AGRICULTURAL ISSUES

ISSUE 1: SELF-EMPLOYMENT TAX

A. APPLICABLE LAW

Agricultural tax law practitioners focus attention on whether or not there is material participation in a farming business in order to determine if payments to an owner of farmland are subject to the self-employment tax. To understand why material participation is an important issue in the agricultural setting, the structure of the statutes that impose the self-employment tax must be reviewed.

1. General Rule

I.R.C. §§1401(a) and 1402(a) and (b) impose the self-employment tax on net income from a taxpayer's trade or business or from a partnership in which the taxpayer is a member. For purposes of this general rule, trade or business includes the business of renting property.

Rent received from personal property is subject to self-employment tax if the taxpayer is in the business of renting personal property. It **does not matter** whether or not the taxpayer is materially participating in the business. The instructions for the 1999 Schedule E (Form 1040) state, "You are in the business of renting personal property if the primary purpose for renting the property is income or profit and you are in involved in the rental activity with continuity and regularity."

Example 1.1. Rich Mann has a speedboat that he uses for skiing and fishing. He has never rented it to anyone and has never used it in a business. In July 2000, he rented it to his neighbor who used it for a one-week vacation.

Rich is not in the rental business. He does not have to pay self-employment tax on his rental income. He must report the rental income on line 21 of Form 1040 and any deductible expenses from renting the boat on line 32 of Form 1040.

If Rich rented his boat to his neighbor every summer for a week, the IRS is likely to argue that he is renting it "with regularity" and must pay self-employment tax on the net income. Therefore, the rental income and deductible expenses must be reported on Schedule C (Form 1040).

> **Practitioner Note**. There is a narrow exception for personal property that is "leased with the real estate" that is exempt under the first exception discussed below.

Rent from real estate is subject to self-employment tax unless it falls within the real estate exception discussed below.

2. Real Estate Exception

Generally, rent from real estate is excluded from self-employment income for purposes of the self-employment tax. I.R.C. §1402(a)(1).

Observation. Because of this broad exception, rent from real estate is generally not subject to self-employment tax.

Example 1.2. The owner of a building used in a construction business does not have to pay self-employment tax on rent received for that building. It does not matter whether or not the taxpayer is materially participating in the business that uses the real property.

The real estate exception includes personal property leased with the real estate. However, there is no guidance on what personal property will qualify for this exception. It is likely that personal property that uniquely fits the real property is included in this exception, such as window shades and appliances in an apartment or equipment in a feeding shed on a farm. It could also be argued that a line of farm machinery, including tractors, planters, cultivators, and harvesting equipment, that is used solely on the rented real estate is included. It is likely that a line of farm machinery rented with a building in which it is stored does not qualify for this exception.

3. Exceptions to the Real Estate Exception

There are two exceptions to the general rule that rent from real estate is not subject to self-employment tax.

One of the exceptions is not important in the agricultural setting. It is for rentals received in the course of a trade or business as a real estate dealer.

The other exception applies only in the agricultural setting. It says that the real estate exception does not apply if both of the following requirements are met:

1. The land is used under **an arrangement** that provides:
   - **a.** That another individual will produce agricultural or horticultural commodities on the land.
   - **b.** That the owner of the land will materially participate in the production of the agricultural or horticultural commodities.
2. There is material participation by the owner of the land with respect to the agricultural or horticultural commodity.

The above statutory structure of the self-employment tax is applied to three situations below:

- Land rented to an entity
- CRP payments
- 4-H and FFA projects

B. LAND RENTED TO AN ENTITY

Until 1995, the IRS did not challenge the common practice of treating rent from an entity to an owner of the entity for farmland held outside the entity as not being subject to self-employment tax.

Example 1.3. Cliff Hanger is a partner in a farming partnership. His three sons are the other partners. Cliff owns farmland in his own name and rents that land to the partnership. Before 1995, the IRS did not require Cliff to pay self-employment tax on his rental income.

Beginning in 1995, the IRS has taken the position that rent received by a landowner for land rented to an entity and used in agricultural or horticultural production is subject to self-employment tax if:

1. There is an arrangement calling for the landowner's material participation.

> **Practitioner Note.** The IRS argues, and the courts have agreed, that a partnership agreement or an employment agreement with the entity is such an arrangement.

2. The landowner materially participates in the farming business.

1. Line of Cases, Rulings, and Advisory Opinions

There is now a line of cases, rulings, and advisory opinions all holding that rent received by the landowner from an entity is subject to self-employment tax.

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

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

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

In FSA 199917005 and FSA 199917006, issued in May 1999, H rented land from W to use in his farm business. The lease did not require W to materially participate in the farm business. However, H employed W to work in the farm business. The IRS concluded that the rent H paid to W was subject to self-employment tax on the rent because the employment agreement was an arrangement that required W to materially participate.

In FSA 199917008, issued in May 1999, H was the 100% owner of a corporation that rented land from H and W for use in a farm business. The lease did not require H or W to materially participate. The corporation employed H and W. The IRS concluded that the employment agreement required H and W to materially participate, so H and W were subject to self-employment tax on the rental income.

In *Bot v. Commissioner*, T. C. Memo 1999-256, Mr. Bot rented land from his wife to use in his farming business, which was organized as a sole proprietorship. Mrs. Bot was also paid for services she provided to the farm business under an employment agreement. The court stated, "With respect to whether under the arrangement Mrs. Bot was to materially participate in the farming operations, we look not only to the obligations imposed upon Mrs. Bot by the oral lease, "but to those obligations that existed within the overall scheme of the farming operations which were to take place" on Mrs. Bot's property. *Mizell v. Commissioner*, T. C. Memo 1995-571." The court concluded that the employment agreement called for Mrs. Bot's material participation and that she did materially participate. Therefore, her rental income is subject to self-employment tax.

In *Hennen v. Commissioner*, T.C. Memo 1999-306, Mrs. Hennen rented 200 acres to her husband for use in his farming business. She also provided services to the farming business under an employment agreement and was compensated for those services. The court used the same reasoning as in *Bot v. Commissioner, supra,* and held that Mrs. Hennen's rent is subject to the self-employment tax.

In *McNamara v. Commissioner*, T.C. Memo 1999-333, Mr. and Mrs. McNamara owned farmland as joint tenants. They cash-rented the land to a corporation that was solely owned by Mr. McNamara. Mr. and Mrs. McNamara were also both employees of the corporation. The court followed the reasoning of *Mizell, supra,* and found that the obligations as longstanding participants in the farming business as well as the general understanding between the taxpayers and the corporation with respect to the production of agricultural products was an arrangement that provided or contemplated that the taxpayers materially participate in the production of agricultural commodities on the farmland. The court also found that the taxpayers did materially participate in the farming business. Therefore, the rent they received was subject to self-employment tax.

In summary, the IRS has won four tax court cases on this issue and has issued four of its own pronouncements saying rent is subject to self-employment tax.

Practitioner Note. The last three court cases have been appealed to the 8th Circuit Court of Appeals. Several other cases in the tax court are being held pending the outcome of the appeals in the above cases.

2. Improvements on the Land

The authorities discussed above do not address the issue of whether rent received for buildings or other improvements on the land is subject to self-employment tax.

The language of I.R.C. §1402(a)(1) appears to include rent on the buildings in the real estate exception but exclude that rent from the agricultural or horticultural exception to the real estate exception.

The real estate exception excludes "rentals from real estate" from self-employment income. Since real estate includes the improvements on the land, buildings are apparently included in the real estate exception.

The agricultural and horticultural exception to the real estate exception includes "land" for which the material participation requirements are met. By using a different term in the agricultural and horticultural exception, Congress must have meant something different from "real estate." A logical conclusion is that they meant to include only bare land in the agricultural and horticultural exception and not improvements. If improvements are not in the agricultural and horticultural exception, then rent received for the improvements is not subject to self-employment tax even if the material participation requirements are met.

Example 1.4. Fran Chise is the sole shareholder of Holstein Heaven, Inc., which operates a dairy farm. Holstein Heaven has a cash lease with Fran that calls for $24,000 of rent for 300 acres of farmland and $10,000 of rent for Fran's dairy buildings. Fran is also an employee of Holstein Heaven.

The IRS is likely to argue and the Tax Court is likely to agree that the $24,000 of rent for the farmland is subject to self-employment tax. However, the $10,000 of rent for the dairy buildings is apparently not subject to self-employment tax since that rent is not paid for "land."

Practitioner Note. The proposed regulations that implement the income-averaging rules interpret the term "land" as used in I.R.C. §1301 to not include improvements on the land. If that same interpretation is applied to the use of the term "land" in I.R.C. §1401, then the rent paid for improvements on the land is not subject to the self-employment tax even if the owner of the improvements has an arrangement calling for material participation and materially participates in the farming business.

3. Planning to Avoid Self-employment Tax on Rent From an Entity

Avoiding Material Participation. Under the reasoning of the above cases and rulings, avoiding self-employment tax on the rent paid for farmland requires the owner of the land to avoid material participation in the farming operation.

One way to avoid material participation by the landowner is to shift ownership of the land to an individual who is not involved in the farming operation.

Example 1.5. Howie Duzzitt farms with his son in a partnership. The partnership rents land that Howie owns individually. Howie's wife, Betty, manages a retirement home and does not participate in the farming business.

Rent paid from the partnership to Howie is subject to self-employment tax under the above authority. If Howie gave his land to Betty and the partnership rented it from her, the rent would not be subject to self-employment tax.

Practitioner Note. The IRS may argue that the only reason for giving the land to Betty was to avoid self-employment tax and therefore treat the rent as being received by Howie. Howie and Betty should document reasons for the gift other than the self-employment tax savings, such as estate planning or protection of assets from creditors, and file applicable gift tax returns.

Transferring Land to Another Entity. Another **arguable** way to avoid material participation by the landowner is to shift ownership of the land to an entity such as a corporation or a limited partnership.

If land is put into a corporation to avoid self-employment tax problems, other tax issues should be considered to ensure that putting the land into the corporation does not create more tax liability than it saves. Other tax issues to consider include recognition of gain if the land is taken out of the corporation, the personal-holding company tax under I.R.C. §541, special use valuation of assets in a decedent's estate under I.R.C. §2032A, the family-owned business deduction under I.R.C. §2057, and installment payment of estate taxes under I.R.C. §6166.

Putting the land into a family limited partnership (FLP) may accomplish some estate planning objectives as well as reduce self-employment tax. An FLP does not pay income or self-employment tax on its net rental income. General partners are subject to income tax and self-employment tax on their share of the net rental income, but limited partners are only subject to income tax on their share of net rental income. Only the net rental income allocable to the general partnership interest would be subject to self-employment tax.

Example 1.6. Rocky and Sandy Beach own 640 acres of land as joint tenants. They rent the land to Beach Farms, LLC, under a written cash lease. Rocky owns a 50% interest in Beach Farms, LLC, and he materially participates in the farming activity of Beach Farms, LLC. Sandy does not participate in the farming activity. Rocky and Sandy receive $64,000 of rent each year for their land and pay $7,000 in property taxes and other deductible expenses each year.

Rocky and Sandy could form an FLP and contribute their 640 acres to it. Rocky could own a 1% general partnership interest and Sandy could own a 99% limited partnership interest.

Ninety-nine percent of the FLP's $57,000 ($64,000 – $7,000) of net rental income would flow through to Sandy for income tax purposes and 1% would flow through to Rocky. Arguably, only Rocky's 1% share (1% × $57,000 = $570) as a general partner would be subject to the self-employment tax.

Practitioner Note. If both spouses materially participate in the farming business, they could still put the land in an FLP and argue that the rent they receive as limited partners is not subject to self-employment tax. The proposed regulations for imposing self-employment tax on a limited partner's share of income recognize that an individual can receive income as a general partner that is subject to self-employment tax as well as income as a limited partner that is not subject to self-employment tax. Prop. Reg. §1.1402(a)-2. Those proposed regulations were put on hold by Congress and have not been issued as temporary or final regulations since the hold expired on July 1, 1998, but they do open the door to an argument that the partners of an FLP can bifurcate their ownership interest so that part of the income that flows through to them is subject to self-employment tax and some of it is not.

C. RENT PAID TO RETIRED LANDOWNERS

Retired landowners face the same issues as landowners who rent to an entity. If the retired landowner materially participates in the farming operation and there is an arrangement providing for that material participation, the rent received for the farmland is subject to self-employment tax.

Example 1.7. Jerry Rigg retired from farming and rented his farm to Penny Weise, a beginning farmer, under a share-lease. To ensure proper management, the lease stated that Jerry would advise Penny on crop and livestock management. Jerry regularly inspected the crops and livestock and advised Penny on when to plant, cultivate, and harvest crops as well as on the care of the livestock. Jerry's share-rent income is subject to self-employment tax.

If the lease does not provide for the landowner's participation in the farming business and there is no other arrangement providing for material participation, **the rent should not be subject to self-employment tax, even if the landowner in fact materially participates** in the farming business.

Example 1.8. Lily Padd retired from farming and rented her farm to her son for cash rent. The lease gives her son complete authority to decide what crops to plant and how to care for the farm so long as he uses good management practices. Lily enjoys being on the farm and is there about half of the time helping her son with farming activities. They regularly discuss management issues that affect the farm. Since there is no arrangement providing for Lily's participation in the farming business, her rent is not subject to self-employment tax.

Under the IRS interpretation of I.R.C. §1401 (with which the tax court has agreed), an employment agreement meets the requirement that there is an arrangement providing for the landowner's participation.

Example 1.9. If Lily's son paid her to work on his farm, the IRS is likely to argue that there is an employment agreement (whether or not it is in writing) that meets the "arrangement" requirement.

IRS Publication 225, *Farmer's Tax Guide* (1999), states on page 80 that rent received for farmland is subject to self-employment tax "if the rental arrangement provides that the landlord will, and he or she does, materially participate in the production or management of production of the farm products on the land." It also defines material participation as follows:

Material participation. You materially participate 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, using cash or credit, 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 totality, 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.

Practitioner Note. Under the Senior Citizens Freedom to Work Act of 2000, beginning in 2000, workers who have reached age 65 can earn an unlimited amount and not be subject to a reduction in social security benefits. This change in the law may cause more retired landowners to decide to participate in the farming activity on their land. That participation may increase the number of cases in which rent is subject to the self-employment tax.

D. CONSERVATION RESERVE PROGRAM (CRP) PAYMENTS

1. Materially Participating Landowners

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

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

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

Having determined that the CRP payments are rental payments, the *Wuebker* court then applied I.R.C. §1402. Since the CRP payment was found to be rental from real estate, it falls within the real estate exception discussed above. However, it did not fall into the agricultural land exception to the real estate exception since the CRP land was not used in agricultural or horticultural production. The CRP agreement prohibits the owner from using the land in agricultural production.

In *Wuebker v. Commissioner,* 85 AFTR 2d 1057 (6th Cir. 2000) the 6th Circuit reversed the decision of the Tax Court. The 6th Circuit held that CRP payments are not rent for purposes of the self-employment tax rules since the government does not occupy the CRP land. Instead, the 6th Circuit treated the payments as government payments. Accordingly, the exception for rent from real estate does not apply. If the landowner receives the payments as part of a business, then the payments are subject to self-employment tax. *Ray v. Commissioner*, 72 T.C.M. 780 (1960); Rev. Rul. 60-32, 1960-1 C.B. 23.

a. Reporting Obligations: Returns Filed Before the 6th Circuit Opinion

Some taxpayers amended prior year's returns and filed their 1999 income tax return relying on the Tax Court decision in *Wuebker.* That is, they reported CRP payments as not being subject to the self-employment tax. Do these taxpayers have an obligation to amend the 1999 and/or prior year returns to conform to the 6th Circuit opinion?

IRS Publication 17, *Your Federal Income Tax for Individuals* (1999), states,

> You should correct your return if, after you have filed it, you find that:
>
> 1. You did not report some income,
> 2. You claimed deductions or credits you should not have claimed,
> 3. You did not claim deductions or credits you could have claimed, or
> 4. You should have claimed a different filing status.

Since these taxpayers have reported all of their income, the above rules do not require them to file an amended return. Similarly, nothing in the Form 1040X instructions requires taxpayers to file an amended return due to a change in the law after they filed their return.

I.R.C. §6222 imposes a 20% penalty on taxpayers if they take a position on their tax return that is successfully challenged by the IRS. However, the penalty does not apply if there was substantial authority to support the position taken on the tax return. There is substantial authority for the tax treatment of an item if there is substantial authority at the time the tax return is filed or if there was substantial authority at the end of the tax year for which the position was taken. Treas. Reg. §1.6662-4(d)(3)(iv)(C); *Kretschmer v. Commissioner*, T.C. Memo 1989-242. Since the Tax Court's *Wuebker* opinion was substantial authority at the time of filing the tax returns, no penalty will be imposed under I.R.C. §6222, even if the taxpayer does not amend the return.

Example 1.10. Anita Fixx owns and operates a farm and receives CRP payments for part of her farm. She filed her 1999 calendar year income tax return on April 1, 2000. On that return, she reported her CRP payments on Schedule E and did not pay self-employment tax on them in reliance on the Tax Court opinion in *Wuebker.* If the IRS audits her return and successfully argues that her CRP payments are subject to the self-employment tax, she will have to pay the tax with interest but will not be subject to the 20% underpayment penalty since there was substantial authority for her position at the end of the tax year for which she took that position.

Example 1.11. If Anita amended her 1997 and 1998 returns on April 1, 1999, and followed the Tax Court opinion, she would be treated as having substantial authority for the amended returns since the Tax Court opinion was decided before the amended returns were filed and the 6th Circuit opinion was decided after they were filed.

Practitioner Note. If Anita had amended her 1997 income tax return before June 23, 1998, she would not be treated as having substantial authority for following the Tax Court opinion since there was no substantial authority at the time she filed the amended return or at the end of the tax year.

2. Reporting Obligations: Returns Filed After the 6th Circuit Opinion

Taxpayers who file returns after the 6th Circuit opinion was issued on March 3, 2000 must determine the effect of the opinion on the existence of substantial authority and on the existence of a reasonable basis for the contrary position.

(1) SUBSTANTIAL AUTHORITY

If there is substantial authority for the contrary position, then the taxpayer is not subject to a penalty under I.R.C. §6222 even if he or she does not disclose the position on the tax return and is successfully challenged by the IRS. Treas. Reg. §1.6662-4(d)(1).

For **taxpayers who are in the jurisdiction of the 6th Circuit Court of Appeals** (Kentucky, Michigan, Ohio, and Tennessee), the Tax Court case cannot be treated as authority since it was overruled by a higher court. Treas. Reg. §1.6662-4(d)(3)(iii). Consequently, there is no substantial authority for the position contrary to the 6th Circuit opinion. Therefore, if taxpayers in the jurisdiction do not disclose the fact that they are taking a position contrary to the 6th Circuit opinion, they will be subject to the 20% penalty under I.R.C. §6222 if the IRS successfully challenges the position they take on the tax return.

For **taxpayers who are outside the jurisdiction of the 6th Circuit**, the Tax Court opinion is not considered overruled. Treas. Reg. §1.6662-4(d)(3)(iii). Since there can be substantial authority for more than one position (Treas. Reg. §1.6662-4(d)(3)(i)), it is possible that taxpayers outside of the 6th Circuit have substantial authority for the Tax Court position. However, Treas. Reg. §1.6662-4(d)(3)(iv)(B) says that the taxpayer's residence is not taken into account for purposes of the applicability of a court case in determining whether or not there is substantial authority for the tax treatment of an item. Consequently, taxpayers outside of the 6th Circuit must consider **both the Tax Court and the 6th Circuit opinions** when determining whether or not there is substantial authority for the Tax Court opinion.

