1999 Income Tax School

AGRICULTURAL ISSUES

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A Form T must be completed if the taxpayer claims a deduction for depletion of timber or for depreciation of plant and other improvements relating to timber accounts, or elects under I.R.C. §631(a) to treat the cutting of timber as a sale or exchange.

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1999 Income Tax School

AGRICULTURAL ISSUES

ISSUE 1: INCOME AVERAGING FOR FARMERS

PERMANENT PROVISION

The Tax and Trade Relief Extension Act of 1998 made income averaging permanent. That change increases the advantage of long-term planning. Taxpayers and their practitioners can now include the use of income averaging for multiple years as a tool to level income. For example, a taxpayer may want to use income averaging in the current year to empty out low-income brackets so that income averaging in future years will move income into those low brackets.

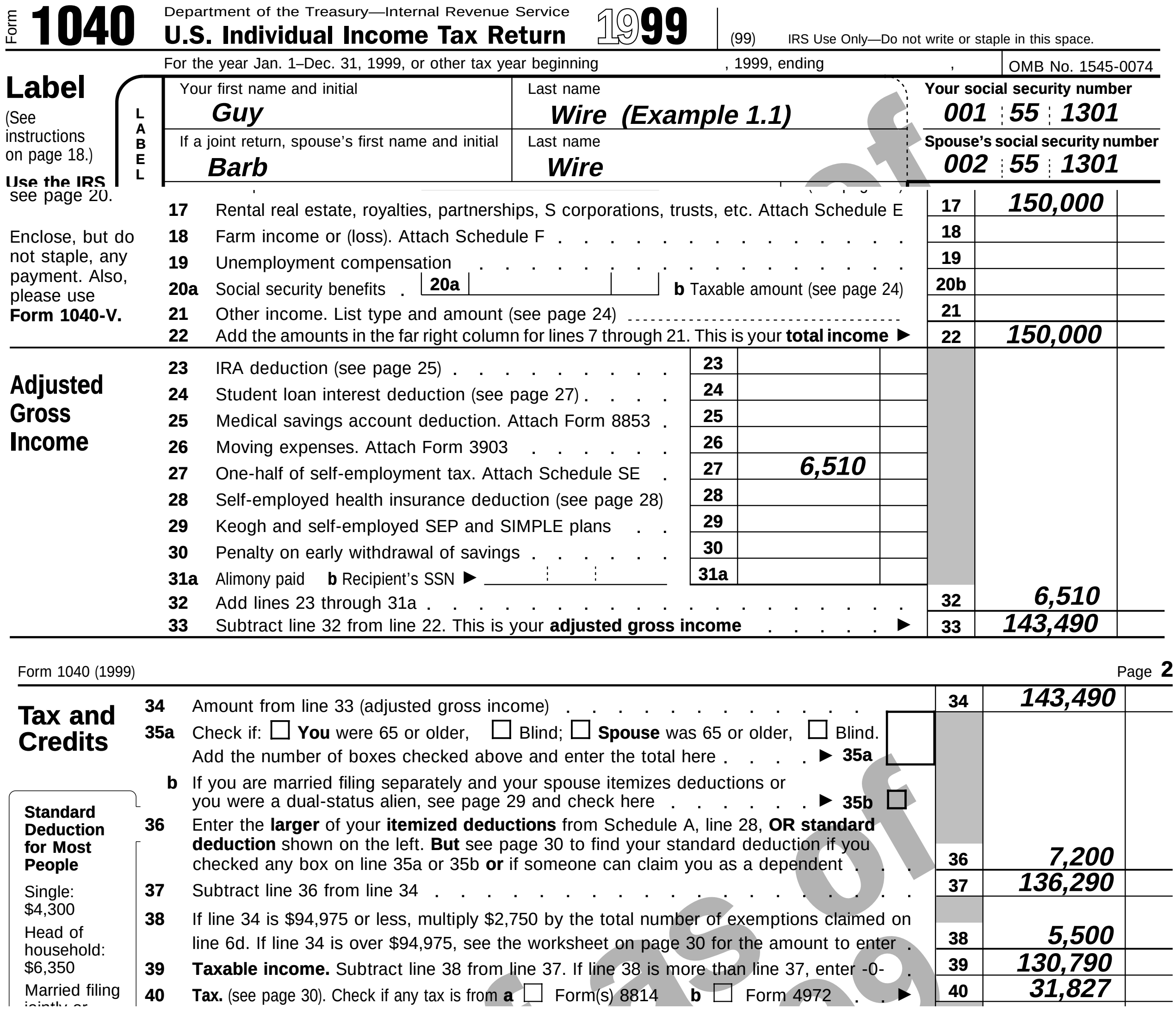
Practitioner Note. The rules are easier to understand if they are viewed as bringing unused tax brackets from the three years prior to the election year forward to use in calculating income taxes due for the election year. They should not be viewed as allowing the taxpayer to carry income back to the three prior years.

EFFECT ON THE ALTERNATIVE MINIMUM TAX

The IRS has interpreted the 1997 legislation as saying that income averaging does not apply for purposes of calculating the tentative minimum tax under I.R.C. §55, but does apply for purposes of calculating regular taxes under I.R.C. §55. See I.R.S. Publication 553, *Highlights of 1998 Tax Changes*, Rev. December 1998, p. 12.

Practitioner Note. The committee report for the Taxpayer Relief Act of 1997 states, "Further, the provision does not apply for purposes of the alternative minimum tax under section 55."

Example 1.1. Guy and Barb Wire are married and have no dependents. In 1996, 1997, and 1998 they had no taxable income. In 1999 they had $150,000 of net farm profit from their Schedule F and no other income. Their regular tax on a joint tax return without income averaging is $31,827, as shown in the following form.



Form **1040** Department of the Treasury—Internal Revenue Service
U.S. Individual Income Tax Return 1999 (99) IRS Use Only—Do not write or staple in this space.

For the year Jan. 1–Dec. 31, 1999, or other tax year beginning , 1999, ending , OMB No. 1545-0074

Label (See instructions on page 18.) **Use the IRS** … see page 20.

Your first name and initial: *Guy*
Last name: *Wire (Example 1.1)*
Your social security number: *001 55 1301*
If a joint return, spouse's first name and initial: *Barb*
Last name: *Wire*
Spouse's social security number: *002 55 1301*

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

17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E	17	*150,000*
18	Farm income or (loss). Attach Schedule F	18	
19	Unemployment compensation	19	
20a	Social security benefits 20a b Taxable amount (see page 24)	20b	
21	Other income. List type and amount (see page 24)	21	
22	Add the amounts in the far right column for lines 7 through 21. This is your **total income** ▶	22	*150,000*

Adjusted Gross Income

23	IRA deduction (see page 25)	23			
24	Student loan interest deduction (see page 27)	24			
25	Medical savings account deduction. Attach Form 8853	25			
26	Moving expenses. Attach Form 3903	26			
27	One-half of self-employment tax. Attach Schedule SE	27	*6,510*		
28	Self-employed health insurance deduction (see page 28)	28			
29	Keogh and self-employed SEP and SIMPLE plans	29			
30	Penalty on early withdrawal of savings	30			
31a	Alimony paid b Recipient's SSN ▶	31a			
32	Add lines 23 through 31a			32	*6,510*
33	Subtract line 32 from line 22. This is your **adjusted gross income** ▶			33	*143,490*

Form 1040 (1999) Page **2**

Tax and Credits

34	Amount from line 33 (adjusted gross income)	34	*143,490*
35a	Check if: ☐ **You** were 65 or older, ☐ Blind; ☐ **Spouse** was 65 or older, ☐ Blind. Add the number of boxes checked above and enter the total here ▶ 35a ☐		
b	If you are married filing separately and your spouse itemizes deductions or you were a dual-status alien, see page 29 and check here ▶ 35b ☐		
36	Enter the **larger** of your **itemized deductions** from Schedule A, line 28, **OR standard deduction** shown on the left. **But** see page 30 to find your standard deduction if you checked any box on line 35a or 35b **or** if someone can claim you as a dependent	36	*7,200*
37	Subtract line 36 from line 34	37	*136,290*
38	If line 34 is $94,975 or less, multiply $2,750 by the total number of exemptions claimed on line 6d. If line 34 is over $94,975, see the worksheet on page 30 for the amount to enter	38	*5,500*
39	**Taxable income.** Subtract line 38 from line 37. If line 38 is more than line 37, enter -0-	39	*130,790*
40	**Tax.** (see page 30). Check if any tax is from **a** ☐ Form(s) 8814 **b** ☐ Form 4972 ▶	40	*31,827*

Standard Deduction for Most People
Single: $4,300
Head of household: $6,350
Married filing jointly or

Question 1.1.1. *How much would income averaging reduce the Wires' income taxes for 1999?*

Answer 1.1.1. Income averaging reduces the Wires' net taxes by $6,220, as shown below.

Regular income taxes without averaging	$31,827
Regular taxes with averaging	19,616
Reduction in regular income taxes	$12,211
AMT caused by income averaging	5,991
Net income tax savings	$ 6,220

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

1999

Attachment
Sequence No. **50**

Name(s) shown on Form 1040: *Guy and Barb Wire (Example 1.1)*

Social security number (SSN): *001 55 1301*

1	Enter your taxable income from Form 1040, line 39			**1**	*130,790*
2	Enter your **elected farm income** (see page J-1)			**2**	*120,300*
3	Subtract line 2 from line 1. If zero or less, enter -0-			**3**	*10,490*
4	Figure the tax on the amount on line 3. Use the **1999** Tax Table, Tax Rate Schedules, Capital Gain Tax Worksheet, or Schedule D, whichever applies			**4**	*1,571*
5	If you filed Schedule J for 1998, enter the amount from line 11 of that Schedule J. Otherwise, enter the taxable income (but not less than zero) from your **1996** Form 1040, line 37; Form 1040A, line 22; or Form 1040EZ, line 6	**5**	*0*		
6	Divide the amount on **line 2** by 3.0	**6**	*40,100*		
7	Add lines 5 and 6	**7**	*40,100*		
8	Figure the tax on the amount on line 7. Use the **1996** Tax Rate Schedules or Capital Gain Tax Worksheet, whichever applies (see page J-2)			**8**	*6,015*
9	If you filed Schedule J for 1998, enter the amount from line 15 of that Schedule J. Otherwise, enter the taxable income (but not less than zero) from your **1997** Form 1040, line 38; Form 1040A, line 22; or Form 1040EZ, line 6	**9**	*0*		
10	Enter the amount from line 6	**10**	*40,100*		
11	Add lines 9 and 10	**11**	*40,100*		
12	Figure the tax on the amount on line 11. Use the **1997** Tax Rate Schedules or Schedule D, whichever applies (see page J-3)			**12**	*6,015*
13	If you filed Schedule J for 1998, enter the amount from line 3 of that Schedule J. Otherwise, enter the taxable income (but not less than zero) from your **1998** Form 1040, line 39; Form 1040A, line 24; or Form 1040EZ, line 6	**13**	*0*		
14	Enter the amount from line 6	**14**	*40,100*		
15	Add lines 13 and 14	**15**	*40,100*		
16	Figure the tax on the amount on line 15. Use the **1998** Tax Rate Schedules or Schedule D, whichever applies (see page J-4)			**16**	*6,015*
17	Add lines 4, 8, 12, and 16			**17**	*19,616*
18	If you filed Schedule J for 1998, enter the amount from line 12 of that Schedule J. Otherwise, enter the tax from your **1996** Form 1040, line 38*; Form 1040A, line 23; or Form 1040EZ, line 10	**18**	*0*		
19	If you filed Schedule J for 1998, enter the amount from line 16 of that Schedule J. Otherwise, enter the tax from your **1997** Form 1040, line 39*; Form 1040A, line 23; or Form 1040EZ, line 10	**19**	*0*		
20	If you filed Schedule J for 1998, enter the amount from line 4 of that Schedule J. Otherwise, enter the tax from your **1998** Form 1040, line 40*; Form 1040A, line 25; or Form 1040EZ, line 10	**20**	*0*		
	***Caution:** *Do not include any amount from Form 4972 or 8814.*				
21	Add lines 18 through 20			**21**	*0*
22	Subtract line 21 from line 17. If the result is less than the tax figured on the taxable income on line 1 above using the **1999** Tax Table, Tax Rate Schedules, Capital Gain Tax Worksheet, or Schedule D, also include this amount on Form 1040, line 40. Otherwise, you do not qualify for farm income averaging; **do not** file Schedule J			**22**	*19,616*

Form **6251**

Department of the Treasury
Internal Revenue Service (99)

Alternative Minimum Tax—Individuals

▶ See separate instructions.

▶ Attach to Form 1040 or Form 1040NR.

OMB No. 1545-0227

1999

Attachment
Sequence No. 32

Name(s) shown on Form 1040: *Guy and Barb Wire (Example 1.1)*

Your social security number: *001 55 1301*

Part I Adjustments and Preferences

1	If you itemized deductions on Schedule A (Form 1040), go to line 2. Otherwise, enter your standard deduction from Form 1040, line 36, here and go to line 6	1	*7,200*
2	Medical and dental. Enter the smaller of Schedule A (Form 1040), line 4 **or** 2½% of Form 1040, line 34	2	
3	Taxes. Enter the amount from Schedule A (Form 1040), line 9	3	
4	Certain interest on a home mortgage **not** used to buy, build, or improve your home	4	
5	Miscellaneous itemized deductions. Enter the amount from Schedule A (Form 1040), line 26	5	
6	Refund of taxes. Enter any tax refund from Form 1040, line 10 or line 21	6	( )
7	Investment interest. Enter difference between regular tax and AMT deduction	7	
8	Post-1986 depreciation. Enter difference between regular tax and AMT depreciation	8	
9	Adjusted gain or loss. Enter difference between AMT and regular tax gain or loss	9	
10	Incentive stock options. Enter excess of AMT income over regular tax income	10	
11	Passive activities. Enter difference between AMT and regular tax income or loss	11	
12	Beneficiaries of estates and trusts. Enter the amount from Schedule K-1 (Form 1041), line 9	12	
13	Tax-exempt interest from private activity bonds issued after 8/7/86	13	
14	Other. Enter the amount, if any, for each item below and enter the total on line 14.	14	

a Circulation expenditures		**h** Loss limitations	
b Depletion		**i** Mining costs	
c Depreciation (pre-1987)		**j** Patron's adjustment	
d Installment sales		**k** Pollution control facilities	
e Intangible drilling costs		**l** Research and experimental	
f Large partnerships		**m** Section 1202 exclusion	
g Long-term contracts		**n** Tax shelter farm activities	
		o Related adjustments	

15	**Total Adjustments and Preferences.** Combine lines 1 through 14 ▶	15	*7,200*

Part II Alternative Minimum Taxable Income

16	Enter the amount from **Form 1040, line 37.** If less than zero, enter as a (loss) ▶	16	*136,290*
17	Net operating loss deduction, if any, from Form 1040, line 21. Enter as a positive amount	17	
18	If Form 1040, line 34, is over $126,600 (over $63,300 if married filing separately), and you itemized deductions, enter the amount, if any, from line 9 of the worksheet for Schedule A (Form 1040), line 28	18	( )
19	Combine lines 15 through 18 ▶	19	*143,490*
20	Alternative tax net operating loss deduction. See page 7 of the instructions	20	
21	**Alternative Minimum Taxable Income.** Subtract line 20 from line 19. (If married filing separately and line 21 is more than $165,000, see page 7 of the instructions.) ▶	21	*143,490*

Part III Exemption Amount and Alternative Minimum Tax

22 **Exemption Amount.** (If this form is for a child under age 14, see page 7 of the instructions.)

IF your filing status is . . .	**AND line 21 is not over . . .**	**THEN enter on line 22 . . .**
Single or head of household	$112,500	$33,750
Married filing jointly or qualifying widow(er)	150,000	45,000
Married filing separately	75,000	22,500

If line 21 is **over** the amount shown above for your filing status, see page 7 of the instructions.

22	Exemption Amount	22	*45,000*
23	Subtract line 22 from line 21. If zero or less, enter -0- here and on lines 26 and 28 ▶	23	*98,490*
24	If you reported capital gain distributions directly on Form 1040, line 13, **or** you completed Schedule D (Form 1040) and have an amount on line 25 or line 27 (or would have had an amount on either line if you had completed Part IV) (as refigured for the AMT, if necessary), go to Part IV of Form 6251 to figure line 24. **All others:** If line 23 is $175,000 or less ($87,500 or less if married filing separately), multiply line 23 by 26% (.26). Otherwise, multiply line 23 by 28% (.28) and subtract $3,500 ($1,750 if married filing separately) from the result ▶	24	*25,607*
25	Alternative minimum tax foreign tax credit. See page 8 of the instructions	25	
26	Tentative minimum tax. Subtract line 25 from line 24 ▶	26	*25,607*
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	*19,616*
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	*5,991*

5

Observation. The AMT caused by income averaging hits middle-income taxpayers the hardest. The following table shows the AMT caused by income averaging, the net savings from income averaging after AMT, and the AMT as a percentage of savings from income averaging before the AMT for taxpayers with the following characteristics:

1. Taxpayers are married filing jointly with two personal exemption deductions.
2. Taxpayers had no income in 1995, 1996, and 1997.
3. Taxpayers had no income in 1998 other than their farm income.
4. Taxpayers' elected farm income is 75% of their 1998 farm income.

1998 Farm Income	Regular Taxes Without Averaging	Regular Taxes With Averaging	Savings from Averaging before AMT	AMT Caused by Averaging	Savings from Averaging after AMT	AMT as a Percent of Savings from Averaging before AMT
95,000	16,048	11,545	4,503	22	4,481	0.49%
100,000	17,434	12,287	5,147	562	4,585	10.92%
150,000	32,113	19,688	12,426	5,988	6,438	48.19%
200,000	48,754	29,509	19,245	11,792	7,453	61.27%
250,000	67,290	43,926	23,364	14,318	9,046	61.28%
300,000	85,980	58,313	27,667	17,197	10,470	62.16%
350,000	105,857	72,368	33,489	19,632	13,857	58.62%
400,000	125,392	86,228	39,164	19,585	19,579	50.01%
450,000	144,926	101,180	43,746	18,445	25,301	42.16%
500,000	164,462	116,473	47,989	16,965	31,024	35.35%
550,000	183,996	131,765	52,231	14,426	37,805	27.62%
600,000	203,531	147,057	56,474	14,006	42,468	24.80%

Practitioner Note. 1999 tax rates will give similar results to the above figures based on 1998 tax rates.

Question 1.1.2. *Will Guy and Barb Wire from the previous example get an AMT credit for the $5,991 of AMT they paid in 1999?*

Answer 1.1.2. No. Only adjustments and preferences that are deferral items create an AMT credit. Since the Wires have no deferral items, they do not get an AMT credit to reduce regular taxes in future years.

Form **8801**

Department of the Treasury
Internal Revenue Service (99)

Credit For Prior Year Minimum Tax— Individuals, Estates, and Trusts

▶ Attach to your tax return.

OMB No. 1545-1073

1999

Attachment
Sequence No. **74**

Name(s) shown on return: *Guy and Barb Wire (Example 1.1)*

Identifying number *001 55 1301*

Part I Net Minimum Tax on Exclusion Items

1	Combine lines 16 through 18 of your 1998 Form 6251. Estates and trusts, see instructions	1	*136,290*
2	Enter adjustments and preferences treated as exclusion items. See instructions	2	*7,200*
3	Minimum tax credit net operating loss deduction. See instructions	3	( )
4	Combine lines 1, 2, and 3. If zero or less, enter -0- here and on line 15 and go to Part II. If more than $165,000 and you were married filing separately for 1998, see instructions	4	*143,490*
5	Enter: $45,000 if married filing jointly or qualifying widow(er) for 1998; $33,750 if single or head of household for 1998; or $22,500 if married filing separately for 1998. Estates and trusts, enter $22,500	5	*45,000*
6	Enter: $150,000 if married filing jointly or qualifying widow(er) for 1998; $112,500 if single or head of household for 1998; or $75,000 if married filing separately for 1998. Estates and trusts, enter $75,000	6	*150,000*
7	Subtract line 6 from line 4. If zero or less, enter -0- here and on line 8 and go to line 9	7	*0*
8	Multiply line 7 by 25% (.25)	8	*0*
9	Subtract line 8 from line 5. If zero or less, enter -0-. If this form is for a child under age 14, see instructions	9	*45,000*
10	Subtract line 9 from line 4. If zero or less, enter -0- here and on line 15, and go to Part II. Form 1040NR filers, see instructions	10	*98,490*
11	If you completed Schedule D (Form 1040 or 1041) for 1998 and had an amount on line 25 or line 27 of Schedule D (Form 1040) (line 24 or line 26 of Schedule D (Form 1041)) or you would have had an amount on either of those lines had you completed Part IV of Schedule D (Form 1040) (or Part V of Schedule D (Form 1041)), go to Part III of Form 8801 to figure the amount to enter on this line. **All others:** Multiply line 10 by 26% (.26) **if** line 10 is: $175,000 or less if single, head of household, married filing jointly, qualifying widow(er), or an estate or trust for 1998; or $87,500 or less if married filing separately for 1998. **Otherwise,** multiply line 10 by 28% (.28) and subtract from the result: $3,500 if single, head of household, married filing jointly, qualifying widow(er), or an estate or trust for 1998; or $1,750 if married filing separately for 1998	11	*25,607*
12	Minimum tax foreign tax credit on exclusion items. See instructions	12	
13	Tentative minimum tax on exclusion items. Subtract line 12 from line 11	13	*25,607*
14	Enter the amount from your 1998 Form 6251, line 27, or Form 1041, Schedule I, line 38	14	*19,616*
15	**Net minimum tax on exclusion items.** Subtract line 14 from line 13. If zero or less, enter -0-	15	*5,991*

Part II Minimum Tax Credit and Carryforward to 2000

16	Enter the amount from your 1998 Form 6251, line 28, or Form 1041, Schedule I, line 39	16	*5,991*
17	Enter the amount from line 15 above	17	*5,991*
18	Subtract line 17 from line 16. If less than zero, enter as a negative amount	18	*0*
19	**1998 minimum tax credit carryforward.** Enter the amount from your 1998 Form 8801, line 26	19	*0*
20	Enter the total of your 1998 unallowed nonconventional source fuel credit and 1998 unallowed qualified electric vehicle credit. See instructions	20	*0*
21	Combine lines 18, 19, and 20. If zero or less, **stop here** and see instructions	21	*0*
22	Enter your 1999 regular income tax liability minus allowable credits. See instructions	22	
23	Enter the amount from your 1999 Form 6251, line 26, or 1999 Form 1041, Schedule I, line 37	23	
24	Subtract line 23 from line 22. If zero or less, enter -0-	24	
25	**Minimum tax credit.** Enter the **smaller** of line 21 or line 24. Also enter this amount on the appropriate line of your 1999 tax return. See instructions	25	
26	**Minimum tax credit carryforward to 2000.** Subtract line 25 from line 21. See instructions	26	

Practitioner Note. Income averaging can create an AMT credit if the taxpayer has adjustments or preferences that are deferral items. Income averaging can cause the deferral items to add to the AMT, which in turn can add to the AMT credit.

