2001 Workbook

AGRICULTURAL ISSUES

ISSUE 1: INCOME AVERAGING

NEGATIVE TAXABLE INCOME

In the 2000 Publication 225, *Farmers Tax Guide*, the instructions for the 2000 Schedule J (Form 1040), the IRS reversed its position on the use of negative taxable income from base years in the income averaging calculation. The IRS now agrees that the tax brackets borrowed from base years to calculate income tax for the election can include negative taxable income.

This new interpretation adds some complexity to the calculation since net operating losses and capital losses that are carried from the base year to other years must be removed from the base year negative taxable income before using that income to calculate taxes on the elected farm income. If the losses carried to other years were not removed, the taxpayer would get a double tax benefit from those losses. Worksheets in the Schedule J (Form 1040) instructions carry out the removal of those losses.

Practitioner Note. This change in interpretation of I.R.C. §1301 is retroactive to the effective date of the income averaging rules. Therefore, amended returns can be filed for 1998 and 1999 to apply the new interpretation. Taxpayers who elected income averaging on their 1998 and/or 1999 return can use the new rules to calculate their income tax on an amended return. They can change the amount of elected farm income on that amended return. Taxpayers who did not make the election can file an amended return on which they make the election and apply the new rules to calculate their income tax.

Example 1. Neil and Eileen Down had the following taxable income for 2000 and the three base years, 1997–1999. They had no capital gains or losses for the base years. They file a joint return on which they claim the standard deduction and four personal exemption deductions.

Year	Taxable income
1997	(48,289)[1]
1998	15,655[2]
1999	(1,413)
2000	99,344

[1]Neil and Eileen elected to forgo the carryback of the 1997 $30,789 NOL
[2]Includes a $30,789 NOL carryover from 1997

Neil and Eileen had no electible farm income in 1998 or 1999. Their electible farm income for 2000 is as follows:

Schedule F net loss	$ (9,469)
Gain on sale of raised cows held more than 24 months for breeding purposes (I.R.C. §1231 gain on Part I of Form 4797)	34,986
Gain on sale of purchased cows held more than 24 months for breeding purposes and a pickup truck (I.R.C. §1245 gain reported on Part III of Form 4797 as recaptured depreciation)	21,983
Electible farm income	$47,500*

* Note that $34,986 of the electible farm income is capital gains and $12,514 is ordinary income.

> **Practitioner Note.** 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:
>
> a. Net Schedule F (Form 1040) income
>
> b. An owner's share of net farm income from an S corporation, partnership, or limited liability company and wages received by an S corporation shareholder from the S corporation
>
> c. 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

Neil and Eileen complete the Schedule J (Form 1040) on page 100 as follows:

1. On line 1 they enter their $99,344 of taxable income for 2000.
2. Neil and Eileen elect the full amount of electible farm income for income averaging, so they enter $47,500 on line 2.
3. Line 3 is $51,844—the result of subtracting $47,500 from $99,344.
4. On line 4 they enter the $8,811 tax liability from the Tax Table.
5. On line 5, they enter $17,500 of negative taxable income from the following worksheet from the Schedule J (Form 1040) instructions.

1997 Taxable Income Worksheet—Line 5 *Keep for Your Records*

Complete this worksheet if you figured your tax for both 1998 and 1999 without using Schedule J **and** the taxable income on your 1997 tax return is zero or less. See the instructions above before completing this worksheet.

1.	Figure the taxable income from your 1997 tax return (or as previously adjusted) without limiting it to zero. If you had an NOL for 1997, **do not** include any NOL carryovers or carrybacks to 1997. Enter the result as a positive amount		**1.**	*48,289*
2.	If there is a loss on your 1997 Schedule D, line 18, add that loss (as a positive amount) and your 1997 capital loss carryover to 1998. Subtract from that sum the amount of the loss on your 1997 Schedule D, line 17, and enter the result	**2.**		
3.	If you had an NOL for 1997, enter it as a positive amount. Otherwise, enter as a positive amount the portion, if any, of the NOL carryovers and carrybacks to 1997 that were not used in 1997 and were carried to years after 1997	**3.** *30,789*		
4.	Add lines 2 and 3		**4.**	*30,789*
5.	Subtract line 4 from line 1. Enter the result as a negative amount on Schedule J, line 5		**5.**	*17,500*