The substantial authority standard is less stringent than the "more likely than not" standard–the standard that is met when there is greater than 50% likelihood of the position being upheld. Treas. Reg. §1.6662-4(d)(2). However, the substantial authority standard is more stringent than the reasonable basis standard discussed below. Treas. Reg. §1.6662-4(d)(2). Based on this definition, it could be argued that there is substantial authority for the Tax Court position, but it is likely that a court will rule there is not substantial authority. Therefore, **the safe position of a taxpayer outside of the 6th Circuit is to disclose any position contrary to the 6th Circuit opinion.**

(2) REASONABLE BASIS

If there is not substantial authority for a position contrary to the 6th Circuit opinion and the taxpayer discloses the fact that he or she is taking a contrary position on the tax return, the I.R.C. §6222 20% understatement penalty will not apply if there is a reasonable basis for the contrary position. Treas. Reg. §1.6662-3(c)(1).

The reasonable basis standard is not satisfied by a return position that is merely arguable or is merely a colorable claim. It must be reasonably based on authorities that can be used to find substantial authority for a position–taking into account the relevance and persuasiveness of the authorities and subsequent developments. Treas. Reg. §1.6662-3(b)(3). The reasonable basis standard apparently does not require a consideration of the weight of authority. Consequently, **taxpayers outside the 6th Circuit clearly have a reasonable basis for their position** if they follow the Tax Court opinion since it is not treated as overruled by the 6th Circuit opinion. Taxpayers in the 6th Circuit cannot rely on the Tax Court opinion. Therefore, it is likely that **they do not have a reasonable basis** for taking a position contrary to the 6th Circuit opinion.

Practitioner Note. Some landowners may prefer to have their CRP payments treated as self-employment income because of the effect on other tax provisions. For example, if the CRP payments are not subject to self-employment tax, the CRP land may not qualify for special use valuation or the qualified family-owned business deduction. Also, the CRP payments may not qualify as farm income for purposes of tax provisions such as the exception to the estimated tax rules or the qualified farm indebtedness rules.

2. Non–Materially Participating Landowners

The *Wuebker* case does not affect non–materially participating landowners. Since they are not engaged in the business of farming, CRP payments they receive are not subject to the self-employment tax under either the Tax court or the 6th Circuit holding.

Example 1.12. Lorna Buckmaster put her entire farm into the CRP. She paid her neighbor to establish the required ground cover and pays him each year to mow the land. Since Lorna is not materially participating, she is not subject to self-employment tax on the CRP payments.

Example 1.13. If Lorna from the previous example established the ground cover herself and mowed the land each year, she is still likely to be treated as not materially participating in a trade or business and therefore not subject to the self-employment tax under either the Tax Court or the 6th Circuit opinion.

E. 4-H AND FFA PROJECTS

Net income received from a 4-H or FFA project is not subject to self-employment tax if the project is primarily for educational purposes and not for profit, and is completed by the child under the rules and economic restrictions of the sponsoring 4-H or FFA organization. Such a project is generally not considered a trade or business. See IRS Publication 225, *Farmer's Tax Guide* (1999), p. 79.

F. PROPOSED LEGISLATION

1. Self-employment Tax on Rent

Several bills (see H.R. 1044, H.R. 4260, S. 569, S. 1861, and S 2422) have been introduced in Congress that would amend I.R.C. §1402 as follows:

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

The above amendment would likely take away the IRS's argument that the required arrangement can be found in agreements other than the lease. Therefore, a partnership agreement or employment agreement that provides for material participation of the landowner would not meet the requirement that there be an arrangement providing for the landowner's material participation. The above amendment is likely to reverse the outcome in fact situations such as *Mizell, Bot, Hennen, and McNamara,* discussed above.

The above amendment would not solve the problem for all retired landowners. Landowners who want to put their right to make management decisions in the lease would still be subject to self-employment tax. Similarly, **landowners who have an oral lease and materially participate** may be subject to self-employment tax because the provision for material participation may be treated as included in the oral agreement.

A more comprehensive solution to the self-employment tax on rent problem is to repeal the agricultural and horticultural exception to the real estate exception. That would eliminate any ambiguity about the applicability of the self-employment tax on rent paid to an entity and would also solve the problem for all retired landowners. The amendment would change I.R.C. §1402 as follows:

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

The more comprehensive solution puts owners of agricultural land in the same position as owners of other real estate. Consequently, it takes away the agricultural landowner's option under current law to pay self-employment tax on the rental income as a means of increasing his or her earned income for purposes of calculating social security benefits. Under the more comprehensive amendment, agricultural landowners could subject their income from the land to self-employment tax by entering into a partnership arrangement with a farm operator or by continuing to use the land in their own farming business and using custom operators to work the land.

Practitioner Note. Neither of the above legislative proposals would change the result in the 6th Circuit opinion in *Wuebker*. Under the 6th Circuit reasoning, the CRP payments are not rent and therefore are not included in the expanded real estate exception of either of the above amendments.

2. Self-employment Tax on CRP Payments

Legislation has also been introduced that would explicitly exclude CRP payments from self-employment income. See H.R. 4260, S. 2344, and S 2422. These proposals would exempt CRP payments from self-employment tax regardless of the landowner's involvement in the farming business.

ISSUE 2: INCOME AVERAGING

The 1997 Taxpayer Relief Act of 1997 (P.L. 105-34, 111 Stat. 788) added the income averaging rules for farmers to the Internal Revenue Code. As originally enacted, the income averaging rules were effective for only 1998, 1999, and 2000.

The Tax and Trade Relief Extension Act of 1998 (P.L. 105-277, 112 Stat. 2681) made farm income averaging permanent. That change increases the advantage of long-term planning. Taxpayers and their practitioners can now include using 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.

The 1998 and 1999 *Farm Income Tax Books* discuss the income averaging rules in detail. The discussion that follows updates that previous comprehensive coverage.

> **Practitioner Note.** The rules are easier to understand if they are viewed as bringing forward unused tax brackets from the three years prior to the election year to be used 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.

A. PROPOSED REGULATIONS

1. Terminology

The proposed regulations use some terminology that is useful in describing the rules.

Election year. The year for which the income averaging election is being made is called the election year. For example, 2000 is the election year if a taxpayer elects to use income averaging in 2000. Prop. Reg. §1.1301-1(a).

Base year. The three years before the election year are called base years. Prop. Reg. §1.1301-1(a).

Electible farm income. The amount of income that is eligible for averaging is called electible farm income. Prop. Reg. §1.1301-1(e).

Elected farm income. The amount of electible farm income that a taxpayer designates for the income averaging rules is called elected farm income. Prop. Reg. §1.1301-1(a).

2. Making, Changing, or Revoking the Election

The proposed regulations say that an election is made by filing Schedule J, Farm Income Averaging, with the taxpayer's timely filed income tax return (including extensions.) Prop. Reg. §1.1301-1(c)(1). Treas. Reg. §301.9100-2(b) gives taxpayers an automatic six-month extension to make the election if a timely income tax return was filed for the tax year. Consequently, if the election was not made on the original, timely filed return, the taxpayer can make the election on an amended return filed within six months of the due date of the original return

> **Practitioner Note.** The automatic six-month extension to make the election applies whether or not there is adjustment on the return other than the income averaging election.

The proposed regulations also allow a taxpayer to make a late farm income averaging election or change or revoke a previous election if the taxpayer has an adjustment for the election year or a base year. An adjustment is **any change in taxable income or tax liability** that is permitted to be made by filing an amended income tax return, or a change in table income or tax liability resulting from an IRS examination. If there is no adjustment for an election year or base year, a late election, change, or revocation may be made only with the consent of the Commissioner. Prop. Reg. §1.1301-1(c)(2).

Example 2.1. 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 for 1998 on the amended return.

Observation. The bottom line is that a taxpayer can almost always find a change that will allow making, changing, or revoking an income averaging election on an amended return.

3. Eligible Taxpayers

The proposed regulations allow taxpayers who have 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 to elect income averaging for that tax year. It does not matter whether or not the taxpayer was engaged in farming in any prior year. Prop. Reg. §1.1301-1(b).

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 proposed regulations are silent on whether income received by landowners from share-rental arrangements is eligible for income averaging. The instructions for the 1999 Schedule J (Form 1040) do not include Form 4835 in the list of forms on which farm income and deductions are generally reported. Therefore, they imply that income received by a non-materially participating landowner is not eligible for income averaging. The instructions for the 1999 Schedule J (Form 1040) imply 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.

4. Electible Farm Income

Income that is eligible for the income averaging election is any income that is attributable to a farm business. Farm income includes items of income, deduction, gain, and loss attributable to the individual's farming business. Therefore, electible farm income includes:

- Net Schedule F (Form 1040) income
- An owner's share of net farm income from an S corporation, partnership, or limited liability company
- Gain from the sale of assets used in the farming business and reported on Form 4797 and/or Schedule D (Form 1040), but not gain from the sale of land or timber

Farm losses include an NOL carryover or carryback, or a net capital loss carryover to an election year, that is attributable to a farming business. Prop. Reg. §1.1301-1(e)(1)(i).

Farm business as defined has the meaning given such term by I.R.C. §263A(e)(4), which states:

The term “farming business” means the trade or business of farming. 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. Gain from the sale of trees that are more than 6 years old at the time they are severed from their roots is not electible farm income.

The proposed regulations state that income, gain, or loss from the sale of development rights, grazing rights, and other similar rights is not treated as attributable to a farming business. Prop. Reg. §1.1301-1(e)(1)(i).

Example 2.2. Amanda Reckonwith has farm income that puts her within $10,000 of the top of the 28% bracket every year. In 2000, she has $40,000 of gain from the sale of development rights to her farmland in addition to her normal farm income. The $40,000 of gain from the sale of development rights is not eligible for income averaging. However, she could elect to average $30,000 of her farm income, which would have the effect of spreading the gain from the sale of development rights evenly over four tax years (1997–2000).

The proposed regulations state that farm income does not include wages. Prop. Reg. §1.1301-1(e)(1)(i).

Example 2.3. Art Tickle is the sole owner of Shady Lane, Inc., a C corporation that operates a farming business. Art receives a $60,000 salary from Shady Lane, Inc. His salary is not electible farm income.

5. Gains From the Sale of Property

The proposed regulations make it clear that gain from the sale of improvements on land qualify for income averaging. They state, “Gain or loss from the sale or other disposition of property (other than land, but including a structure affixed to land) that was regularly used in the individual’s farming business for a substantial period of time is treated as attributable to a farming business.” Prop. Reg. §1.1301-1(e)(1)(ii)(A).

Example 2.4. Jill Tedd sold her farm and farm buildings in 2000. The gain from her buildings is eligible for income averaging, but the gain from the land is not.

The proposed regulations also state that whether property was used for a substantial period depends on all of the relevant facts and circumstances. Consequently, there is no safe harbor for the interpretation of “substantial period.” Prop. Reg. §1.1301-1(e)(1)(ii)(A).

However, the proposed regulations provide a safe harbor for the disposition of property after the cessation of a farming business. Prop. Reg. §1.1301-1(e)(1)(ii)(B). They state,

> If gain or loss [from the disposition of property] is realized after cessation of a farming business, such gain or loss is treated as attributable to a farming business if the property is sold within a reasonable time after cessation of the farming business. A sale or other disposition within one year of cessation of a farming business is presumed to be within a reasonable time. Whether a sale or other disposition that occurs more than one year after cessation of the farming business is within a reasonable time depends on all the facts and circumstances.

6. Allocation of Ordinary Income and Capital Gains

The proposed regulations allow taxpayers who have both ordinary income and capital gains that are eligible for income averaging to choose how much of the elected farm income is made up of capital gains and how much of ordinary income. Prop. Reg. §1.1301-1(e)(2)(i).

Example 2.5. Paige Turner files as a single taxpayer and has $50,000 of taxable income in 2000, 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 her $24,000 elected amount.

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

Example 2.6. If Paige Turner from Example 2.5 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 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 rates for the prior year. Prop. Reg. §1.1301-1(d)(1).

Example 2.7. If Paige Turner from Example 2.6 had a $10,000 net capital loss and taxable income of $20,000 for 1997, she does not reduce the $10,000 capital loss by the $3,000 of capital gains that are moved from her 2000 tax bracket to her 1997 tax bracket. Instead, she pays tax on the $3,000 of capital gains at the lesser of the 20% rate for capital gain in 1997 or her ordinary income tax rate.

The amount of the elected farm income that is treated as capital gains cannot exceed the taxpayer's net capital gain for the year. Prop. Reg. §1.1301-1(e)(2)(i).

Example 2.8. If Paige Turner from Example 2.5 had $20,000 of non-farm capital losses, her electible farm income is $15,000 ordinary income + ($30,000 farm capital gain – $20,000 non-farm capital gain) = $25,000 electible farm income. She can treat up to $10,000 of her election as capital gains.

The proposed regulations state that a farm capital loss carryover reduces electible farm income. Prop. Reg. §1.1301-1(e)(1)(i). However, taxpayers will rarely have a farm capital loss carryover since most assets used in the farming business are §1231 assets rather than capital assets. Sales of §1231 assets do not create capital loss carryovers since a taxpayer with net §1231 losses gets ordinary gain and loss treatment for all §1231 transactions. I.R.C. §1231(a)(2).

The proposed regulations say that 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. Prop. Reg. §1.1301-1(d)(1).

Observation. This rule implies that the taxpayer can include farm §1231 gain in elected farm income even though it exceeds the net §1231 gain for the election year. If the amount of farm §1231 gains that could be included in elected farm income were limited to the net §1231 gain, this rule would not be necessary.

Example 2.9. Assume Paige Turner from Example 2.6 had $25,000 of losses from the sale of non-farm §1231 assets in 2000. 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 $30,000 of §1231 gains and $25,000 of §1231 losses for 2000 are all characterized as long-term capital gains and losses. (These gains and losses are netted on Form 4797 and the net $5,000 gain is carried to Schedule D (Form 1040) to be netted with other long-term capital gains.) The income averaging election does not change that result, even though $9,000 of §1231 gain is moved out of the 2000 tax bracket.

Unanswered question. What happens if Paige's net long-term capital gain for the election year is less than the $9,000 reduction of §1231 gain? For example, if her net long-term capital gain is the $5,000 net §1231 gain, a $9,000 reduction of §1231 gain will reduce the net long-term capital gain to zero, but what is reduced by the remaining $4,000 of the §1231 gain reduction?

7. Change in Filing Status

The proposed regulations state that an individual is not prohibited from making a farm income averaging election solely because the individual's filing status is not the same in an election year and the base years. Prop. Reg. §1.1301-1(e)(f)(ii). 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 2.10. If Paige Turner from the previous examples (who filed single in 2000) 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.

8. Effect of Income Averaging on Net Operating Losses

NOL carryovers to the election year are applied to the election year income before the elected farm income is subtracted. Prop. Reg. §1.1301-1(d)(1).

Example 2.11. Allen Wrench has a $30,000 NOL carryover to 2000 that reduces his taxable income for 2000 to $50,000. Allen can elect no more than $50,000 as elected farm income in 2000. His elected farm income is subtracted from the $50,000 to compute his tax liability using income averaging.

A farm NOL that is carried to the election year reduces electible farm income. Prop. Reg. §1.1301-1(e)(1)(i).

Example 2.12. Doris Close has $60,000 of Schedule F income in 2000 and a $20,000 farm NOL carryover to 2000. Her electible farm income is $40,000.

An NOL that was carried to a base year does not offset the elected farm income that is carried to the tax bracket for that year. Prop. Reg. §1.1301-1(d)(1).

Example 2.13. Tommy Gunn had $20,000 of taxable income in 1999 before subtracting a $45,000 NOL carryover to 1999. The NOL carryover reduces his taxable income to zero. Tommy's modified taxable income in 1999 is $32,000, so his NOL carryover to 2000 is $13,000 ($45,000 – $32,000). Tommy elects to treat $60,000 as elected farm income in 2000. The $20,000 (1/3 of $60,000) of elected farm income that is carried to the 1999 tax brackets is not offset by the $25,000 of unused NOL deduction ($45,000 – $20,000) in 1999 and does not change the NOL absorption calculation. The $20,000 is added to Tommy's zero 1999 taxable income for purposes of the income averaging tax calculation.

9. Effect on the Alternative Minimum Tax

The IRS has not changed its interpretation of 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 IRS Publication 553, *Highlights of 1998 Tax Changes* (Rev. December 1998), p. 12. Under that interpretation, **income averaging can create or increase an AMT liability**. Consequently, some or all of the income tax savings from income averaging can be offset by an increase in the AMT liability.

Income averaging can also 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.

See the *1999 Farm Income Tax Book* for an extensive discussion of the effect of income averaging on the AMT and the AMT credit.

10. Effect on Unearned Income of a Minor

The tax rate on a parent's return for purposes of taxing his or her child's unearned income under the kiddie tax rules of I.R.C. §1(g) in an election year is determined after the elected farm income is subtracted from the election year income. However, the tax on a minor's unearned income is not affected by farm income averaging in the base years. Prop. Reg. §1.1301-1(f)(5).

11. Short Taxable Years

If a base year is a short taxable year, the increase in taxes for that year caused by income averaging is calculated by annualizing the taxable income for the base year before adding the elected farm income allocated to that year. Prop. Reg. §1.1301-1(f)(1)(ii). If an election year is a short taxable year, the elected farm income for that year is annualized before it is allocated to the base years.

B. ISSUES ON 1999 SCHEDULE J (FORM 1040)

The apparent error in the instructions for lines 5, 9, and 13 of the early drafts of the 1999 Schedule J (Form 1040) was corrected in the final draft. The apparent error was discussed in the 1999 *Farm Income Tax Book,* which went to press before the final version of Schedule J was released. The early draft instructions told the taxpayer to enter taxable income from the taxpayer's 1996, 1997, and 1998 Forms 1040 respectively. The instructions for those lines on the final version tell taxpayers to use figures from the prior year Schedule J if Schedule J was filed.

Similarly, the apparent error in the instructions for line 22 of the early drafts of the 1999 Schedule J (Form 1040) was corrected in the final draft. The early draft instructions prohibited a taxpayer from filing Schedule J if it did not reduce income tax liability. The instructions for line 22 of the final version of the 1999 Schedule J (Form 1040) caution the taxpayer that the tax liability may be less without Schedule J but do not prohibit calculating his or her tax on Schedule J.

This change in the instructions allows a taxpayer to use the income averaging rules to do the following income tax planning:

1. Elect income averaging in an election year to empty the election year 15% bracket.
2. Elect income averaging in one or more of the three years following the election year to move income from a higher bracket in those years into the election year 15% bracket (and the bracket of two other base years).

Example 2.14. 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 close to zero in those years. In 2002 she will have several animals ready for sale and expects about $100,000 in taxable income.

Income averaging will not reduce her 1999 tax liability. However, 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% brackets 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 potentially reduce her tax liability in 2002.

C. MAKING THE OPTIMAL USE OF THE INCOME AVERAGING RULES

Several factors must be kept in mind when planning for the use of the income averaging rules to minimize total income tax liability.

