There is no specific prohibition of carrying insurance in the name of the self-employed spouse and qualifying the premium payment for exclusion under I.R.C. §105. Therefore, such payments are likely to qualify for the exclusion.

However, such an arrangement gives the IRS an opening to attack the arrangement as a sham transaction. Therefore, whenever possible, the insurance should be carried in the name of the employee spouse.

III. MEALS AND LODGING

The value of meals provided to an employee, the employee's spouse, and the employee's dependent children is excluded from the employee's income if the meals

1. are furnished on the business premises of the employer and
2. are furnished for the convenience of the employer [I.R.C. §119(a)(1)].

The value of lodging provided by an employer is excluded from the employee's income if it meets the above requirements and if, in addition, the employee is required to accept the lodging as a condition of employment [I.R.C. §119(a)(2)]. The lodging on the premises must be necessary for the employee to perform the duties of his or her employment to qualify for the exclusion. Furthermore, any meals provided by the employer to an employee while the employee is living in lodging that meets the requirements are excluded from income [Reg. §1.119-1(a)(2)(i)].

The exclusion also applies to FICA [I.R.C. §3121(a)(19)], FUTA [I.R.C. §3306(b)(14)], and withholding (IRS Pub. 937, **Business Reporting,** p. 8).

Effective for tax years beginning **after December 31, 1997,** the **Taxpayer Relief Act of 1997** [amended I.R.C. §132(e)(2)] specifically provides that business meals that are excludable from an employee's income under I.R.C. §119 because they are provided for the convenience of the employer at an employer-operated eating facility are excludible as a de minimis fringe benefit and, therefore, are 100 percent deductible to the employer. Many farm producers will be able to meet these requirements.

Example 10-F. Cherry Bloom provides meals on the farm premises for workers in her orchard. The meals are provided because it would disrupt the care of the orchard for the workers to leave the orchard to eat their midday meal.

Cherry's workers can exclude the value of the meals from income under I.R.C. §119 and Cherry can deduct 100% of the cost of providing the meals.

IV. WAGES FOR AMISH WORKERS

If an Amish person is self-employed, he or she can **claim exemption** from paying self-employment tax.

If an Amish worker is employed by an Amish employer who was exempt from FICA tax, the Amish employee is exempt from FICA taxes. But if an Amish worker is employed by a non-Amish employer, or any employer who paid FICA tax, the Amish worker **is also subject to FICA tax.**

In order to take advantage of this exemption, both the employer and employee must have applied for and received approval on Form 4029, Application for Exemption From Social Security Taxes and Waiver of Benefits. Nevertheless, such an employer must pay the FICA tax and withhold it on wages of employees who do not have an approved Form 4029.

The exemption does not apply to federal income taxes and FUTA taxes; these taxes must be withheld or paid in the usual manner.

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