6. On line 6 they enter $47,500 ÷ 3 = $15,833.

7. On line 7 they enter zero since the result of combining lines 5 and 6 is less than zero.

Observation. The $1,667 difference between the $17,500 of negative taxable income from 1997 and the $15,833 of elected farm income from 2000 that is taxed in the 1997 income tax brackets will never provide a tax benefit under the income averaging rules since the 1997 tax brackets will no longer be available for income averaging after 2000. By not using up the below-the-line deductions for 1997 by 2000, Neil and Eileen lose the benefit of the unused deductions.

If Neil and Eileen had electible farm income in 1998 or 1999, they could use up more of the 1997 below-the-line deductions by electing income averaging for one or both of those years.

8. On line 8, they enter zero.

9. On line 9, they enter the $15,655 of taxable income from 1998.

10. On line 10 they enter $47,500 ÷ 3 = $15,833.

11. On line 11 they enter $15,655 + $15,833 = $31,488.

12. On line 12 they enter $4,140 of tax liability computed on the following 1998 Schedule D (Form 1040).

Part IV Tax Computation Using Maximum Capital Gains Rates

19	Enter your taxable income from Form 1040, line 39			19	31,488
20	Enter the **smaller** of line 16 or line 17 of Schedule D	20	11,662*		
21	If you are filing Form 4952, enter the amount from Form 4952, line 4e	21			
22	Subtract line 21 from line 20. If zero or less, enter -0-	22	11,662		
23	Combine lines 7 and 15. If zero or less, enter -0-	23			
24	Enter the **smaller** of line 15 or line 23, but not less than zero	24			
25	Enter your unrecaptured section 1250 gain, if any, from line 17 of the worksheet on page D-8	25			
26	Add lines 24 and 25	26	0		
27	Subtract line 26 from line 22. If zero or less, enter -0-			27	11,662
28	Subtract line 27 from line 19. If zero or less, enter -0-			28	19,826
29	Enter the **smaller** of: • The amount on line 19, **or** • $25,350 if single; $42,350 if married filing jointly or qualifying widow(er); $21,125 if married filing separately; or $33,950 if head of household			29	31,488
30	Enter the **smaller** of line 28 or line 29	30	19,826		
31	Subtract line 22 from line 19. If zero or less, enter -0-	31	19,826		
32	Enter the **larger** of line 30 or line 31 ▶	32	19,826		
33	Figure the tax on the amount on line 32. Use the Tax Table or Tax Rate Schedules, whichever applies			33	2,974
	Note. If the amounts on lines 29 and 30 are the same,skip lines 34 through 37 and go to line 38				
34	Enter the amount from line 29	34	31,488		
35	Enter the amount from line 30	35	19,826		
36	Subtract line 35 from line 34. ▶	36	11,662		
37	Multiply line 36 by 10% (.10)			37	1,166
52	Add lines 33, 37, 41, 47, and 51			52	4,140
53	Figure the tax on the amount on line 19. Use the Tax Table or Tax Rate Schedules, whichever applies			53	4,723
54	**Tax on all taxable income (including capital gains).** Enter the **smaller** of line 52 or line 53 here and on Form 1040, line 40			54	4,140

* The $11,662 of capital gains entered on line 20 is one-third of the $34,986 of capital gains in the 2000 elected farm income.

13. On line 13, they enter $1,413 of negative taxable income from the following worksheet from the Schedule J (Form 1040) instructions.

1999 Taxable Income Worksheet—Line 13 *Keep for Your Records*

Complete this worksheet if the taxable income on your 1999 tax return is zero or less. See the instructions above before completing this worksheet.