1. Loss of personal exemption deductions and itemized or standard deduction

Under the **IRS interpretation** of the income averaging rules, **taxpayers cannot use negative taxable income as the beginning point for recalculating the income taxes for the base years**. The effect of that interpretation is that a taxpayer does not get the benefit of personal exemption deductions and itemized or standard deduction in the base years to the extent that the base year taxable income is negative.

Example 2.15. Hugh Midd is single and claimed the standard deduction on his 1999 income tax return. He had $5,000 of net income from his farming business in 1999 and no other income or deductions. His taxable loss for 1999 is:

Schedule F income	$ 5,000
½ SE tax deduction	353
Adjusted gross income	$ 4,647
Standard deduction	4,300
Personal exemption deduction	2,750
Taxable income (loss)	$(2,401)

If Hugh uses the income averaging rules in 2000, 2001, or 2002, he must use zero taxable income as the base for calculating the additional taxes from his 1999 income tax brackets. Therefore, the income averaging rules do not allow him to get the benefit of the $2,401 of his personal exemption deduction that was not used in 1999.

The above result means that taxpayers are better off leveling income by shifting income or deductions than by using the income averaging rules to the extent that there are unused personal exemption deductions and itemized deductions or standard deduction in the base years.

Example 2.16. If Hugh from Example 2.15 moved $2,401 of net income into 1999 from 2000, he could offset that net income with the unused $2,401 of personal exemption deductions. By contrast, if his elected farm income for 2000 were $2,401, the $800 that is added to his 1999 taxable income would be taxed in the 15% marginal bracket.

2. Emptying tax brackets for future elected farm income

In some cases, the income averaging election should be used to empty out the election year tax brackets, even though that election does not save income taxes, so that elected farm income from future years will be taxed in a lower bracket. See Example 2.14 above.

3. Average marginal tax bracket of base years

Income averaging will save income taxes for the election year only if the **average** marginal tax rate for the base years is lower than the **marginal** tax rate for the election year.

Example 2.17. Gail Force has taxable income that is $30,000 higher than the beginning of her 28% marginal income tax bracket in 2000. Her taxable income for her base years was as follows:

Year	Taxable Income
1997	$8,000 below the beginning of her 28% bracket
1998	$5,000 below the beginning of her 31% bracket
1999	$10,000 below the beginning of her 36% bracket

The first $15,000 of elected farm income would be taxed at a (15% + 28% + 31%) ÷ 3 = 24.67% marginal tax rate. Therefore, the first $15,000 of elected farm income will reduce her income tax liability by 28% – 24.67% = 3.33% × $15,000 = $499.50.

The next $9,000 of elected farm income will be taxed at a (15% + 31% + 31%) ÷ 3 = 25.67% marginal tax rate. Therefore, the next $9,000 of elected farm income will save her 28% – 25.67% = 2.33% × $9,000 = $209.70.

The next $6,000 of elected farm income will be taxed at a (28% + 31% + 31%) ÷ 3 = 30% marginal tax rate. Therefore, she should not include any more than $15,000 + $9,000 = $24,000 in elected farm income.

Capital gains in a base year. If the taxpayer had capital gains in a base year, there are some **surprising effective marginal tax rates** for elected farm income tax in that year's brackets.

Example 2.18. Buzz Hoff is married and files a joint tax return with his wife. They claim two personal exemption deductions and the standard deduction. In 1999, they had $18,000 of net long-term capital gains and $5,000 of net farm income. Their taxable income is $9,946, calculated as follows:

Net long-term capital gains	$18,000
Net farm income	+5,000
Total income	$23,000
One-half of SE tax	–354
Adjusted Gross Income	$22,646
Standard deduction	–7,200
Personal exemption deduction	–5,500
Taxable income	$9,946

Since their taxable income is less than their net long-term capital gain, it is all taxed at the 10% marginal rate. If the remainder of the 1999 bracket is carried to another year to compute the tax on elected farm income, the elected farm income will be taxed at the 10% marginal tax rate until the total taxable income (1999 taxable income plus the elected farm income added to the 1999 taxable income) equals the $18,000 of 1999 net long-term capital gain. The amount of Buzz Hoff's elected farm income taxed at the 1999 10% rate and the amounts taxed at other marginal tax rates are shown on the following table:

Marginal Tax Rate	Formula for the amount taxed at this rate	Amount at this marginal tax rate
10%	1999 net long-term capital gains minus 1999 taxable income	$18,000 – $ 9,946 = $ 8,054
15%	Top of the 15% marginal tax bracket minus 1999 net long-term capital gains	$43,050 – $18,000 = $25,050
25%*	The 1999 net long-term capital gains	$18,000
28%	Top of the 28% marginal tax bracket minus the top of the 15% marginal tax bracket	$104,050 – $43,050 = $61,000
31%	Top of the 31% marginal tax bracket minus the top of the 28% marginal tax bracket	$158,550 – $104,050 = $54,500
36% or greater	Everything above the top of the 31% bracket	

* The 25% marginal tax rate results from a combination of the 15% tax on the ordinary elected farm income and the 10% increase in the tax rate on long-term capital gains that are moved from the 10% rate to the 20% rate.

The following tables report the effective tax rates for elected farm income carried to a base year for all levels of income net long-term capital gain. To use the tables, first determine whether the net long-term capital gain for the base year is below the top of the 15% tax bracket, between the top of the 15% bracket and the top of the 28% bracket, or above the top of the 15% bracket in order to find the appropriate table. Then, using the appropriate table, find the appropriate row for the sum of the taxable income from the base year plus 1/3 of the elected farm income (the amount reported on lines 7, 11, or 15 of Schedule J). The marginal tax rate is reported in the last column of the table

Net Long-term Capital Gain for Base Year Is in the 15% Bracket

If the taxpayer's net long-term capital gain for the base year is less than the top of the taxpayer's 15% income tax bracket and:

If zero	<	taxable income plus 1/3 of elected farm income (Lines 7, 11, or 15 of Schedule J)	≤	net long-term capital gains	then the marginal tax rate is 10%
If net long-term capital gains	<	taxable income plus 1/3 of elected farm income (Lines 7, 11, or 15 of Schedule J)	≤	the top of the taxpayer's 15% marginal tax bracket	then the marginal tax rate is 15%
If the top of the taxpayer's 15% marginal tax bracket	<	taxable income plus 1/3 of elected farm income (Lines 7, 11, or 15 of Schedule J)	≤	the top of the taxpayer's 15% marginal tax bracket **plus** the net long-term gains	then the marginal tax rate is 25%
If the top of the taxpayer's 15% marginal tax bracket **plus** the net long-term capital gains	<	taxable income plus 1/3 of elected farm income (Lines 7, 11, or 15 of Schedule J)	≤	the top of the taxpayer's 28% marginal tax bracket **plus** the net long-term capital gain	then the marginal tax rate is 28%
If the top of the taxpayer's 28% marginal tax bracket **plus** the net long-term capital gains	<	taxable income plus 1/3 of elected farm income (Lines 7, 11, or 15 of Schedule J)	≤	the top of the taxpayer's 31% marginal tax bracket **plus** the net long-term capital gains	then the marginal tax rate is 31%
If the top of the taxpayer's 31% marginal tax bracket **plus** the net long-term capital gains	<	taxable income plus 1/3 of elected farm income (Lines 7, 11, or 15 of Schedule J)			then the marginal tax rate is 36% or greater

Net Long-term Capital Gain for Base Year Is in the 28% Bracket

If the taxpayer's net long-term capital gain for the base year is greater than the top of the taxpayer's 15% income tax bracket but less than the top of the taxpayer's 28% tax bracket and:

If zero	<	taxable income plus 1/3 of elected farm income (Lines 7, 11, or 15 of Schedule J)	≤	the top of the taxpayer's 15% marginal tax bracket	then the marginal tax rate is 10%
If the top of the taxpayer's 15% marginal tax bracket	<	taxable income plus 1/3 of elected farm income (Lines 7, 11, or 15 of Schedule J)	≤	net long-term capital gains	then the marginal tax rate is 20%
If net long-term capital gains	<	taxable income plus 1/3 of elected farm income (Lines 7, 11, or 15 of Schedule J)	≤	the top of the taxpayer's 15% marginal tax bracket **plus** the net long-term capital gain	then the marginal tax rate is 25%
If the top of the taxpayer's 15% marginal tax bracket **plus** the net long-term capital gains	<	taxable income plus 1/3 of elected farm income (Lines 7, 11, or 15 of Schedule J)	≤	the top of the taxpayer's 28% marginal tax bracket **plus** the net long-term capital gains	then the marginal tax rate is 28%
If the top of the taxpayer's 28% marginal tax bracket **plus** the net long-term capital gains	<	taxable income plus 1/3 of elected farm income (Lines 7, 11, or 15 of Schedule J)			then the marginal tax rate is 31% or greater

Net Long-term Capital Gain for Base Year Is above the 28% Bracket

If the taxpayer's net long-term capital gain for the base year is greater than the top of the taxpayer's 28% income tax bracket and:

If zero	<	taxable income plus 1/3 of elected farm income (Lines 7, 11, or 15 of Schedule J	≤	the top of the taxpayer's 15% marginal tax bracket	then the marginal tax rate is 10%
If the top of the taxpayer's 15% marginal tax bracket	<	taxable income plus 1/3 of elected farm income (Lines 7, 11, or 15 of Schedule J)	≤	the long-term capital gains	then the marginal tax rate is 20%
If the net long-term capital gains	<	taxable income plus 1/3 of elected farm income (Lines 7, 11, or 15 of Schedule J)	≤	the top of the taxpayer's 15% marginal tax bracket **plus** the net long-term capital gains	then the marginal tax rate is 25%
If the top of the taxpayer's 15% marginal tax bracket **plus** the net long-term capital gains	<	taxable income plus 1/3 of elected farm income (Lines 7, 11, or 15 of Schedule J)			then the marginal tax rate is 28% or greater

ISSUE 3: ACCOUNTING FOR INVENTORY—REV. PROC. 2000-22

Rev. Proc. 2000-22 provides an exception to the general rule of I.R.C. §471 that a taxpayer must account for inventories to determine income if the production, purchase, or sale of merchandise is an income-producing factor in the taxpayer's business. The exception also applies to the requirement in Treas. Reg. §1.446-1(c)(2)(ii) that such taxpayers use the accrual method of accounting.

A. THRESHOLD REQUIREMENT

The threshold requirement for this exception is that the taxpayer's average annual gross receipts for each prior tax year ending on or after December 17, 1998 are $1,000,000 or less.

1. Average annual gross receipts are defined as the average annual gross receipts for the 3-tax-year period ending with the applicable tax year.
   - **a.** A taxpayer in existence in 1998 must meet the test for the 1998 tax year and each tax year thereafter.
   - **b.** If the taxpayer was not in existence for three years before the applicable tax year, the taxpayer uses the average gross receipts for the years it was in existence.
2. For purposes of the average gross receipts test, sales taxes that are collected and remitted to the government are not included in gross receipts if under state or local law the tax is imposed on the purchaser.
3. All taxpayers that are treated as a controlled group under I.R.C. §52 or as an affiliated service group under I.R.C. §414(m) are treated as one taxpayer for purposes of the $1,000,000 gross receipts test. However, sales among members of the same group are not included in gross receipts for purposes of the $1,000,000 limit.

B. CONFORMITY REQUIREMENT

To make use of the exception under this revenue ruling, taxpayers must act fairly quickly. Section 5.07 of the revenue procedure sets out a conformity requirement that makes it **imperative to change to the cash method of accounting by no later than the first tax year ending after December 17, 2000.**

1. The conformity requirement says the exception applies only if the taxpayer does not regularly use any method other than the cash method of accounting for purposes of its books, records, and reports to shareholders, partners, other proprietors and beneficiaries, and for credit purposes for the current and prior 3 tax years, excluding tax years ending before December 17, 2000. For example, an isolated use of an accrual financial statement to get a bank loan does not prevent the use of this exception.
2. If a taxpayer does not use the cash method for the first tax year ending on or after December 17, 2000, then the taxpayer cannot use the exception of this revenue procedure because the taxpayer has used a method other than the cash method for a tax year ending on or after December 17, 2000.

C. EFFECT OF THE EXCEPTION

If a taxpayer qualifies for the exception under this revenue ruling, the taxpayer can use the cash method of accounting and does not have to use inventories to calculate income. However, the taxpayer must treat merchandise inventory in the same manner as a material or supply that is not incidental under Treas. Reg. §1.162-3.

1. That regulation says that the cost of material or supplies can be deducted only in the year they are actually consumed.

2. For merchandise inventory, that means the cost of purchased merchandise cannot be deducted as an expense in the year the inventory is purchased. It is deducted in the year the inventory is sold.
3. Therefore, taxpayers must keep track of the purchase price of each item of purchased inventory and deduct that cost in the year the item of inventory is sold.

D. EFFECT ON I.R.C. §263A

The revenue procedure states that I.R.C. §263A does not apply to merchandise inventory if the taxpayer elects to use the exception provided in this revenue procedure. Consequently, it appears that the cost of producing inventory does not have to be capitalized. Therefore, the cost of producing inventory can be deducted in the year the cost is incurred and the inventory will have a zero basis when it is sold.

E. APPLICATION TO GREENHOUSES AND GARDEN CENTERS

A taxpayer who operates a greenhouse or garden center and meets the $1,000,000 gross receipts test can switch to the cash method of accounting and does not have to include as income the change in value of inventory.

1. Plants that are purchased for resale can be treated like livestock purchased for resale by a cash-basis farmer. That is, the cost of the plants will be deducted in the year the plants are sold.
2. The cost of raising plants, both plants that are purchased and those that are raised from seed can be deducted in the year the cost is incurred. This is true even if the plant has a preproductive period of more than two years, since the revenue procedure says that I.R.C. §263A does not apply to inventory that is subject to the election.

F. PROCEDURE FOR CHANGING

To change to the cash method of accounting allowed by this revenue procedure, a taxpayer must follow the automatic change in method of accounting provisions of Rev. Proc. 99-49.

1. In general, that requires filing Form 3115, Application for Change in Accounting Method.
2. However, if the taxpayer files the original return for the first tax year ending after December 17, 1999 by July 14, 2000 and files an amended return with a Form 3115 attached by November 13, 2000, the taxpayer is not subject to all of the filing requirements of Rev. Proc. 99-49.

Example 3.1. Mary Rose Early owns and operates a greenhouse and garden center. Mary has been in business since 1980 and has average sales revenues of $900,000 for the last five years. She uses the calendar year to file her income tax returns. Mary purchases some of the plants that she sells and she raises some of them from seed. Some of the plants she purchases for sale are ready to be sold at the time she purchases them, while others must be grown for a period of time before they are ready for sale. Pursuant to I.R.C. §471 and Treas. Reg. §1.446-1(c)(2)(ii), Mary has **used accrual accounting and has valued her inventory at fair market value** at the beginning and end of each tax year to report her taxable income. She filed her 1999 income tax return on April 1, 2000.

Rev. Proc. 2000-22 allows Mary to switch to the cash method of accounting and to discontinue using her inventory to calculate income beginning in 1999. The change in accounting method has automatic consent from the Commissioner. If Mary files Form 3115 with the national office and files an amended return for 1999 with a copy of Form 3115 attached, she does not have to follow all of the filing requirements of Rev. Proc. 2000-22.

Because Mary has made a change in accounting method, she must make the necessary changes from her accrual method and treat her merchandise inventory as an expense in the year it is sold. Consequently, on her amended 1999 return, Mary would not report a beginning and an ending inventory. Instead, she would treat the cost of plants on hand at the beginning of the year as an expense in the year those plants are sold. Similarly, the cost of plants that are purchased during 1999 will be deducted in the year those plants are sold. Mary must also adjust her income to reflect the difference between the accrual and the cash method of accounting.

To illustrate, assume Mary had the following at the end of 1998:

Accounts receivable			$45,000
Ending merchandise inventory	Cost	FMV	
10,000 azaleas (raised)	-0-	$50,000	
1,000 rose bushes (purchased)	$10,000	$15,000	
Total			$65,000

During 1999, Mary sold 9,000 of the 10,000 azaleas that were in her 1998 ending inventory for $90,000. She sold 800 of the 1,000 rose bushes that were in her 1998 ending inventory for $24,000. She also raised 15,000 azaleas during 1999 and sold 5,000 of them for $30,000. During 1999, she purchased 2,000 rose bushes at a cost of $40,000 ($20 per bush) and sold 1,500 of them for $45,000.

On her amended 1999 return, Mary will not report a beginning or ending inventory. Instead, she will deduct her basis in any plant that was sold during 1999 from its sale price. Her basis in items that were raised is zero since she is not subject to I.R.C. §263A capitalization rules and can deduct the cost of raising those plants. Her basis in items that were purchased is the acquisition cost. Consequently, her gross income from 1999 sales is as follows:

Sale of 9,000 azaleas from 1998 ending inventory	$90,000	
Less basis	-0-	
Gross income		$90,000
Sale of 800 rose bushes from 1998 ending inventory	$24,000	
Less basis (800 × $10)	8,000	
Gross income		16,000
Sale of 5,000 azaleas raised in 1999		30,000
Sale of 1,500 rose bushes purchased in 1999	$45,000	
Less basis (1,500 × $20)	30,000	
Gross income		15,000
Total gross income		$151,000

Mary may also claim a **negative adjustment to income** to reflect the accounts receivable included in income at the end of 1998 and the inventory value included in income in excess of her cost for that inventory. Her total adjustment is calculated as follows:

Accounts receivable		$45,000
Change in inventory		
Ending inventory value of azaleas	$50,000	
Less cost of azaleas	-0-	
Adjustment		$50,000
Ending inventory of rose bushes	$15,000	
Less cost of rose bushes	10,000	
Adjustment		$5,000
Total adjustment		$100,000

Observation. Included in this $100,000 reduction of income is the 1998 ending inventory value of the 9,000 azaleas and 800 rose bushes that were sold in 1999 as well as the 1,000 azaleas and 2,000 rose bushes that are still in inventory at the end of 1999.

This $100,000 adjustment must be spread over four years under Rev. Proc. 99-49. Thus, Mary can report a $25,000 negative adjustment to income on her amended 1999 income tax return and on her original 2000, 2001, and 2002 income tax returns.

Example 3.2. Jack Pine owns and operates a greenhouse and garden center. Jack has been in business since 1980 and has average sales revenues of $900,000 for the last five years. He uses the calendar year to file his income tax returns. Jack purchases some of the plants that he sells and he raises some of them from seed. Some of the plants he purchases for sale are ready to be sold at the time he purchases them, while others must be grown for a period of time before they are ready for sale. Pursuant to I.R.C. § 471 and Treas. Reg. §1.446-1(c)(2)(ii), Jack has **used cash accounting and has valued his inventory at cost** at the beginning and end of each tax year to report his taxable income. He has elected out of capitalizing expenses under I.R.C. §263A. He filed his 1999 income tax return on April 1, 2000.

Rev. Proc. 2000-22 allows Jack to discontinue using his inventory to calculate income beginning in 1999. The change in accounting method has automatic consent from the Commissioner. If Jack files Form 3115 with the national office and files an amended return for 1999 with a copy of Form 3115 attached, he does not have to follow all of the filing requirements of Rev. Proc. 2000-22.