Example 1.2. Clay and Lilly Fields had $120,000 of net income from farming in 1998 and no other income. They had $50,000 of AMT deferral adjustments. Before income averaging, their 1998 income tax return showed the following:

Total income (line 22 of Form 1040)		$120,000
One-half of self-employment tax (line 27 of Form 1040)		5,848
Adjusted gross income (line 34 of Form 1040)		$114,152
Standard deduction (line 36 of Form 1040)		7,100
Personal exemption deductions (line 38 of Form 1040)		5,400
Taxable income (line 39 of Form 1040)		$101,652
Regular income tax (line 40 of Form 1040)		22,957
Alternative minimum tax		
Tentative minimum tax (line 26 of Form 6251)	$31,899	
Less regular income tax (line 27 of Form 6251)	22,957	8,942
Total income tax liability		$31,899

After income averaging, their 1998 income tax return showed the following:

Regular income tax [line 22 of Schedule J (Form 1040)]		$15,248
Alternative minimum tax		
Tentative minimum tax (line 26 of Form 6251)	$31,899	
Less regular income tax (line 27 of Form 6251)	15,248	16,651
Total income tax liability		$31,899

Their 1999 AMT credit resulting from their 1998 AMT liability before and after income averaging is as follows:

	Before	*After*
Tentative minimum tax on exclusion items (line 13 of Form 8801)	$17,980	$17,980
Regular tax for 1998 (line 27 of 1998 Form 6251)	22,957	15,248
Net minimum tax on exclusion items (line 15 of Form 8801)	$ -0-	$ 2,732
1998 AMT (line 16 of Form 8801)	$ 8,942	$16,651
Net minimum tax on exclusion items (line 17 of Form 8801)	$ -0-	$ 2,732
Minimum tax credit (line 18 of Form 8801)	$ 8,942	$13,919

Therefore, income averaging increased the Fields' AMT credit carried to 1999 by $13,919 – $8,942 = $4,977.

> **Practitioner Note.** It could be argued that the comment in the committee report 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, the Fields' regular tax liability would decrease by $7,709 but their alternative minimum tax liability would remain at $8,942 in the previous example.

Section 604 of the Senate amendment of HR 2488, which was followed in the conference agreement, adds the following new paragraph to I.R.C. §55(c):

> (2) Coordination with income averaging for farmers. Solely for purposes of this section, §1301 (relating to averaging of farm income) shall not apply in computing regular tax.

HR 2488, as passed by Congress (but not signed by President Clinton), also phases out the AMT beginning in 2005. It is fully phased out for tax years beginning after 2007.

ISSUES ON 1999 SCHEDULE J (FORM 1040)

The instructions for lines 5, 9, and 13 tell the taxpayer to enter taxable income from the taxpayer's 1996, 1997, and 1998 Forms 1040, respectively. Those instructions appear to be in error for taxpayers who filed Schedule J (Form 1040) in 1998. If the 1998 Schedule J was filed the amounts from lines 11, 15, and 3, respectively, of the 1998 Schedule J (Form 1040) would be the correct figures to report on lines 5, 7, and 13 of the 1999 Schedule J.

The instructions for line 22 state that the taxpayer does not qualify for income averaging and cannot file Schedule J (Form 1040) if income averaging does not reduce the tax liability. That instruction will prevent a taxpayer from using the income averaging rules to do the following income tax planning:

1. Elect income averaging in 1999 to empty the 1999 15% bracket
2. Elect income averaging in 2000, 2001, and/or 2002 to move income from a higher bracket in those years into the 1999 15% bracket (and the bracket of two other prior years)

Example 1.3. Sue S. Canal had $14,000 of taxable income in 1996, 1997, and 1998 because she is building up a herd of goats. In 1999 she sold a champion billy goat and had $25,000 of taxable income. She plans to sell very few animals in 2000 and 2001 and therefore expects her taxable income to be about zero in those years. In 2002 she will have several animals ready for sale and expects about $100,000 in taxable income.

Question 1.3.1. *Will income averaging in 1999 reduce Sue's income taxes?*

Answer 1.3.1. Yes, but not in 1999. If Sue's predictions are accurate, income averaging in 1999 will empty her 15% bracket so that an income averaging election in 2002 will move income from her 28% and 31% brackets in 2002 to her 15% bracket in 1999, 2000, and 2001. If she does not income-average in 1999, one-third of her elected farm income from 2002 will be moved into her 28% bracket for 1999 instead of her 15% bracket. Therefore, income averaging in 1999 will reduce her tax liability in 2002.

Question 1.3.2. *Is Sue allowed to income-average in 1999?*

Answer 1.3.2. The instructions for line 22 of the 1999 Schedule J (Form 1040) say that she does not qualify for income averaging and cannot file Schedule J (Form 1040). However, that instruction appears to be contrary to I.R.C. §1301, which states:

> At the election of an individual engaged in a farming business, the tax imposed by section 1 for such taxable year shall be equal to the sum of–

1. A tax computed under such section on taxable income reduced by elected farm income, plus
2. The increase in tax imposed by section 1 which would result if taxable income for each of the three prior taxable years were increased by an amount equal to one-third of the elected farm income.

> **Practitioner Note.** Since the election to use income averaging must be made when the tax return is filed (see "Making, Changing, or Revoking the Election" below), taxpayers may want to follow I.R.C. §1301 rather than the line 22 instructions and file Schedule J (Form 1040) to preserve that election.

MAKING, CHANGING, OR REVOKING THE ELECTION

The committee report says that an election shall be made in the manner prescribed by the Secretary of the Treasury and except as provided by the Secretary, shall be irrevocable. IRS Publication 553 for 1998 says that an election can be made, changed, or revoked only if there is another change on the tax return.

Example 1.4. Jim Nastics sold 100 raised beef cows for $50,000 in 1998 because of a drought. On his 1998 income tax return, he made the I.R.C. §1033(e) election to roll the gain into replacement cows. Since the $50,000 gain was not recognized in 1998, he did not need the income averaging election and did not make the election.

In 2000, Jim decided not to replace the cows and therefore filed an amended return for 1998 to report the $50,000 of gain. Since there is another change on his 1998 return, Jim is allowed to make the income averaging election on the amended return.

ELIGIBLE TAXPAYERS

A taxpayer who has farm income during the tax year as an individual, a partner in a partnership, a member of an LLC, or a shareholder in an S corporation can elect income averaging for that tax year. **It does not matter whether or not the taxpayer was engaged in farming in any prior year.** A beneficiary of an estate or trust is not treated as being engaged in farming through the trust or estate.

Corporations, partnerships, LLCs, estates, and trusts cannot use farm income averaging.

The instructions for the 1998 Schedule J (Form 1040) do not include Form 4835 in the list of forms on which farm income and deductions are generally reported. Forthcoming regulations are likely to say that a non-materially participating landowner's rental income is not eligible for averaging.

The regulations are likely to leave open the question of whether rental income from a materially participating landowner is eligible for averaging. The instructions for the 1998 Schedule J (Form 1040) indicate that materially participating landowners can use income averaging. They include Schedule F (Form 1040) in the list of forms on which farm income and deductions are generally reported without any exception of materially participating landowners.

ELIGIBLE INCOME

Income that is eligible for the income averaging election is any income that is attributable to a farm business. Farm business has the meaning given such term by I.R.C. §263A(e)(4), which states:

> The term "farming business" shall include the trade or business of –
>
> (i) operating a nursery or sod farm, or
>
> (ii) the raising or harvesting of trees bearing fruit, nuts, or other crops, or ornamental trees.
>
> For purposes of clause (ii), an evergreen tree which is more than 6 years old at the time severed from the roots shall not be treated as an ornamental tree.

Observation. A taxpayer who has eligible farm income can use the income averaging rules to level out an increase in income from another source.

Example 1.5. Amanda Reckonwith has farm income that puts her within $10,000 of the top of the 28% bracket every year. In 1999 she has $40,000 of off-farm income in addition to her normal farm income. She could elect to average $30,000 of her farm income, which would have the effect of spreading the off-farm income evenly over four tax years (1996–1999).

Gains from the Sale of Property

Gains from the sale of property (other than land and timber) that is used regularly for a substantial period in the farming business are eligible for income averaging.

Farm liquidation. Property sold in the liquidation of a farm business will be treated as property used in the farming business if it is sold within one year from the time farming operations stop.

No safe harbor. There is no safe harbor for "substantial period." Publication 553 states, "Whether the property has been regularly used for a substantial period depends on all the facts and circumstances."

Land. There are two possible interpretations of the term "land" as used in the income averaging rules:

1. It could be interpreted to include improvements that are permanently attached to the land, such as buildings, fences, and tile lines. Therefore, gain from buildings, fences, and tile lines would not be eligible income. This interpretation is consistent with the definition of "land" under most state laws.
2. However, the Joint Committee on Taxation interpreted the term "land" to mean only the bare soil and not the improvements on the soil when that term was used in I.R.C. §483(e) to allow a 6% imputed rate for sales of land between family members. If this interpretation is used for the income averaging rules, then the gain from buildings, fences, and tile lines would be eligible income.

Practitioner Note. The IRS has never enforced the Joint Committee on Taxation interpretation of the term "land" for purposes of the imputed interest rules and may not use that interpretation for the income averaging rules.

ALLOCATION OF ORDINARY INCOME AND CAPITAL GAINS

Capital Gains in Elected Farm Income

Forthcoming regulations are likely to state that the taxpayer can choose how much of the elected farm income is made up of capital gains.

Example 1.6. Paige Turner files as a single taxpayer and has $50,000 of taxable income in 1999, of which $15,000 is ordinary income from her Schedule F (Form 1040) and $30,000 is gain from the sale of farm assets that are reported on Form 4797 and qualify for capital gains treatment.

Paige wants to elect $24,000 of her 1999 farm income for income averaging. Paige can choose to include all $15,000 of the ordinary income and $9,000 of the capital gains in the elected farm income. Alternatively, Paige can choose to include $24,000 of capital gains or any other combination that adds to $24,000.

Observation. Since the maximum tax rate for capital gains is 28% for 1996, taxpayers who are in the 28% bracket in both 1999 and 1996 will be moving capital gains from the 20% maximum bracket in 1999 to the 28% maximum bracket in 1996 if they include capital gains in elected farm income.

Allocation of Capital Gain to Prior Years

If the elected farm income includes both ordinary income and capital gains, they must be allocated in equal portions among the tax brackets of the three prior years.

Example 1.7. If Paige Turner from the previous example chooses to include $15,000 of ordinary income and $9,000 of capital gains in her elected farm income for 1999, she must put $5,000 of ordinary income and $3,000 of capital gains in the tax brackets for each of the three prior years.

Capital Losses in Prior Years

Capital gains that are included in the tax bracket of a prior year do not offset capital losses from that year. They are taxed at the lesser of the capital gains rate for the prior year or the ordinary income tax rate for the prior year.

Example 1.8. Paige Turner from the previous example had a $10,000 net capital loss for 1996 and taxable income of $20,000. She does not reduce the $10,000 capital loss by the $3,000 of capital gains that are moved from her 1999 tax bracket to her 1996 tax bracket. Instead, she pays tax on the $3,000 of capital gains at the lesser of the 28% rate for capital gain in 1996 or her ordinary income tax rate.

I.R.C. §1231 Netting

The netting of gains and losses from the sale of I.R.C. §1231 property is done before the income is reduced by the elected farm income. Therefore, if §1231 gain is moved out of the tax bracket of the income averaging year, it does not affect the character of the §1231 gains and losses that are left in the tax bracket of the income averaging year.

Example 1.9. Assume Paige Turner from the previous example had $25,000 of losses from the sale of nonfarm §1231 assets in 1999. When those losses are netted with her $30,000 of §1231 gain from farm property, she has a net $5,000 §1231 gain. Therefore, her §1231 gains and losses for 1999 are all characterized as long-term capital gains and losses. The income averaging election does not change that result even though $9,000 of §1231 gain is moved out of the 1999 tax bracket.

Practitioner Note. The previous example raises an unanswered question. Can Paige elect to include $9,000 of §1231 gain in her elected farm income when her net §1231 gain is only $5,000?

CHANGE IN FILING STATUS

If the taxpayer's filing status has changed between one or more of the prior years and the election year, the taxpayer uses the status that was in effect for each of the years.

Example 1.10. If Paige Turner from the previous examples (who filed single in 1999) was married and filed jointly in the prior years, she simply adds one-third of her elected farm income to the taxable income shown on her joint return for each prior year and uses the married filing jointly tax rates to calculate the added tax from each prior tax year's brackets.

EFFECT OF INCOME AVERAGING ON NET OPERATING LOSSES

NOL Carryovers to Election Year

NOL carryovers to the election year are applied to the election year income before the elected farm income is subtracted.

Example 1.11. Allen Wrench had a $30,000 NOL carryover to 1999 that reduced his taxable income for 1999 to $50,000. Allen can use no more than $50,000 as elected farm income in 1999. His elected farm income is subtracted from the $50,000 to compute his tax liability using income averaging.

NOL Carryovers to Prior Years

An NOL that was carried to a prior year does not offset the elected farm income that is carried to the tax bracket for that year.

Example 1.12. Tommy Gunn had $20,000 of taxable income in 1998 before subtracting a $45,000 NOL carryover to 1998. The NOL carryover reduces his taxable income to zero. Tommy's modified taxable income in 1998 is $32,000, so his NOL carryover to 1999 is $13,000 ($45,000 – $32,000). Tommy elects to treat $60,000 as elected farm income in 1999. The $20,000 (one-third of $60,000) of elected farm income that is carried to the 1998 tax brackets is not offset by the $25,000 of unused NOL in 1998 and does not change the NOL absorption calculation. The $20,000 is added to Tommy's zero 1998 taxable income for purposes of the income averaging tax calculation.

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 1.13. Mary and Gary have two children and file a joint tax return. In November 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.

INCORRECT LETTERS ON SCHEDULE J TAX CALCULATION

On May 28, 1999, the IRS issued the following announcement.

> Some taxpayers who filed Schedule J, Farm Income Averaging, with their return may have mistakenly received letters from IRS stating that they figured or entered their tax incorrectly on their returns. The letters (CP-11, 12 or 13) refer to Math Error Code 181. In these cases, the IRS figured the tax incorrectly because the Schedule J tax calculation was not processed.
>
> Taxpayers who filed Schedule J with their return and received a letter from IRS informing them of a change to their tax amount should contact the IRS to request an adjustment to their accounts. Contact the toll-free customer service line at 1-800-829-8815 or write to the IRS at the address on the letter. Taxpayers responding via telephone should have a copy of the Schedule J available to fax to the IRS. Taxpayers submitting a letter to the IRS should include a copy of Schedule J to expedite processing of their claim.

ISSUE 2: FARM NOLS—FIVE-YEAR CARRYBACK RULES

1997 LEGISLATION

The Taxpayer Relief Act of 1997 changed the carryback period for NOLs from 3 years to 2 years, with some exceptions, and the carryforward period from 15 years to 20 years. One of the exceptions to the two-year carryback rule applies to farmers who have a net operating loss attributable to a presidentially declared disaster area.

1998 LEGISLATION

The Trade Extension Relief Act of 1998 created a 5-year carryback for farming NOLs by adding a new I.R.C. §172(b)(1)(G) and 172(i). They are as follows:

> (G) Farming losses. In the case of a taxpayer which has a farming loss (as defined in subsection (i)) for a taxable year, such farming loss shall be a net operating loss carryback to each of the 5 taxable years preceding the taxable year of such loss.
>
> * * *
>
> **(i) Rules relating to farming losses.**
>
> For purposes of this section–
>
> **(1) In general.**
>
> The term "farming loss" means the lesser of–
>
> > (A) The amount which would be the net operating loss for the taxable year if only income and deductions attributable to farming businesses (as defined in section 263A(e)(4)) are taken into account, or
> >
> > (B) The amount of the net operating loss for such taxable year.
>
> **(2) Coordination with subsection (b)(2).**
>
> For purposes of applying subsection (b)(2), a farming loss for any taxable year shall be treated in a manner similar to the manner in which a specified liability loss is treated.
>
> **(3) Election.**
>
> Any taxpayer entitled to a 5-year carryback under subsection (b)(1)(G) from any loss year may elect to have the carryback period with respect to such loss year determined without regard to subsection (b)(1)(G). Such election shall be made in such manner as may be prescribed by the Secretary and shall be made by the due date (including extensions of time) for filing the taxpayer's return for the taxable year of the net operating loss. Such election, once made for any taxable year, shall be irrevocable for such taxable year.

The Trade Extension Relief Act of 1998 also added a phrase at the end of I.R.C. §172(b)(1)(F), so that it now reads as follows:

> **(ii) Eligible loss.** For purposes of clause (i), the term "eligible loss" means–
>
> > (I) in the case of an individual, losses of property arising from fire, storm, shipwreck, or other casualty, or from theft,

(II) in the case of a taxpayer which is a small business, net operating losses attributable to Presidentially declared disasters (as defined in section 1033(h)(3)), and

(III) in the case of a taxpayer engaged in the trade or business of farming (as defined in section 263A(e)(4)), net operating losses attributable to such Presidentially declared disasters.

Such term shall not include any farming loss (as defined in subsection (i)).

Observation. While there is technically still a 3-year carryback rule for a farmer's NOLs attributable to a presidentially declared disaster area, as a practical matter, there will be no losses that fall into that category since the term "eligible loss" for purposes of the 3-year carryback cannot include any farming loss.

Therefore farmers have the following options with respect to farm NOLs:

1. **Carry them back 5 years, or**
2. **Forgo the 5-year carryback and carry them back 2 years, or**
3. **Forgo the 5-year and the 2-year carryback and carry them forward 20 years.**

Practitioner Note. If a taxpayer has both farm and nonfarm NOLs, an election to forgo the 2-year carryback of the non-farm NOLs apparently does not preclude carrying the farm NOLs back 5 years.

Example 2.1. Clarence Jacobs raises wheat and runs a stained-glass business in Oklahoma. In 1999 he suffered a loss in both businesses. His wife, Betty, is a nurse. In 1999 they had the following income and deductions:

Income	
Wages (line 7 of Form 1040)	$ 20,000
Taxable Interest (line 8a of Form 1040)	5,500
Schedule C (line 12 of Form 1040)	(30,000)
Schedule F (line 18 of Form 1040)	(70,000)
Adjusted gross income (line 33 of Form 1040)	$(74,500)
Standard deduction (line 36 of Form 1040)	7,200
Personal exemption deduction (line 38 of Form 1040)	11,000
Taxable income (line 39 of Form 1040)	$(92,700)

Clarence and Betty have an $80,000 NOL for 1999. Code §172(i)(1) defines "farming loss" as the lesser of:

A. the amount which would be the net operating loss for the taxable year if only income and deductions attributable to farming businesses (as defined in section 263A(e)(4)) are taken into account, or

B. the amount of the net operating loss for such year.

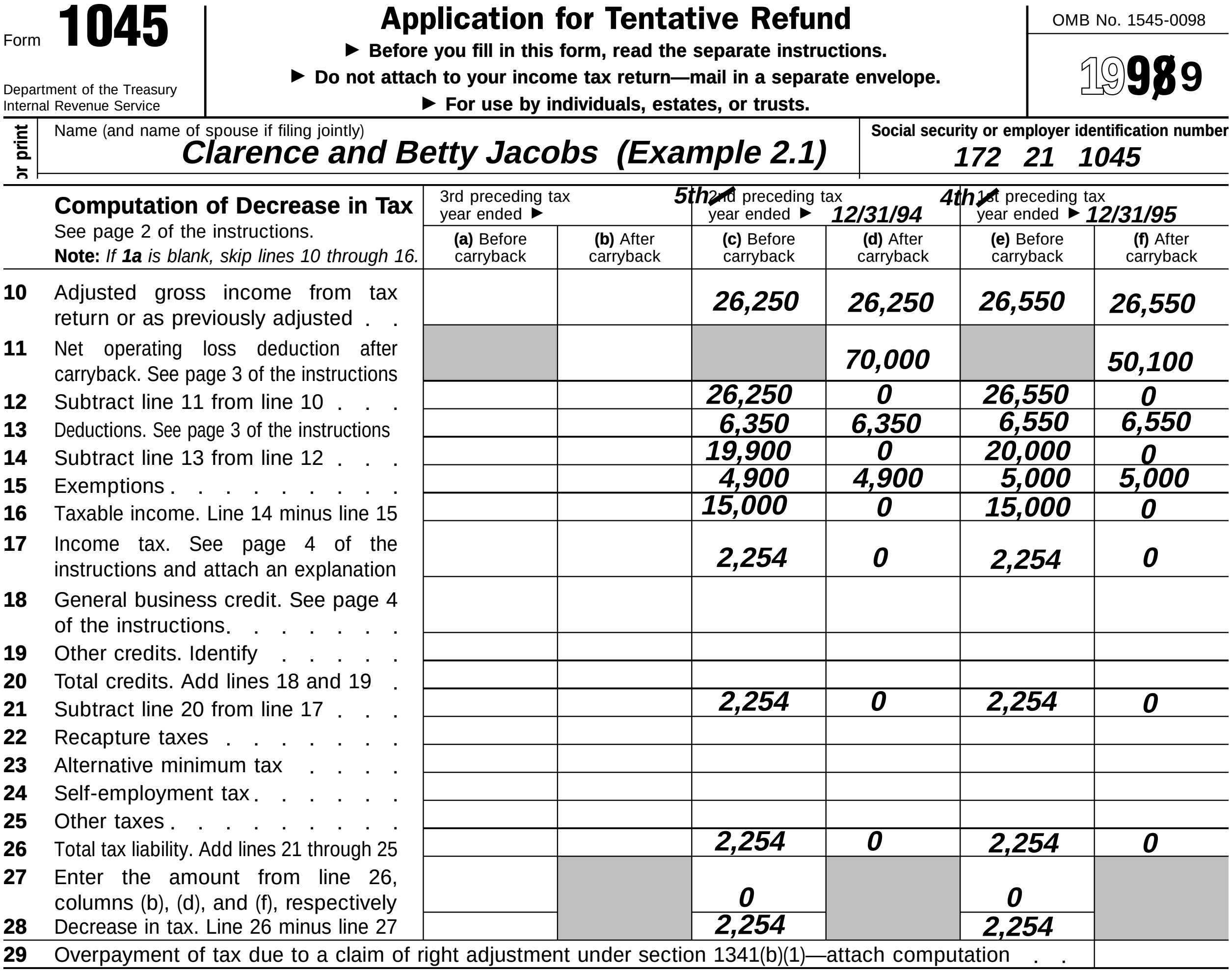
If only income and deductions attributable to Clarence's farm business are taken into account, the Jacobs' NOL is $70,000. Therefore, only $10,000 of the NOL is allocated to the stained-glass business. Clarence and Betty have the following options for carrying their NOL back:

1. Carry the $70,000 farm loss back 5 years and the $10,000 stained-glass loss back 2 years.

2. Carry the whole $80,000 loss back 2 years.
3. Carry the $70,000 farm loss back 5 years and do not carry the $10,000 stained-glass loss back. (Carry the $10,000 stained-glass loss forward only.)
4. Do not carry any of the $80,000 loss back. (Carry the whole $80,000 NOL forward only.)