1. Figure the taxable income from your 1999 tax return (or as previously adjusted) without limiting it to zero. If you had an NOL for 1999, **do not** include any NOL carryovers or carrybacks to 1999. Enter the result as a positive amount		**1.** *1,413*
2. If there is a loss on your 1999 Schedule D, line 18, add that loss (as a positive amount) and your 1999 capital loss carryover to 2000. Subtract from that sum the amount of the loss on your 1999 Schedule D, line 17, and enter the result	**2.**	
3. If you had an NOL for 1999, enter it as a positive amount. Otherwise, enter as a positive amount the portion, if any, of the NOL carryovers and carrybacks to 1999 that were not used in 1999 and were carried to years after 1999	**3.**	
4. Add lines 2 and 3		**4.**
5. Subtract line 4 from line 1. Enter the result as a negative amount on Schedule J, line 13		**5.** *1,413*

14. On line 14, they enter $47,500 ÷ 3 = $15,833.

15. On line 15, they enter $15,833 – $1,413 = $14,420.

16. On line 16, they enter $1,580 of tax liability computed on the following 1999 Schedule D (Form 1040).

17. On line 17 they enter $8,811 + $4,140 + $1,580 = $14,531.

18. On line 18 they enter their zero income tax liability from their 1997 income tax return.

19. On line 19 they enter their $2,351 income tax liability from their 1998 income tax return.

20. On line 20 they enter their zero income tax liability from their 1999 income tax return.

Part IV Tax Computation Using Maximum Capital Gains Rates

19	Enter your taxable income from Form 1040, line 39			19	*14,420*
20	Enter the **smaller** of line 16 or line 17 of Schedule D	20	*11,662**		
21	If you are filing Form 4952, enter the amount from Form 4952, line 4e	21			
22	Subtract line 21 from line 20. If zero or less, enter -0-	22	*11,662*		
23	Combine lines 7 and 15. If zero or less, enter -0-	23			
24	Enter the **smaller** of line 15 or line 23, but not less than zero	24			
25	Enter your unrecaptured section 1250 gain, if any, from line 16 of the worksheet on page D-7	25			
26	Add lines 24 and 25	26	*0*		
27	Subtract line 26 from line 22. If zero or less, enter -0-			27	*11,662*
28	Subtract line 27 from line 19. If zero or less, enter -0-			28	*2,758*
29	Enter the **smaller** of: ● The amount on line 19, **or** ● $25,750 if single; $43,050 if married filing jointly or qualifying widow(er); $21,525 if married filing separately; or $34,550 if head of household			29	*14,420*
30	Enter the **smaller** of line 28 or line 29	30	*2,758*		
31	Subtract line 22 from line 19. If zero or less, enter -0-	31	*2,758*		
32	Enter the **larger** of line 30 or line 31 ▶	32	*2,758*		
33	Figure the tax on the amount on line 32. Use the Tax Table or Tax Rate Schedules, whichever applies			33	*414*
	Note. If line 29 is less than line 28, go to line 38.				
34	Enter the amount from line 29	34	*14,420*		
35	Enter the amount from line 28	35	*2,758*		
36	Subtract line 35 from line 34. If zero or less, enter -0- ▶	36	*11,662*		
37	Multiply line 36 by 10% (.10)			37	*1,166*
52	Add lines 33, 37, 41, 47, and 51			52	*1,580*
53	Figure the tax on the amount on line 19. Use the Tax Table or Tax Rate Schedules, whichever applies			53	*2,163*
54	**Tax on all taxable income (including capital gains).** Enter the **smaller** of line 52 or line 53 here and on Form 1040, line 40			54	*1,580*

* The $11,662 of capital gains entered on line 20 is one-third of the $34,986 of capital gains in the 2000 elected farm income.

21. On line 21 they enter $2,351—the sum of lines 18 through 20.

22. On line 22 they enter $14,531 – $2,351 = $12,180.

SCHEDULE J (Form 1040)

Department of the Treasury
Internal Revenue Service (99)

Farm Income Averaging

► Attach to Form 1040.

► See Instructions for Schedule J (Form 1040).