Because Jack has made a change in accounting method, he must make the necessary adjustments and treat his merchandise inventory as an expense in the year it is sold. Consequently, on his amended 1999 return, Jack would not report a beginning and an ending inventory. Instead, he would treat the inventory value of plants on hand at the beginning of the year as an expense in the year those plants are sold. Similarly, the cost of plants that are purchased during 1999 will be deducted in the year those plants are sold.

To illustrate, assume Jack had the following at the end of 1998:

Ending merchandise inventory	
10,000 azaleas (raised)	-0-
1,000 rose bushes (purchased)	$10,000
Total	$10,000

During 1999, Jack sold 9,000 of the azaleas that were in his 1998 ending inventory for $90,000. He sold 800 of the rose bushes that were in his 1998 ending inventory for $24,000. He also raised 15,000 azaleas during 1999 and sold 5,000 of them for $30,000. During 1999, he purchased 2,000 rose bushes at a cost of $40,000 ($20 per rose bush) and sold 1,500 of them for $45,000.

On his amended 1999 return, Jack will not report a beginning or ending inventory. Instead, he will deduct his basis in any plant that was sold during 1999 from its sale price. His basis in items that were in inventory at the end of 1998 is the acquisition cost (which is also the inventory value) of those items. His basis in items that were purchased in 1999 is the acquisition cost. His basis in items that were raised in 1999 is zero since he is not subject to I.R.C. §263A capitalization rules and can deduct the cost of raising those plants. Consequently, his gross income from 1999 sales is as follows:

Sale of 9,000 azaleas from 1998 ending inventory	$90,000	
Less basis	-0-	
Gross income		$90,000
Sale of 800 rose bushes from 1998 ending inventory	$24,000	
Less basis (800 × $10)	8,000	
Gross income		16,000
Sale of 5,000 azaleas raised in 1999		30,000
Sale of 1,500 rose bushes purchased in 1999	$45,000	
Less basis (1,500 × $20)	30,000	
Gross income		15,000
Total gross income		$151,000

Jack does not have to make any adjustments to his income as a result of his change to not keeping inventories since the basis in the items in his merchandise inventory is the same as the inventory value that was included in income.

Note that for cash-basis taxpayers who use the cost of items to value inventory, the revenue procedure does not change the amount of income that has to be reported, since the cost of items purchased for resale cannot be deducted until the year the item is sold.

Practitioner Note. Taxpayers may be required to account for inventory for purposes of state sales taxes and personal property taxes.

ISSUE 4: DIRECT PAYMENTS TO TOBACCO PRODUCERS AND TOBACCO QUOTA HOLDERS IN 1999 AND 2000

INTRODUCTION

As a result of a private settlement among tobacco companies, tobacco-producing states, tobacco producers, and tobacco quota holders, two annual payments are to be made to states, tobacco producers, and tobacco quota holders. These annual payments are expected between 1999 and 2010. These payments are called Phase 1 and Phase 2 of the private settlement with Phase 2 being the most significant for producers and quota holders. Taxation of these payments varies depending upon the activities in which the recipient is engaged.

Following weather and market conditions of 1999, Congress made supplemental funds to scheduled Transition Payments (under the 1996 Farm Bill) available as direct payments under the Market Loss Assistance Program (MLAP). Producers of many agricultural commodities qualified for these funds; tobacco producers were but one group. These funds were released through the Farm Service Agency (FSA).

These three payments (Phase 1, Phase 2, and MLAP) are direct payments to the recipient to replace income "lost" due to the reduction of federal quota levels from the high of 1997. The recipient must make a determination as to how these payments are to be reported depending on his or her activity relative to the payments.

PHASE 2 TOBACCO PAYMENTS

Example 4.1. Sunnie Fields grows and sells tobacco. Sunnie received $32,500 of Phase 2 payments in January 2000 for the 1999 payment year. Attached to this payment was a Form 1099 MISC with $32,500 in the "Other Income" box.

Sunnie is a material and active participant producing tobacco in her farming business. The Phase 2 payment is subject to self-employment tax and federal income tax at ordinary rates. The income should be reported on Line 10, other income of Schedule F.

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 — 2000 — Attachment Sequence No. 14

Name of proprietor: *Sunnie Fields* — Social security number (SSN): *197 01 1099*

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

B Enter code from Part IV ▶ *1 1 1 9 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 2000? If "No," see page F-2 for limit on passive losses. ☒ Yes ☐ No

c If election to defer to 2001 is attached, check here — 8d Amount deferred from 1999

9	Custom hire (machine work) income	9	
10	Other income, including Federal and state gasoline or fuel tax credit or refund (see page F-3)	10	32,500
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	

Practitioner Note. Some states (such as Kentucky) have exempted Phase 2 receipts from state income taxation.

Example 4.2. Resting Fields owns tobacco quota, which is rented to his granddaughter Sunnie under a crop-share arrangement in which Resting does not materially participate. Resting received $15,000 of Phase 2 payments in January 2000 for the quota he holds. Attached to this payment was a Form 1099 MISC with $15,000 in the "Other income" box.

Because Resting rents his quota and does not materially participate in tobacco production, this income is not subject to self-employment tax. Resting reports this income on Line 10, other income of Form 4835.

Form **4835** — Department of the Treasury, Internal Revenue Service (99)

Farm Rental Income and Expenses

(Crop and Livestock Shares (Not Cash) Received by Landowner (or Sub-Lessor))

(Income not subject to self-employment tax)

▶ Attach to Form 1040. ▶ See instructions on back.

OMB No. 1545-0187 — 2000 — Attachment Sequence No. 37

Name(s) shown on Form 1040: *Resting Fields* — Your social security number: *197 02 1099*

Employer ID number (EIN), if any

5	Crop insurance proceeds and certain disaster payments. See instructions:		
a	Amount received in 2000 . . . 5a — 5b Taxable amount	5b	
c	If election to defer to 2001 is attached, check here ▶ ☐ 5d Amount deferred from 1999	5d	
6	Other income, including Federal and state gasoline or fuel tax credit or refund. See instructions	6	15,000

Practitioner Note. If the landowner is receiving cash rent, the Phase 2 payment is reported on Schedule E.

Practitioner Note. For quota holders who rent their quota, the Forms 1099 received were prepared incorrectly. The IRS may expect to see the amount reported under "Other income" on either Schedule F or directly on Schedule SE. Rental income of tobacco quota with no material participation is not subject to SE tax.

B. SALE OF A QUOTA

The Phase 2 payments of the private settlement are for the replacement of income relative to the reduction in tobacco quota since 1997. The United States Secretary of Agriculture must set the annual national flue-cured tobacco quota amount by December 15th for the following production year. This quota is determined by formula. Other tobacco quotas are similarly announced. 1997 saw the highest level of flue-cured tobacco quota in recent history. Producers and quota holders did not "pay" for this increase in quota and therefore, did not "pay" for the "right" to grow or rent more pounds of tobacco. Similarly then, when tobacco quota is decreased by the Secretary's action, there is no sale of quota.

Therefore, Phase 2 receipts **cannot** be construed as capital gain or loss.

C. YEAR OF REPORTING PHASE 2 TOBACCO PAYMENTS

On December 31, 1999 the first of 12 Phase 2 payments was issued to growers and tobacco quota holders. Since December 31, 1999 was a Friday, the earliest that recipients of these funds could have received payments by mail was Monday, January 3, 2000. The issue of constructive receipt for cash-basis taxpayers came into question.

Under the strictest interpretation of constructive receipt, funds are constructively received when they are credited to the recipient's account (i.e., the issuance of the Phase 2 check in 1999). Section 1.451-2(a). However, when applying the ruling of *McEuan v. Commission* 196 F2d 127, 130 (5th Cir. 1952), checks sent through the mail are generally not constructively received in advance of actual receipt unless the amounts are made available to the taxpayer in the earlier year.

Based on *McEuan*, recipients of Phase 2 payments did not have available any of these funds in 1999. In an undated memo, the IRS stated that 1999 Phase 2 payments were constructively received in 2000.

Practitioner Note. This is not withstanding that Forms 1099 for 1999 were issued. There may be issues that will need to be resolved regarding the Forms 1099.

PHASE 1 TOBACCO SETTLEMENT PAYMENTS

Phase 1 tobacco payments are generally payments that come directly to the states under the private settlement. Phase 1 payments are made in order for states to recoup the health care costs of treating tobacco-related illness and to lessen the impact of reduced economic activity in rural areas due to the reduction of tobacco production. Individual states determine how these payments are to be allocated. Some states are making direct payments to tobacco producers and quota holders from a percentage of these funds. These payments receive the same tax treatment as the Phase 2 payments discussed above.

MARKET LOSS ASSISTANCE PAYMENTS

In October of 1999, Congress allocated additional financial relief to farmers. Part of the relief package was in the form of Market Loss Assistance Payments (MLAP). These payments were for the replacement of income due to the reduction of market prices and, in the case of tobacco, reduction of quota allotments.

In the fall of 1999 and the spring of 2000, FSA issued MLAP checks. These payments are not disaster payments in the usual sense. MLAP do not qualify under Treas. Reg. §1.451-6(a)(1) for income deferral to the year after they were received. The 1999 payments do not qualify because they were not for a loss from a natural disaster such as a drought or a flood. The 2001 payments were received in the year following the year of production and loss.

Tobacco producers and quota holders receiving MLAP report the amount received on line 6a and 6b of Schedule F. The amount of the MLAP will be included on the Form 1099-G issued by FSA.

ISSUE 5: SALE OF A FARM

Example 5.1. June Bugg paid $500,000 for a 200-acre farm on November 15, 1985. Included in the purchase were a house and a barn. She properly allocated the original purchase price among the house, barn, and land as follows:

House	$60,000
Barn	90,000
Land	350,000
Total	$500,000

June sold the farm and all of the improvements on it on November 27, 2000 for $825,982. She paid $41,299 in brokerage fees.

Additional facts for specific assets are as follows:

Barn. June elected to depreciate the barn using the alternate ACRS method. She elected straight-line depreciation over the 19-year recovery period. The depreciation she claimed is as follows:

Year	Unadjusted Basis	Percent		Depreciation
1985	$90,000	× 0.7%	=	$ 630
1986	$90,000	× 5.3%	=	4,770
1987	$90,000	× 5.3%	=	4,770
1988	$90,000	× 5.3%	=	4,770
1989	$90,000	× 5.3%	=	4,770
1990	$90,000	× 5.3%	=	4,770
1991	$90,000	× 5.3%	=	4,770
1992	$90,000	× 5.3%	=	4,770
1993	$90,000	× 5.3%	=	4,770
1994	$90,000	× 5.3%	=	4,770
1995	$90,000	× 5.3%	=	4,770
1996	$90,000	× 5.3%	=	4,770
1997	$90,000	× 5.3%	=	4,770
1998	$90,000	× 5.2%	=	4,680
1999	$90,000	× 5.2%	=	4,680
2000	$90,000	× 5.2% × 11 ÷ 12	=	4,290*
	Total			$71,520

* The full-month convention applies to ACRS property in the year of sale.

Machine Shed. On August 18, 1988, June paid $20,000 for a new machine shed. She claimed 150% declining balance depreciation over a 20-year recovery period as follows:

Year	Unadjusted Basis	Percent		Depreciation
1988	$20,000 ×	3.750%	=	$ 750
1989	$20,000 ×	7.219%	=	1,444
1990	$20,000 ×	6.677%	=	1,335
1991	$20,000 ×	6.177%	=	1,235
1992	$20,000 ×	5.713%	=	1,143
1993	$20,000 ×	5.285%	=	1,057
1994	$20,000 ×	4.888%	=	978
1995	$20,000 ×	4.522%	=	904
1996	$20,000 ×	4.462%	=	892
1997	$20,000 ×	4.461%	=	892
1998	$20,000 ×	4.462%	=	892
1999	$20,000 ×	4.461%	=	892
2000	$20,000 ×	4.462% × .50	=	446*
	Total			$12,860

*The half-year convention applies to MACRS 20-year property in the year of the sale.

Wheat Crop. Included in the sale of the farm was a winter wheat crop. June incurred $400 of expenses to plant the crop in 2000.

Cost-sharing Payments. In August of 1989, June paid $40,000 for some terraces and waterways on her land. She received $30,000 of cost-sharing payments from the government and elected to exclude those payments from income under I.R.C. §126. She added the remaining $10,000 of cost to the basis of her land.

House. June converted one room of the house to an office for her farm business in September of 1990. The office occupied 150 of the 1,500 square feet in her house and June used it exclusively for her farm business. June allocated one-tenth (150 ÷ 1,500) of the $60,000 basis in the house to the office in the home and claimed depreciation on that basis using straight-line depreciation over a 31.5-year recovery period. In September of 1998, she converted the office back to personal use. The depreciation she claimed on her tax return for 1990 through 1998 is as follows:

Unadjusted

Year	Basis	Percent	Depreciation
1990	$6,000	× 0.926%	= $ 56
1991	$6,000	× 3.175%	= 190
1992	$6,000	× 3.175%	= 190
1993	$6,000	× 3.174%	= 190
1994	$6,000	× 3.175%	= 190
1995	$6,000	× 3.174%	= 190
1996	$6,000	× 3.175%	= 190
1997	$6,000	× 3.174%	= 190
1998	$6,000	× 3.175% × 8.5 ÷ 12	= 135*
	Total		$1,521

* In 1998, June had a loss from her farming business and was not allowed to deduct any of the office in the home expenses—including the depreciation. She carried her office in the home deduction forward, but she had no farming income in 1999 and 2000 and therefore has never been allowed to deduct the office in the home expenses for 1998.

Soil and Water Conservation Expenses. On May 10, 1994, June paid $160,000 for another 80 acres of land next to her original 200 acres. In July of 1996 she paid $8,000 for soil and water conservation expenses on that 80 acres. She elected to deduct the $8,000 on her 1994 income tax return under I.R.C. §175.

Question 5.1.1. How should June allocate the sale price among the land and improvements?

Answer 5.1.1. If the sale price is not allocated among the assets in the selling contract, June should allocate them according to the fair market value of each item. In this case, the sum of the fair market values of each asset is $841,000. June sold the farm for a $15,000 discount because she wanted to sell it all as one unit to avoid dealing with more than one seller. The fair market value and the sale price allocated to each asset is as follows:

Asset	Fair Market Value	Percent of Total Value	Total Sales Price	Allocated Sales Price
House	$100,000	11.89%	$825,982	$ 98,214
Barn	15,000	1.78%	825,982	14,732
Machine Shed	25,000	2.97%	825,982	24,554
Wheat crop	1,000	0.12%	825,982	982
Land: 200 acres	500,000	59.45%	825,982	491,071
Land: 80 acres	200,000	23.78%	825,982	196,429
Total	$841,000			$825,982

Question 5.1.2. How does June allocate the brokerage fees among the assets?

Answer 5.1.2. The brokerage fees are allocated among the assets in proportion to the sales price allocated to each asset. Therefore, the same percentages used to allocate the sales price can be used to allocate the brokerage fees. They are allocated as follows:

Asset	Percent of Total Value	Total Brokerage Fees	Allocated Brokerage Fees
House	11.89%	$41,299	$ 4,911
Barn	1.78%	41,299	737
Machine Shed	2.97%	41,299	1,228
Wheat crop	0.12%	41,299	49
Land: 200 acres	59.45%	41,299	24,553
Land: 80 acres	23.78%	41,299	9,821
Total			$41,299

Question 5.1.3. How does June report the gain or loss for each asset?

Answer 5.1.3. June must report her gain or loss as follows:

House. June is required to reduce the basis in her home by the depreciation that is allowed or allowable. While June claimed $1,521 of depreciation for the business use of her home, she was not allowed to deduct $135 of that amount due to the business income limitation on office in the home expenses. Consequently, June's basis in her home is calculated as follows:

Unadjusted basis		
Less depreciation allowed		**$60,000**
Depreciation claimed	$1,521	
Depreciation not allowed	135	
Depreciation allowed		1,386
Adjusted basis		$58,614

Practitioner Note. I.R.C. §1016 requires the basis of assets to be reduced by any depreciation allowed or allowable by the subtitle A of Title 26 of the United States Code. Since the rules that limit the depreciation deduction of the office in the home are in subtitle A, the depreciation is not allowed by subtitle A and the basis is not reduced by the disallowed deduction

Since June converted the office in her home to personal use more than two years before she sold her home, the space that was used as her office in the home meets the two-out-of-five year test at the time of sale. Therefore, June is allowed to exclude the gain realized on the portion used as an office in the home except to the extent that she reduced basis due to depreciation after May 6, 1997. None of the $135 depreciation claimed in 1998 reduced basis since she was not allowed to deduct it. Of the $190 of depreciation claimed in 1997, 239 ÷ 365 is attributable the period after May 6, 1997. Therefore, $190 × 239 ÷ 365 = $124 of the gain she realizes on the sale of the house must be reported as ordinary income.

June reports the $124 of gain by reporting the sale of the home in Part III of Form 4797.

The entry on line 21 is calculated as follows:

Unadjusted basis	$60,000
Brokerage fees	4,911
Total	$64,911

The full $34,689 of gain on the sale of the house is included on line 32 and carried to line 6 in Part I of Form 4797. The $34,565 exclusion is claimed on line 2 of Form 4797 so that the $124 net gain due to depreciation after May 6, 1997 is included on line 7 of Form 4797. That gain is unrecaptured section 1250 gain and is included in the capital gains that are subject to the 25% rate. It is included in the amount reported on line 25 of Schedule D.

Barn. The adjusted basis in the barn is calculated as follows:

Unadjusted basis	$90,000
Less depreciation claimed	71,520
Adjusted basis	$18,480

Since the $14,732 sale price allocated to the barn is less than the $18,480 adjusted basis, June will report the loss from the sale in Part I of Form 4797 as shown below.

The amount to report in column (f) is calculated as follows:

Unadjusted basis	$90,000
Brokerage fees	737
Total	$90,737

Machine Shed. The sale of the machine shed is subject to the I.R.C. §1250 recapture rules. Therefore, the sale is reported in Part III of Form 4797.

The entry on line 21 is calculated as follows:

Unadjusted basis	$20,000
Brokerage fees	1,228
Total	$21,228

The additional depreciation to report on line 26a is calculated as follows:

Year	Depreciation Claimed	Straight-line Depreciation	Additional Depreciation
1988	$ 750	$ 500	$250
1989	1,444	1,000	444
1990	1,335	1,000	335
1991	1,235	1,000	235
1992	1,143	1,000	143
1993	1,057	1,000	57
1994	978	1,000	(22)
1995	904	1,000	(96)
1996	892	1,000	(108)
1997	892	1,000	(108)
1998	892	1,000	(108)
1999	892	1,000	(108)
2000	446*	500*	(54)
Total	$12,860	$12,000	$860

* The half-year convention applies to MACRS 20-year property in the year of the sale

Wheat Crop. Since the wheat crop was sold to the same buyer as the underlying farm and in the same transaction, it is considered I.R.C. §1231 property. Therefore, the sale is reported in Part I of Form 4797. The entry for column (f) is calculated as follows:

Unadjusted basis	$400
Brokerage fees	49
Total	$449

Practitioner Note. June must exclude the $400 cost of planting her wheat crop from her 2000 Schedule F expenses.

Observation. When the buyer of the farm sells the wheat crop, he can deduct the $982 purchase price of the wheat from the sale proceeds even though June was allowed to report her gain as long-term capital gain.

200-acre parcel. The sale of the 200-acre parcel is subject to the I.R.C. §1255 recapture rules since the cost-sharing payments received for that land were excluded from income under I.R.C. §126.