> **Observation.** If Clarence's loss from his stained-glass business had been only $10,000 instead of $30,000, the Jacobs' NOL would have been only $60,000. In that case, the farm NOL would be $60,000 and there would be no stained-glass business NOL.

Example 2.2. Assume that Clarence and Betty from the previous example have $15,000 of taxable income for each of the 5 years prior to 1999. If they do not elect to forgo the NOL carrybacks, they must carry the $70,000 farm NOL back 5 years and the $10,000 stained-glass business NOL back 2 years, as shown on the following Form 1045.



Form **1045**

Department of the Treasury
Internal Revenue Service

Application for Tentative Refund

▶ Before you fill in this form, read the separate instructions.
▶ Do not attach to your income tax return—mail in a separate envelope.
▶ For use by individuals, estates, or trusts.

OMB No. 1545-0098

199~~8~~9

or print

Name (and name of spouse if filing jointly): Clarence and Betty Jacobs (Example 2.1)

Social security or employer identification number: 172 21 1045

	Computation of Decrease in Tax See page 2 of the instructions. **Note:** *If **1a** is blank, skip lines 10 through 16.*	3rd preceding tax year ended ▶		5th ~~2nd~~ preceding tax year ended ▶ 12/31/94		4th ~~1st~~ preceding tax year ended ▶ 12/31/95	
		(a) Before carryback	**(b)** After carryback	**(c)** Before carryback	**(d)** After carryback	**(e)** Before carryback	**(f)** After carryback
10	Adjusted gross income from tax return or as previously adjusted			26,250	26,250	26,550	26,550
11	Net operating loss deduction after carryback. See page 3 of the instructions				70,000		50,100
12	Subtract line 11 from line 10			26,250	0	26,550	0
13	Deductions. See page 3 of the instructions			6,350	6,350	6,550	6,550
14	Subtract line 13 from line 12			19,900	0	20,000	0
15	Exemptions			4,900	4,900	5,000	5,000
16	Taxable income. Line 14 minus line 15			15,000	0	15,000	0
17	Income tax. See page 4 of the instructions and attach an explanation			2,254	0	2,254	0
18	General business credit. See page 4 of the instructions						
19	Other credits. Identify						
20	Total credits. Add lines 18 and 19						
21	Subtract line 20 from line 17			2,254	0	2,254	0
22	Recapture taxes						
23	Alternative minimum tax						
24	Self-employment tax						
25	Other taxes						
26	Total tax liability. Add lines 21 through 25			2,254	0	2,254	0
27	Enter the amount from line 26, columns (b), (d), and (f), respectively			0		0	
28	Decrease in tax. Line 26 minus line 27			2,254		2,254	
29	Overpayment of tax due to a claim of right adjustment under section 1341(b)(1)—attach computation						

Schedule B—Net Operating Loss Carryover. See the instructions beginning on page 4.

	Complete one column before going to the next column.	**(a)** 3rd preceding tax year ended ▶		**(b)** ~~2nd~~ 5th preceding tax year ended ▶12/31/94		**(c)** ~~1st~~ 4th preceding tax year ended ▶12/31/95	
1	**Net operating loss deduction** from Form 1045, line 11, on page 1 . .				*70,000*		*50,100*
2	Taxable income from tax return (or as previously adjusted) before ~~1998~~ *1999* NOL carryback. See page 5 of the instructions			*15,000*		*15,000*	
3	Net capital loss deduction. See page 5 of the instructions			*0*		*0*	
4	Adjustments to adjusted gross income. See page 5 of the instructions			*0*		*0*	
5	Adjustment to itemized deductions. See page 5 of the instructions . .			*0*		*0*	
6	Deduction for exemptions from tax return (or as previously adjusted). Estates and trusts, enter exemption amount			*4,900*		*5,000*	
7	Modified taxable income. Combine lines 2 through 6. If zero or less, enter -0-				*19,900*		*20,000*
8	**Net operating loss carryover.** Subtract line 7 from line 1. If zero or less, enter -0-. See page 5 of the instructions				*50,100*		*30,100*

Form **1045**

Department of the Treasury
Internal Revenue Service

Application for Tentative Refund

► **Before you fill in this form, read the separate instructions.**
► **Do not attach to your income tax return—mail in a separate envelope.**
► **For use by individuals, estates, or trusts.**

OMB No. 1545-0098

199~~8~~9

r print

Name (and name of spouse if filing jointly): *Clarence and Betty Jacobs (Example 2.1)*

Social security or employer identification number: *172 21 1045*

Computation of Decrease in Tax See page 2 of the instructions. **Note:** *If **1a** is blank, skip lines 10 through 16.*	3rd preceding tax year ended ► *12/31/96*		2nd preceding tax year ended ► *12/31/97*		1st preceding tax year ended ►	
	(a) Before carryback	**(b)** After carryback	**(c)** Before carryback	**(d)** After carryback	**(e)** Before carryback	**(f)** After carryback
10 Adjusted gross income from tax return or as previously adjusted	*26,800*	*26,800*	*27,200*	*27,200*		
11 Net operating loss deduction after carryback. See page 3 of the instructions	▨	*30,100*	▨	*20,000*	▨	
12 Subtract line 11 from line 10	*26,800*	*0*	*27,200*	*7,200*		
13 Deductions. See page 3 of the instructions	*6,700*	*6,700*	*6,900*	*6,900*		
14 Subtract line 13 from line 12	*20,100*	*0*	*20,300*	*300*		
15 Exemptions	*5,100*	*5,100*	*5,300*	*5,300*		
16 Taxable income. Line 14 minus line 15	*15,000*	*0*	*15,000*	*0*		
17 Income tax. See page 4 of the instructions and attach an explanation	*2,254*	*0*	*2,254*	*0*		
18 General business credit. See page 4 of the instructions						
19 Other credits. Identify						
20 Total credits. Add lines 18 and 19						
21 Subtract line 20 from line 17	*2,254*	*0*	*2,254*	*0*		
22 Recapture taxes						
23 Alternative minimum tax						
24 Self-employment tax						
25 Other taxes						
26 Total tax liability. Add lines 21 through 25	*2,254*		*2,254*	*0*		
27 Enter the amount from line 26, columns (b), (d), and (f), respectively	*0*	▨	*0*	▨		▨
28 Decrease in tax. Line 26 minus line 27	*2,254*	▨	*2,254*	▨		▨

Form 1045 (~~1998~~) 1999 **Clarence and Betty Jacobs (Example 2.1)** Page **3**

Schedule B—Net Operating Loss Carryover. See the instructions beginning on page 4.

Complete one column before going to the next column.	**(a)** 3rd preceding tax year ended ▶ 12/31/96		**(b)** 2nd preceding tax year ended ▶ 12/31/97		**(c)** 1st preceding tax year ended ▶ 12/31/98	
1 **Net operating loss deduction** from Form 1045, line 11, on page 1 . .		*30,100*		*20,000**		
2 Taxable income from tax return (or as previously adjusted) before ~~1998~~ 1999 NOL carryback. See page 5 of the instructions	*15,000*		*15,000*			
3 Net capital loss deduction. See page 5 of the instructions	*0*		*0*			
4 Adjustments to adjusted gross income. See page 5 of the instructions	*0*		*0*			
5 Adjustment to itemized deductions. See page 5 of the instructions . .	*0*		*0*			
6 Deduction for exemptions from tax return (or as previously adjusted). Estates and trusts, enter exemption amount	*5,100*		*5,300*			
7 Modified taxable income. Combine lines 2 through 6. If zero or less, enter -0-		*20,100*		*20,300*		
8 **Net operating loss carryover.** Subtract line 7 from line 1. If zero or less, enter -0-. See page 5 of the instructions		*10,000*		*0*		

*$10,000 farm NOL remaining after carryback from 1999 to 1994, 1995, and 1996 plus $10,000 nonfarm NOL carried back from 1999.

ISSUE 3: EARNED INCOME TAX CREDIT

1996 LEGISLATIVE CHANGE

The Welfare Reform Act of 1996 expanded the definition of "disqualified income" to include, among other things, "capital gain net income." The effect of this expansion is to disqualify more taxpayers from claiming the earned income credit. The committee reports indicate that Congress expanded the definition of disqualified income because it is a proxy for determining the taxpayer's assets that could be liquidated to pay living expenses as an alternative to receiving the earned income credit. Congress reasoned that gains from the sale of passive investments should be included in the category of "disqualified income."

The IRS originally interpreted the term "capital gain net income" to include some gains from the sale of assets used in a trade or business, such as land, buildings, equipment, and livestock. The gains included by the IRS interpretation are those from the sale of assets that:

1. Satisfy the holding-period requirement of I.R.C. §1231 (more than a year for most assets, 12 months or more for livestock other than cattle and horses, and 24 months for cattle and horses) and
2. Are not subject to the recapture rules of I.R.C. §1245 (depreciation recapture on personal property), §1250 (depreciation recapture on real property), §1252 (recapture of soil and water conservation expenses), §1254 (recapture of depletion), or §1255 (recapture of excluded cost sharing expenses).

1998 RULING

In Rev. Rul. 98-56, issued in November 1998, the IRS announced that it was reversing its position. That revenue ruling stated:

> Section 32 of the Internal Revenue Code allows an earned income credit to eligible individuals whose income does not exceed certain limits. Section 32(i) denies the earned income credit to an otherwise eligible individual if the individual's "disqualified income" exceeds a specified level for the taxable year for which the credit is claimed. Disqualified income is income specified in section 32(i)(2). Gain that is treated as long-term capital gain under section 1231(a)(1) is not disqualified income for purposes of section 32(i).

Practitioner Note. Although the example most often used for this issue is culled dairy cows, the problem and the IRS solution apply to all long-term capital gains under I.R.C. §1231. Therefore, gain from the sale of sows and boars, horses, beef cattle, and equipment that are §1231 property are covered by the new IRS position.

1999 ANNOUNCEMENTS

On May 6, 1999, the IRS released IR-99-46 (reprinted below), which announced that Rev. Rul. 98-56 had come out so late that the Form 4797 instructions did not reflect the change and the IRS computers had not been reprogrammed to accommodate the change. Consequently, taxpayers were erroneously being denied the earned income credit.

> **IRS Communications Center**
>
> **IR-99-46:**
>
> **IRS MOVES TO CORRECT EITC REJECTIONS FOR DAIRY FARMERS, BUSINESS OWNERS**
>
> WASHINGTON – The Internal Revenue Service announced Thursday that it is taking steps to correct instances where the Earned Income Tax Credit (EITC) has been improperly denied to some taxpayers with investment income exceeding $2,300 for tax year 1998.
>
> The exact number of EITC claims affected is unclear at this point, but the IRS believes it is a relatively small number.
>
> The error involves EITC claims made by some taxpayers using Form 4797, Sales of Business Property. This category includes some dairy farmers who sold culled cows, farming equipment and other business assets.
>
> In the past, dairy farmers and others with gains from selling business assets frequently found themselves with too much investment income to qualify for the EITC. But in November, the IRS announced Revenue Ruling 98-56 (Internal Revenue Bulletin No. 1998-47), which allowed taxpayers to exclude in EITC calculations any investment income involving gains from selling business assets – a switch that allowed more business owners and farmers to qualify for EITC.
>
> Following the late change, IRS computers could not be reprogrammed in time to recognize the EITC revision for 1998. In addition, the directions for Form 4797 had already been printed and did not reflect the changes. The combination of factors led to some taxpayers being erroneously denied EITC claims.
>
> If taxpayers who used Form 4797 have received a notice that their investment income disqualified them from EITC, they should notify the contact person or office listed on the notice to correct the problem. Taxpayers can also reach the IRS toll-free help line at 1-800-829-1040 and say they are calling about disqualified income on Form 4797 for EITC purposes.
>
> The IRS will expedite processing for people who received erroneous notices.

The IRS is also moving on several fronts to correct the problem:

IRS Service Centers have taken corrective steps to prevent improper EITC denials involving Form 4797. IRS employees who process returns have been alerted to manually compute taxpayers' investment income to ensure these EITC claims will not be rejected.

Taxpayers and tax practitioners are being alerted to EITC problems.

Additional details regarding EITC and investment income will be posted on the IRS Internet site at www.irs.ustreas.gov. The information will be available on the "Tax Professional's Corner" under the "News for the Tax Professional" section. The Tax Professional's Corner can be reached via the "Tax Info for Business" section on the IRS home page.

The IRS will review how to make this area clearer in several documents, including Publication 596, Earned Income Credit, and the EITC Worksheet.

In addition, the IRS reminds taxpayers with investment income they may still be eligible for EITC for two previous years. **Taxpayers who were otherwise eligible to claim the EITC on 1996 or 1997 returns -- but had too much investment income on the Form 4797 calculation due to the sale of business assets -- may still claim a refund.**

These taxpayers must file an amended return on Form 1040X for each of the years that the new calculation lowers their investment income below the limit for that year. The limit is $2,200 for 1996 and $2,250 for 1997. Although these gains are now excluded from EITC calculations, the gains are still included in the taxpayer's total income figure.

Also on May 6, 1999, the IRS posted the following on its web page.

IRS Moves to Correct EITC Rejections for Dairy Farmers

Some dairy farmers and others who filed Form 4797, Sales of Business Property, and claimed the Earned Income Tax Credit (EITC), have received erroneous math error notices saying they were ineligible for the credit. The IRS sent out the erroneous error notices in response to certain returns with a combination of Form 4797, Earned Income Tax Credit, and in some cases, Schedule J (Farm Income Averaging).

Practitioners with clients who received a math error notice on this issue should either call or write to the IRS.

- Call the number listed on the notice. This option should result in quicker resolution. Have a copy of the notice, a copy of the tax return, and a power of attorney that may need to be faxed to IRS. Indicate to the assistor that the notice relates to Disqualified Income (from Culled Cows) on Form 4797 for EITC Purposes. If the taxpayer otherwise qualifies for EITC, the assistor may be able to make an on-line adjustment to the taxpayer's account and issue a notice that the correction has been made and a refund is being issued.
- Respond by mail, sending a letter re: "Disqualified Income (from Culled Cows) on Form 4797 for EITC Purposes." Indicate the taxpayer received a math error notice incorrectly computing investment income and disallowing EITC (and income averaging, if applicable). Include a power of attorney, a copy of the math error notice, and copies of all applicable schedules filed with the return, including Form 4797, Schedule EIC, Schedules C, F, and D, and Schedule J. Mark "COPY – DO NOT PROCESS" at the top of each form submitted; do not send a copy of the complete return. An amended return should not be filed unless there are other changes. Mail the documents to the address on the notice (the Service Center that processed the taxpayer's return).

IRS has sent alerts to all Service Centers to: (1) establish procedures for customer service representatives to recognize returns affected by the erroneous notices, and (2) correct the calculations so that income from the sale of culled cows is excluded from investment income and excluded from the EITC computations.

IRS also is reminding farmers who reported income from the sale of culled cows in previous years that they may still be eligible for EITC. Taxpayers who were otherwise eligible to claim EITC on 1996 or 1997 returns, but had too much investment income because of the Form 4797 calculation due to the sale of business assets, may still claim a refund. These taxpayers should file an amended return on Form 1040X to claim their refunds. Refer to "Disqualified Income (from Culled Cows) on Form 4797 for EITC Purposes" in Part II, Explanation of Changes to Income, Deductions and Credits, of Form 1040X.

Example 3.1. Willie and Annette Jump were denied the earned income tax credit in 1997 because they had $8,166 of income from the sale of culled cows, as shown on the following Form 4797. In 1997, they had $19,300 of adjusted gross income, of which $10,179 was earned income.

Willie and Annette can file the following Form 1040X to claim their $2,962 earned income credit for 1997.

Form **1040X**
(Rev. November 1998)

Department of the Treasury—Internal Revenue Service

Amended U.S. Individual Income Tax Return

▶ **See separate instructions.**

OMB No. 1545-0091

(Example 3.1)

This return is for calendar year ▶ 1997 , OR fiscal year ended ▶ , 19 .

Please print or type

Your first name and initial *Willie*	Last name *Jump*	**Your social security number** *001 32 4797*
If a joint return, spouse's first name and initial *Annette*	Last name *Jump*	**Spouse's social security number** *002 32 4797*
Home address (no. and street) or P.O. box if mail is not delivered to your home	Apt. no.	Telephone number (optional) ( )
City, town or post office, state, and ZIP code. If you have a foreign address, see page 2 of the instructions.		**For Paperwork Reduction Act Notice, see page 6.**

A If the name or address shown above is different from that shown on the original return, check here . . . . . . ▶ ☐

B Has the original return been changed or audited by the IRS or have you been notified that it will be? . . ☐ **Yes** ☒ **No**

C Filing status. Be sure to complete this line. **Note:** *You cannot change from joint to separate returns after the due date.*

On original return ▶ ☐ Single ☒ Married filing joint return ☐ Married filing separate return ☐ Head of household ☐ Qualifying widow(er)

On this return ▶ ☐ Single ☒ Married filing joint return ☐ Married filing separate return ☐ Head of household* ☐ Qualifying widow(er)

* If the qualifying person is a child but not your dependent, see page 2.

USE PART II ON THE BACK TO EXPLAIN ANY CHANGES		**A. Original amount** or as previously adjusted (see page 2)	**B. Net change—** amount of increase or (decrease)— explain in Part II	**C. Correct amount**
Income and Deductions (see pages 2–5)				
1 Adjusted gross income (see page 3)	1			
2 Itemized deductions or standard deduction (see page 3)	2			
3 Subtract line 2 from line 1	3			
4 Exemptions. If changing, fill in Parts I and II on the back	4			
5 Taxable income. Subtract line 4 from line 3	5	*0.*		*0.*
Tax Liability				
6 Tax (see page 4). Method used in col. C	6			
7 Credits (see page 4)	7			
8 Subtract line 7 from line 6. Enter the result but not less than zero	8			
9 Other taxes (see page 4)	9			
10 Total tax. Add lines 8 and 9	10	*137.*		*137.*
Payments				
11 Federal income tax withheld and excess social security and RRTA tax withheld. If changing, see page 4	11			
12 Estimated tax payments, including amount applied from prior year's return	12			
13 Earned income credit	13	*0.*	*2962.*	*2962.*
14 Additional child tax credit from Form 8812	14			
15 Credits from Form 4136 or Form 2439	15			
16 Amount paid with Form 4868, 2688, or 2350 (applications for extension of time to file)	16			
17 Amount of tax paid with original return plus additional tax paid after it was filed	17			*137.*
18 Total payments. Add lines 11 through 17 in column C	18			*3099.*
Refund or Amount You Owe				
19 Overpayment, if any, as shown on original return or as previously adjusted by the IRS	19			
20 Subtract line 19 from line 18 (see page 4)	20			*3099.*
21 **AMOUNT YOU OWE.** If line 10, column C, is more than line 20, enter the difference and see page 4	21			
22 If line 10, column C, is less than line 20, enter the difference	22			*2962.*
23 Amount of line 22 you want **REFUNDED TO YOU**	23			*2962.*
24 Amount of line 22 you want **APPLIED TO YOUR 19 ESTIMATED TAX** 24				

Part II **Explanation of Changes to Income, Deductions, and Credits**

Enter the line number from the front of the form for each item you are changing and give the reason for each change. Attach only the supporting forms and schedules for the items changed. If you do not attach the required information, your Form 1040X may be returned. Be sure to include your name and social security number on any attachments.

If the change relates to a net operating loss carryback or a general business credit carryback, attach the schedule or form that shows the year in which the loss or credit occurred. See page 1 of the instructions. Also, check here . . . . . . ▶ ☐

An adjustment was made deleting the agricultural capital gains to allow the earned income credit. Refer to Rev. Rul. 98-56

Result: Refund is due to taxpayer.

See attached supporting schedule.

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: *Willie and Annette Jump (Example 3.1)*

Identifying number *001 32 4797*

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	*cows - raised*	*various*	*05/01/97*	*3592.*			*3592.*	*3592.*
	cows - raised	*various*	*12/31/97*	*4574.*			*4574.*	

3	Gain, if any, from Form 4684, line 39	**3**		
4	Section 1231 gain from installment sales from Form 6252, line 26 or 37	**4**		
5	Section 1231 gain or (loss) from like-kind exchanges from Form 8824	**5**		
6	Gain, if any, from line 32, from other than casualty or theft	**6**		
7	Combine lines 2 through 6 in columns (g) and (h). Enter gain or (loss) here, and on the appropriate line as follows:	**7**	*8166.*	*3592.*

ISSUE 4: GETTING OUT OF A FARM BUSINESS

Farm producers often defer income by building up the value of assets for which they do not have to recognize gain. Producers who use cash accounting can postpone the recognition of income on inventory as well as assets held for use in the trade or business.

When it comes time to get out of the farm business, the deferred income must generally be recognized. If the deferred income is all recognized in one tax year, some of it may be pushed into the higher income tax brackets

Example 4.1. Bud Light is ready to retire from farming and wants to sell his farm to his daughter, Dee, who will operate the farming business. Bud owns the following assets with the characteristics listed. The table also shows the gain or loss that must be reported if the asset is sold this year.

Asset	Date Acquired	Cost or Other Beginning Basis	Depreciation Method	Depreciation Claimed	Adjusted Basis	Fair Market Value	Gain or Loss
Land	May 10, 1965	$ 160,000	N/A	-0-	$160,000	$ 640,000	$ 480,000
Grain elevator	May 15, 1995	500,000	ACRS 19 years Accelerated	$ 388,400	111,600	200,000	88,400
Machine shed	June 20, 1991	60,000	MACRS SL 20 years	24,000	36,000	50,000	14,000
Other buildings	May 10, 1965	200,000	SL	200,000	-0-	40,000	40,000
Machinery	Various	600,000	MACRS 150% DB	450,000	150,000	225,000	75,000
Herd of beef cows	January 12, 1995	100,000	MACRS 150% DB	75,010	24,990	150,000	125,010
Beef calves (raised)	March 1998	-0-	N/A	-0-	-0-	50,000	50,000
Grain	Fall 1998	-0-	N/A	-0-	-0-	350,000	350,000
Total		$1,620,000		$1,137,410	$482,590	$1,705,000	$1,222,410

If Bud sold all of his assets in 1999 he would have to report the following income:

	Schedule F	Form 4797 Depreciation Recapture	Form 4797 20% Capital Gain	Form 4797 25% Capital Gain	Total
Land			$480,000		$ 480,000
Grain elevator		$ 88,400			88,400
Machine shed					14,000
				$14,000	
Other buildings				40,000	40,000
Machinery		75,000			75,000
Beef cows		75,010	50,000		125,010
Beef calves	$ 50,000				50,000
Grain	350,000				350,000
Total	$400,000	$238,410	$530,000	$54,000	$1,222,210

Assuming Bud and his wife have no other income and they file a joint return with $20,000 of allowed itemized deductions and two personal exemption deductions, their income and self-employment tax liability for 1999 would be as follows:

Income tax on ordinary income	$214,148
Self-employment tax	19,715
Income tax on 20% capital gains	106,000
Income tax on 25% capital gains	13,500
Total	$353,363

Bud can reduce and postpone his tax liability from the sale of the farm by selling the farm to Dee on a four-year installment contract. However, the tax on the depreciation recapture from the grain elevator, machinery, and beef cows cannot be postponed. Assume the contract calls for a $205,000 down payment in 1999 with the $1,500,000 balance of the purchase price amortized over four years at a 6% interest rate. The following table shows the taxes Bud must pay and his after-tax wealth based on the following assumptions:

1. Bud reinvests the after-tax proceeds from his sale at 6% interest.
2. Bud and his wife consume $50,000 of after-tax income each year.
3. Bud and his wife file a joint return claiming a $20,000 itemized deduction and two personal exemption deductions (1999 rates and deductions are used for all years).