OMB No. 1545-0074

2000

Attachment Sequence No. 20

Name(s) shown on Form 1040: *Neil and Eileen Down*

Social security number (SSN): *162 01 1301*

1	Enter your taxable income from Form 1040, line 39			1	*99,344*
2	Enter your **elected farm income,** but not more than the amount on line 1. See page J-1			2	*47,500*
3	Subtract line 2 from line 1			3	*51,844*
4	Figure the tax on the amount on line 3. Use the **2000** Tax Table, Tax Rate Schedules, Capital Gain Tax Worksheet, or Schedule D, whichever applies			4	*8,811*
5	If you used Schedule J to figure your tax for 1999, enter the amount from line 11 of your 1999 Schedule J. If you did not use Schedule J for 1999 but you did use Schedule J for 1998, enter the amount from line 15 of your 1998 Schedule J. Otherwise, enter the taxable income from your **1997** Form 1040, line 38; Form 1040A, line 22; or Form 1040EZ, line 6. If zero or less, see page J-2	5	*(17,500)*		
6	Divide the amount on **line 2** by 3.0	6	*15,833*		
7	Combine lines 5 and 6. If zero or less, enter -0-	7	*0*		
8	Figure the tax on the amount on line 7 using **1997** tax rates. See page J-3			8	*0*
9	If you used Schedule J to figure your tax for 1999, enter the amount from line 15 of your 1999 Schedule J. If you did not use Schedule J for 1999 but you did use Schedule J for 1998, enter the amount from line 3 of your 1998 Schedule J. Otherwise, enter the taxable income from your **1998** Form 1040, line 39; Form 1040A, line 24; or Form 1040EZ, line 6. If zero or less, see page J-4	9	*15,655*		
10	Enter the amount from line 6	10	*15,833*		
11	Combine lines 9 and 10. If less than zero, enter as a negative amount	11	*31,488*		
12	Figure the tax on the amount on line 11 using **1998** tax rates. See page J-5			12	*4,140*
13	If you used Schedule J to figure your tax for 1999, enter the amount from line 3 of your 1999 Schedule J. Otherwise, enter the taxable income from your **1999** Form 1040, line 39; Form 1040A, line 24; or Form 1040EZ, line 6. If zero or less, see page J-6	13	*(1,413)*		
14	Enter the amount from line 6	14	*15,833*		
15	Combine lines 13 and 14. If less than zero, enter as a negative amount	15	*14,420*		
16	Figure the tax on the amount on line 15 using **1999** tax rates. See page J-7			16	*1,580*
17	Add lines 4, 8, 12, and 16			17	*14,531*
18	If you used Schedule J to figure your tax for 1999, enter the amount from line 12 of your 1999 Schedule J. If you did not use Schedule J for 1999 but you did use Schedule J for 1998, enter the amount from line 16 of your 1998 Schedule J. Otherwise, enter the tax from your **1997** Form 1040, line 39*; Form 1040A, line 23; or Form 1040EZ, line 10	18	*0*		
19	If you used Schedule J to figure your tax for 1999, enter the amount from line 16 of your 1999 Schedule J. If you did not use Schedule J for 1999 but you did use Schedule J for 1998, enter the amount from line 4 of your 1998 Schedule J. Otherwise, enter the tax from your **1998** Form 1040, line 40*; Form 1040A, line 25; or Form 1040EZ, line 10	19	*2,351*		
20	If you used Schedule J to figure your tax for 1999, enter the amount from line 4 of your 1999 Schedule J. Otherwise, enter the tax from your **1999** Form 1040, line 40*; Form 1040A, line 25; or Form 1040EZ, line 10	20	*0*		
	***Caution.** Do not include any amount from Form 4972 or 8814.				
21	Add lines 18 through 20			21	*2,351*
22	Subtract line 21 from line 17. Also include this amount on Form 1040, line 40			22	*12,180*

Caution. Your tax may be less if you figure it using the 2000 Tax Table, Tax Rate Schedules, Capital Gain Tax Worksheet, or Schedule D. Attach Schedule J only if you are using it to figure your tax.

Amending 1998 and 1999 Returns

Taxpayers are allowed to amend their 1998 and 1999 income tax returns to take advantage of this new interpretation whether or not a Schedule J was filed for those years.

Example 2. Sam Green had negative taxable income in 1997 but did not elect income averaging on his 1998 income tax return because his 1998 income was all in the 15% income tax bracket, so income averaging under the rules in the 1998 Schedule J (Form 1040) instructions did not reduce his tax liability. Sam is allowed to file Form 1040X for 1998 and make the income averaging election to take advantage of the negative taxable income in 1997 for purposes of applying the income averaging rules in 1998.