The entry on line 21 is calculated as follows:

Unadjusted basis	$350,000
Improvements	10,000
Brokerage fees	24,554
Total	$384,554

The entry for line 29a is calculated as follows:

Amount excluded under I.R.C. §126	$30,000
Applicable percentage	80%*
Amount of recapture	$24,000

* The applicable percentage is 100% reduced by 10% for each full and partial year the land was held more than ten years **after** the cost-sharing payment was received

80-acre parcel. The sale of the 80-acre parcel is subject to the I.R.C. §1252 recapture rules since soil and water conservation expenses for that parcel were deducted from income under I.R.C. §175.

The entry on line 21 is calculated as follows:

Unadjusted basis	$160,000
Brokerage fees	9,821
Total	$169,821

The entry for line 27b is calculated as follows:

Amount deducted under I.R.C. §175	$8,000
Applicable percentage	60%*
Amount of recapture	$4,800

* The applicable percentage is 100%, except as follows:
- 80% if the farmland was disposed of within the sixth year after it was acquired
- 60% if disposed of within the seventh year
- 40% if disposed of within the eighth year
- 20% if disposed of within the ninth year

Observation. The recapture under I.R.C. §1252 is based on the date the land was acquired, not the date the soil and water conservation expenses were deducted. By contrast, recapture under I.R.C. §1255 is based on when the cost-sharing payments were excluded from income.

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

2000

Attachment Sequence No. **27**

Name(s) shown on return: *June Bugg*

Identifying number: *121-01-4797*

1	Enter here the gross proceeds from the sale or exchange of real estate reported to you for 1999 on Form(s) 1099-S (or a substitute statement) that you will be including on line 2, 10, or 20	1	*825,000*

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)
2 *Section 121 exclusion*						*(34,565)*
Barn	*11/15/85*	*11/27/00*	*14,732*	*71,520*	*90,737*	*(4,485)*
Wheat crop	*10/15/00*	*11/27/00*	*982*	*0*	*449*	*533*
(sold with farm)						

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	*154,340*
7	Combine lines 2 through 6. Enter the gain or (loss) here and on the appropriate line as follows:	7	*115,823*

Partnerships (except electing large partnerships). Report the gain or (loss) following the instructions for Form 1065, Schedule K, line 6. Skip lines 8, 9, 11, and 12 below.

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

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

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

S corporations. Enter any gain from line 9 on Schedule D (Form 1120S), line 14, and skip lines 11 and 12 below.

All others. If line 9 is zero, enter the gain from line 7 on line 12 below. If line 9 is more than zero, enter the amount from line 8 on line 12 below, and enter the gain from line 9 as a long-term capital gain on Schedule D.

Part II Ordinary Gains and Losses

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

11	Loss, if any, from line 7	11	( )
12	Gain, if any, from line 7 or amount from line 8, if applicable	12	
13	Gain, if any, from line 31	13	*29,660*
14	Net gain or (loss) from Form 4684, lines 31 and 38a	14	
15	Ordinary gain from installment sales from Form 6252, line 25 or 36	15	
16	Ordinary gain or (loss) from like-kind exchanges from Form 8824	16	
17	Recapture of section 179 expense deduction for partners and S corporation shareholders from property dispositions by partnerships and S corporations (see instructions)	17	
18	Combine lines 10 through 17. Enter the gain or (loss) here, and on the appropriate line as follows:	18	

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

b For individual returns:

(1)	If the loss on line 11 includes a loss from Form 4684, line 35, column (b)(ii), enter that part of the loss here. Enter the part of the loss from income-producing property on Schedule A (Form 1040), line 27, and the part of the loss from property used as an employee on Schedule A (Form 1040), line 22. Identify as from "Form 4797, line 18b(1)." See instructions	18b(1)	
(2)	Redetermine the gain or (loss) on line 18, excluding the loss, if any, on line 18b(1). Enter here and on Form 1040, line 14	18b(2)	

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 13086I Form **4797** (1999)

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

19 (a) Description of section 1245, 1250, 1252, 1254, or 1255 property:	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)
A House	11/15/85	11/27/00
B Machine Shed	08/18/88	11/27/00
C 200-acre parcel of farmland	11/15/85	11/27/00
D 80-acre parcel of farmland	05/10/94	11/27/00

These columns relate to the properties on lines 19A through 19D. ▶		Property A	Property B	Property C	Property D
20 Gross sales price (**Note:** *See line 1 before completing.*)	20	98,214	24,554	491,071	196,429
21 Cost or other basis plus expense of sale	21	64,911	21,228	384,554	169,821
22 Depreciation (or depletion) allowed or allowable	22	1,386	12,860	0	0
23 Adjusted basis. Subtract line 22 from line 21	23	63,525	8,368	384,554	169,821
24 Total gain. Subtract line 23 from line 20	24	34,689	16,186	106,517	26,608
25 **If section 1245 property:**					
a Depreciation allowed or allowable from line 22	25a				
b Enter the **smaller** of line 24 or 25a	25b				
26 **If section 1250 property:** If straight line depreciation was used, enter -0- on line 26g, except for a corporation subject to section 291.					
a Additional depreciation after 1975 (see instructions)	26a		860		
b Applicable percentage multiplied by the **smaller** of line 24 or line 26a (see instructions)	26b		860		
c Subtract line 26a from line 24. If residential rental property or line 24 is not more than line 26a, skip lines 26d and 26e	26c		15,326		
d Additional depreciation after 1969 and before 1976	26d		0		
e Enter the **smaller** of line 26c or 26d	26e		0		
f Section 291 amount (corporations only)	26f				
g Add lines 26b, 26e, and 26f	26g	0	860		
27 **If section 1252 property:** Skip this section if you did not dispose of farmland or if this form is being completed for a partnership (other than an electing large partnership).					
a Soil, water, and land clearing expenses	27a				8,000
b Line 27a multiplied by applicable percentage (see instructions)	27b				4,800
c Enter the **smaller** of line 24 or 27b	27c				4,800
28 **If section 1254 property:**					
a Intangible drilling and development costs, expenditures for development of mines and other natural deposits, and mining exploration costs (see instructions)	28a				
b Enter the **smaller** of line 24 or 28a	28b				
29 **If section 1255 property:**					
a Applicable percentage of payments excluded from income under section 126 (see instructions)	29a			24,000	
b Enter the **smaller** of line 24 or 29a (see instructions)	29b			24,000	

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

30 Total gains for all properties. Add property columns A through D, line 24	30	184,000
31 Add property columns A through D, lines 25b, 26g, 27c, 28b, and 29b. Enter here and on line 13	31	29,660
32 Subtract line 31 from line 30. Enter the portion from casualty or theft on Form 4684, line 33. Enter the portion from other than casualty or theft on Form 4797, line 6	32	154,340

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

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

ISSUE 6: LIKE-KIND EXCHANGE OF CONSERVATION EASEMENTS

Local government units and non-profit organizations that are interested in preserving open space have offered to buy conservation easements from farmland owners. The effect of the purchase is to allow the land to continue in its farming use but to prevent the land from being developed. The landowner often benefits from lower property taxes in addition to the purchase price that is received for the conservation easement.

A disadvantage the landowner may face is paying income taxes on the amount received. If a landowner sells a conservation easement, the proceeds of the sale are first used to reduce the basis of the affected land. To the extent that the proceeds exceed the basis of the land, they must be reported as gain on the seller's income tax return.

Example 6.1. Rhoda Dendron owns farmland (Whiteacre) along a scenic coastline. Her local Land Trust Commission would like to acquire a conservation easement on Whiteacre to preserve the scenic view by preventing the land from being developed. Whiteacre is worth $500,000 before the conservation easement is transferred. The conservation easement is worth $200,000, and Whiteacre without the conservation easement is worth $300,000. Rhoda has owned Whiteacre for 30 years and has a $50,000 income tax basis in it.

If Rhoda sells the conservation easement to the Land Trust Commission for $200,000, she will have to report $150,000 ($200,000 – $50,000) of capital gain on her income tax return. Rhoda 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 Whiteacre without the conservation easement. Therefore, if she later sells the rest of her interest in Whiteacre 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.

EXCHANGING CONSERVATION EASEMENTS FOR OTHER PROPERTY

One option for avoiding the recognition of gain from the sale of a conservation easement is to exchange the conservation easement for other real property. The IRS has ruled that exchanging a scenic conservation easement on one piece of land for a fee interest in another piece of land is a like-kind exchange for purposes of I.R.C. §1031. Ltr. Rul. 9621012. An exchange of development rights for a fee interest in land is also a like-kind exchange. Ltr. Rul. 9851039; Ltr. Rul. 9232030; Ltr. Rul. 9215049.

Example 6.2. Assume the same facts as in Example 1 except that Rhoda trades the conservation easement on Whiteacre for a fee interest in other farmland (Greenacre). Greenacre is worth $200,000.

Rhoda does not have to recognize any gain from the exchange. However, her basis in Greenacre is a carryover basis from the conservation easement. Therefore, to calculate her basis in Greenacre, she must allocate her $50,000 basis in Whiteacre between the interest in Whiteacre that she retained and the conservation easement. The allocation is based on the fair market value of the conservation easement she transferred and the fair market value of Whiteacre without the development rights. Her basis is allocated as follows:

Interest in Property	Fair Market Value	Percent of FairMarket Value	Portion of $50,000 Basis
Whiteacre without conservation easement	$300,000	60%	$30,000
Conservation Easement	$200,000	40%	$20,000
Total	$500,000	100%	$50,000

Practitioner Note. The entity that is buying the conservation easement may not want to (or may not have authority to) buy the property that the farmland owner wants to acquire in the trade. In that case, a deferred exchange can be arranged under the Starker rules that have been codified into I.R.C. §1031. Under those rules, the money for the conservation easement will go into an escrow account that can be used to purchase the replacement property.

EXCHANGING CONSERVATION EASEMENTS FOR OTHER PROPERTY SUBJECT TO A CONSERVATION EASEMENT

The like-kind exchange rules will also apply to an exchange of a conservation easement for an interest in property that is subject to a conservation easement.

Example 6.3.

Phil O. Dendron owns a farm (Farm A) that is near a metropolitan area. His local Land Trust Commission has purchased the farm next to his (Farm B) in order to acquire the development rights to Farm B. The Land Trust Commission is willing to sell Farm B without the development rights and wants to buy the development rights to Phil's Farm A.

Phil's basis in Farm A is $60,000. The fair market value of Farm A is $300,000. The fair market value of the development rights to Farm A is $100,000 and the fair market value of Farm A without the development rights is $200,000. The fair market value of Farm B without the development rights is $150,000. The Land Trust Commission has offered to exchange Farm B without the development rights for the development rights to Farm A and $50,000 of cash.

If Phil accepts this offer, the exchange will qualify as a like-kind exchange and Phil will not have to recognize any gain. His basis in Farm A and Farm B are calculated as follows:

Interest in Property	Fair Market Value	Percent of Fair Market Value	Portion of $60,000 Basis
Farm A without development rights	$200,000	66 2/3%	$40,000
Development rights to Farm A	$100,000	33 1/3%	$20,000
Total	$300,000	100%	$60,000

Basis in Farm B	
Carryover basis from development Rights in Farm A	$20,000
Plus cash paid in exchange	50,000
New basis	$70,000

ISSUE 7: DEPRECIATION RECAPTURE OF A TRACTOR RECEIVED AS A GIFT

Example 7.1. Minnie Apoulos paid $100,000 for a tractor in 1995. She used it in her farming business until she gave the tractor to her daughter Anne in 1998. There were no gift taxes due on the gift, Anne gets a $49,005 carryover basis from Minnie calculated as follows:

Unadjusted basis of tractor		\$100,000
Less depreciation:		
1995: \$100,000 × 10.71% =	\$10,710	
1996: \$100,000 × 19.13% =	19,130	
1997: \$100,000 × 15.03% =	15,030	
1998: \$100,000 × 12.25% × .5 =	6,125	
Total		–50,995
Adjusted basis of tractor		\$ 49,005

Anne sold the tractor in 2000 for \$55,000. At the time of sale, her total depreciation and adjusted basis are as follows:

Unadjusted basis of tractor		\$ 49,005
Less depreciation:		
1998: \$49,005 x 10.71% =	\$5,248	
1999: \$49,005 x 19.13% =	9,375	
2000: \$49,005 x 15.03% × .5 =	3,683	
Total		–18,306
Adjusted basis of tractor		\$ 30,699

When Anne reports the sale on her Form 4797, she must make the following adjustments to the amounts that she reports on lines 21 and 22. Treas. Reg. §1.1245-2(a)(4).

1. The depreciation she reports on line 22 includes not only the \$18,306 of depreciation that she claimed on the tractor but also the \$50,995 that Minnie claimed on the tractor. Therefore she reports \$18,306 + \$50,995 = \$69,301 on line 22.
2. Since Anne is required to include the depreciation claimed by Minnie on line 22, Anne is allowed to report Minnie's \$100,000 unadjusted basis on line 21. This substitution is necessary to arrive at the proper adjusted basis on line 23.

Part of Anne's Form 4797 follows.

Form 4797 (1999) Page **2**

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

		(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)
19	**(a)** Description of section 1245, 1250, 1252, 1254, or 1255 property:		
A		*02/13/98*	*06/20/00*
B			
C			
D			

	These columns relate to the properties on lines 19A through 19D. ▶		**Property A**	**Property B**	**Property C**	**Property D**
20	Gross sales price (**Note:** *See line 1 before completing.*)	**20**	*55,000*			
21	Cost or other basis plus expense of sale	**21**	*100,000*			
22	Depreciation (or depletion) allowed or allowable	**22**	*69,301*			
23	Adjusted basis. Subtract line 22 from line 21	**23**	*30,699*			
24	Total gain. Subtract line 23 from line 20	**24**	*24,301*			
25	**If section 1245 property:**					
a	Depreciation allowed or allowable from line 22	**25a**	*69,301*			
b	Enter the **smaller** of line 24 or 25a	**25b**	*24,301*			

Observation. If Anne reported only her own $18,306 of depreciation on line 22 and her $49,005 unadjusted basis on line 21, she would get the proper $30,699 basis on line 23 and $24,301 gain on line 24, but she would erroneously report only $18,306 of depreciation recapture on line 25b. The remaining $5,995 of gain would erroneously get capital gain treatment.

ISSUE 8: EFFECT OF A SALE/LEASEBACK ON I.R.C. §179

Example 8.1. Jean Splice purchased $240,000 of equipment in 2000 for use in her farming business. Included in the $240,000 is a $90,000 chopper that she purchased in May and used for four months before entering into a sale/lease-back with Farm Credit. Under the terms of the sale/lease-back, Farm Credit paid Jean $90,000 for the chopper and leases it to Jean for a fair-market-value rental rate.

Question 8.1.1. Is the $90,000 cost of the chopper included in the $200,000 limit for reducing the $20,000 limitation for I.R.C. §179 deductions in 2000?

Answer 8.1.1. Apparently, the $90,000 is not included in the $200,000 limit. Therefore, Jean can claim the full $20,000 I.R.C. §179 deduction for 2000. The arguments for that result are as follows.

I.R.C. §179(b)(2) reduces the $20,000 limit on the §179 deduction "by the amount of the cost of §179 property placed in service during such taxable year that exceeds $200,000."

I.R.C. §179(d)(1) defines §179 property as "any tangible property (to which §168 applies), which is §1245 property [as defined in §1245(a)(3)], and which is acquired by purchase for use in the active conduct of a trade or business. Such term shall not include any property described in §50(b) and shall not include air conditioning or heating units."

Two possible interpretations for the phrase "to which §168 applies" are

1. It could be interpreted to mean property for which depreciation can be claimed. If that interpretation is used, then the cost of the chopper is not included in the $200,000 limit since no depreciation can be claimed on property that is placed in service and disposed of in the same year. Treas. Reg. §1.168(d)-(1)(b)(3)(ii).
2. The phrase "to which §168 applies" could also be interpreted to mean property that is governed by the §168 rules. Under this interpretation, it could be argued that the I.R.C. §168 rules apply to the chopper and therefore it is §179 property even though I.R.C. §168 does not allow a deduction because the chopper was disposed of in the same year it was purchased. If this interpretation is used, then the cost of the chopper is included in the $200,000 limit.

Legislative History. The phrase "tangible property (to which §168 applies)" was added to the code by the Technical and Miscellaneous Revenue Act of 1988. It replaced "recovery property." "Recovery property" was added to the code by the Economic Recovery Tax Act of 1981. It replaced "tangible personal property of a character subject to the allowance for depreciation under §167."

Effect of the Second Interpretation. The position that property purchased and sold in the same year is §179 property (interpretation 2 above) seems too good to be true for taxpayers who have not exceeded the $200,000 limit.

For example, assume that a taxpayer purchased a piece of equipment for $20,000 in 2000 and sold it under a leaseback arrangement. He could claim the full $20,000 §179 deduction, which would reduce SE income. He would report the sale on Form 4797 where the $20,000 of §1245 recapture would be ordinary income but not subject to SE tax. He could then deduct his lease payments on Schedule F and further reduce his income for both income tax and SE tax purposes. The IRS is not likely to go along with this result. Therefore, **the IRS is not likely to follow interpretation #2.**

Alternative Argument. An alternative argument is that property sold and leased back in the year it is purchased is §179 property and therefore is included in the $200,000 limit, but it cannot be expensed under §179 because it was sold during the year. That does not appear to be a winning argument because the language of §179(a) that allows the expense deduction is almost identical to the language of §179(b)(2) that requires property to be included in the $200,000 limit.

I.R.C. §179(a) says, "the cost of any §179 property" may be treated as an expense. It also says, "Any cost so treated shall be allowed as a deduction for the taxable year in which the §179 property is placed in service." Therefore, to qualify for the §179 deduction, the property must be both "§179 property" and "placed in service" during the tax year.

As noted above, §179(b)(2) says the limit is reduced "by the amount of the cost of §179 property placed in service during such taxable year that exceeds $200,000."

Given the similarity of these two requirements, it is difficult to argue that property that is purchased and sold to a leasing company in the same year is "§179 property placed in service during the tax year" for purposes of the $200,000 limit in §179(b)(2) and is not "§179 property" for which a deduction can be claimed in the year "placed in service."

Other Authority. The regulations under I.R.C. §179 use language similar to I.R.C. §179. IRS Publication 946, *How to Depreciate Property*, and IRS Publication 225, *Farmers Tax Guide*, both say, "If the cost of your qualifying §179 property placed in service in a year is over $200,000, reduce the maximum dollar limit for each dollar over $200,000." That language appears to be consistent with interpretation 1 above and inconsistent with interpretation 2. This issue has not been addressed in any cases or rulings.

Interpretation 1 is illustrated by Example 8.1 and Answer 8.1.1. The authors believe this to be the correct interpretation.

ISSUE 9: TAX CONSEQUENCES OF PUTTING THE RESIDENCE IN THE LLC

As producers create new business entities for their farming assets, they often face the question of whether the residence should be put into the business entity. In many cases, the residence is located on property that is part of the real estate used in the farming business.

Example 9.1. Neil and Eileen Down own and operate a fruit and vegetable farm. Their personal residence is located on land next to the buildings used in the farming operation. They plan to sell their house to the LLC that operates the farming business. The LLC will have employment agreements with Neil's and Eileen's daughters that require them to live in the house in order to monitor the sensitive plants in the farming business. Neil, Eileen, and their two daughters are all members of the LLC.