	Outright Sale in 1999		Four-Year Installment Sale	
Year	Taxes	After-Tax Wealth	Taxes	After-Tax Wealth
1999	$353,363	$1,351,637	$ 98,761	$1,606,329
2000	9,971	1,372,764	71,650	1,580,963
2001	10,326	1,394,804	74,227	1,551,594
2002	10,696	1,417,796	76,911	1,517,778
2003	11,082	1,441,782	80,543	1,481,001
Total	$395,438		$402,092	

Observation. At the end of the five-year period, Bud will have $39,219 ($1,481,001 – $1,441,782) more after-tax wealth under the installment sale method even though he pays $6,654 ($402,092 – $395,438) more in taxes. The increase in taxes is more than offset by the increase in income Bud realizes from the interest on the deferred taxes.

THE STORY BEHIND THE NUMBERS

Some of the tax consequences of the installment sale are hidden in the above numbers because they offset each other. The following table reports the breakdown between income taxes and self-employment taxes for the five tax years.

	Sale in One Year	Installment Sale	Change
Income taxes	$375,723	$349,863	$(25,860)
Self-employment taxes	19,715	52,230	32,515
Total	$395,438	$402,092	$ 6,654

It is important to note the following consequences of the installment sale.

1. The net decrease in income taxes is a result of two offsetting tax consequences.
   - **a.** The installment sale moved most of the gain that was reported in the 39.6% and 36% brackets in 1999 to the 15% and 28% brackets in 2000 through 2003. This reduced the income tax liability.
   - **b.** The deferred and reduced income taxes left more money in Bud's hands to earn interest for him. That increase in income increased his income tax liability, which partially offset the decrease in income tax liability from spreading out the sale of the farm assets. A longer installment sale would give Bud more after-tax wealth than the four-year installment sale

because it would move more income to lower tax brackets and defer more taxes. The increased income from the reduced and deferred taxes adds to his after-tax wealth.

Observation. Taxpayers who are in the 28% or higher income tax bracket do not realize a reduction in income taxes from an installment sale of assets that qualify for long-term capital gain treatment since the gain is taxed at 20% whether it is reported all in one year or spread over several years. However, the installment sale postpones the payment of taxes. The taxpayer earns interest (at the contract rate) on the deferred income taxes.

2. The self-employment tax increase under the installment sale is a result of paying the 12.4% social security tax on the $72,600 wage base in each of the five tax years rather than in the one year of the outright sale.

Practitioner Note. Paying the extra self-employment tax may increase Bud's social security benefits by adding years with higher earnings to his base years for calculating benefits.

OTHER PLANNING OPTIONS

There are several other options for Bud to reduce and postpone the taxes he must pay on the sale of his farm.

Sell Only Assets that Trigger Depreciation Recapture

Instead of an installment sale of all of the assets, Bud could first sell the assets for which depreciation recapture must be reported and sell the remaining assets in a later tax year. That is easier to do with the machinery and beef cows than with the grain elevator since they are easier to transfer separately. The grain elevator and the land on which it stands can be sold separately, but that will require a legal description of the separate parcel.

Example 4.2. If Bud sold only the machinery in 1999, he would receive a $225,000 payment and would have to report only $75,000 of ordinary income. He could lease the remaining assets to Dee and sell them in future years.

Gradual Sale of Assets

Bud could lease his assets to Dee and sell them only as necessary for the operation of her business tax on part or all of the rent he receives from Dee.

Grain. Bud could sell grain to Dee as she needs it to feed the livestock and sell excess grain on the market. The market sales could be spread over two or more tax years to keep the income out of the higher income tax brackets.

Practitioner Note. The grain sales are excluded from Bud's earnings from self-employment for purposes of reducing his social security benefits if:

1. The grain was produced and in storage before or during the first month Bud drew social security benefits, and
2. The grain is sold in a year after the first year Bud draws social security benefits. See 20 CFR §404.429(b)(2)(ii)(A).

The grain sales are subject to self-employment tax.

Machinery. Bud could lease the machinery to Dee with an option to buy as follows. When Dee wants to replace a piece of equipment, she could buy it from Bud and pay the boot when she traded it for a new piece of machinery. Bud would have to recognize both the rental payments and the sale of the machinery as income, but the gain on sale would be spread over the years that Dee replaced the machinery.

Practitioner Note. Bud could also give Dee a piece of machinery when it was time to replace it. He would not have to recognize any income from the gift, but Dee would get a carry-over basis in the piece that was given to her, which will reduce the basis in the replacement.

The rent Bud receives on the machinery is subject to self-employment tax.

Practitioner Note. Bud could argue that his machinery is leased with the real estate and bring it within the following exception in I.R.C. §1402(a)(1):

> There shall be excluded rentals from real estate and from personal property leased with the real estate.

The IRS may argue that this exception does not apply to machinery since it only applies to personal property specifically made for the real property or attached to the real property (such as stationary grinders, farrowing crates, livestock water fountains, etc.).

Beef Cows. Bud could lease the beef cows to Dee under an arrangement that allows Dee to keep the replacement heifers. Bud would report the culled cow and culled calf sales. This will spread Bud's taxable gain (including depreciation recapture on purchased cows) over several tax years. Dee will own the herd of beef cows when the existing cows have all been replaced. Bud's rental income will be reduced as his ownership of the herd is reduced.

The rent received for the beef cows is also subject to self-employment tax unless Bud can bring it within the exception for personal property leased with real estate.

Land and Buildings. If Bud materially participates in Dee's farm business, he will be subject to self-employment tax on the rent he receives for the land.

Bud is arguably not liable for self-employment tax on the rent he receives for the buildings even if he materially participates, since only land is subject to the material participation exception to the exclusion of real estate rent from self-employment income [I.R.C. §1402(a)(1)].

Keep Assets until Death

Death of the owner of an asset eliminates the gain or loss that is built into the asset since the basis in the asset is adjusted to its date-of-death value. If Bud were to keep any assets until his death, no one would have to pay tax on the gain that is accumulated to the date of death.

Example 4.3. If Bud leased his land and buildings to Dee with an option to buy from his estate, there would be no gain to report on the sale of the land and buildings, and Dee would have a basis in the land and buildings equal to their fair market value. The accumulated $480,000 of gain would escape income taxation. Estate planning could probably avoid any estate tax.

Practitioner Note. If Bud's will gave the land and buildings to Dee, the gain would still escape taxation since Dee would still get a date-of-death basis in the land and buildings. However, Dee may be uncomfortable with this arrangement because Bud could change his will at any time before death and leave the land and buildings to another person.

ISSUE 5: FINANCIAL DISTRESS

Producers often face significant income tax consequences from financial distress transactions. The two most common income tax consequences from these transactions are:

1. The recognition of gain or loss from the transfer of assets
2. Discharge of indebtedness income

RECOGNITION OF GAIN OR LOSS FROM THE TRANSFER OF ASSETS

The rules that require the recognition of gain or loss as a result of transferring assets in financial distress are the same as those that apply to transfers outside of financial distress.

Example 5.1. Les Filling has the same assets and the same basis in those assets as Bud Light from Example 4.1. However, unlike Bud, Les has $1,700,000 of debt, and his lenders will not give him a loan to put in his year 2000 crop. Les uses the cash method of accounting. The following table shows Les's debt, the basis of his assets, the fair market value of his assets, and the gain or loss that he must report if he transfers those assets. Les is current on his debt payments, so none of the debt is interest–it is all principal.

Asset	Debt	Adjusted Basis	Fair Market Value	Gain or Loss
Land and improvements	$1,250,000	$307,600	$ 930,000	$ 622,400
Machinery	250,000	150,000	225,000	75,000
Livestock and Grain	200,000	24,990	550,000	525,010
Total	$1,700,000	$482,590	$1,705,000	$1,222,410

Question 5.1.1. *What are the tax consequences of Les selling all of his assets in 2000 and using the proceeds from the sale to pay his debts?*

Answer 5.1.1. Les has the same consequences from the sale of assets as Bud Light in Example 4.1. Using the proceeds to repay the principal debt does not change the income tax result. Therefore, assuming Les has the same itemized and personal exemption deductions as Bud Light, Les will owe $353,363 in income and self-employment taxes if he sells all of his assets in one tax year and uses the proceeds to pay principal.

Observation. After paying his $1,700,000 of debt, Les will have only $5,000 of the sale proceeds left to pay his $353,363 of tax liability.

Payment of Interest

If the taxpayer uses the cash method of accounting and uses proceeds from the sale of assets to pay accrued interest, the interest payment can be deducted.

Question 5.1.2. *If $100,000 of the $1,700,000 debt that Les pays with the proceeds from the asset sales were accrued interest instead of principal, would his income tax consequences be different?*

Answer 5.1.2. Yes. Since Les uses the cash method of accounting, he can deduct the $100,000 of interest that he pays with the proceeds of the asset sales. That deduction will reduce his income and self-employment tax liability by $41,748 to $311,615.

DISCHARGE OF DEBT

Creditors of a financially distressed taxpayer sometimes forgive some or all of the taxpayer's debt because the taxpayer is unable to pay or because the cost of collecting the debt is more than the debt. For income tax purposes, if the creditor forgives debt for any reason other than for the purpose of making a gift to the debtor, the discharged debt is treated as income to the debtor **unless one of the following exceptions applies**:

1. If the debt that was discharged had been paid by the taxpayer, the taxpayer would have been allowed to deduct the amount paid [I.R.C. §108(e)(2)].
2. The debtor was in bankruptcy at the time the debt was discharged [I.R.C. §108(a)(1)(A)].
3. The debtor was insolvent at the time the debt was discharged [I.R.C. §108(a)(1)(B)].
4. The seller of property under an installment contract discharged the debt and the original purchaser under the contract owed the debt discharged [I.R.C. §108(e)(5)].
5. The debt discharged is qualified farm indebtedness [I.R.C. §108(a)(1)(C)].
6. The debtor is not a C corporation, and the debt discharged is qualified real property business indebtedness [I.R.C. §108(a)(1)(D)].

Practitioner Note. If discharged debt qualifies for more than one of the above exceptions, the first exception in the list is applied to the discharged debt.

Example 5.2. Assume the same facts as in Example 5.1 except that Les Filling has $1,850,000 of debt, of which $100,000 is accrued interest owed to Second State Bank, which holds a second mortgage on Les's real estate. The agreement between Les and the Second State Bank applies payments on the loan first to accrued interest and then to principal. The debt owed to Second Sate Bank is qualified farm indebtedness. Since Second State Bank is unlikely to collect all of the debt Les owes, it has agreed to forgive $150,000 of Les's debt in 1999.

Question 5.2.1. *What are the income tax consequences of the $150,000 debt discharge?*

Answer 5.2.1. Since payments are applied first to accrued interest, the first $100,000 of debt discharge is treated as a discharge of the $100,000 of accrued interest. Since that interest would have given Les a $100,000 deduction if it had been paid, the first exception in the above list applies, and the discharge of that $100,000 is not income to Les.

After the $100,000 of interest is discharged, Les has $1,750,000 of debt and $1,705,000 of assets, so he is still insolvent by $45,000. Consequently, the next $45,000 of debt discharge qualifies for the third exception in the above list, and Les does not have to include that discharged debt in income.

The remaining $5,000 of the $150,000 discharged debt is discharged while Les is solvent. Since it is qualified farm indebtedness, the discharge of this $5,000 qualifies for the fifth exception in the above list, and Les does not have to report it as income if he has enough tax attributes to pay the price for not reporting the $5,000 as income. (See "Paying the Price" below.)

In summary, all of the discharged debt potentially qualifies for an exception to the rule that it must be reported as income. The amount that qualifies for each exception is as follows:

Exception	Amount
Deductible if paid	$100,000
Insolvent	45,000
Qualified farm debt	5,000
Total	$150,000

Practitioner Note. The IRS has reversed its position on the treatment of exempt assets for purposes of calculating a taxpayer's solvency. In Ltr. Rul. 9125010 it had taken the position that the value of assets that were exempt from the reach of creditors under state law was not included in calculating a taxpayer's solvency. On August 13, 1999, the IRS released Ltr. Rul. 199932013, in which it revoked Ltr. Rul. 9125010 and held that the value of exempt assets is included.

Paying the Price

In most cases, the taxpayer must pay a price for not recognizing discharge of indebtedness income. The price is a reduction of the taxpayer's following tax attributes:

1. **NOL:** Any net operating loss for the taxable year of the discharge, and any net operating loss carry-over to such taxable year
2. **General business credit:** Any carry-over to or from the taxable year of a discharge of an amount for purposes for determining the amount allowable as a credit under I.R.C. §38 (relating to general business credit)
3. **Minimum tax credit:** The amount of the minimum tax credit available under I.R.C. §53(b) as of the beginning of the taxable year immediately following the taxable year of the discharge
4. **Capital loss carry-overs:** Any net capital loss for the taxable year of the discharge, and any capital loss carry-over to such taxable year under I.R.C. §1212
5. **Basis reduction:** The basis of the property of the taxpayer (see I.R.C. §1017)
6. **Passive activity loss and credit carry-overs:** Any passive activity loss or credit carry-over of the taxpayer under I.R.C. §469(b) from the taxable year of the discharge
7. **Foreign tax credit carry-overs:** Any carry-over to or from the taxable year of the discharge for purposes of determining the amount of the credit allowable under I.R.C. §27

Order. The general rule is that the tax attributes are reduced in the order listed above [I.R.C. §108(b)(2)]. However, the taxpayer can elect to reduce the basis in depreciable property first [I.R.C. §108(b)(5)].

Example 5.3. Assume that Les in Example 5.2 had the following tax attributes carried into his 1999 tax year and that Second State Bank discharged the same $150,000 of debt as in Example 5.2.

NOL	$ 15,000
Capital loss carry-over	10,000
Bases	482,590

Question 5.3.1. *What tax attributes does Les reduce as a result of the discharged debt?*

Answer 5.3.1. Les does not have to reduce tax attributes for the $100,000 of accrued interest that was discharged. He has in effect already paid that price by not getting a deduction for payment of the interest.

The $45,000 that was excluded from income under the insolvency exception requires Les to reduce tax attributes. If Les does not make the election to reduce the basis of depreciable property first, he must reduce his NOL and capital loss carry-over to zero, as shown in the following table:

Attribute	Amount before Attribute Reduction	Attribute Reduction	Amount after Reduction	Balance of Discharged Debt
				$45,000
NOL	$15,000	$15,000	-0-	30,000
Capital loss	10,000	10,000	-0-	20,000

Les does not have to pay the price for the remaining $20,000 of discharged debt that was excluded under the insolvency exception. That is a result of the limit on bases reduction discussed below.

The $5,000 that was reduced under the qualified farm indebtedness exception requires Les to reduce the bases in his assets by $5,000. Therefore, the discharge of debt reduces Les's bases in assets to $477,590.

Limit on Bases Reduction. If the debt discharge is excluded from income under the bankruptcy or insolvency exception, there is a limit on the reduction of the aggregate bases in the taxpayer's assets. The aggregate of the bases in the taxpayer's assets is reduced only down to the remaining debt after the discharge [I.R.C. §1017(b)(2)].

In Example 5.3 above, Les had $1,700,000 of debt after the discharge and only $482,790 of bases in assets (before the reduction for discharge of indebtedness). Therefore, he was not required to reduce bases for the $20,000 of discharged debt that was excluded by the insolvency rules since his bases in assets are were already below his remaining debt.

Timing. The attribute reduction occurs **after** the taxes have been computed for the year of the discharge. Therefore, the attributes are used on the tax return **before** they are subject to the reduction under the discharge of indebtedness rules.

Example 5.4. Assume the same facts as in Example 5.3. If Les sold his "other buildings" in 1999 ($40,000 fair market value, zero basis), he could use the $15,000 NOL and $10,000 capital loss carryover to offset part of the $40,000 long-term capital gain that he must recognize from the sale of the buildings. If he waits until 2000 to make the sale, he will have no NOL or capital loss carry-forward to offset the gain because they will be absorbed by the reduction required under the discharge of indebtedness rules. His basis in the buildings will also be reduced slightly by the portion of the $5,000 bases reduction that is allocated to the bases in the buildings.

ISSUE 6: SALE OF DEVELOPMENT RIGHTS

If a landowner transfers development rights by sale, the proceeds of the sale are first used to reduce the basis of the affected land. To the extent the proceeds exceed the basis of the land, they must be reported as gain on the seller's income tax return.

Example 6.1. Lucy Landowner owns farmland that is within 25 miles of a metropolitan area. The Land Trust Commission would like to acquire the development rights on the land to manage development in the area. The land is worth $500,000 before the development rights are transferred. The development rights are worth $200,000, and the land without the development rights 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.

If Lucy sells the development rights 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 and about $4,000 of state income tax on that gain, leaving her $166,000 of after-tax proceeds from the sale. She would 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 for $300,000, she will have to report the entire $300,000 as capital gain and pay about $68,000 of federal and state income taxes on that gain.

Example 6.2. Assume the same facts as in Example 6.1 except that Lucy has a $300,000 income tax basis in the land.

If Lucy sells the development rights to the Land Trust Commission for $200,000, she will have to reduce her basis in the land from $300,000 to $100,000 but will not have to report any gain on her income tax return. If she later sells the rest of her interest in the land for $300,000, she will have to report $200,000 as capital gain and pay about $45,000 of federal and state income taxes on that gain.

EXCHANGING DEVELOPMENT RIGHTS FOR OTHER PROPERTY

If a landowner exchanges development rights for an interest in other real property and meets the requirements of the like-kind exchange rules under I.R.C. §1031, no gain is recognized.

Example 6.3. Assume the same facts as in Example 6.1 except that Lucy trades the development rights in her land for other land without the development rights. The land she acquires is worth $200,000 without the development rights.

Lucy does not have to recognize any gain from the exchange. She must allocate her basis in the land she originally owned between her original land and the land she acquired in the exchange, based on the fair market value of the development rights she gave up and the fair market value of the land she retained without the development rights. Therefore, she has a $30,000 ($50,000 × $300,000 ÷ $500,000) basis in the land she originally owned and a $20,000 ($50,000 × $200,000 ÷ $500,000) basis in the land she acquired in the exchange.

DONATING DEVELOPMENT RIGHTS

New tax rules that became effective in 1998 make donating development rights 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 development rights.
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.
4. The donor's estate can be reduced by up to 40% of the remaining value of the property.

Example 6.4. Assume the same facts as in Example 6.1 except that Lucy donates the development rights to the Land Trust Commission. Also assume that 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.

Lucy 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 deduction of $200,000, which means that 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% × $300,000) from the value of her estate, which will reduce her federal estate taxes by $49,200 ($120,000 × 41%).

These tax savings are reduced by the additional estate tax on the $92,000 of federal income taxes that she does not have to pay. The additional estate tax is $92,000 × 41% = $37,720.

In summary, by making a gift of the easement, Lucy forgoes the $200,000 of sale proceeds but saves $185,480 ($30,000 + $62,000 + $82,000 + $49,200 – $37,720) in federal income, gift, and estate taxes.

The tax savings are not as dramatic for taxpayers 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 the development rights even if it does not fully offset that cost.

Example 6.5. Fred Farmer owns farmland that is within 25 miles of a metropolitan area. The Land Trust Commission would like to acquire the development rights on the land to manage development in the area. The land is worth $500,000 before the development rights are transferred. The development rights are worth $200,000, and the land without the development rights 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 applicable exemption amount available beginning in 2006, so there will be no estate taxes due on his death.

If Fred sells the development rights 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 and about $4,000 of state income tax on that gain, leaving him $166,000 of after-tax proceeds from the sale. He will also have a zero basis in the land without the development rights. Therefore, if he later sells the rest of his interest in the land for $300,000, he will have to report the entire sale price as capital gain and pay about $68,000 of federal and state income taxes.

By contrast, if Fred donates the development rights to the Land Trust Commission, he will get the following tax benefits:

1. He will not have to report any gain on the sale of the development rights, which will save him $34,000 of federal and state 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 carry-over of charitable contribution deductions is limited to five years. Those deductions will reduce his federal and state income taxes by about $47,000.
3. He can claim a gift tax exclusion of $200,000, which means that his gift will neither cause him to pay any gift taxes nor reduce his applicable exclusion amount. 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 development rights, Fred forgoes the $200,000 of sale proceeds but saves $81,000 ($34,000 + $47,000) in income taxes. Therefore, Fred's $200,000 donation cost him $119,000 in after-tax dollars.

ISSUE 7: CONTRACT AND CUSTOM FARMING

Several issues could arise from a custom work arrangement for other farm producers or a contract farming arrangement with canneries, seed companies, and packers. Taxpayers should be careful to keep as many characteristics of a farming business as possible in order to qualify for the favorable tax treatments available only to farm businesses.

ADVANTAGES OF "FARMER" STATUS

The taxpayer must be a "farmer" to take advantage of the following tax provisions:

1. The exception to the estimated tax penalty [I.R.C. §6654(i)]
2. The deduction of soil and water conservation expenses (I.R.C. §175)
3. The deduction of fertilizer expenses (I.R.C. §180)
4. The exemption from the requirement that a beginning and ending inventory be used to account for income [Treas. Reg. §1.471-6(a)]
5. The solvent farmer exception to the discharge of indebtedness rules [I.R.C. §108(a)(1)(C)]

6. The exemption from FICA taxes on noncash wages paid to labor [I.R.C. §3121(a)(8)(A)]
7. The exemption from the prohibition of cash accounting for corporations [I.R.C. §448(b)(1)]
8. The exemption from the excise tax on gasoline (I.R.C. §6420)

Taxpayers must use assets in a "trade or business" in order to take advantage of the following tax provisions:

1. The I.R.C. §179 expense deduction
2. The ordinary loss deduction for net I.R.C. §1231 losses

In order to take advantage of the income averaging rules of I.R.C. §1301, the taxpayer must have farming income.