Question 9.1.1. Does the sale of the house to the LLC qualify for the I.R.C. §121 exclusion of gain on sale of a personal residence?

Answer 9.1.1. It is likely that the sale will qualify for the I.R.C. §121 exclusion. In Ltr. Rul. 9625035, the IRS allowed a taxpayer to roll gain into a replacement home when the first home was sold to the taxpayer's wholly owned corporation in order to meet the requirement of former I.R.C. §1034 that the replacement home be purchased no more than two years before the sale of the of the first home. The new I.R.C. §121 rules are no more restrictive than the former I.R.C. §1034 rules.

Question 9.1.2. What are the tax consequences of the LLC owning the personal residence?

Answer 9.1.2. These facts raise two separate tax questions.

1. Can the LLC deduct the cost of providing the home to members?
2. Can the members exclude the value of the home from their income?

The early cases that addressed this issue did not distinguish between these two questions. In *Commissioner v. Moran,* 236 F.2d 595 (8th Cir. 1956), the taxpayers were husband and wife who owned and operated a hotel as a partnership. The taxpayers lived in and ate their meals in the hotel. The Commissioner denied deductions claimed on their tax returns for the cost of providing meals and lodging to the partners. The Tax Court allowed the deductions but was reversed by the Eighth Circuit Court of Appeals. The Eighth Circuit reasoned that if the business had been incorporated and the corporation employed the owners to work in the hotel, the corporation could have deducted the cost of providing meals and lodging and the employee/owners could have excluded it from income under the "convenience of employer" provision. However, having chosen to operate as a partnership, the partners could not be treated as employees, and the expenses could not be deducted by the partnership. Almost identical facts led to the same result in *Commissioner v. Doak*, 234 F.2d 704 (4th Cir. 1956) and *Commissioner v. Robinson*, 273 F.2d 315 (3rd Cir. 1959).

In later cases, the IRS does not challenge the deduction of the expense by the partnership other than depreciation of the residence. Instead, it argues that the partner must include the value of the meals and lodging in income. The IRS has had mixed success with that argument.

In *Wilson v. United States*, 19 AFTR 2d 1225 (Ct. Cl. 1967) the taxpayers were a husband and wife who owned a one-ninth interest in a partnership that owned a ranch in Oklahoma. They lived on the ranch and ate their meals on the ranch, as did another married couple and four individuals who were employed by the partnership. The partnership paid for groceries and fuel consumed by the employees and the partners. The IRS argued that the cost of groceries and fuel consumed by the partners should be added to their income. The Court of Claims agreed with the IRS saying that I.R.C. §119 does not apply to partners because they are not employees.

In *Armstrong v. Phinney*, 21 AFTR 2d 1260 (5th Cir. 1968) the taxpayer was a five-percent owner of a ranching partnership. In return for his services of managing the ranch, the partnership paid him a fixed salary and provided a home for the taxpayer and his family, most of the groceries, utilities, and insurance for the house, and maid service. Taxpayer also received 5% of the profits of the partnership. The IRS argued that the value of the meals and lodging should be included in taxpayer's income. The District Court agreed with the IRS, but the Court of Claims reversed. The Court of Claims reasoned that the holdings of *Moran, Doak and Robinson, supra* are no longer applicable because Congress added I.R.C. §707(a) since they were decided. That section allows a partner to be treated as one who is not a partner when he or she engages in a transaction with the partnership other than in his or her capacity as a partner. Therefore, the court concluded, it is now possible for a partner to stand in an employer-employee relationship with the partnership, and the partner can claim the benefits of I.R.C. §119 if the requirements of that section are met.

In GCM 34173 (July 25, 1969) the IRS took a strong position against the holding in *Armstrong v. Phinney.* GCM 34173 argues that I.R.C. §707(a) is a codification of prior law and does not allow partners to be treated as employees. It also argues that treating a partner as a firm employee would frustrate the general objective of Subchapter K and would nullify several statutory provisions. Such treatment would completely undermine the structure established by Congress for the taxation of partnership income.

GCM 34173 specifically stops short of arguing that the value of lodging be included in the taxpayer's income. It does not concede that the value of the lodging is excluded, but recommends that, as a simplifying measure, a publication on taxability of meals and living expenses not address the issue of the value of the lodging. This caution is based on GCM 33316 (August 23, 1966), which concludes that a share-rent farm operator could have a dual capacity–as renter of the farmland and as an employee who is paid lodging for his upkeep of fences and equipment. As an employee he can exclude the value of the lodging from his income. In this author's opinion, GCM 33316 does not warrant the caution of GCM 34173. It is hard to see how a partner can benefit from the dual capacity theory of GCM 33316.

In *Russell v. Commissioner*, T. C. Memo 1982-709, the Tax Court agreed with the IRS argument that a partner could not claim depreciation on a house in which another partner lived. The court followed

Moran and Doak, *supra* and held that, since there is no employer-employee relationship; the personal use of the house by a partner disallows depreciation on the house.

In Ltr. Rul 9134003, the taxpayers operated a hog farm. They transferred their home and personal property into a corporation but kept the farmland out of the corporation. They then became employees of the corporation under an employment agreement that required them to live and eat their meals on the premises. The corporation deducted the cost of the meals and lodging under I.R.C. §162, and the employee/shareholders excluded the value of the meals and lodging from their income under I.R.C. §119. The agent applied I.R.C. §269 to deny the deductions for the corporation claiming that the taxpayers formed the corporation for the purpose of evasion or avoidance of the federal income tax.

One of the taxpayers' arguments was that they were not using the corporation to avoid income taxes since they could have accomplished the same tax results if they formed a partnership. The IRS agreed that the partnership would have been allowed to claim a §162 deduction for the living expenses if the farming operation had been contributed to a partnership.

CONCLUSIONS

Based on the above authority, the apparent positions of the IRS are as follows:

1. Living expenses such as utilities paid by the partnership on behalf of a partner are treated as guaranteed payments that are deducted by the partnership and included in the partner's income.
2. No depreciation can be claimed on a house used by a partner as his or her personal residence.
3. A partner is not an employee and cannot claim the I.R.C. §119 exclusion of the value of lodging.

The conclusion that depreciation cannot be claimed by the partnership appears to be inconsistent with the position that other living expenses can be deducted as a guaranteed payment. It would be consistent for the IRS to argue that the partnership can depreciate the residence, but the partner living in the residence must include the depreciation in income as a guaranteed payment. That would preserve the same parity among the partners as the deduction of living expenses as a guaranteed payment. It allows all of the partners to reduce their share of partnership income by the depreciation and requires the partner living in the house to include it in income. If the partnership is not allowed to depreciate the residence, then all of the partners share in the denied deduction.

What Position Should the Taxpayer Take?

Given the conflict in the authority, taxpayers are likely to avoid a penalty no matter what position they take on lodging expenses paid by a partnership on behalf of a partner.

Therefore, if Neil and Eileen want to be aggressive, they could follow the *Armstrong v. Phinney* opinion and deduct the cost of maintaining the residence and claim depreciation on the residence. Their daughters could argue that they do not have to recognize any income for the value of the lodging since it is excluded under I.R.C. §119.

The IRS will argue that the value of the meals and lodging provided by the LLC must be included in the daughters' income as a guaranteed payment from the LLC. The IRS lost on that argument in *Armstong v. Phinney, supra*, but won on that argument in all of the other cases. Alternatively, the IRS will argue that the LLC cannot claim depreciation on a house that is occupied by members of the LLC.

If Neil and Eileen are not willing to make the I.R.C. §119 argument, then most of the tax benefit of putting the residence in the LLC is lost since the member's income is increased by the same amount as the LLC's deduction.

Question 9.1.3. If the residence is in the LLC when it is sold to a third party, will the I.R.C. §121 exclusion apply to that sale so that the gain realized after the residence was placed in the LLC can be excluded?

Answer 9.1.3. No. The I.R.C. §121 exclusion does not apply to the sale by a partnership. *Gibbons v. Commissioner,* 98-2 USTC 85,248 (4th Cir. 1998).

Practitioner Note. The I.R.C. §121 exclusion may be applied if the LLC distributed the house to a member who lived in the house in a tax-free distribution more than two years before the sale. Gain due to depreciation after May 6, 1997, would not qualify for the I.R.C. §121 exclusion.

ISSUE 10: LEASING BUILDINGS AND EQUIPMENT

A. BUILDINGS

As a means of financing the cost of buildings, leasing companies offer to build a building on the lessee's property and lease the building to the property owner. These facts raise the income tax question of whether the arrangement is a true lease or an installment sale of the building to the property owner.

Example 10.1. Fred Smith is a farmer who needs to acquire a building in which to store his equipment. Fred has determined that there are two options available to him. He could have the building built by a local contractor or enter into a contract with a leasing company that would have the building built for him and then lease the building from that company. After a review of both options, Fred has decided to enter into the leasing contract. The lease that Fred signs contains the following terms and conditions:

- Fred gives the leasing company rights of access to the property.
- The lease is for seven years, beginning November 1, 1998, and ending October 31, 2005. The lease payments are even amounts of $4,800, payable on November 1 of each year.
- Fred is required to pay all real estate taxes, insurance, and repairs on the building.
- At the end of the lease term, the lease may be renewed for additional periods of one year, each at a rental equivalent to the fair rental value of the building at that time, the building may be purchased for the fair market value, or the lease may be terminated and lessor maintains the ownership of the building.

Conclusion. Fred may treat this as a true tax lease. The transaction described above meets both the equity tests and the useful life test as defined in Rev. Proc. 75–21. In addition, Fred does not have a bargain purchase option, Fred did not furnish any cost of the building to the leasing company, and he did not lend any of the funds necessary to acquire the building to the leasing company (or guarantee the debt). Because there is an option to purchase at fair market value, the transaction meets the residual test described in Rev. Proc. 75–21.

B. EQUIPMENT

Equipment leasing arrangements raise the income tax issue of whether the arrangements should be treated as a lease or a purchase/sale.

- **If the arrangement is a lease,** the payments under the arrangement are deductible by the payor and included in ordinary income by the payee.
- **If the arrangement is treated as a sale,** only the portion of the payments that are properly allocated as interest are deducted by the payor and included in ordinary income by the payee. The remainder of the payment is treated as an installment payment on the purchase of the machinery or equipment.

Practitioner Note. If the transaction is treated as a purchase/sale, and the seller has depreciated the machinery, all of the gain created by depreciation deductions must be reported as ordinary income under the depreciation recapture rules of I.R.C. §1245 in the year of sale [I.R.C. §453(i)].

Practitioner Note. If the transaction is treated as a lease, and the lessor is an individual, the lease payments may be subject to the self-employment tax.

Example 10.2. In July of 1994, Ace, who is retired, and Tom, his son, entered into an arrangement under which Ace leased his machinery to Tom for use in Tom's business for five years. Tom agreed to pay Ace $5,000 per year. The first payment was due at the time the agreement was signed, and the others in July of each subsequent year. At the end of the five-year period, Tom had an option to purchase the machinery for $6,000.

If the arrangement is treated as a lease, Tom can claim a $5,000 deduction on his Schedule F for each of the five annual payments. Ace must report those payments as ordinary income. If Tom pays the additional $6,000 at the end of the agreement to purchase the machinery, he will have a $6,000 basis in the machinery, and Ace must report the $6,000 as the sale price of his equipment.

If the arrangement is treated as a sale, a portion of each payment will be treated as interest and the remainder as an installment payment of the purchase price of the equipment. This transaction is not subject to the unstated interest rules of I.R.C. §1274 since it falls within the under-$250,000 exception of I.R.C. §1274(c)(3)(C). **It is subject to the unstated interest rules of §483.**

- Under those rules, the applicable federal rate [under I.R.C. §1274(d)] is used to determine how much of each payment is to be treated as interest.
- I.R.C. §1274(d) sets the interest rate at the least of the applicable federal rates for the month of the transaction or the previous two months.
- Since the arrangement is for five years and calls for annual payments, the appropriate rate is the midterm rate for annual compounding.

Determining whether an arrangement is a lease or a sale is based on many factors. *Farmer's Tax Guide,* Publication 225, states the following:

> Whether the agreement, which in form is a lease, is in substance a conditional sales contract depends on the intent of the parties. This intent is shown by the agreement, read in the light of the facts and circumstances existing at the time you made the agreement. In determining the intent, no single test, or special combination of tests, is absolutely definitive. However, in the absence of compelling and persuasive factors to the contrary, treat an agreement as a conditional sales contract rather than a lease **if any of the following is true.**
>
> 1. The agreement applies part of each payment toward an equity interest you will receive.
> 2. You receive title to the property after you pay a stated amount of required payments.
> 3. You must pay, over a short period of time, an amount that represents an unusually large part of the price you would pay to buy the property.
> 4. You pay rent that is much more than the current fair rental value of the property.

5. You have an option to buy the property at a small price compared to the value of the property at the time you can exercise the option. You determine this value at the time of entering into the original agreement.

6. You have an option to buy the property at a small price compared to the total amount you must pay under the lease.
7. The lease designates some part of the payments as interest, or part of the payments are easy to recognize as interest.

As the above factors indicate, the IRS will look at the substance of the agreement to determine whether it is in fact a disguised sale or a true lease. The IRS has been successful in treating a purported lease as a sale when the terms of the arrangement make it look more like a sale than a lease. [*Mt. Mansfield Television, Inc. v. United States,* 239 F. Supp. (D. Vt. 1964), *aff'd per curiam* 342 F.2d 994 (2d Cir. 1965), *cert. denied* 382 U.S. 818 (1965).]

C. TRADE-IN OF MACHINERY FOR A LEASING ARRANGEMENT

Example 10.3. On February 15, 2000, Spencer McDonald traded his tractor (tractor A) for a five-year lease on a new tractor (tractor B). He had purchased tractor A for $50,000 on March 3, 1987, and has fully depreciated it. The lease calls for a $17,500 payment each year for the five years. Spencer was given a credit of $15,000 against the first lease payment in exchange for tractor A and paid the remaining $2,500 in cash. Spencer is allowed to purchase tractor B at the end of the lease for a price determined by the market value of used tractors at the time of the purchase.

Question 10.3.1. Is Spencer allowed to deduct the $15,000 lease payment made by trading in his old tractor?

Answer 10.3.1. Yes, Spencer can claim a deduction for the value of the tractor he traded in as long as the arrangement is a true lease arrangement and not a disguised installment sale. The facts of this case appear to be a true lease.

Question 10.3.2. Must Spencer report any income as a result of trading in his tractor?

Answer 10.3.2. Yes, Spencer is treated as if he sold his tractor for $15,000 and paid that amount to the dealer in lease payments. Therefore, he must report his gain ($15,000 – 0 = $15,000) in Part III of Form 4797. Since the gain is less than the depreciation he has claimed on tractor A, all of the gain is recaptured as ordinary income under I.R.C. §1245.

Question 10.3.3. Assume Spencer's arrangement with his dealer was as follows. The lease payments for tractor B are set by subtracting the $15,000 trade-in value of tractor A from the $70,000 list price of tractor B and amortizing the remaining $55,000 over five years at a 7% interest rate. At the end of the lease, Spencer is allowed to keep the tractor. Does Spencer report the transaction in the same manner as described above?

Answer 10.3.3. No. The arrangement is now a like-kind exchange and an installation purchase/sale. Therefore, Spencer's basis in Tractor B is $55,000, for which he can claim the I.R.C. §179 expense election and depreciate the balance. Spencer can deduct his interest payments. He cannot claim any lease payment deductions.

D. REVENUE PROCEDURES

The IRS has issued four Revenue Procedures to provide guidance on determining whether a transaction is a lease or a purchase. While these documents mainly pertain to the filing of a request by a taxpayer for an advance ruling by the IRS, the guidelines provided are useful in assisting tax practitioners in determining whether a transaction is a lease or purchase. The four Revenue Procedures are

- Revenue Procedure 75-21, 1975-1 C.B. 715
- Revenue Procedure 75-28, 1975-1 C.B. 752
- Revenue Procedure 76-30, 1976-2 C.B. 647
- Revenue Procedure 79-48, 1979-2 C.B. 529

Revenue Procedure 75–21 is the most important of the four. The remaining three provide additional detail or guidance.

Revenue Procedure 75–21 provides that the IRS will accept a transaction as a valid lease if all of the following conditions are met:

1. **Minimum unconditional "at risk" investment.** When the lessee first places the property in service or use, the minimum investment of the lessor must be equal to 20 percent of the cost of the property. This minimum investment must be unconditional and must remain equal to at least 20 percent of the cost of the property at all times throughout the entire lease term. The lessor must also demonstrate that an amount equal to at least 20 percent of the original cost of the property is a reasonable estimate of what the fair market value of the property will be at the end of the lease term.
2. **Lease term and renewal options**. The lease term includes all renewal or extension periods except renewals or extensions at the option of the lessee at fair rental value at the time of such renewal or extension.
3. **Purchase and sale rights.** No lessee may have a contractual right to purchase the property from the lessor at a price less than its fair market value at the time the right is exercised.
4. **No investment by lessee**. No part of the cost of the property may be furnished by any lessee.
5. **No lessee loans or guarantees**. No lessee may lend to the lessor any of the funds necessary to acquire the property or guarantee any indebtedness created in connection with the acquisition of the property by the lessor.
6. **Profit requirement**. The lessor must represent and demonstrate that it expects to receive a profit from the transaction, apart from the value of or benefits obtained from the tax deductions, allowances, credits, and other tax attributes arising from such transactions.

Revenue Procedure 75–21 also addresses transactions that involve "uneven" rent payments. If the preceding six requirements are met, a transaction will not be denied lease status if one of the two following conditions are met:

- The annual rent is not more than 10% above or below the amount calculated by dividing the total rent payable over the lease term by the number of years in such term, **or**
- During at least the first two-thirds of the lease term, the annual rent is not more than 10% above or below the amount calculated by dividing the total rent payable over such initial portion of the lease term by the number of years in such initial portion of the lease term, and the annual rent for any year during the remainder of the lease term is no greater than the highest annual rent for any year during the initial portion of the lease term and no less than one-half of the average annual rent during such initial portion of the lease term.

Revenue Procedure 75–28 sets forth the information and representations required to be furnished by the taxpayers in a request for an advance ruling. This Revenue Procedure does not alter in any way the six requirements of Revenue Procedure 75–21.

Revenue Procedure 76–30 reflects the decision of the IRS to not issue advance rulings regarding lease categorization when the property is "limited use property."

"Limited use property" is defined as property that is expected to not be useful or usable by the lessor at the end of the lease term except for purposes of continued leasing or transfer to any lessee.

In effect, the IRS will not recognize a transaction as a lease when the transaction involves "limited use property." Accordingly, a lease of "limited use property" should be treated as a sale or a loan because the lessor is economically compelled to sell or release the property to the lessee.