In general, the definitions of "farm," "farmer," and "business of farming" are consistent among the various provisions in the Internal Revenue Code. However, there is not a single definition of these terms that is applicable for all provisions in the Code. Therefore, the terms could be interpreted differently for purposes of different provisions.

MACHINE WORK VERSUS CUSTOM WORK CONTRACTOR

There is no clear guidance on when a taxpayer crosses the line from being a farmer who has some custom hire income to report on line 9 of Schedule F (Form 1040) to being a custom work contractor who reports his or her income and expenses on Schedule C.

At one extreme, a full-time farm producer who combines a few acres for a neighbor at the end of the harvest season does not have to report the income on Schedule C (Form 1040). He or she can clearly report the income on line 9 of Schedule F (Form 1040) and include all of the expenses for the custom work with the farming expenses reported on Schedule F (Form 1040).

At the other extreme, a taxpayer who owns machinery that is used to complete contract work for others but raises no crops or livestock on land that he or she owns or leases cannot report income and expenses from those contracts on Schedule F (Form 1040). He or she must report the contract income and expenses on Schedule C (Form 1040).

The safe position is to report contract income and expenses on Schedule C (Form 1040) if the contract work is anything more than incidental to the farming business. It would be an aggressive position to report contract income and expenses on Schedule F (Form 1040) if the taxpayer uses the machinery more than 50% of the time in contract work.

If the machinery is used more than incidentally in contract work but less than 50%, other factors should be considered in determining the proper reporting of income and expenses. Factors to be considered include:

1. Whether the taxpayer intends to operate the contracting business as a separate profit center or just as a means of spreading the capital cost of equipment needed for farming over more acres of land
2. Whether the taxpayer receives more than 50% of his or her gross income from the contract activities
3. Whether the taxpayer has ever had a Schedule C (Form 1040) contracting business or has always been a farmer

CONTRACT FARMING

In general, the contract farming arrangements that farm producers enter into with canneries, seed companies, and packers of chickens and hogs leave the farm producer with less risk, fewer management decisions, and no marketing decisions. (See *A Farmer's Legal Guide to Production Contracts* by Neil D. Hamilton, Farm Journal, Inc., January 1995, for a description of typical contracts.) While the IRS has not yet taken issue with treating the taxpayer who raises the crops or livestock as a farmer, producers should be careful to keep as many characteristics of a farming business as possible in order to qualify for the favorable tax treatments available only to farm businesses.

Income Tax Issues

In the context of contract farming, the decided income tax cases have dealt with the issue of cash versus accrual accounting. The issue has been whether the "owner" of the commodity—the packer, nursery, or processor, for example—is a "farmer" for purposes of the rules that allow cash accounting for inventory (Treas. Reg. §1.417-6). Those cases shed light on whether the "grower"—the person who owns the farm and raises the commodity—will be treated as a "farmer."

In *Maple Leaf Farms, Inc. v. Commissioner*, 64 T.C. 438 (1975), the court summarized the cases dealing with this issue and concluded that the cases reflect two essential elements for being a "farmer":

1. The taxpayer must participate to a significant degree in the growing process.
2. The taxpayer must bear a substantial risk of loss from that process.

However, in subsequent discussion, the court pointed out that "a landowner receiving a rent based on production need not participate at all" (Treas. Reg. §1.175-3). Therefore, it appears that bearing risk of the production process is an essential requirement, and participation is required unless the taxpayer is a landowner receiving rent based on production.

Practitioner Note. Although the issue in *Maple Leaf Farms* was whether the owner was a farmer, the court noted in passing that the growers were undoubtedly farmers. That is particularly important since the owner was also found to be a farmer. Therefore, both parties to the contract can be farmers as long as they each bear some risk of the production process and either participate in the growing process or receive rent based on production.

Example 7.1. Larry Leghorn has a contract with Big Chick, Inc. to grow broilers. Under the contract, Larry provides the facilities and labor to grow the broilers. Big Chick delivers its baby chicks to Larry and provides the feed, vaccines, and medication necessary to raise the birds as well as a fieldman who supervises Larry's caring for the birds.

Big Chick pays Larry for the pounds of broilers delivered to Big Chick's processing plant. The rate per pound is determined by a formula that reflects Larry's efficiency in producing the broilers.

Since Larry is at risk as to both the amount of broilers produced and the efficiency in producing them, he is a farmer for income tax purposes.

Reporting Payments Received by a Contract Grower. If the grower is a farmer with respect to a production contract, the payments should be reported on Schedule F.

Example 7.2. Larry Leghorn in Example 7.1 should report the payments he receives from Big Chick, Inc. and any expenses he incurs in growing the broilers on his Schedule F. He should include interest paid on money borrowed to build the facilities, depreciation of the facilities, and property taxes as farm expenses.

Form 1099-MISC. Some processors are reporting the payment to the grower on Form 1099-MISC and checking the "Rent" box. Such reporting makes it tempting for the grower to report part or all of the payment on Schedule E rather than on Schedule F and thereby reduce self-employment taxes. However, it is difficult to justify reporting the payment on Schedule E since the grower is materially participating in the production in most cases. Code §1402(a)(1) exempts rent on real estate from the self-employment tax but not if the owner of the land materially participates in the production. Therefore, the materially participating grower must report the payment on Schedule F so that it is included in self-employment income.

This issue was addressed in *Gill v. Commissioner*, T.C. Memo 1995-328. In that case, the taxpayer contracted with a processor to raise broilers. The taxpayer argued that his labor was applied to the upkeep of the building and not to the flock of broilers. Consequently, he argued that the payments he received were rent that is not subject to the self-employment tax. The court rejected that argument and held that the taxpayer materially participated in raising the broilers and was therefore subject to the self-employment tax (see also Rev. Rul. 58-568, 1958-2 C.B. 730).

Part-Time Contractual Arrangements. If the farmer enters into a contract farming arrangement that requires only a minimal amount of labor on his part, the growing activity will likely still be classified as farming in most factual circumstances. As long as the farmer participates in the growing process to a significant degree and bears a substantial risk of loss, the activity is properly reported on Schedule F.

Example 7.3. Red Tuber has a contract with a food company to grow canning beets on his land. Red is primarily a dairy farmer, but he agreed to grow beets on 16 acres of land. Red furnished the machinery, labor, and other facilities necessary to produce the beets. He worked less than 100 hours each year to produce the beet crop. The company controlled the planting and harvest dates but did not advise Red on other management decisions in producing the beets. Red purchased the beet seed, fertilizer, and herbicide. The food company issued Red a document stating that all payments to Red were for leased land, are considered rental income, and as such are reportable on Form 1099-MISC.

Question 7.3.1. *Can Red report the payments received from the food company as rent on Schedule E (Form 1040)?*

Answer 7.3.1. No, the payments are reported on Schedule F and are therefore considered earnings from self-employment. There was an arrangement for material participation, and Red did actually materially participate in the production of the beets. The contract (arrangement) called for Red to supply the labor, machinery, seed, fertilizer, and other resources. In fact, Red supplied the machinery and performed the labor necessary to produce the beets. The fact that Red spent less than 100 hours per year to produce the beets does not diminish the pivotal role he played in producing the beet crop. Without Red, there would have been no beet crop. (See *Kenneth C. Schmidt*, T.C. Memo 1997–41, for recent authority similar to this example.)

Example 7.4. Golden Tuber has a contract with a canning company to grow carrots on his land. The canning company provides the seed, tells Golden when to plant the carrots, and periodically inspects his fields during the growing season. The canning company decides when to harvest, and provides the harvesting equipment and crews. The amount Golden is paid each year is based on the quality and quantity of carrots that are harvested.

Question 7.4.1. *If Golden receives a Form 1099 from the canning company showing the payment he received from the canning company as rent, can Golden report the payment on his Schedule E (Form 1040)?*

Answer 7.4.1. It would be difficult to justify reporting the payment on Schedule E; Golden is materially participating in the production. Code §1402(a)(1) exempts rent on real estate from the self-employment tax but not if the land is used in agriculture and the owner of the land materially participates in the production. Therefore, the materially participating grower must report the payment on Schedule F so that it is included in self-employment income. (See the *Gill* and *Schmidt* cases referenced earlier.)

Example 7.5. Port A. John contracts with I. B. Pigs, Inc. to finish hogs for $32 per pig space. Port mechanically feeds the hogs and walks through the facilities daily, and he orders the feed. He is paid an incentive bonus in addition to his "per space" payment for production efficiency. He does not own the hogs and is not at risk for death loss or poor production (other than losing his efficiency bonus).

Question 7.5.1. *Should Port report his income from this enterprise on Schedule F or on Schedule E?*

Answer 7.5.1. Since Port materially participates in the hog production and has production risk, he should report the income on Schedule F.

Example 7.6. Assume the same facts as Example 7.5 except that Port A. John is retired and hires his son Johnnie II to feed and care for the hogs. He pays Johnnie II $10 per day and gives him the manure from the hogs to put on Johnnie's fields.

Question 7.6.1. *Should the income Port A. John receives from I. B. Pigs, Inc. be reported on Schedule F or on Schedule E?*

Answer 7.6.1. Port A. John is not materially participating in the hog production, so he should report his income from I. B. Pigs, Inc. on Schedule E.

Leasing Land for Production Buildings. In some arrangements, landowners lease land to the processing company, and the processing company builds and operates the production building. Since the landowner is not involved in the operation of the production enterprise, the rental income should be reported on Schedule E. The costs of maintaining the land, purchasing insurance, and property taxes should be deducted on Schedule E.

Employee Status. If the farm producer enters into a contract to feed livestock for a packer under which the packer owns the livestock, feed, and equipment and tells the producer when and how to feed the livestock, the arrangement could be characterized as an employer-employee relationship. As an employee, the producer would have wage income rather than income and expenses to report on Schedule C or Schedule F. If the producer owns the real estate on which the livestock are fed, he or she could be treated as holding that property for investment rather than for use in a trade or business. This classification as an employee is unlikely unless the risk of loss on the part of the farm producer has been eliminated or greatly diminished by the terms of the contractual arrangement. If this is the case, the farm producer would be participating in the growing process but might not meet the "risk of loss" test to be a farmer for purposes of the feeding activity.

ISSUE 8: LEDGER CONTRACTS FOR HOG PRODUCERS

Hog producers are using more long-term contracts to market their hogs. One long-term contract arrangement is called a "ledger contract." This contract sets a price that the producer is paid for hogs as they are delivered. If the market price for hogs is above the contract price at the time of delivery, the amount by which the market price exceeds the contract price is credited to a "ledger account."

Example 8.1. Doug A. Hole has a ledger contract with a packing company that sets the contract price at 38¢ per pound. Doug delivered 40 hogs weighing a total of 10,000 pounds at a time when the market price for hogs was 43¢ per pound. Doug is paid 10,000 × 38¢ = $3,800, and his ledger account is credited with 10,000 × (43¢ – 38¢) = $500.

If the market price for hogs is below the contract price when hogs are delivered, the producer is paid the contract price, and the difference between the contract price and the market price is subtracted from the producer's ledger account.

Example 8.2. Doug A. Hole from the previous example delivered 20 hogs weighing a total of 5,000 pounds when the market price was 35¢ per pound. Doug is paid 5,000 × 38¢ = $1,900, and 5,000 × (38¢ – 35¢) = $150 is subtracted from his ledger account.

The parties to the ledger contract expect that the fluctuations in the hog market will balance out over time and there will not be a large positive or negative balance in the ledger account. However, the contracts generally require the packing company to pay a positive balance to the producer at the end of the contract or the producer to pay a negative balance to the packer at the end of the contract. Consistently low hog prices have caused some producers to accumulate significant negative balances in their ledger accounts.

INCOME TAX CONSEQUENCES OF LEDGER BALANCES

The income tax issue concerns the tax consequences of a payment on a ledger account balance at the end of a contract. To address that issue, we must first note that the amounts actually paid to the producer are reported as income when they are received.

Example 8.3. When Doug A. Hole received $3,800 for his hogs in Example 8.1, he was required to report that $3,800 as income on line 4 of Schedule F (Form 1040). When he received $1,900 for his hogs in Example 8.2, he was required to report that $1,900 as income on line 4 of Schedule F (Form 1040). Since he did not have a right to collect the positive balance in the ledger account or an obligation to pay a negative balance in the ledger account until the end of the contract, **he is not required** or **allowed** to report the ledger account balances on his income tax return until the end of the contract.

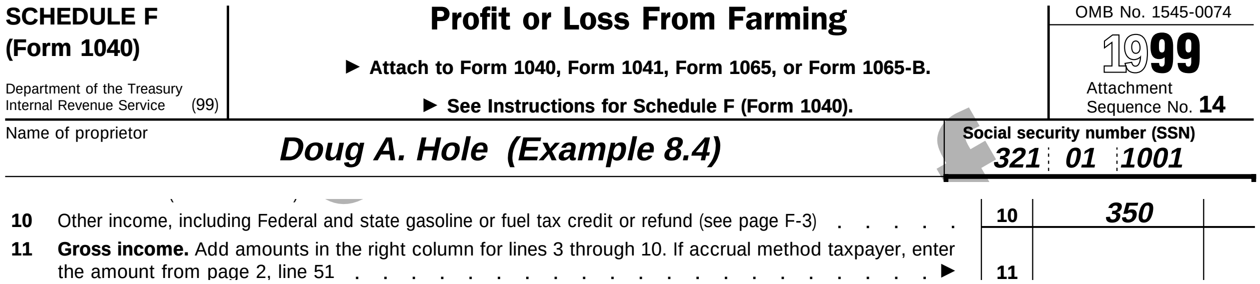
Practitioner Note. The tax consequences of the ledger contract are the same whether the producer uses the cash method of accounting or the accrual method of accounting; the producer must report the current payments as income under either method of accounting. The right to receive a positive balance or the obligation to pay a negative balance does not arise until the end of the contract and is dependent on market prices up until the end of the contract. Consequently, the economic performance rules do not require an accrual-basis taxpayer to recognize income or allow him or her to recognize a loss until the year the contract ends.

Positive Balances

If a producer receives a positive balance from the packer at the end of a contract, the producer must report the amount received as ordinary income on Schedule F (Form 1040).

Observation. The payment is treated as ordinary income for income tax purposes and also as self-employment income.

Example 8.4. If Doug A. Hole from the previous examples had a $350 positive balance in his contract when it ended in 1999 and was paid that $350, he must report it as income on line 10 of his Schedule F (Form 1040), as shown below.



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

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

OMB No. 1545-0074
1999
Attachment Sequence No. **14**

Name of proprietor: *Doug A. Hole (Example 8.4)*
Social security number (SSN): *321 01 1001*

10	Other income, including Federal and state gasoline or fuel tax credit or refund (see page F-3)	**10**	*350*
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**	

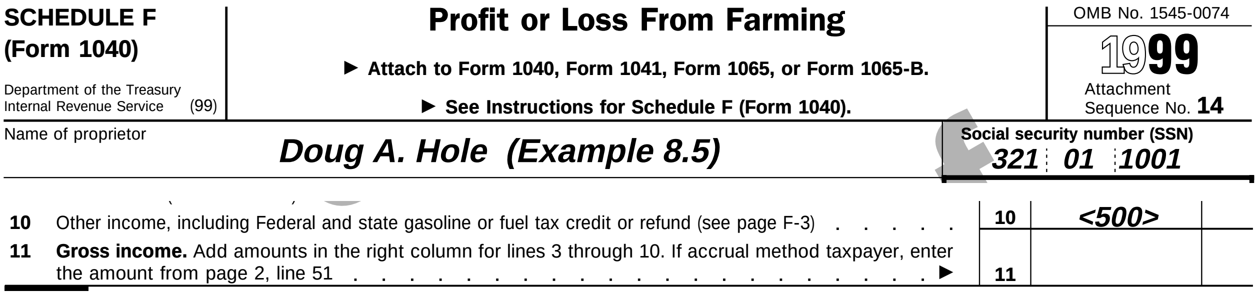
Practitioner Note. The payment from the packer for the positive balance could be reported on line 4 of Schedule F (Form 1040) but is more properly reported on line 10 of Schedule F (Form 1040) since it is a gain from a marketing arrangement rather than from a sale of produce in the current tax year.

Negative Balances

If the producer is required to pay a negative balance at the end of the contract, he or she can reduce income by the amount of the payment since it is a return of income that was reported when the hogs were sold. The payment should be reported as a negative amount on line 10 of Schedule F (Form 1040).

> **Observation.** The payment reduces ordinary income for income tax purposes and also reduces self-employment income.

Example 8.5. If Doug A. Hole had a $500 negative balance in his ledger account when his contract ended in 1999, he should report the $500 as a negative amount on line 10 of Schedule F (Form 1040), as shown below.



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

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

OMB No. 1545-0074
1999
Attachment Sequence No. **14**

Name of proprietor: *Doug A. Hole (Example 8.5)*
Social security number (SSN) *321 01 1001*

10	Other income, including Federal and state gasoline or fuel tax credit or refund (see page F-3)	10	*<500>*
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	

Financial Distress

If the producer is in financial distress and is unable to pay the negative balance at the end of the contract, discharge of the debt by the packer does not result in recognition of income since the producer would have been allowed to deduct the payment had it been made. Code §108(e)(2) excludes discharged debt from income if payment of the debt would have allowed the taxpayer to claim a deduction.

Example 8.6. If Doug A. Hole in Example 8.5 was unable to pay the $500 negative balance at the end of his contract and the packer forgave the debt, Doug would not have to report discharge of indebtedness as income because he would have been allowed to deduct the $500 had he made the payment.

ISSUE 9: PAYMENTS FOR EASEMENTS AND DAMAGES TO CROPS

Payments received from a utility company when it purchases an easement to install a pipeline, power line, telephone cable, or other utility must be carefully allocated among three different categories for income tax purposes:

1. Payments for the easement that are a tax-free return of basis
2. Payments for the easement in excess of basis that are gain from the sale of I.R.C. §1231 property
3. Payments for damage to crops that are ordinary income on Schedule F (Form 1040)

BASIS

Payments received from the sale of an easement are first treated as the return of the taxpayer's basis. To the extent of basis, the taxpayer does not have to recognize income but does have to reduce the basis of the land affected by the easement.

Example 9.1. Mega Energy Company paid Dawn S. Breaking $1,500 for an easement across her farm that affected 5 acres of land. Dawn's basis in the 5 acres was $2,500 before the purchase of the easement.

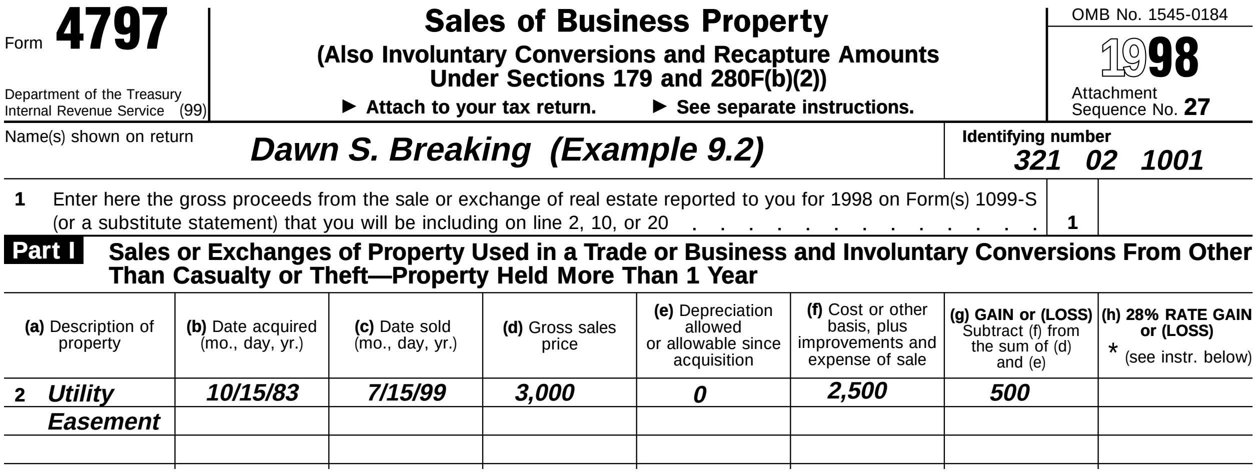
Dawn applies the $1,500 payment first to the basis in the land. Therefore, she does not have to recognize any gain from the sale of the easement, but she must reduce her basis in the 5 acres from $2,500 to $1,000.

> **Practitioner Note.** When an easement is sold, the taxpayer does not have to allocate basis between the easement that is sold and the remaining interests in the land that are retained (Rev. Rul. 77-414). Instead, the taxpayer can apply the full basis in the land that is affected by the easement to the sale of the easement.

GAIN ON SALE

Any amount received for the easement that exceeds the basis in the land that is affected must be reported as gain from the sale of an asset used in the trade or business. Consequently, the gain is reported in Part I of Form 4797 if the underlying land was held for more than one year. The gain is reported in Part II of Form 4797 if the underlying land was held for one year or less.

Example 9.2. Assume that Dawn S. Breaking from Example 9.1 received $3,000 for the easement. Also assume that she owned the land for more than a year before she sold the easement. She must report $500 of gain, as shown on the following Form 4797.



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
1998
Attachment Sequence No. **27**

Name(s) shown on return: *Dawn S. Breaking (Example 9.2)*

Identifying number *321 02 1001*

1 Enter here the gross proceeds from the sale or exchange of real estate reported to you for 1998 on Form(s) 1099-S (or a substitute statement) that you will be including on line 2, 10, or 20 1

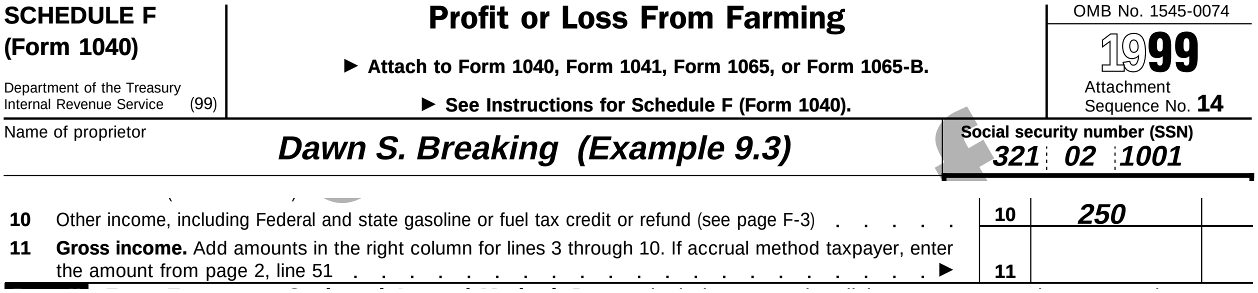
Part I **Sales or Exchanges of Property Used in a Trade or Business and Involuntary Conversions From Other Than Casualty or Theft—Property Held More Than 1 Year**

	(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)** Subtract (f) from the sum of (d) and (e)	**(h) 28% RATE GAIN or (LOSS)** * (see instr. below)
2	*Utility Easement*	*10/15/83*	*7/15/99*	*3,000*	*0*	*2,500*	*500*	

DAMAGE TO CROPS

In many cases, the utility company pays the landowner for damages to crops that were growing at the time the utility was installed. Since these payments replace the income the landowner would have received from the sale of crops, they must be reported as ordinary income on line 10 of Schedule F (Form 1040).

Example 9.3. Assume that Mega Utility Company paid Dawn S. Breaking $250 for the damage to her crops. Dawn must report that $250 as shown on the following Schedule F (Form 1040).



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

Profit or Loss From Farming

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

OMB No. 1545-0074
1999
Attachment
Sequence No. **14**

Name of proprietor: *Dawn S. Breaking (Example 9.3)*
Social security number (SSN) *321 02 1001*

10	Other income, including Federal and state gasoline or fuel tax credit or refund (see page F-3)	10	*250*
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	

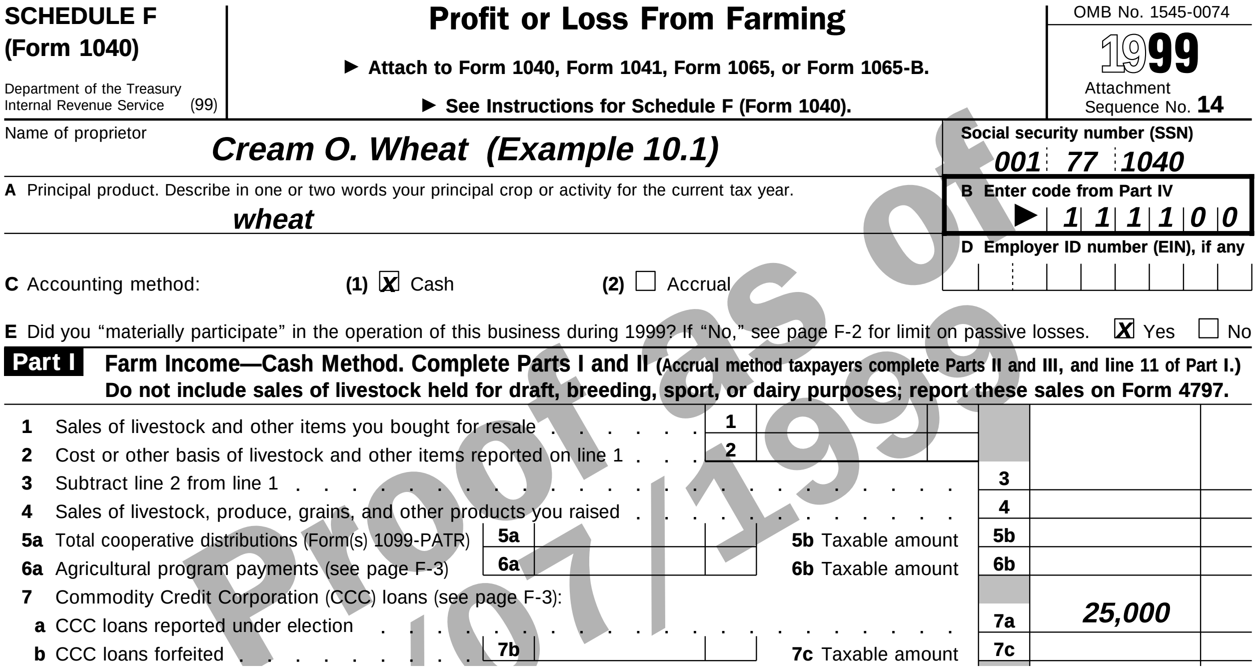
ISSUE 10: CCC LOANS AND LOAN DEFICIENCY PAYMENTS

Producers continue to use Commodity Credit Corporation (CCC) loans and loan deficiency payments (LDPs) to increase the amount they receive for their crops and to affect the timing of their income. As market prices for commodities fall below the marketing assistance loan rates offered by the 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.

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. 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 10.1. Cream O. Wheat pledged 10,000 bushels of his 1999 wheat harvest as collateral for a $25,000 CCC loan at the rate of $2.50 per bushel. If Cream has made the I.R.C. §77 election to treat CCC loans as income in 1999 or any previous year, Cream must report the $25,000 as income on line 7a of his 1999 Schedule F (Form 1040), as shown below.



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

Profit or Loss From Farming

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

OMB No. 1545-0074
1999
Attachment
Sequence No. **14**

Name of proprietor: *Cream O. Wheat (Example 10.1)*
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 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 1999? 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	

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.

Example 10.2. If Cream 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.

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. 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.

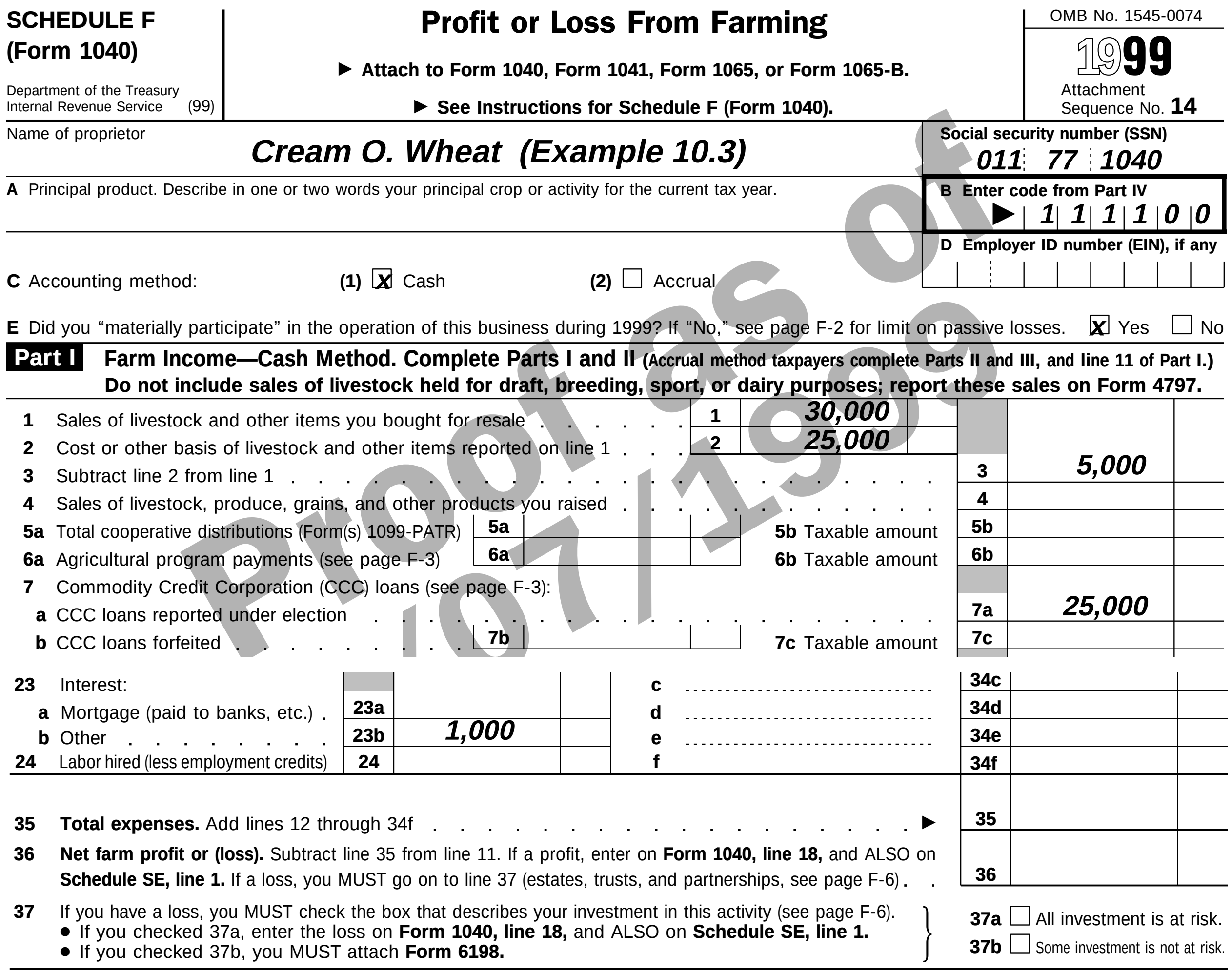
Practitioner Note. Schedule F no longer has a line to check indicating that the taxpayer has made the I.R.C. §77 election. Tax preparers should make a reasonable effort to determine whether the taxpayer has made the §77 election in any prior year.

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

Example 10.3. If Cream 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) below.



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

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

OMB No. 1545-0074
1999
Attachment Sequence No. 14

Name of proprietor: *Cream O. Wheat (Example 10.3)*
Social security number (SSN): *011 77 1040*

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

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

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

D Employer ID number (EIN), if any

E Did you "materially participate" in the operation of this business during 1999? 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	*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	

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.**

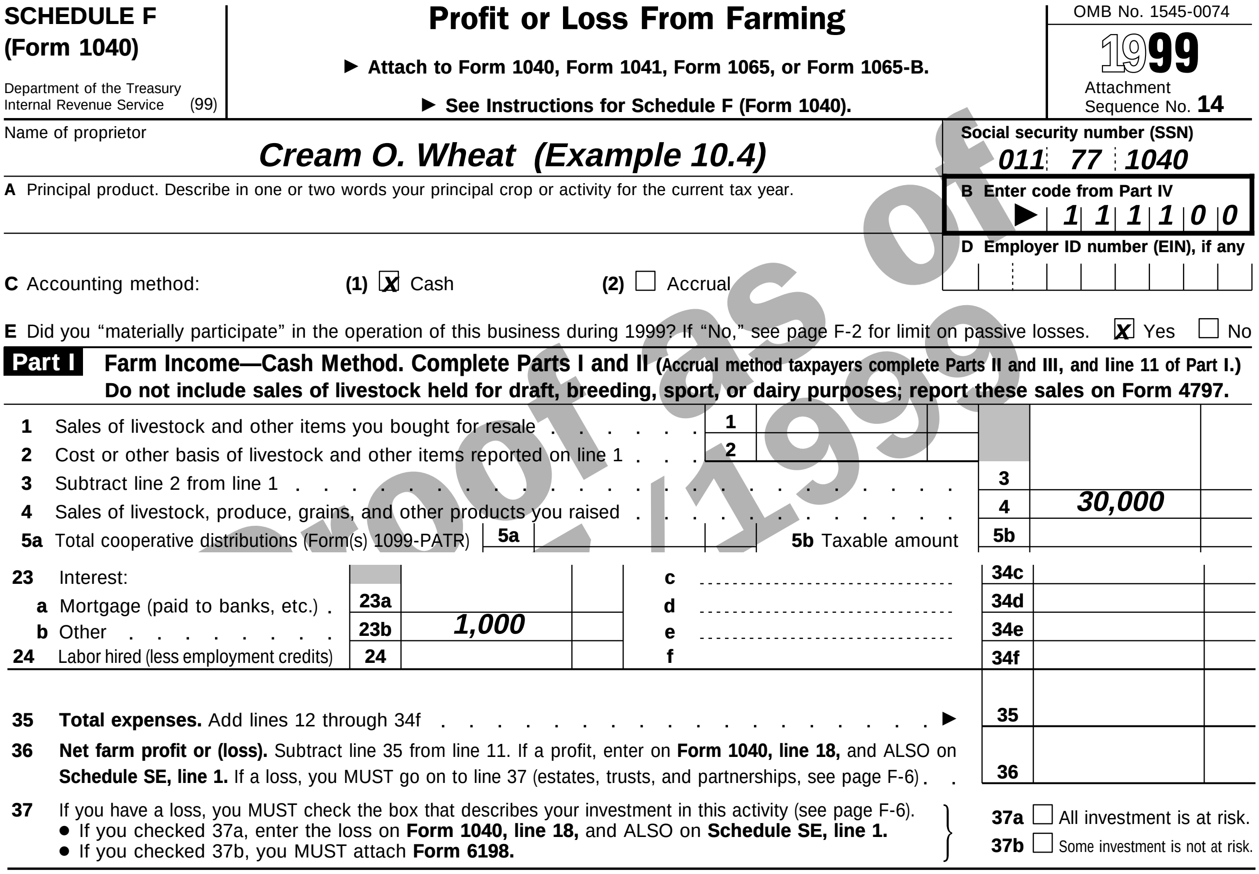
37a ☐ All investment is at risk.
37b ☐ Some investment is not at risk.

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 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 Cream to report the loan as income, as shown in this example.

Example 10.4. If Cream 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 1999, 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) below.



SCHEDULE F (Form 1040)

Department of the Treasury
Internal Revenue Service (99)

Profit or Loss From Farming

▶ Attach to Form 1040, Form 1041, Form 1065, or Form 1065-B.

▶ See Instructions for Schedule F (Form 1040).

OMB No. 1545-0074
1999
Attachment Sequence No. 14

Name of proprietor: *Cream O. Wheat (Example 10.4)*

Social security number (SSN) *011 77 1040*

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

B Enter code from Part IV ▶ *1 1 1 1 0 0*

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

D Employer ID number (EIN), if any

E Did you "materially participate" in the operation of this business during 1999? 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	

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.

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.

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.

> **Practitioner Note.** If the commodity is not sold until 2000, the producer does not have to report the sale until 2000 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).

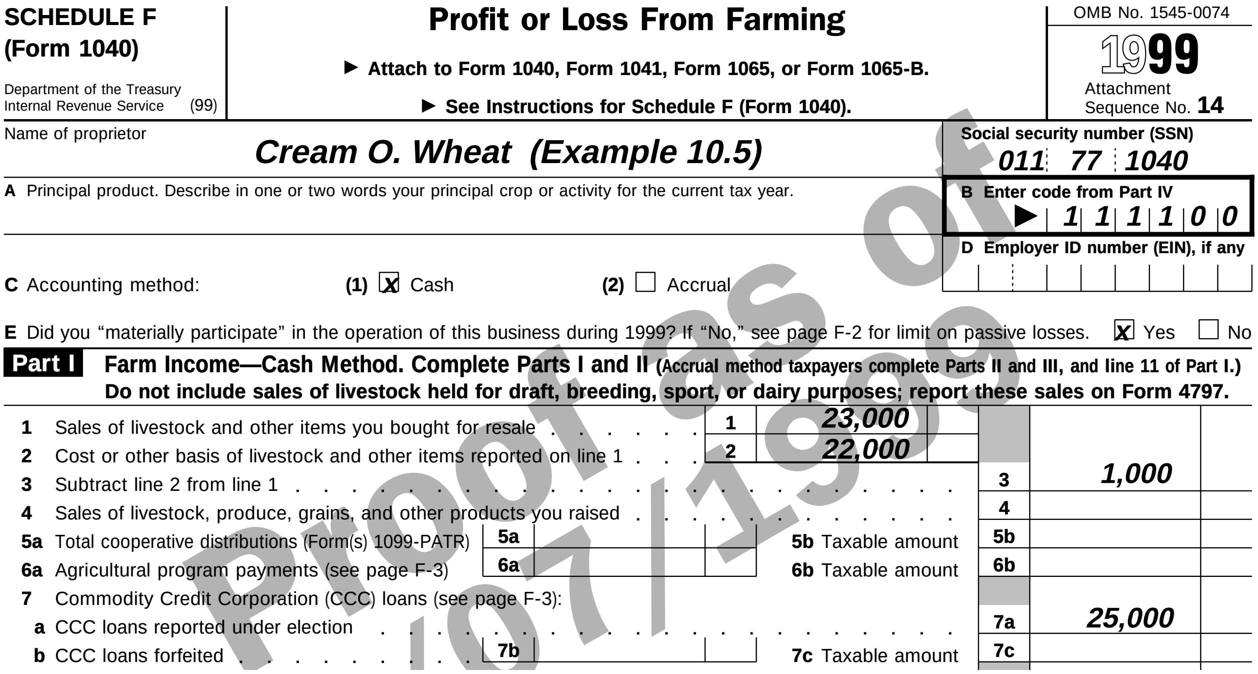
If the producer made the §77 election, the difference between the loan rate and the PCP is not reported on line 6b of Schedule F (Form 1040), since the loan has already been reported on line 7a. The producer has a basis in the commodity equal to the PCP.

Example 10.5. If Cream O. Wheat makes the I.R.C. §77 election on his $25,000 loan, 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 (it is not reported on line 6b since it is already reported on line 7a)
5. The $25,000 loan on line 7a

See the Schedule F (Form 1040) below.



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

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

OMB No. 1545-0074
1999
Attachment Sequence No. **14**

Name of proprietor: *Cream O. Wheat (Example 10.5)*
Social security number (SSN) *011 77 1040*

A Principal product. Describe in one or two words your principal crop or activity for the current tax year.
B Enter code from Part IV ▶ *1 1 1 1 0 0*
C Accounting method: **(1)** ☒ Cash **(2)** ☐ Accrual
D Employer ID number (EIN), if any
E Did you “materially participate” in the operation of this business during 1999? 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		**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

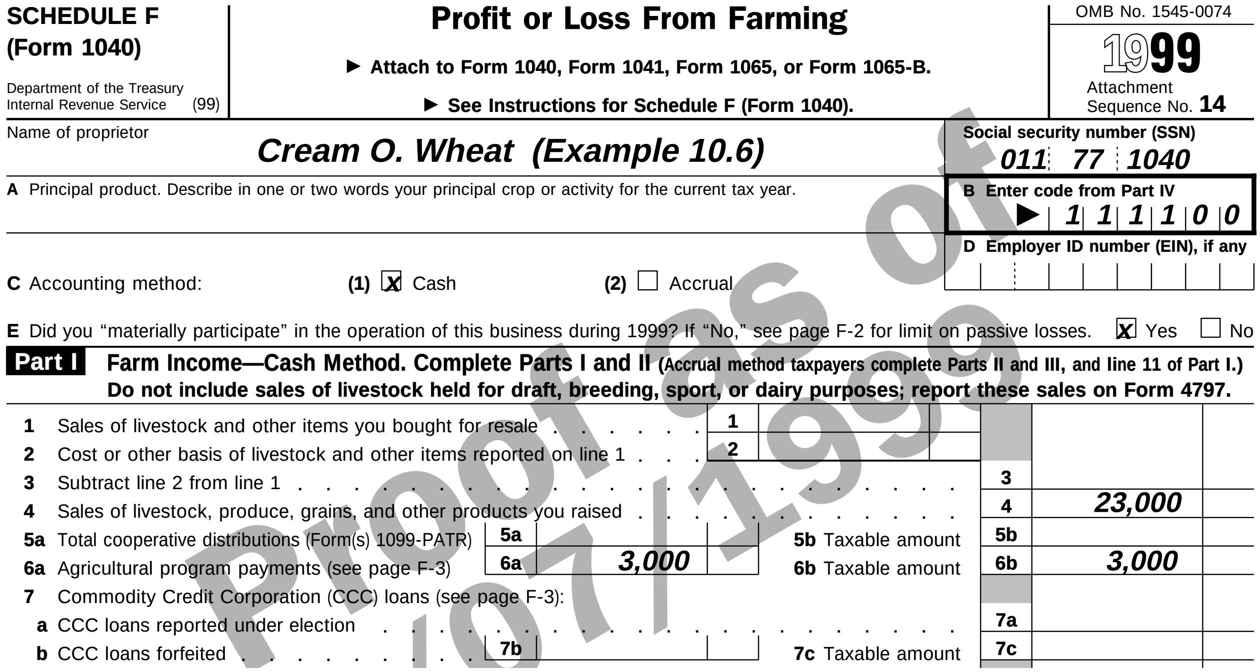
A producer who redeems the commodity by paying the PCP will receive a Form CCC-1099-G from the CCC for the difference between the loan rate and the PCP. That amount must be reported on line 6a of the producer’s 1999 Schedule F (Form 1040).

If the producer has not made the I.R.C. §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 10.6. If Cream O. Wheat 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) below.



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

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

OMB No. 1545-0074
1999
Attachment Sequence No. **14**

Name of proprietor: *Cream O. Wheat (Example 10.6)*

Social security number (SSN): *011 77 1040*

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

B Enter code from Part IV ▶ *1 1 1 1 0 0*

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

D Employer ID number (EIN), if any

E Did you "materially participate" in the operation of this business during 1999? 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	

Observation. Although the reporting procedure differs, the amount received for the crop and the total taxable income are exactly the same in Examples 10.5 and 10.6. When the income is reported will depend on specific situations.

Loan Deficiency Payment

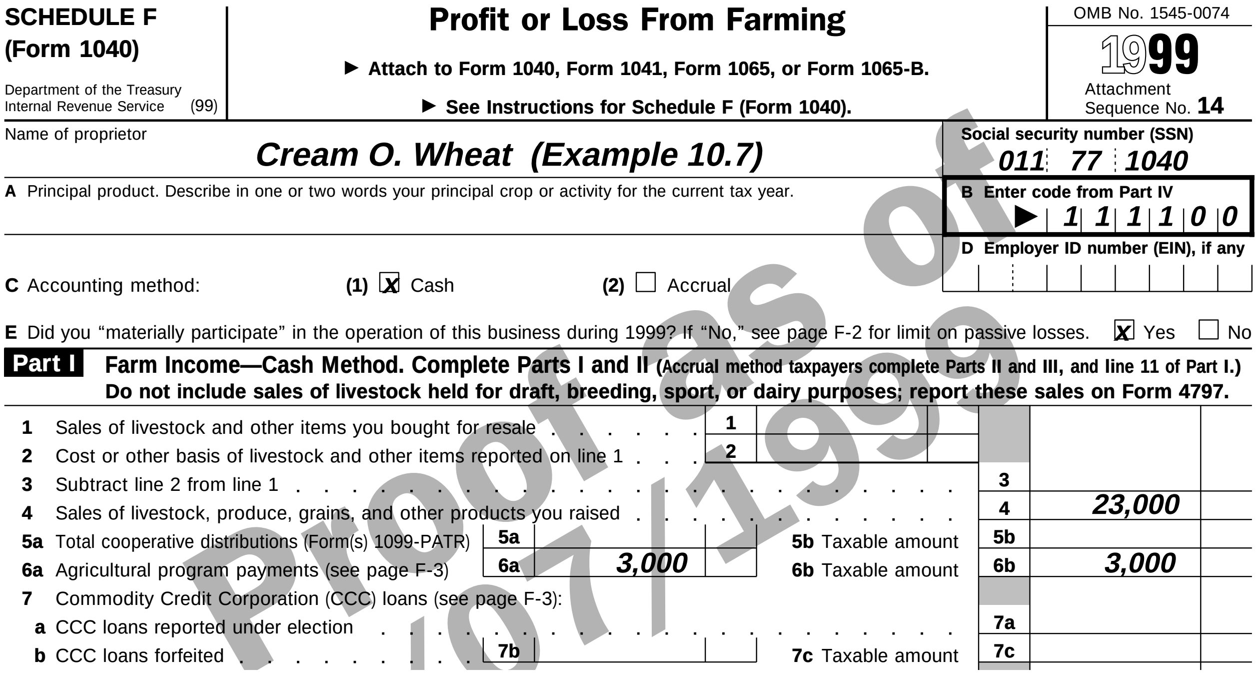
Instead of taking a CCC loan and paying it off at the PCP, producers can simply claim a loan deficiency payment (LDP) for the commodity they have produced. That payment is equal to the difference between the loan rate and the PCP on the date the LDP is claimed. Consequently, producers get the same result 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 10.7. Cream 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 1999 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) below.