Revenue Procedure 76–30 provides six examples involving "limited use property." None of the examples involves the typical equipment lease that most practitioners will see. However, for purposes of understanding "limited use property," the following two examples contained in the Revenue Procedure are provided:

1. X builds a masonry smokestack attached to a masonry warehouse building owned by Y, and leases the smokestack to Y for use as an addition to the heating system of the warehouse. The lease term is 15 years; the smokestack has a useful life of 25 years, and the warehouse has a remaining useful life of 25 years. It would not be commercially feasible to disassemble the smokestack at the end of the lease term and reconstruct it at a new location. The smokestack is considered to be limited use property.
2. X builds an electrical generating plant on land owned by Y and leases the plant to Y. The lease term is 40 years, and the plant has an estimated useful life of 50 years. The land is leased to X pursuant to a ground lease for a term of 50 years. The plant is adjacent to a fuel source that it is estimated will last for at least 50 years. Access to this fuel source is necessary for the commercial operation of the plant, and Y has recently obtained the contractual right to acquire all fuel produced from the source for 50 years. Y will use the plant to produce and generate electrical power for sale to a city located 500 miles away. The plant is synchronized into a power grid that makes the sale of electrical power to a number of potential markets commercially feasible. It would not be commercially feasible to disassemble the plant and reconstruct it at a new location. The electrical generating plant is considered to be limited-use property because access to this fuel source held exclusively by Y is necessary for the commercial operation of the plant.

Revenue Procedure 79–48 was issued by the IRS to provide guidance as to the amount and type of improvements that a valid "lessee" can make to leased property without endangering characterization of the lease itself.

ISSUE 11: CHARITABLE CONTRIBUTIONS OF COMMODITIES

Example 11.1. In 2000, Lyon Christian donated 800 bushels of corn to his church. This donation represented the production from five acres. Lyon's cost of production was $1,750, and the fair market value at the time of the donation was $1,600. Lyon uses the cash method of accounting.

Question 11.1.1. How much can Lyon deduct for his corn donation?

Answer 11.1.1. I.R.C. §170 allows a deduction of the lesser of fair market value or basis in property given to a charitable [I.R.C. §501(c)(3)] organization or to a state government or subdivision of a state government if the gift was for a public purpose. However, Lyon must reduce his basis by the expenses that are claimed on Schedule F. Therefore, Lyon claims the $1,750 of expenses on Schedule F, reduces his basis to zero, and has no charitable contribution deduction [Treas. Reg. §1.170A–1(c)(4), Examples 5 and 6].

Question 11.1.2. Are there any additional tax forms that Lyon must file to claim this charitable contribution deduction?

Answer 11.1.2. No, Lyon does not have to file a Form 8283 since he is not claiming a charitable contribution deduction. That form is required if the taxpayer's non-cash contributions exceed $500.

Observation. Lyon's church must complete a Form 8282 to report the sale of the corn. Generally, the IRS will be able to compare the actual sale price of a non-cash contribution with the value the taxpayer reported on Form 8283.

ISSUE 12: DEPRECIATION ON UNUSUAL FARM ASSETS

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

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

1. Race horses more than 2 years old and other horses more than 12 years old are 3-year property under I.R.C. §168(e)(3)(A).
2. Automobiles and light general-purpose trucks are 5-year property under I.R.C. §168(e)(3)(B).
3. Single-purpose agricultural or horticultural structures are 10-year property under I.R.C. §168(e)(3)(D)(i).

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

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

A. FRUIT AND NUT TREES AND VINES

Although one court has held that mango, citrus, and avocado trees are nondepreciable [*Krome v. Commissioner*, Nos. 14774, 14775, 14776 (T.C.M. 1950)], subsequent authority clearly treats them as being depreciable (Rev. Rul. 78–264, 1978–2 C.B. 9; Rev. Rul. 67–51, 1967–1 C.B. 68).

Under the Technical and Miscellaneous Revenue Act of 1988 (TAMRA), orchards, groves, and vineyards (OGV) placed in service after 1988 are to be depreciated on a straight-line basis using a 10-year recovery period under MACRS [§168(e)(3)(D)(ii) and §168(b)(3)(E)]. If the fruit or nut producer elects ADS, the OGV is assigned a 20-year life.

For OGV placed in service during 1981–86, fruit and nut trees were commonly depreciated over a 5-year recovery period under ACRS rules. Some fruit and nut growers adopted a 15-year recovery period under MACRS rules (150 percent declining balance) for trees and vines placed in service in 1987 and 1988. Other growers classified fruit and nut trees as 7-year general agricultural property eligible for the 200 percent declining balance rate.

Comparison of Recovery Periods for Orchards, Groves, or Vineyards Based on Year Placed in Service

Year Placed in Service	Recovery Period	Method	Rate	Alternate MACRS Life
1981–86	5	ACRS	150% DB	
1987–88	7	MACRS	200% DB	10
1989 and later	10	MACRS	Straight-line	20

Observation. If a farmer elects out of capitalizing preproductive expenses under I.R.C. §263A(d)(3), then he or she must use alternative MACRS for depreciating all property used in the farming business [IRS §263A(e)(2)(A)].

Example 12.1. In 2000, Wally Nutt purchased a pecan orchard. He paid $25,000 for the trees and $2,000 for the land. The trees are two years old and are not yet bearing nuts. Therefore, the trees are **not** deemed to be placed in service in 2000.

Wally must wait until the year the trees begin bearing nuts to claim depreciation on them. If the trees become productive in 2002, Wally can begin depreciating his $25,000 basis in that year. He can choose the 10-year straight-line depreciation under MACRS, or he can choose the 20-year alternative MACRS life. If he has elected out of capitalizing preproductive expenses under IRS §263A(d)(3), he must use the alternative MACRS life.

Example 12.2. Russ Ticke raises blackberries, blueberries, and raspberries for sale in the course of his farming business. He harvests marketable quantities of blackberries and raspberries before the end of two years from the time he plants new vines. He harvests marketable quantities of blueberries more than two years after they are planted.

Question 12.2.1. What is the depreciable life of these berries?

Answer 12.2.1. The recovery period for any tree or vine bearing fruit under the MACRS rules is 10 years. I.R.C. §168(e)(3)(D)(ii). Under the alternative depreciation system (ADS) the recovery period is 20 years. I.R.C. §168(g)(3)(B).

Question 12.2.2. What depreciation method applies to these berries?

Answer 12.2.2. Any tree or vine bearing fruit or nuts is subject to the straight-line method of depreciation. I.R.C. §168(b)(3)(E).

Question 12.2.3. Is Russ subject to the capitalization of preproduction rules of I.R.C. §263A?

Answer 12.2.3. Yes. Plants are subject to the rules of I.R.C. §263A that require capitalization of preproduction expenses if the plant has a preproductive period of more than two years. I.R.C. §263A(d)(1)(A)(ii). The preproductive period of a plant that is grown in commercial quantities in the United States is based on the nationwide weighted average preproductive period for such plant. I.R.C. §263A(e)(3)(B). Treas. Reg. §1.954-3(a)(1)(ii)(b) includes blackberries, blueberries, and raspberries in a list of agricultural products that are grown in marketable quantities in the United States. In Notice 2000-45, the IRS published a list of plants that have a nationwide average preproductive period of more than two years. All three of these berries are included in that list. Therefore, blackberries, blueberries, and raspberries are subject to the capitalization of preproduction rules.

Question 12.2.4. When can Russ begin depreciating his blackberry, blueberry, and raspberry plants?

Answer 12.2.4. Russ can begin depreciating his plants in the year they become productive in his farming business. He does not have to use the national average period for becoming productive. Therefore, he can begin depreciating his blackberry and raspberry plants in the year they become productive even though that is less than two years from the date he planted them. He must wait until the blueberries are productive to depreciate them, which is more than two years after he planted them.

Question 12.2.5. If Russ elects out of capitalizing preproduction expenses under I.R.C. §263A, what recovery period applies to his blackberries, blueberries, and raspberries?

Answer 12.2.5. If a farmer elects to have I.R.C. §263A not apply to his or her plants, he or she is required to use the ADS depreciation rules for all assets placed in service in the farming business while the election is in effect. I.R.C. §168(e)(2). Therefore, Russ must use a 20-year recovery period for his blackberries, blueberries, and raspberries if he elects out of the capitalization rules.

B. DAMS, PONDS, AND TERRACES

Generally, earthen structures are not depreciable because they do not have a determinable life. Therefore, dams, ponds, and terraces are not depreciable unless the taxpayer can show that they will wear out in a predictable amount of time.

Example 12.3. Rowdy Wrangler bought a farm that had several ponds for watering livestock. The ponds were formed by earthen dams. The purchase agreement allocates $30,000 of the purchase price to the dams and ponds.

If Rowdy can show that these dams and ponds will wear out, he will be allowed to depreciate them. However, the burden of proof is on Rowdy and is difficult to meet. In Tharp v. Commissioner, T.C. Memo 1989–406, the court found that catfish ponds had a limited useful life and allowed the taxpayers a deduction for depreciation.

The cost of dams, ponds, and terraces that are constructed on farmland may be deductible as a soil and water conservation expense if it cannot be depreciated. However, dams, ponds, and terraces that are purchased with the farmland property cannot be deducted as soil and water conservation expenses under I.R.C. §175 since the taxpayer did not construct them.

Recovery Period. Depreciable improvements to land are assigned a class life of 20 years by Rev. Proc. 87–56, 1987–2 C.B. 674 unless the improvement is specifically given another class life. Since dams are not mentioned in Rev. Proc. 87–56, they have the default class life of 20 years. Under MACRS, property with a class life of 20 years but less than 25 years is 15-year property.

Example 12.4. If Rowdy in Example 12.3 can show that his dams have a limited life, he can treat them as 15-year MACRS property.

C. POLLUTION-CONTROL FACILITIES

Farmers are increasingly being subjected to more restrictive environmental control laws and regulations. As a result, costs may be incurred to construct various types of pollution-control facilities. These facilities may be in conjunction with crop production (a chemical containment facility) or livestock production (manure disposal system). Questions arise as to the appropriate depreciation treatment for such assets.

1. Animal Waste Management Systems.

Manure-handling systems may be conventional, slurry, liquid, or composting systems. A conventional system is one in which manure is collected, stored, transported, and utilized in a solid form. In a slurry system, manure is collected with minimal additional water but stored as a slurry in tanks and subsequently hauled and spread using tank wagons or trucks.

A typical liquid manure–handling system consists of a flushing system, lagoon, or storage pit, and spray field for dispersing wastewater on cropland. A large wastewater storage impoundment is sometimes used following the lagoon for long-term storage of effluents. Liquid manure–handling systems may or may not use lagoons in the system. Lagoons may be anaerobic, aerobic, or mechanically aerated. Effluent from the lagoon then can be spread on cropland using irrigation systems. A solids separator or a settling basin can be added to the liquid manure–handling system. Settling basins are particularly advantageous if cows are on dry lots or if sand is used as bedding in free stalls.

A manure composting system typically consists of a structure or location in which manure is contained and turned during the composting period. Usually a concrete pad is used to prevent groundwater contamination.

Example 12.5. Bud Bovine constructs a liquid manure–handling system in conjunction with his dairy operation. He incurs the following costs:

Concrete flush tanks	$ 8,000
Lagoon	$ 6,500
Pump	$11,000
Agitator	$ 4,500
Solids Separator	$18,000

Since all of the items have determinable lives, Bud can depreciate them.

Concrete Flush Tanks. The flush tanks could be defined as a land improvement that is not classified elsewhere and, therefore, fall within the 15-year MACRS class life. As such, they would not qualify for §179.

Lagoon. The lagoon could also be defined as a land improvement not elsewhere classified and would be 15-year MACRS property that does not qualify for §179.

Pump. The pump is equipment used in the farm activity, and, therefore, is 7-year MACRS property. It also qualifies as §179 property since it is personal property.

Agitator. The agitator is also equipment used in the farm business and, therefore, is 7-year MACRS property eligible for §179.

Solids Separator. The solids separator is equipment classified as 7-year MACRS property eligible for §179.

If Bud is eligible to use the half-year convention, the depreciation method, the depreciation percentage for 2000, and the 2000 depreciation for the various assets are itemized in the following table:

DEPRECIATION SUMMARY — INDIVIDUAL ASSETS

Item	Depreciation Method	Depreciation Percentage	2000 Depreciation
Concrete flush tanks	15-year MACRS	5%	$ 400
Lagoon	15-year MACRS	5%	$ 325
Pump	7-year MACRS	10.71%	$1,178
Agitator	7-year MACRS	10.71%	$ 482
Solids separator	7-year MACRS	10.71%	$1,928

Question 12.5.1. If the manure-handling system qualifies as property used as an integral part of production, does the system qualify for the §179 deduction?

Answer 12.5.1. To qualify for the §179 deduction, several provisions must be satisfied.

1. The improvement must be used in an active trade or business.
2. The improvement must qualify as §1245 property. Improvements such as a waste management system may qualify as §1245 property under one of two provisions of I.R.C. §1245(a)(3).
   - **a** One provision includes property that is an integral part of production [I.R.C. §1245(a)(3)(B)(i)]. Under this provision, most manure-storage facilities could be included as an integral part of producing livestock, dairy products, or fertilizer.
   - **b** The other provision includes single-purpose agricultural structures [I.R.C. §1245(a)(3)(D)]. This provision requires that the structure be specifically designed, constructed, and used for housing, raising, and feeding a particular type of livestock and its products and the necessary equipment [I.R.C. §168(i)(13)]. A manure pit that is located under a confinement feeding facility would easily fall within these requirements. A manure-handling system that is located away from the livestock facility may not qualify under this provision because it does not house livestock and, furthermore, may be designed for more than one species of livestock. However, the self-standing facility should qualify under the provision discussed in a. above as an integral part of production.

Since the preceding provisions appear to be satisfied, Bud could arguably elect to expense $20,000 of the cost of the system under I.R.C. §179. Since the equipment items would have been eligible for §179 expensing as personal property, Bud would likely choose to expense part of the cost of the lagoon and/or flush tanks as "property used as an integral part of production." This would result in §179 expensing applied to assets with the longest recovery period.

Question 12.5.2. Assume the manure-handling system is designed and constructed in conjunction with, and as a part of, the dairy milking–free stall production system. The manure handling system, as such, is integrally related to the dairy facility. Can Bud argue that the manure handling system is a required component of a single-purpose agricultural structure?

Answer 12.5.2. Yes, Bud can realistically propose **single-purpose agricultural structure treatment.** Integrated hog raising facilities qualify as single-purpose structures (Rev. Rul. 79–343, 1979–2 C.B. 18). It follows that comprehensive dairy facilities should qualify also.

In Letter Ruling 8323011, taxpayers constructed a milking facility adjacent to and attached to a preexisting barn and also constructed a new silo room section attached to both the milking structure and the preexisting barn. A feedlot was adjacent to the structure. The structure contained a manure pump for pumping the manure out of the structure to a lagoon. The IRS determined that the equipment in the structure (including the manure pump) was an **integral part of the structure.** The structure was then determined to be a single-purpose livestock structure.

Similarly, in Letter Ruling 8324009, a **dairy facility consisting of four sections was classified as a single-purpose livestock structure.** The sections consisted of a main barn, hay-storage room, sawdust-storage section, and milking-equipment wing. There were also a cement gutter and moving trolley system for carrying manure outside the structure. The equipment, including the manure moving system, was determined to be an integral part of the structure.

In both rulings, the IRS referred to Congressional intent in establishing the **parameters of a single-purpose agricultural structure:**

"Congress intended to include structures used in such dairy cow/milking activities, which met the statutory criteria, as single purpose livestock structures, as indicated by H.R. Rep. No. 95–1800. 'The full range of livestock breeding, raising and production activities is intended to be included so that special purpose structures will qualify for credit if used, for example…to produce milk from dairy cattle,…and as indicated by S.Rep. No. 95–1263, 'It is intended that this provision be broadly construed to apply to all types of special purpose structures and enclosures used to breed, raise, and feed livestock and poultry (including the production of…milk)' The taxpayers' structure is specifically designed and constructed for housing, raising, and feeding of dairy cows and their produce, i.e.,…milk, and for housing the equipment necessary for the aforementioned activities."

"Producing milk from dairy cows" must, by necessity, include the proper disposal of manure. Thus, a manure handling system is arguably an integral component of a single-purpose structure.

If the manure handling system is treated as a component of the structure, the concrete flush tanks and lagoon could be classified as 10-year MACRS property, but the equipment would continue to be eligible for a 7-year life [per Reg. 1.48–10(b)(4)(i)].

DEPRECIATION SUMMARY—SINGLE-PURPOSE AG STRUCTURE

Item	Depreciation Method	Depreciation Percentage	2000 Depreciation
SPAS—Concrete flush tanks	10-year MACRS	7.5%	$ 600
SPAS—Lagoon	10-year MACRS	7.5%	$ 488
Pump	7-year MACRS	10.71%	$1,178
Agitator	7-year MACRS	10.71%	$ 482
Solids separator	7-year MACRS	10.71%	$1,928

Question 12.5.3. Can Bud recover the cost of the manure storage facility under the 60-month amortization provision for pollution-control facilities (I.R.C. §169)?

Answer 12.5.3. Generally, taxpayers can elect to amortize the cost of certified pollution-control facilities over a period of 60 months. If the useful life of the facility is greater than 15 years, the taxpayer must make an adjustment by reducing the amortizable basis of the facility.

A certified pollution-control facility is depreciable property that is a new, identifiable treatment facility used to abate or control water or atmospheric pollution or contamination by removing, altering, disposing, storing, or preventing the creation or emission of pollutants, contaminants, wastes, or heat. The state and federal certifying authorities must appropriately certify it. Examples of such a facility include septic tanks and manure-control facilities.

Since Bud meets the following requirement, he can amortize the cost of his manure storage facility:

1. The manure handling system is new.
2. Bud operated the dairy farm before 1976 and all of the dairy facility was in operation before that date.
3. Bud has no intention of recovering the cost of the facility through sale of the waste, and a federal authority has so certified.

> **Practitioner Note.** The requirement that the property be in operation before 1976 (I.R.C. §169(d)(1)) makes it difficult to qualify for 60-month amortization. If production facilities have been replaced after 1975, a manure system added to that facility would not qualify for the 60-month amortization. An expansion after 1975 may disqualify a subsequent addition of a manure system.

2. Poultry Composting Systems.

Disposal of dead birds is a major problem in the poultry industry. Millions of chickens die each year. When a chicken dies, the operator has the option of burning, rendering, burying, or composting the bird. Composting has become a popular option for disposal.

A composting unit usually consists of an open metal building in which bins approximately 7.5 ft. wide, 6 ft. long, and 5 ft. deep are constructed. The bins are constructed so that 2' × 8' boards can be added to the height as the bin is filled.

Usually the bins will first receive a layer of sawdust and/or straw to form a base layer. Then chicken carcasses and poultry litter are added in layers with hay and/or straw. Water is added, and the bin is capped with sawdust to prevent flies and odors and to hold in moisture. As the composting process proceeds, the carcasses disintegrate and, ultimately, are used as fertilizer materials.

Example 12.6. Larry Leghorn constructs a **composting unit for his poultry operation.** He erects a 28' × 56' open metal structure, in which he builds six bins that are 8' × 8'. The cost of the structure is $10,000.

The composting unit will not qualify as a single-purpose structure, since it is a totally separate facility from the poultry growing houses. It appears that the structure will be classified as a general-purpose farm building, since it is an open shed with a concrete floor and could easily be adapted to other uses. If this is the case, the structure will have a 20-year MACRS life.

Question 12.6.1. Will the composting unit qualify for §179 expensing?

Answer 12.6.1. It would appear on the surface that the composting unit may qualify as property that is an integral part of production. Disposal of dead birds is necessary to the normal operations of a poultry production unit. If so, then the $10,000 cost of the composting unit would be property eligible for §179 expensing.