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

Profit or Loss From Farming

▶ Attach to Form 1040, Form 1041, Form 1065, or Form 1065-B.

▶ See Instructions for Schedule F (Form 1040).

OMB No. 1545-0074
1999
Attachment Sequence No. 14

Name of proprietor: *Cream O. Wheat (Example 10.7)*

Social security number (SSN): *011 77 1040*

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

B Enter code from Part IV ▶ *1 1 1 1 0 0*

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

D Employer ID number (EIN), if any

E Did you “materially participate” in the operation of this business during 1999? 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	

MARKETING LOAN GAIN

Characteristics of Marketing Loans

Marketing loans allow repayment of the nine-month nonrecourse price support loan at less than the loan rate plus accrued interest charges and service fees. Commodities that are eligible for marketing loans include cotton, wheat, feed grains, rice, and oilseeds. The marketing loan gains for all commodities are subject to a $75,000-per-person payment limitation. This payment limitation is separate from the $50,000-per-person limitation for market transition payments.

The economic benefit the farmer receives from paying back less than the amount borrowed is reported on Form CCC-1099-G as marketing gain.

IRS Guidance

The following examples illustrate the proper reporting of market gain. The proposed treatment of marketing loan gain from CCC loan transactions is based on which of the following the farmer does:

1. The farmer redeems the commodity from the CCC and subsequently sells it.
2. The farmer sells an option to a merchant or commodity broker while the commodity is still in the loan program. In this case, the farmer has sold the equity, and the merchant or commodity broker is the party who redeems and disposes of the commodity.

In either situation, the critical issue is to reconcile the taxable income with the cash received. The document reporting trail may require adjustments to be consistent with tax results.

Commodity Redeemed. The following example shows how the reporting trail may lead farmers astray when the commodity is redeemed with resulting marketing gain.

Example 10.8. Bud Bolls, a cash-method, calendar-year farmer, has deducted all of the expenses incurred in producing an eligible commodity and has a zero basis. In 1998 Bud pledges 1,000 pounds of the commodity as collateral for a $500 CCC price support loan at 50¢ per pound. Bud redeems the commodity in 1999 by paying the then-prevailing world market price of 42¢ per pound, or $420. Later in 1999, Bud sells the commodity for 60¢ per pound.

As a result of the redemption of the commodity, Bud receives a Form CCC-1099-G from the CCC showing a marketing gain in 1999 of $80. This is calculated as the difference between the original loan rate (50¢ per pound) and the subsequent repayment rate (42¢ per pound) multiplied by the pounds of the commodity redeemed (8¢ × 1,000). The proper reporting of the $80 marketing gain on Bud's 1999 return, however, depends on whether Bud has made the I.R.C. §77 election.

If the I.R.C. §77 election has been made, Bud recognized income of $500 in 1998 (line 7a, Part I, Schedule F). The commodity is repurchased by Bud for $420 when redeemed by repayment of the CCC loan, but no gain or loss is recognized. Subsequently, Bud has income of $180 in 1999 attributable to the sale of the commodity ($600 sale price less $420 basis). Since Bud has already included the $500 CCC loan in 1998 income, the inclusion in income of the $80 marketing gain shown on the 1999 Form CCC-1099-G would overstate Bud's income by $80. Therefore, for 1999 Bud should report the $80 marketing gain as an agricultural program payment on line 6a of Part I of Schedule F, but should not report the $80 marketing gain as a taxable amount on line 6b of Part I of Schedule F. Exhibit 1 compares Bud's document reporting trail, cash received, and taxable income.

Without the I.R.C. §77 election, Bud has $80 of marketing gain income in 1999, and the sale of the commodity generates additional income of $600 (sale price less zero basis). Bud should report as income in 1999 both the $600 attributable to the sale and the $80 marketing gain. The $80 marketing gain should be reported on both lines 6a and 6b of Part I of Schedule F. Exhibit 2 summarizes the transaction.

As Exhibits 1 and 2 demonstrate, both the income method and the loan method of reporting CCC loans generate a document reporting trail that suggests the farmer received $760 of income instead of the actual $680. Thus, overreporting of taxable income is a distinct possibility if care is not taken to analyze the CCC loan transactions.

EXHIBIT 1: FARMER *WITH* I.R.C. §77 ELECTION REDEEMS COMMODITY

Transaction	Document Reporting Trail	Cash Received by Farmer	Farmer's Taxable Income	Schedule F Year	Schedule F Line(s)
Receipt of loan proceeds	$500	$500	$500	1998	7a
Cash redemption of commodity	(420)	(420)			
Marketing gain reported on CCC-1099-G	80	0	0	1999	6a
Sale of commodity	600	600	180	1999	1–3
Total	$760	$680	$680		

Practitioner Note. The amount by which the CCC loan payoff is less than the face value will be reported on the CCC Form 1099-G that is sent to the producer. **If the producer made the election to report the loan as income (under I.R.C. §77), this reduction in the loan payoff should not be reported as income.** It should be reported on line 6a of Schedule F but not on line 6b of Schedule F.

EXHIBIT 2: FARMER *WITHOUT* I.R.C. §77 ELECTION REDEEMS COMMODITY

Transaction	Document Reporting Trail	Cash Received by Farmer	Farmer's Taxable Income	Schedule F Year	Schedule F Line(s)
Receipt of loan proceeds	$500	$500	$ 0	No	
Cash redemption of commodity	(420)	(420)			
Marketing gain reported on CCC-1099-G	80	0	80	1999	6a, 6b
Sale of commodity	600	600	680	1999	4
Total	$760	$680	$680		

Option Sold. When farmers sell options on their pledged commodities, the tax rules are somewhat different. (This option is not an exchange-traded commodity option and **applies primarily to the cotton industry.**)

Example 10.9. The facts are the same as in the preceding example, except that later in 1998 a merchant pays Bud 5¢ per pound for the option to purchase the 1,000 pounds of the commodity. The merchant also gets a power of attorney with authority to repay the loan on the farmer's behalf. In 1999, the merchant exercises the option, repaying the loan at 42¢ per pound and redeeming Bud's commodity. Bud will receive a Form CCC-1099-G for 1999 from the CCC showing marketing gain of $80. Again, the proper reporting of the marketing gain depends on whether Bud has made an I.R.C. §77 election.

With the §77 election, in 1998 Bud has income of $500 from the CCC loan and also has $50 of income from the option. The $50 of income from the option is reported on line 10 (Other income) of Schedule F. Bud is treated as having repurchased the commodity for 42¢ per pound when the merchant repays the CCC loan, and recognizes no income. Since Bud has already included the $500 CCC loan in income, the $80 marketing gain shown on the 1999 Form CCC-1099-G would overstate Bud's income, as shown in Exhibit 3. Therefore, for 1998 Bud should report the $500 CCC loan on line 7a of Part I of Schedule F. For 1999 Bud should report the $80 marketing gain as an agricultural program payment on line 6a of Part I of Schedule F, but should not report the $80 marketing gain as a taxable amount on line 6b of Part I of Schedule F.

If the §77 election is not in effect, the commodity is not treated as sold when it is pledged as collateral for the CCC loan. Bud still has $50 of income from the option in 1998. The sale of the commodity to the merchant in 1999 generates income of $420 (sale price less zero basis) to Bud. As shown in Exhibit 4, Bud should report the $50 attributable to the option as income in 1998. The $420 from the sale of the commodity and the $80 marketing gain shown on Form CCC-1099-G are income in 1999. The $80 marketing gain should be reported on both lines 6a and 6b of Part I of Schedule F.

EXHIBIT 3: FARMER *WITH* I.R.C. §77 ELECTION SELLS OPTION

Transaction	Document Reporting Trail	Cash Received by Farmer	Farmer's Taxable Income	Schedule F Year	Schedule F Line(s)
Receipt of CCC loan proceed	$500	$500	$500	1998	7a
Sale of equity	50	50	50	1998	10
Payment of CCC loan by merchant	0	0	0	No[1]	
Marketing gain reported on CCC-1099-G	80[2]	0	0	1999	6a
Total	$630	$550	$550		

[1] $420 received from merchant less $420 paid to repurchase commodity from CCC is zero.
[2] $500 CCC loan proceeds received less $420 repayment = $80.

EXHIBIT 4: FARMER *WITHOUT* §77 ELECTION SELLS OPTION

Transaction	Document Reporting Trail	Cash Received by Farmer	Farmer's Taxable Income	Schedule F Year	Schedule F Line(s)
Receipt of CCC loan proceeds	$500	$500	$ 0	No	
Sale of equity	50	50	50	1998	10
Payment of CCC loan by merchant	0	0	420[1]	1999	4
Marketing gain reported on CCC-1099-G	80	0	80[2]	1999	6a, 6b
Total	$630	$550	$550		

[1] Treated as redemption by farmer for $420 and sale to merchant for $420 (basis of zero).

[2] $500 CCC loan proceeds received less $420 repayment = $80.

Direct Redemption versus Sale

If the farmer redeems the commodity personally and later sells it, the marketing gain should be identifiable on an individual transaction basis. The farmer should have documentation of the original loan proceeds and the redemption payment. Thus, the marketing gain on the transaction is easily determinable and likely can be verified against the CCC-1099-G issued by CFSA. If, however, the farmer sells the equity in the commodity to a merchant (i.e., sells an option), the farmer will not necessarily know when the merchant redeemed the loan or for how much. Thus, the farmer may not be able to verify the marketing gain reported on the CCC-1099-G.

If an I.R.C. §77 election is in effect, the farmer will simply enter the marketing gain on line 6a of Schedule F as a government payment received. The payment will not be taxable, however (it is omitted from line 6b), and thus is reported for information purposes only. If instead the farmer is reporting CCC loans as bona fide loans, the marketing gain will be entered on both lines 6a and 6b and will be a taxable payment. At the same time, to arrive at the amount paid by the merchant to redeem the commodity (which is part of the sale proceeds to be reported), the farmer may simply have to subtract the marketing gain from the original loan proceeds in order to back into the correct income to be reported on the commodity sale. This determination could prove to be tedious and complex if the farmer has several CCC loan transactions with varying dates and different redemption prices. Difficulty in tax reporting arises in this case because the farmer often receives no notification from CFSA that the merchant has repaid the CCC loan and redeemed the commodity and, if so, the amount for which the commodity was redeemed.

If the farmer makes the §77 election, the marketing gain will not be taxable regardless of whether the farmer redeems and sells the commodity or sells the equity and allows the merchant to redeem the commodity. If there is no election, however, the marketing gain will be a taxable receipt. Such treatment does not create a problem if the farmer redeems and sells the commodity, but it can lead to transaction tracing and reporting problems if the farmer sells the equity and the merchant redeems the commodity. (See Daughtrey, Burckel, and Ferguson, "Marketing Gain or Pledged Commodities Subject to Options May Cause Overstated Income," *Journal of Taxation*, July 1994, pp. 356–361.)

ISSUE 11: DISASTER PAYMENTS AND CROP INSURANCE

Adverse weather conditions have caused crop and livestock losses in many parts of the country in 1999. Several income tax rules allow preferential treatment of gains and losses realized as a result of these weather conditions.

EXCEPTION FOR CASH-BASIS FARMERS

For cash-method farmers, there is an exception to the general rule that payments must be reported in the year they are received. The exception allows the farmer to postpone reporting a payment by one year. (It does not allow the taxpayer to accelerate reporting the payment if the payment is received the year after a loss.)

Generally, these rules apply when crops cannot be planted or are damaged or destroyed by a natural disaster such as a drought or flood. 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 [Treas. Reg. §1.451-6(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 year of the receipt of the payment.**

TWO OPTIONS FOR REPORTING ON TAX RETURNS

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

HOW TO MAKE THE ELECTION

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

1. The name and address of the taxpayer
2. A declaration that the taxpayer is making an election under §451(d)
3. Identification of the specific crop or crops destroyed or damaged
4. A declaration that under the taxpayer's normal business practice the income derived from the crops that were destroyed or damaged would have been included in 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 which payments were received

Example 11.1. Daisy Petal normally sells her soybean and cotton crops in the year **after** they are produced. In 1999 her soybean and cotton crops were damaged by drought. 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 1999.

Question 11.1.1. *How is this transaction reported?*

Answer 11.1.1. Daisy can postpone reporting the $36,000 of income by attaching the following statement to her 1999 return. She then reports the $36,000 on line 8a of her 1999 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	Drought	6/10/99	$15,000	10/15/99	Crops Ins., Inc.
Cotton	Drought	6/10/99	$21,000	10/15/99	Crops Ins., Inc.

Observation. Some farmers have deferred crop insurance and disaster payments from 1998 to be reported in 1998. Those payments should be reported on line 8d of the 1999 Schedule F (Form 1040).

AMBIGUITY IN THE ELECTION REQUIREMENTS

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

1. In Rev. Rul. 74-145, 1974-1 C.B. 113, the IRS stated that if a producer normally sold 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 I.R.C. §451(d) election is made.
2. Notice 89-55 and I.R.C. §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.

Question 11.1.2. *Assume the facts are the same as Example 11.1.1 except that Daisy normally sells her soybeans at harvest time. How are the insurance payments reported?*

Answer 11.1.2. 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 11.2. In 1999, 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.

Question 11.2.1. *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?*

Answer 11.2.1. 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. Therefore Clay must decide between reporting the entire amount of payments ($8,000 + $14,000) in 1999 or deferring both payments to 2000, assuming he meets the requirement of normally selling more than 50% of his crops in the following year.

Question 11.2.2. *Assume that Clay Fields 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?*

Answer 11.2.2. Yes, the two separate farming operations in which Clay participates do not have to make the same election. If a taxpayer has more than one farming business, he or she makes a separate election for each such business. Separate farming businesses are those for which the taxpayer keeps separate books and is allowed to use different methods of accounting.

ISSUE 12: SALES OF LIVESTOCK DUE TO WEATHER

If a farmer sells livestock because of a shortage of water, grazing, or other consequences of a weather-related condition, the recognition of the proceeds from the sale may be postponed.

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.

ELECTION TO POSTPONE GAIN BY PURCHASING REPLACEMENT ANIMALS

If livestock (other than poultry) **held for any length of time for draft, breeding, or dairy** (not 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 I.R.C. §1231.)

The new livestock must be used for the same purpose as the livestock that was sold. Therefore, dairy cows must be replaced with dairy cows. The taxpayer must show that the weather caused the sale of more livestock than would have been sold without the weather-related 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 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 conditions

Example 12.1. Rowdy Drover normally sells 15 cows from his beef herd each year. In 1999 drought conditions reduced his hay crop so that he did not have enough to carry his normal herd through the winter. Consequently, he sold 35 cows rather than 15 in 1999. He plans to purchase an additional 20 cows in 2000 to replace the extra 20 that were sold.

Question 12.1.1. *How is this transaction reported for 1999?*

Answer 12.1.1. Only 20 of the cows sold in 1999 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 1999 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

The drought 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 1999. The raised cows have a zero basis. The 35 cows sold for a total of $20,125. Taxpayer elects to defer the recognition of gain on the 20 extra head that were sold [(20 ÷ 35) × $20,125 = $11,500 of gain] under I.R.C. §1033(e).

If Rowdy reinvests $11,500 on 20 replacement cows in 2000, 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 in 20 cows, he must report the excess of $11,500 over the amount reinvested by **amending his 1999 income tax return.** If he buys only 19 cows in 2000 and 2001, $575 of gain (for the cow not replaced) must be reported on his amended 1999 return regardless of what he paid for the 19 replacement cows.

Rowdy should report the purchase of qualified replacement cows on his 2000 or 2001 return. If there is additional income for 1999, an amended 1999 return must be filed.

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

ELECTION TO DEFER INCOME TO A SUBSEQUENT TAX YEAR

If any livestock is sold because of drought conditions, the taxpayer may be eligible for another exception to the general rule that the sale proceeds must be reported in the year they are received. This election applies to **all livestock.**

This exception allows the taxpayer to postpone reporting the income for one year if the following requirements are met:

- The principal business of the taxpayer must be farming.
- The taxpayer must use the cash method of accounting.
- The taxpayer must show that the livestock would normally have been sold in a subsequent year.
- **A drought 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.

Amount Postponed

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

Example 12.2. Mr. Smith normally sells 100 head of raised beef cattle a year. Because of a drought, he sells 150 head during 1999. He realizes $45,000 from the sale of the 150 head. On September 7, 1999, 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 2000 is determined as follows:

$$\frac{\text{Total income from sale}}{\text{Total number sold}} \times \text{Excess number sold} = \text{ Postponed income}$$

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

Mr. Smith may elect to postpone $15,000 of income until 2000. The $30,000 that would have normally been received in 1999 must be reported on his 1999 Schedule F, line 4.

Due Date of Election

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 drought 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 drought conditions
3. A statement explaining the relationship of the designated drought 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 drought

Note: The number of animals that would have been sold under usual business practices in the absence of drought is determined primarily by the past history of the farmer. If the farmer generally holds all calves until the year after they are born before selling them, but was forced because of drought conditions to sell them in the year they were 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 drought during the taxable year
7. A computation, pursuant to Treas. 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
Disaster area declaration required?	No	Yes
Must livestock be in the disaster area?	No	No
Must livestock be sold in the disaster area?	No	No
Must weather 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 income 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

Practitioner Note. Before 1997, the above rules applied only to sales of livestock due to drought. They did not apply to sales due to other weather-related conditions, such as hurricane, tornado, or flooding.

REVOKING AN ELECTION TO DEFER REPORTING OF WEATHER-RELATED SALES OF LIVESTOCK

Example 12.3. In 1998 Bubba Bitterweed disposed of an unusually high number of dairy cows due to drought conditions. On his 1998 tax return, Bubba made an election under I.R.C. §451(e) to include the income from the excess sales of livestock for 1999, the year following the year of actual sale. Later, in 1999, Bubba decided to replace the excess dairy cows sold.

Question 12.3.1. *Can he revoke the I.R.C. §451(e) election and replace the involuntarily converted dairy cows under I.R.C. §1033(e)?*

Answer 12.3.1. According to Ltr. Ruls. 9127012, 9214021, and 9333032, a taxpayer can revoke the I.R.C. §451(e) election **only with the consent** of the Commissioner. However, all taxpayers in these 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 I.R.C. §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 I.R.C. §451(e) election.

Therefore, a taxpayer originally electing I.R.C. §451(e) treatment has also complied with the information-reporting requirements under I.R.C. §1033(e). Since there is no specific requirement that I.R.C. §1033(e) be elected on a timely filed return (only that the appropriate information be supplied), **a taxpayer can apparently elect I.R.C. §1033(e) treatment on an amended return.**

Practitioner Note. A letter ruling request may have to be filed to request permission for such a change. Thus, Bubba could likely change his I.R.C. §451(e) election to an I.R.C. §1033(e) election, if he filed a letter ruling request to do so. Alternatively, the taxpayer might elect to request a determination letter from the District Director. A determination letter is apparently an option when the issue is the replacement of involuntarily converted property under I.R.C. §1033, if the taxpayer has filed a return for the year in which the property was involuntarily converted (Rev. Proc. 99-1, 1999-1 IRB 6).

Example 12.4. Dolly Dandelion disposed of an abnormally high number of breeding cows in 1998, due to drought conditions. On her 1998 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 1999, Dolly decides that she will **not** replace the cows. However, she would prefer to report the income from the drought sale in 1999, rather than amending her 1998 return, since her marginal tax rate was significantly higher in 1998 than in 1999.

Question 12.4.1. *Can Dolly revoke the I.R.C. §1033(e) election and elect the one-year deferral of sale reporting under I.R.C. §451(e)?*

Answer 12.4.1. **Apparently,** Dolly cannot revoke the I.R.C. §1033(e) election and adopt an I.R.C. §451(e) election. An election under I.R.C. §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 1998 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 I.R.C. §1033(e) treatment is elected and the due date of the return passes, I.R.C. §451(e) treatment is no longer available. If, on the other hand, I.R.C. §451(e) treatment is elected, it may be revoked only with permission, which may require a letter ruling request.

A second option is to request a determination letter. However, if permission to revoke I.R.C. §451(e) treatment is granted, an I.R.C. §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	New Election
I.R.C. §451(e) One-year deferral	Yes	I.R.C. §1033(e) Purchase replacements
WHY: I.R.C. §1033(e) election can be made on amended return.		
I.R.C. §1033(e) Purchase replacements	Yes	I.R.C. §451(e) Not available
WHY: I.R.C. §451(e) election must be made by original tax return due date.		

ISSUE 13: TAX BASIS FOR TIMBER SALES

ALLOCATION OF ORIGINAL BASIS

Sales contracts and other instruments transferring forest property often do not list separate prices or values for the land, timber, and other assets when these are acquired in a single transaction. The total basis in such situations must be allocated among the various assets according to the separate fair market value of each at the time the property is acquired. This requirement applies no matter when the allocation is actually made–even if it is done many years after the acquisition.

CAPITAL ACCOUNTS

The cost of assets should be allocated to the proper capital account at the time the assets are purchased.

Land Account

Assets that are placed in the land account include the land itself and nondepreciable land improvements. Nondepreciable land improvements include earthwork assets of a permanent character, either acquired with the property or constructed later. Examples are the roadbeds of permanent roads (those with an indeterminable useful life to the landowner), land leveling, and earthen impoundments. Refer to Rev. Ruls. 68-281 and 88-99 for guidance regarding permanent and temporary roads.

Depreciable land improvements

Depreciable land improvements may include bridges, culverts, graveling, fences, fire towers, and other nonpermanent structures and improvements. Temporary roads, such as those to be abandoned after completion of a logging operation, may also be depreciated (or amortized). The costs of firebreak construction are treated the same as the expenses of constructing temporary roads.

Forest Fertilization Costs

Code §180 allows farmers to elect to currently deduct the cost of fertilizer and lime. However, that election is not available to producers of timber because growing timber is not treated as a farming business. Therefore, the general tax rule apparently applies that requires taxpayers to amortize the cost of fertilizer over its useful life.

In 1989 the IRS issued, GCM 39791 that addresses this issue but later withdrew it without further explanation (GCM 39844).

William Siegel, who is a respected authority on timber taxation, reports that he was told in an informal meeting with the IRS that its current position is that the fertilizer expenses should be amortized over the useful life of the fertilizer, which is three to five years. Consequently, the cost of fertilizer apparently does not have to be added to the basis of the timber, but can be deducted from income over the useful life of the fertilizer.

Timber Accounts

The timber account should include separate subaccounts for merchantable timber, young growth (naturally seeded trees of premerchantable size), and plantations (planted or seeded trees of premerchantable size). Each of these subaccounts should include two entries–one showing the quantity of timber and the other its dollar basis. For merchantable timber, the quantity is shown in volume measurement terms such as cords or thousand board feet (MBF). For premerchantable timber, the quantity is shown as number of acres. Volume and value entries from the young growth and plantation subaccounts should be transferred to the merchantable timber subaccount as soon as the trees in those two subaccounts become merchantable.

The plantation and young growth subaccounts reflect the establishment of timber stands by planting, or by natural or artificial seeding (Rev. Rul. 75-467). Establishment costs include funds spent to prepare a site for tree planting or seeding and for the cost of the seedlings or tree seeds. Site preparation costs are those incurred for brush, weed, and stump removal; and for leveling and conditioning the land to afford good growing conditions and to facilitate planting or seeding.

Other related costs that must be capitalized include the allocable depreciation charges attributable to equipment used in site preparation and planting or seeding–such as trucks, tractors, and tree planters. The cost of hired labor associated with reforestation must also be capitalized. The term "hired labor" includes family members who are actually paid for their services, but it does not include the taxpayer. In certain cases, "hired labor" may also include the spouse of the taxpayer. The taxpayer cannot capitalize the cost of his or her own labor. Establishment costs may also include some expenditures made after seeding or planting, such as for brush control, because a stand is not considered established until a number of individual stems sufficient to adequately stock the site with the desired species are capable of surviving (Rev. Rul. 76–290).

USE OF FORM T

A taxpayer who claims a deduction for depletion of timber or for depreciation of improvements related to timber accounts, or who makes an election under I.R.C. §631(a) must file Form T. As a practical matter, the IRS has not enforced this requirement for private, nonindustrial owners with relatively small timber holdings who sell timber only occasionally. It is legally enforceable, however, and probably should not be ignored. It has been reported that the IRS has assessed penalties for failure to file Form T in several audits of timber producers.

Practitioner Note. A taxpayer whose primary occupation is not timber, who uses a consulting forester to make management and marketing decisions, and who has infrequent timber sales is treated as an investor. He or she reports sales of timber on Schedule D (Form 1040) and does not have to file Form T.

The instructions for Form T stipulate filing of the form as follows:

> **Who Must File.** Complete and attach Form T to your income tax return if you:
>
> 1. Claim a deduction for depletion of timber.
> 2. Claim a deduction for depreciation of plant and other improvements relating to timber accounts, or
> 3. Elect under section 631(a) to treat the cutting of timber as a sale or exchange.
>
> Generally, you should file Form T to treat the cutting of timber as a sale of timber or if you are involved in other timber transactions.
>
> Complete Form T in accordance with sections 611, 631, and 1231 and related regulations. Complete only Schedules C and F (Form T) if you are a small-woodlot owner whose only timber-related activity during the year was an **isolated** sale of timber.

Form T contains nine schedules covering maps (optional), acquisitions, profit or loss from land and timber sales, losses, reforestation and timber stand activities, capital returnable through depletion, landownership, road construction cost, and drainage structures.

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

Example 13.1. Virginia Pine bought a 200-acre tract of timberland in 1999. The contract price was $130,000, but Virginia also paid $1,800 to have the boundaries surveyed, $500 for a title search and filing, and $2,700 to have the timber cruised and evaluated. Therefore, Virginia's total acquisition cost was $135,000. The timber cruise conducted at the time of the purchase determined that the tract contained 2,000 cords of merchantable pine pulpwood on 180 acres. There were also 20 acres of young growth (trees of premerchantable size) that contributed to the value of the property. The fair market value of the timber on the date of purchase was $35 per cord. The young growth had a fair market value of $180 per acre. The fair market value of the land itself, not considering the timber, was $350 per acre. Therefore, the sum of the separate fair market values of all of the assets purchased was $143,600.

Question 13.1.1. *How is the purchase price allocated among the land, young growth, and merchantable timber?*

Answer 13.1.1. The original cost basis for the land, merchantable timber, and young growth is allocated by determining the proportion of the total fair market value represented by each and multiplying this ratio by the total acquisition cost. The original cost basis for each of the assets is shown in the following table. It is reported on Schedule B of Form T.

DETERMINATION OF COST BASIS

Asset	Fair Market Value	Proportion of Total Fair Market Value	Original Cost Basis
Land	$ 70,000	0.4875	$ 65,812
Young growth	3,600	0.0250	3,375
Merchantable timber	70,000	0.4875	65,813
Total	$143,600	1.0000	$135,000

Question 13.1.2. *In 2003 Virginia Pine remeasures the timber she bought in 1999. Virginia determines that the young growth has reached merchantable size and contains 160 cords. How does Virginia adjust the timber accounts?*

Answer 13.1.2. Virginia transfers the dollar amount shown in the young growth subaccount and the estimated number of units to the merchantable timber subaccount. The closing 2002 balance in the merchantable timber subaccount is therefore $69,188 ($65,813 plus $3,375). The balance in the young growth subaccount is reduced to $0. This reallocation is reported on Schedule F of Form T (shown below).

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

Forest Activities Schedules

► **Attach to your tax return.**

For tax year ended *12-31-99* , ...

OMB No. 1545-0007

Attachment Sequence No. **89**

Name(s) as shown on return: *Virginia Pine (Example 11.1)*

Identifying number: *194 62 1033*

Form T (Timber) (Rev. 3-98) Page **2**

Schedule B Acquisitions

2 Report acquisitions during the tax year (such as by purchase, exchange (whether taxable or not), gift, or inheritance) of timber, timber cutting contracts, or forest land. Report separately each acquisition of $10,000 or more. You may combine acquisitions of less than $10,000 for each account, and omit lines 4 and 5. For an acquisition by gift or inheritance, do not complete lines 6 through 8b. For an acquisition or lease of timber-cutting rights on a pay-as-cut basis, except for those under which all cutting is completed within the tax year, do not complete lines 6 through 10. Instead, briefly give the provisions of the purchase or lease agreement, including the number of years from the effective date to the expiration date, annual minimum cut or payment, and the payment rates for different kinds of timber and forest products. Follow the format of lines 3 through 10 on additional sheets if necessary.

3 Name of block and title of account [1]

4 Location of property (by legal subdivisions or map surveys)
NE 1/4 of Sec. 5 and SE 1/4 of NW 1/4 of Sec. 5, Any Township, Pine Co. GA

5a Name and address of seller or person from whom property was acquired
Douglas Fir
88 Beetle Bark Rd
Longleaf GA

b Date acquired *1-15-99*

6 Amount paid: **a** In cash	*130,000*
b In interest-bearing notes	
c In non-interest-bearing notes	
7a Amount of other consideration	
b Explain the nature of other consideration and how you determined the amount shown on line 7a:	
8a Legal expenses	*500*
b Cruising, surveying, and other acquisition expenses	*4,500*
9 Total cost or other basis of property (add lines 6a through 8b)	*135,000*

10 Allocation of total cost or other basis on books:	**Unit**	**Number of units**	**Cost or other basis per unit**	**Total cost or other basis**
a Forested land	Acre	*200*	*329*	*65,812*
b Other unimproved land	Acre			
c Improved land (describe) ►	Acre			
d Merchantable timber (Estimate the quantity of merchantable timber present on the acquisition date. (See Regulations section 1.611-3(e).) Details of the timber estimate, made for purposes of the acquisition, should be available if your return is examined.)	*cords*	*2,000*	*32.91*	*65,813*
e Premerchantable timber. (Make an allocation here only if it is a factor in the total cost or value of the land.)	*acres*	*20*	*168.75*	*3,375*
f Improvements (list separately)				
g Mineral rights				
h Total cost or other basis (same as line 9)				*135,000*

Schedule F Capital Returnable Through Depletion

On lines 27 through 42, give the data for each timber account separately. Cover any changes that have taken place during the tax year. Attach as many additional pages of this schedule as needed. If you deplete on the block basis, combine new purchases with the opening balances and use the average depletion rate shown on line 34 for all timber cut or sold, regardless of how long held. If you express timber quantity in MBF, log scale, name the log rule used ▶

27	Name of block and title of account ▶ *Virginia Pine - Timber Acct.*	(a) Quantity in MBF, log scale; cords; or other unit[1]	(b) Cost or other basis
28	Estimated quantity of timber and amount of capital returnable through depletion at end of the immediately preceding tax year	*2000 cords*	*65,813*
29	Increase or decrease of quantity of timber required by way of correction[2]		
30a	Addition for growth (period covered ▶ .... years)	*1000*	
b	Transfers from premerchantable timber account	*160*	*3,375*
c	Transfers from deferred reforestation account		
31	Timber acquired during year		
32	Addition to capital during year[3]		
33	Total at end of year, before depletion (add lines 28 through 32, in each column)	*3160*	*69,188*
34	Unit rate returnable through depletion, or basis of sales or losses (line 33, column (b), divided by line 33, column (a))		
35	Quantity of timber cut during year		
36	Depletion sustained (line 34 multiplied by line 35)		
37	Quantity of standing timber sold or otherwise disposed of during year		
38	Allowable as basis of sale (line 34 multiplied by line 37)		
39	Quantity of standing timber lost by fire or other cause during year		
40	Allowable basis of loss (line 34 multiplied by line 39)		
41	Total reductions during year:		
a	Add line 35, column (a); line 37, column (a); and line 39, column (a).		
b	Add line 36, column (b); line 38, column (b); and line 40, column (b).		
42	Net quantity and value at end of year (line 33, column (a) less line 41a, column (a); and line 33, column (b) less line 41b, column (b)).	*3160*	*69,188*

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[1] If MBF, log scale, is not the unit used, state what unit you used and explain it.

[2] Adjust the quantity in MBF, log scale, or other unit remaining at the end of the year for changes in reinventory, standards of use, scattered and/or indefinitely ascertained losses, inaccuracy of the former estimate, or change in the log scale if the log rule now in use differs from the one used as basis for depletion in earlier years. If you make a change, clearly state the basis for it.

[3] Analyze the addition to show the individual items included. Include expenditures for taxes, administration, protection, interest actually paid, etc., if you did not treat these expenditures as expense deductions on your return. Carry expenditures for reforestation, such as site preparation, planting, seeding, etc., in a separate deferred account.

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43 Quantity of cut timber that was sold as logs or other rough products

44 Are you electing, or have you made an election in a prior tax year that is in effect, to report gain or loss from the cutting of timber in accordance with section 631(a)? (This election is binding for all eligible timber cut in the election year and all subsequent years. You may revoke the election only with IRS consent, unless you made the election for a tax year beginning before 1987.) ☐ **Yes** ☐ **No**

If "Yes," furnish the information asked for in items 45 through 51.

45 Gain or loss on standing timber as reported on **Form 4797**, Sales of Business Property. Show the adjusted basis for depletion and the fair market value, by species and unit rates if reported on a species basis. Section 631(a) requires you to determine the fair market value of timber cut during the year for timber you owned, or held under contract right to cut, for more than 1 year. The fair market value is the value of the timber as it stood in the forest on the first day of the tax year.

46 Furnish the date of acquisition of timber that was cut in the tax year, if acquired after March 1, 1913; the quantity of timber remaining (adjusted for growth, correction of estimates, changes in use, and any change in the log rule used); and the adjusted basis at the beginning of the tax year. State the acreage cut over and the amount of timber cut from it during the tax year and the log rule or other method you used to determine the quantity of timber cut. If you kept depletion accounts by separate tracts or purchases, give the information separately for each tract or timber purchase.

If you used an average depletion rate based on the average value or cost of a timber block in earlier years, the adjusted basis referred to in section 631(a) is the average basis shown on lines 34, after adjustment.

47 Describe in detail the characteristics of the timber that affect its value, such as total quantity, species, quality, quantity per acre, size of the average tree, logging conditions, distance to markets, and the like.

POSTACQUISITION DETERMINATION OF BASIS

If the basis of the timber was not established at the time of purchase or inheritance, the basis will have to be determined by working backward from current information. Harry L. Haney and William C. Siegel list the following suggestions for determining the basis of timber after the fact in their reference volume *Timber and the Federal Income Tax* (p. 31).

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

The application of these guidelines is illustrated by the following example.

Example 13.2. In 1999 Red Oakes plans to harvest timber from an 80-acre tract that was purchased 10 years ago for $80,000. Oakes did not prepare any records at the time of purchase. The tract is presently stocked with approximately 560 MBF (7 MBF/acre) and compares closely with timber stands in the vicinity that grow 300 board feet per acre per year. A consulting forester advised Oakes that prices in his area averaged $200 per MBF for similar-quality timber in 1989. Sales records of several real estate brokers indicated that bare timberland values averaged $250 per acre in the general area in 1989.

Question 13.2.1. *How can Oakes establish a timber basis for depletion?*

Answer 13.2.1. In order to establish a basis in his timber retroactively, Oakes must know the timber volume and prices, and fair market value for the land asset at the time of purchase. Timber volume in 1988 would have been 320 MBF at the estimated rate of growth {560 MBF – [(300 BF/acre/year × 80 acres) × 10 years]}. Average timber prices were $200 per MBF, for a $64,000 (320 MBF × $200 per MBF) estimated market value. Oakes' land was valued at $250 per acre ($20,000 total), giving an overall tract value of $84,000. The original price ($80,000) is allocated in the same proportion that each account bears to the total fair market value at the time. Therefore, the timber basis would be $60,960, and the land basis would be $19,040. If Oakes sells all of the merchantable timber, he can deduct $60,960 as recovery of basis (depletion), as shown in the following table.

Account	1989 Fair Market Value	Percent of FMV		Purchase Price	1989 Allocation of Purchase to Basis
Land	$20,000	23.8	×	$80,000	$19,040
Timber	64,000	76.2	×	80,000	60,960
Total	$84,000	100			$80,000

Other procedures that adequately establish the fair market value of the land and timber assets on the date of acquisition may also be used. A key test for the results is their reasonableness for the facts given in each case.

TIMBER DEPLETION

Basis recovery applies to the sale of timber. If all of the timber is sold, the entire basis in the timber account may be deducted; if only part of the timber is sold, the basis is allocated between the portion sold and the portion retained.

Many (if not most) timber dispositions involve trees that are not fungible. For example, a forest owner may sell or cut only mature trees or trees of a certain species, retaining the less mature growth or trees of other species. Because of the serious allocation problems that would otherwise ensue, the Code has established special "depletion" rules that use the volume of timber sold to allocate basis between trees that are cut or disposed of in a particular transaction and trees that remain.

Information in the Timber Accounts Used to Determine the Amount of Depletion

Timber Account's Adjusted Basis. The first determination required is the timber account's adjusted basis; this is the original cost or other basis adjusted for subsequent capital expenditures and losses not otherwise recovered [Treas. Reg. §1.612-1(a)].

Additions. Additions to the original basis include such items as subsequent purchases or other acquisitions added to the existing timber account, capitalized costs, and transfers from other timber accounts.

Deductions. Deductions from the original basis include such items as the basis attributable to prior sales and other transactions such as gifts, and reductions in basis attributable to casualty or other losses.

Total Volume of Timber. After determination of the timber's adjusted basis, the total volume of timber in the account at the time of sale or disposal must also be determined.

Depletion Unit. The depletion unit is determined by dividing the adjusted basis of the timber by the total volume of timber [Treas. Reg. §1.611-3(b)(2)]—usually expressed in dollars per thousand board feet or cords.

Amount of Depletion. The amount of depletion for a given transaction is calculated by multiplying the depletion unit by the number of units of timber cut, sold, or otherwise disposed of during the tax year.

Apportionment of the Depletion Deduction

When more than one taxpayer owns an economic interest in a single tract of timber, apportionment of the depletion deduction among the owners is required. The rules for this allocation are contained in Treas. Reg. §1.611-1(c).

Life Tenant and Remaindermen. The life tenant is entitled to the depletion deduction during his (her) lifetime as if he (she) were the absolute owner of the property. If any basis remains to be depleted after the life tenant's death, the remaindermen are then entitled to the deduction [I.R.C. §611(b)(2)].

Timber Held in Trust. The deduction is apportioned between the income beneficiaries and the trustee on the basis of the trust timber income allocable to each. However, if the trust instrument or local law requires or permits the trustee to maintain a reserve for depletion, the deduction is first allocated to the trustee to the extent that income is set aside for a depletion reserve, and any excess is apportioned between the income beneficiaries and the trustee on the basis of the trust income allocable to each [I.R.C. §611(b)(3)].

Timber Held by an Estate. The deduction is apportioned among the estate and the heirs, legatees, and devisees in proportion to the amount of the estate's timber income allocable to each [I.R.C. §611(b)(4)].

MORE INFORMATION

For more information on the tax treatment of timber, see Agriculture Handbook No. 708, *Forest Owner's Guide to Federal Income Tax*. To order this handbook, call 202-512-1800 or write the Superintendent of Documents, U.S. Government Printing Office, Mail Stop SSOP, Washington, DC 20402-9328. The handbook cost is $10.00 (subject to change). The handbook GPO stock number is 001-000-04621-7. A newly revised edition of the handbook should be available early next year.

AGRICULTURAL ISSUES QUESTIONS AND ANSWERS

Question 1. *I have heard through the media that tax returns should or could be amended to place Conservation Reserve Program (CRP) payments on Schedule E rather than Schedule F. Would you recommend doing this at this time? Is there any provision to amend more than three years?*

Answer 1. The Tax Court has ruled in *Wuebker v. Commissioner*, T.C. 1998, that CRP payments are not subject to self-employment tax because the land for which the rent is paid is not used in agricultural production. The IRS has appealed that case. Pending the outcome of the appeal, taxpayers can follow the Tax Court decision and not pay self-employment tax on CRP payments. It is a good idea to amend prior-year returns before the period for amending those returns has expired. The IRS is likely to hold the amended return until the *Wuebker* appeal is decided. If the *Wuebker* case is reversed, the IRS will not refund the self-employment taxes for taxpayers who materially participate in the farm business.

Practitioner Note. Property taxes, insurance, interest, and other related expenses should be prorated between Schedule F and Schedule E.

Question 2. *How lenient is the IRS in allowing farmers' spouses to participate in Section 105 plans? Hours of work/week? Pay per hour? Total compensation package?*

Answer 2. The IRS looks closely at Section 105 plans if the return is audited. If the employee is the employer's spouse, the IRS will look for signs that there is not a bona fide employment relationship. The IRS will look at the total compensation package (including the §105 benefits) and ask the taxpayer to document the hours worked. If the pay per hour is not consistent with market rates, the IRS will challenge the deduction of excess compensation. The following factors are good indicia of a bona fide employment relationship:

1. Written employment contract with duties listed and rate of pay shown (so much per hour for each listed duty)
2. Good daily records maintained by employee spouse to show number of hours worked and duties performed
3. Spouse paid by check no less than once a month
4. W-2 issued

Question 3. *For the deferred-payment method of sale of grain, how long can a farmer forward-sell grain before he has to report the money as taxable? Can the taxpayer sell 1998 crops in January or February 1999 and have it not taxable until January 2000?*

Answer 3. Yes. A farmer can defer Schedule F income for one tax year following the year of sale via a signed deferred-payment contract. Deferral for more than one year may be questioned by the IRS.

Question 4. *If you have a Schedule F loss in 1998, convert an IRA to a Roth IRA, and elect to put all of the Roth conversion income in 1998 to be offset by the Schedule F loss, can you then elect farm income averaging in 1999 and still utilize the Schedule F loss in income averaging?*

Answer 4. No. The income averaging rules do not allow a negative income to be used from prior years. Therefore, if the Roth conversion did not offset all of the Schedule F loss in 1998, the taxpayer must still begin at zero taxable income for 1998 when calculating 1999 taxes using income averaging.

Question 5. *(Re: Mizell.) A retiring father cash-rents or crop-shares to his son, and the father is an agricultural employee of the son. If the father works on his own ground, is the self-employment tax triggered on the rent/crop share?*

Answer 5. If the father meets one of the tests in the *Farmer's Tax Guide,* IRS Publication 225, his rent is subject to self-employment tax. The 1998 Publication 225 states the following on p. 77:

> **Material participation.** You are materially participating if you have an arrangement with your tenant for your participation and you meet one of the following four tests.
>
> 1. You do any three of the following.
>   - **a.** Pay or stand good for at least half the direct costs of producing the crop or livestock.
>   - **b.** Furnish at least half the tools, equipment, and livestock used in the production activities.
>   - **c.** Advise or consult with your tenant.
>   - **d.** Inspect the production activities periodically.
> 2. You regularly and frequently make, or take an important part in making, management decisions substantially contributing to or affecting the success of the enterprise.
> 3. You work 100 hours or more spread over a period of 5 weeks or more in activities connected with agricultural production.
> 4. You do things which, considered in their total effect, show that you are materially and significantly involved in the production of the farm commodities.
>
> These tests may be used as general guides for determining whether you are materially participating.

Question 6. *A farmer retired in December 1998 and leased his farm under a crop share lease in 1999. The farmer sold 1998 crop in January 1999. There was no passive income, no crop share rent, and no 1999 crop sold in 1999. Should 1998 real estate tax paid in 1999 be reported on Schedule F or Form 4835?*

Answer 6. The sale of the 1998 crop and the 1998 expenses paid in 1999 should be reported on the 1999 Schedule F (Form 1040) since they are from the farming business. In this situation, the 1999 Schedule F will show income and few expenses. The 1999 Schedule F net profit is subject to self-employment tax. However, the net earnings on carry-over grain sales are **not** considered earnings for reduction of social security retirement benefits [20 CFR §404.429(b)(2)(ii)(A)].

Question 7. *Assume the same facts as in Question 6. Is the landowner's share of the 1999 crop production expenses deductible on the 1999 Form 4835?*

Answer 7. Yes. A crop share activity reported on Form 4835 is a rental real estate activity and is treated as passive. The 1999 Form 4835 will show no income and all of the 1999 crop expenses. If the landowner actively participates in the rental activity, up to $25,000 of a loss shown on Form 4835 may qualify for the rental real estate exception to the passive loss rules, depending on the landowner's modified adjusted gross income.

Question 8. *I read that farmers who sell culled cows (Form 4797, Schedule D) still qualify for the earned income credit even if their gain from the sale of those cows is over $2,300.*

Answer 8. That is correct. In Rev. Rul. 98-56, released in November 1998, the IRS stated, "Section 32 of the Internal Revenue Code allows an earned income credit to eligible individuals whose income does not exceed certain limits. Section 32(i) denies the earned income credit to an otherwise eligible individual if the individual's 'disqualified income' exceeds a specified level for the taxable year for which the credit is claimed. Disqualified income is income specified in section 32(i)(2). Gain that is treated as long-term capital gain under section 1231(a)(1) is not disqualified income for purposes of section 32(i)."

In IR-99-46, the IRS stated that the change is retroactive to 1996 and 1997, and taxpayers can file amended returns for those years within the statute of limitations for amending returns.