However, in *Oregon Trail Mushroom Company* (T.C. Memo 1992–293), the Tax Court examined the mixing and storage site for composting in mushroom production. The court noted that the mixing and storage site was not specifically designed with special features but was merely a structure which houses a large concrete slab that is used to store and mix straw, manure, and chemicals. Since the site could be economically adapted to another purpose, it did not meet the "specifically designed and constructed" requirement to be a single-purpose horticultural structure. The court then reasoned that the mix and storage site functions were indicative of a warehouse or barn and, thus, the site was a building. Therefore, **the composting site did not qualify as other tangible property** (used as an integral part of production). Based on this case, the composting unit would not qualify for §179 expensing.

Property used as an integral part of production may still fail to qualify as §1245 property if the property is classified as a building. The result is to also disqualify the property for §179 expensing.

Question 12.6.2. Can Larry recover the cost of the poultry-composting unit under the 60-month amortization provision for pollution control facilities (§169)?

Answer 12.6.2. Yes, if he meets all eligibility requirements. However, if the useful life of the facility is greater than 15 years (which it would be for the composting unit), the taxpayer must make an adjustment by reducing the amortizable basis of the facility. The reduced basis would be calculated by multiplying the original basis ($10,000), by a fraction, the numerator of which is 15 years, and the denominator of which is the assigned MACRS life (20 years, in this case). Therefore, the eligible basis would be $7,500 [$10,000 × (15 ÷ 20)]. See Answer 12.5.3 for other eligibility requirements.

3. Chemical Containment Facilities.

Chemical containment facilities may be constructed to provide a safer area for the storage, transfer, and mixing of agricultural chemicals.

Example 12.7. Crystal Brooks built a containment facility for her farm fertilizer and pesticide storage area. The facility was completed on May 15, 1998, and she paid the contractor $11,700 in June 1998.

The facility consists of a concrete dike that surrounds the fertilizer and pesticide storage area. There is also a concrete load/unload pad to contain any spill that may occur during loading or unloading. Crystal uses the load/unload pad to fill and clean her sprayer. The facility also includes pumps and tanks to move and hold the fertilizers, pesticides, and rinsate (waste water). The bill Crystal received from her contractor did not itemize the cost of the components of the facility. Therefore, her tax preparer asked her to go back to the contractor for an itemized bill. The contractor then provided the following:

Item	Cost
Concrete Dike	$6,400
Load/Unload Pad	$2,100
Pumps	$ 500
Tanks	$2,700

Question 12.7.1. How should Crystal report these expenditures on her income tax return, if she takes a conservative approach to deductions?

Answer 12.7.1. Since all of the items Crystal purchased have determinable lives, she can depreciate them.

Concrete Dike. The concrete dike could be defined as an improvement to land that is not classified in other class lives and, therefore, falls within the 15-year MACRS class life. As such, it would not qualify for §179.

Load/Unload Pad. The load/unload pad could also be defined as a land improvement not elsewhere classified and would also be 15-year MACRS property that does not qualify for §179.

Pumps. The pumps are equipment used in the farm business and are, therefore, 7-year MACRS property. They also qualify as §179 property since they are personal property. Section 179(d)(1) defines §179 property as "any tangible property…which is §1245 property." Section 1245(a)(3)(A) includes personal property in the definition of "§1245 property."

Storage Tanks. The storage tanks are also equipment used in the farm business and, therefore, are 7-year property that qualify for §179.

Assuming Crystal is not subject to the mid-quarter convention, the depreciation method, depreciation percentage for 1998, and the 1998 depreciation for each of the assets are listed in the following table.

DEPRECIATION SUMMARY

Item	Depreciation Method	Depreciation Percentage	1998 Depreciation
Concrete Dike	15-year MACRS	5%	$320
Load/Unload Pad	15-year MACRS	5%	$105
Pumps	7-year MACRS	10.71%	$ 54
Storage Tanks	7-year MACRS	10.71%	$289

Question 12.7.2. If the chemical containment facility qualifies as property used as an integral part of production, does the facility qualify for the §179 deduction?

Answer 12.7.2. To qualify for the §179 deduction, several provisions must be satisfied–

1. The improvement must be used in an active trade or business.
2. The improvement must qualify as §1245 property. Improvements such as a chemical containment facility may qualify as §1245 property under §1245(a)(3). This provision includes property that is an integral part of production.

Since the preceding provisions appear to be satisfied, Crystal could arguably elect to expense the entire $11,700 cost of the containment facility under §179.

Question 12.7.3. Can Crystal recover the cost of the chemical containment facility under the 60-month amortization provisions for pollution control facilities (I.R.C. §169)?

Answer 12.7.3. Generally, taxpayers can elect to amortize the cost of certified pollution control facilities over a period of 60 months. If the useful life of the facility is greater than 15 years, the taxpayer must make an adjustment by reducing the amortizable basis of the facility.

A certified pollution-control facility is depreciable property that is a new, identifiable treatment facility used to abate or control water or atmospheric pollution or containment by removing, altering, disposing, storing, or preventing the creation or emission of pollutants, contaminants, wastes, or heat. The state and federal certifying authorities must appropriately certify it.

If Crystal meets the following requirements, she can likely amortize the cost of her chemical containment facility.

1. The chemical containment facility is new.
2. Crystal operated the farm before 1976.
3. Crystal has no intention of recovering the cost of the facility through sale of any recovered waste, and a federal authority has so certified.

D. Irrigation Systems and Wells.

To be depreciable, an asset must deteriorate and have a determinable life.

In Rev. Rul. 55–367 and Rev. Rul. 56–599 the IRS held that the costs of digging a well are considered capital expenditures that become a part of the cost of the property–implying that the cost of digging the well is not depreciable. However, Treas. Reg. §1.175–2(b)(1) gives examples of depreciable expenses and includes expenses "for dirt moving for making wells composed of masonry, concrete, tile, metal, or wood." Therefore, a well that has any of those materials is apparently depreciable–including the cost of digging the well.

This result is reinforced by Rev. Rul. 72–222, 1972–1 C.B. 17, which determined that water wells that provide water for raising poultry and livestock, regardless of whether they are unlined or contain replaceable or nonreplaceable casings or linings, are "other tangible property" and qualify for investment credit under (former) I.R.C. §38. To qualify as §38 property, the property had to be depreciable property.

Thus, water wells would also qualify as depreciable. *Berry,* 15 TCM 1106 (1956), and *Tidwell,* 20 TCM 810 (1961), also concluded that water wells were capital expenditures recoverable through depreciation. Rev. Rul. 61–206, 1961–2 C.B. 57, stated "a water well containing components which are subject to wear and tear constitutes depreciable property."

The court in *Agro,* 45 TCM 385 (1982), allowed depreciation of a concrete pipe irrigation system. Rev. Rul. 75–151, 1975–1 C.B. 88, stated that an irrigation system with a pumping plant, penstocks, depreciable canals, buried steel mainlines, and portable sprinkler lines is a tangible asset subject to wear, tear, and exhaustion over a determinable period of time and, thus, is subject to depreciation.

Example 12.8. Artesia Wells replaced the irrigation system in her apple orchard. She installed the new system on land that had been used as an orchard but was newly planted with young trees that were not yet bearing fruit. She dug a new well to provide water for the system. The costs of the well, pump, and irrigation pipe are as follows:

Item	Cost
Digging the Well	$20,000
Lining the Well	$15,000
Pump	$ 7,000
Underground Pipe	$4,000
Above-ground Irrigation Equipment	$25,000

The pump, pipe, and above-ground equipment meet the requirements and, therefore, can also be depreciated.

I.R.C. §179. To be eligible for §179, property must be used in the active conduct of a trade or business and must be tangible property (to which §168 applies) that is §1245 property and acquired by purchase [as defined in §1245(a)(3)].

I.R.C. §1245(a)(3) defines §1245 property as follows.

Section 1245 Property. For purposes of this section, the term "§1245 property" means any property which is or has been property of a character subject to the allowance for depreciation provided in §167 (or subject to the allowance of amortization provided in §185 or 1253(d)(2) or (3)) and is either.

1. Personal property
2. Other property (not including a building or its structural components) but only if such other property is tangible and has an adjusted basis in which there are reflected adjustments described in paragraph (2) for a period in which such property (or other property)
   a. Was used as an integral part of manufacturing, production, or extraction or of furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services

In Rev. Rul. 69–273, 1969–1 C.B. 30, the IRS held that the underground pipe and valves used to water a golf course are "other tangible property" but were not used as an integral part of a qualifying activity. However, farming was stated to be a qualifying activity.

Example 12.9. Since Artesia uses all of the property in the active conduct of a trade or business, she can claim the I.R.C. §179 deduction if she meets the §1245 requirement.

It appears that the underground pipe would qualify as §1245 property used as an integral part of production. The pump and the portable sprinklers are tangible personal property according to Rev. Rul. 69–273, 1969–1 C.B. 30, and, therefore, qualify as §1245 property eligible for the §179 expense deduction.

The well is a land improvement but may still qualify as §1245 property used as an integral part of production. Therefore, it should qualify for the §179 expense deduction.

Depreciable Life. The depreciable life of assets is determined by the classifications set out in IRS Publication 534, Depreciation.

Pumps and above-ground irrigation equipment qualify as farm equipment and, therefore, have a 7-year MACRS life and a 10-year alternative MACRS life. The underground pipe and well are "land improvements" and have a 15-year life under MACRS and a 20-year alternative MACRS life.

E. GAME MANAGEMENT ACTIVITIES

Example 12.10. Buck Wilde purchased a tract of range land and initiated an exotic game production activity. Buck intends to sell exotic game animals both to other game ranchers for breeding purposes and for harvest by hunters. Buck purchased the following animals to be used for breeding purposes:

Species	Sex	No. of Animals	Cost per Animal	Total Cost
Fallow Deer	Male	70	$1,000	$ 70,000
Fallow Deer	Female	130	$ 350	$ 45,500
Axis Deer	Male	90	$ 400	$ 36,000
Axis Deer	Female	110	$ 320	$ 35,200
Sika Deer	Male	80	$1,500	$120,000
Sika Deer	Female	120	$ 700	$ 84,000
Blackbuck Antelope	Male	90	$ 200	$ 18,000
Blackbuck Antelope	Female	110	$ 175	$ 19,250
Aoudad Sheep	Male	70	$ 150	$ 10,500
Aoudad Sheep	Female	130	$ 75	$ 9,750
Total		1,000		$448,200

(Reference: Exotic Game Ranching Budgets, Texas A & M University.)

Buck also constructed the fences necessary to contain the animals within the boundaries of his land. [Note. An eight-to-nine-foot high net wire fence with taut top and bottom retaining wires is recommended for exotics. (See Exotics on the Range, p. 138.) Materials and labor to construct game fences cost $12,000 to 15,000 per mile.]

Buck spends $180,000 for 12 miles of fence and also constructs 1.25 miles of catch pen fencing at a cost of $20,000. Buck also acquires the necessary farm equipment, including a 16-foot game trailer.

1. Farming Status.

Question 12.10.1. Does the exotic game activity of Buck qualify for farming status?

Answer 12.10.1. Yes, §464(e)(1) broadly defines "farming" to include the management of animals; §1.61–4(d) defines "farm" as including stock farms and ranches owned and operated by a corporation; §175(c)(2) defines "land used in farming" to include land used for the sustenance of livestock; under §1.263A–4T(c)(4)(i)(A), "Farming business" includes a trade or business involving the raising, feeding, caring for, and management of animals; and finally, §3121(g)(1) includes within the meaning of "agricultural labor," service connected with raising wildlife. Taken together, these provisions are broad enough to classify the exotic game as a farm, an exotic game rancher as a farmer, and work on an exotic game ranch as agricultural labor.

This is the decision reached in Letter Ruling 9615001 (4-22-96), which examined the activities of an S corporation involved in cultivating a herd of trophy deer. The IRS concluded that,

> Applying these provisions, in total, to the activities engaged in by Taxpayer regarding its project of importing, breeding, raising, feeding, protecting, and ultimately harvesting the deer on its property, leads to the conclusion that Taxpayer operates a farm and is a farmer. We are

satisfied that Taxpayer engages in most, if not all of the activities of any farmer or rancher raising more conventional livestock, such as horses or cattle.

2. Tax Classification of Exotic Game Animals.

Question 12.10.2. Are the exotic game animals that Buck has purchased classified as livestock?

Answer 12.10.2. Yes, Letter Ruling 9615001 concluded that imported white-tail deer were livestock. Exotic game animals would be treated in the same way. Reg. Sec. 1.1231–2(a)(3) states that for purposes of §1231, the term livestock includes "…cattle, horses, hogs, mules, donkeys, sheep, goats, fur-bearing animals, and other mammals…" (Emphasis added.) The IRS determined that livestock includes virtually any mammal held for breeding or sporting purposes.

The Letter Ruling stated,

> Although the type of animal that Taxpayer is raising may not be the usual type of stock found on most farms, and the method of harvest is by hunting, rather than by slaughter, these are not factors upon which the Code or regulations make distinctions. The factors that are determinative in this case are the activities engaged in by Taxpayer to produce stock of marketable size and quality. These activities include the introduction of superior breeding stock to its enclosed property, exercise of control over the breeding and feeding habits of the animals, its management of the range, and its cultivation of large tracts of land within the enclosure to yield and insure the adequacy of forage (in amount, type, and quality) available for the animals.

3. Depreciable Life.

Under MACRS rules, cattle have a recovery period of five years, sheep and goats have a recovery period of five years, and hogs have a recovery period of three years.

Question 12.10.3. Buck asks what is the appropriate recovery period for exotic game animals?

Answer 12.10.3. Rev. Proc. 87–56 (1987–2 C.B. 647) states that for property that is not described in any asset class or used in a described activity, a 7-year class is assigned for the general MACRS method and a 12-year class life for alternative MACRS. Exotic game animals are not specifically described in any asset class and thus fall into this 7-year category. However, since the animals are "used" in farming, there is a strong argument to classify them in the category of depreciable assets used in agriculture. The recovery period would still be 7 years, but the alternative life would decrease to 10 years.

Aoudad and mouflon-type sheep could also logically be placed in the category of "sheep and goats," since there is no requirement that the animals be domesticated. This would result in a 5-year recovery period under MACRS. An argument can be advanced to classify all ruminant exotic game animals as 5-year property. It is significant that the livestock species that already are specifically included in the 5-year category are cattle, sheep, and goats. These are ruminant animals. Both hogs and horses, which are nonruminants, have different recovery periods from cattle, sheep, and goats. Thus, the 5-year category may be most appropriate for ruminant exotic game animals.

If Buck selects the 7-year recovery period for his exotic animals, he would deduct $48,002 ($448,200 cost × 10.71%) of depreciation expense for the animals for the first year of operation. If Buck selects the 5-year recovery period as being appropriate for ruminant exotic game animals, he would deduct $67,230 ($448,200 cost × 15%) of depreciation expense for the animals for the first year of operation. Note. Buck would use 150% DB for farm assets.

Question 12.10.4. What is the appropriate recovery period for the game fences and catch pens used in the exotic game activity?

Answer 12.10.4. Fences used in animal husbandry and livestock operations are 7-year MACRS property. Since exotic game animals are classified as livestock, the fences qualify as agricultural assets.

Practitioner Note. If exotic game production were not considered farming, the fences would be classified as land improvements with a 15-year life. Thus Buck would select the 7-year recovery period and deduct $21,420 ($200,000 cost × 10.71%) of depreciation expense for fences and pens in the first year of operation.

4. Section 179 Expensing.

Question 12.10.5. Do the exotic game animals that Buck has purchased qualify for the §179 expensing deduction?

Answer 12.10.5. Yes. Since the exotic game animals are classified as tangible personal property, they are eligible for §179 expensing. Livestock are designated as qualifying property. Section 179 expensing would also be permitted for the qualifying costs of the game fences and catch pens. Section 179 expensing is available for up to $20,000 (in 2000) of qualifying costs, assuming the other requirements are met.

F. Bees and Bee-Raising Equipment.

Example 12.11. May Bee purchased 10 colonies of honeybees and 10 hives with the related equipment in 2000.

Question 12.11.1. What is the depreciable life of the honeybees?

Answer 12.11.1. Bee colonies can live for 5–10 years or more. The individual worker bees only live for 4 weeks in summer and 3–7 months in winter. Therefore, the cost of the worker bees can be deducted as an expense in the year in which it is paid. Queens live about 2 years but can live up to 5–8 years. Therefore, the cost of queen bees arguably must be depreciated rather than deducted as an expense in the year the cost is incurred. However, most beekeepers claim the cost of the queen bee as a deduction in the year the cost is incurred.

Question 12.11.2. What is the depreciable life of the hives and related equipment?

Answer 12.11.2. The useful life of the hive and related equipment depends on how well they are maintained. A standard hive can be used for 20 years or more if kept painted and protected. Frames and combs (the inside parts) are more variable and may be used for 4–5 years. Since the useful life is more than a year, the cost of the equipment cannot be deducted as an expense. As equipment used in farming, the equipment has a 7-year MACRS recovery period and a 10-year ADS life.

G. EMUS, OSTRICHES, AND EQUIPMENT

1. **Ostriches and Emus.** Rev. Proc. 87-56 (1987-2 C.B. 647) states that for property that is not described in any asset class or used in a described activity, a 7-year class is assigned for the general MACRS method and a 12-year class life for alternative MACRS. Emus and ostriches are not specifically described in any asset class and thus logically fall into this 7-year category. If it is argued that they are "used" in agriculture, the recovery period would still be 7 years, but the alternative life would decrease to 10 years.
2. **Breeding and Rearing Pens.** Fences used in animal husbandry are 7-year MACRS property. Emu and ostrich fences are normally 6-foot chain link fencing with a pipe frame. If emu and

ostrich production were not considered farming, the fences would be classified as land improvements with a 15-year life.

3. **Equipment.** Required equipment includes feeders, waterers, squeeze chute, and magnetic sweeper. All of these items will be classified as 7-year MACRS property.
4. **Hatchery Facilities.** Equipment requirements for a hatchery include forced draft incubators and hatchers, generators, and assorted other equipment. The equipment should be classified as 7-year MACRS property. The more aggressive taxpayer may assert that the hatchery building qualifies as a single-purpose agricultural structure, designed to house, raise, and feed emus and ostriches. Since poultry houses and integrated hog-raising facilities qualify for treatment as single-purpose structures (Rev. Rul. 79-343, 1979-2 C.B. 18), it would appear that emu and ostrich facilities should also be eligible, if they otherwise qualify. Furthermore, Conference Report No. 95-1800 of the Revenue Act of 1978, which defined single-purpose structures, provides that "…The full range of livestock breeding, raising, and production activities is intended to be included so that special-purpose structures will qualify for credit if used, for example, to breed chickens or hogs…or to produce…eggs."

The Senate Report (S. Report No. 95-1253, 1978-3 C.B. 315,414) states further that "It is intended that this provision be broadly construed to apply to all types of special-purpose structures and enclosures used to breed, raise, and feed livestock and poultry."

Practitioner Note. Working space is permitted in the structure, but more than an incidental use to store feed or machinery will result in disqualification as a single-purpose structure.

If classified as a single-purpose agricultural structure, the hatchery facility will be assigned a 10-year recovery period. Otherwise, it would appear by default to be included with general-purpose farm structures having a 20-year recovery period.

Hatchery facilities that meet the definition of single-purpose structure are in the 10-year MACRS class.

2000 Income Tax School

DEPRECIATION