If taxpayers filed Schedule J (Form 1040) for 1998 or 1999 and had negative taxable income in any of the base years for either year was zero, they are **required** to refigure their income tax liability on Schedule J (Form 1040) using the negative income from the base year before filing Schedule J (Form 1040) for 2000 or 2001.

Example 3. Nancy Brown filed Schedule J with her 1999 income tax return. Her eligible farm income and elected farm income for 1999 was $45,000. Her taxable income for 1996 through 1999 before the 1999 income averaging election was as follows:

Year	Taxable Income
1996	$30,000
1997	5,000
1998	(20,000)
1999	60,000

The income averaging election reduced her 1999 income tax liability from $13,460 to $10,954.

If Nancy chooses to use the income averaging rules in either 2000 or 2001, she must first refigure her tax liability for 1999 using the $20,000 negative taxable income for 1998. That reduces her 1999 income tax by $2,250 to $8,704. It also increases her 1998 taxable income to a negative $5,000 for purposes of using it as a base year for the 2000 income averaging election (or for purposes of using it for a 2001 income averaging election if the election is not made in 2000).

Practitioner Note. Nancy is not required to amend her 1999 income tax return. However, amending the return will reduce her tax liability by $2,250. She is treated as paying only $8,704 of income taxes for 1999 in a subsequent income averaging calculation whether or not she amends her 1999 return.

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 an 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 taxable 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 4. Jim Nastics sold 100 raised beef cows for $50,000 in 1998 because of a drought. On his 1998 income tax return, he made the I.R.C. §1033(e) election to roll the gain into replacement cows. Since the $50,000 gain was not recognized in 1998, he did not need the income averaging election and did not make the election. In 2000, Jim decided not to replace the cows and therefore filed an amended return for 1998 to report the $50,000 of gain. Since there is another change on his 1998 return, Jim is allowed to make the income averaging election 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.

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 and Prop. Treas. Reg. §1.1301-1(f)(4).

Under the IRS interpretation, a taxpayer will lose part of the benefit of income averaging if the income averaging rules reduce regular tax liability below the tentative minimum tax. If a taxpayer owed alternative minimum tax before the income averaging election, the election will not reduce the total tax liability for the year. The election increases the alternative minimum tax liability by the same amount as it reduces the regular tax liability.

Example 5. Clay and Lilly Fields had $120,000 of net income from farming in 2001 and no other income. They had $50,000 of AMT adjustments. Before income averaging, their 2001 income tax return showed the following:

Total income (line 22 of Form 1040)		$120,000
One-half of self-employment tax (line 27 of Form 1040)		6,592
Adjusted gross income (line 34 of Form 1040)		$113,408
Standard deduction (line 36 of Form 1040)		7,600
Personal exemption deductions (line 38 of Form 1040)		5,800
Taxable income (line 39 of Form 1040)		$100,008
Regular income tax (line 40 of Form 1040)		$ 21,852
Alternative minimum tax		
Tentative minimum tax (line 26 of Form 6251)	$28,148	
Less regular income tax (line 27 of Form 6251)	21,852	6,296
Total income tax liability		$ 28,148

After income averaging, their 2001 income tax return showed the following:

Regular income tax (line 22 of Schedule J (Form 1040))		$ 19,409
Alternative minimum tax		
Tentative minimum tax (line 26 of Form 6251)	$28,148	
Less regular income tax (line 27 of Form 6251)	19,409	8,739
Total income tax liability		$ 28,148

Observation. Income averaging reduced regular tax liability by $21,852 – $19,409 = $2,443 but increased alternative minimum tax by the same amount, so the total tax liability was not changed.

While taxpayers who owe AMT before the income averaging election will not save taxes as a result of the election, the election may increase their AMT credit for future years. That credit can be used to offset regular tax liability in those years.

Example 6. Assume the same facts as in Example 5. In addition, assume that $30,000 of the AMT adjustments were deferral adjustments and $20,000 were exclusion adjustments.

The Fields' 2002 AMT credit resulting from their 2001 AMT liability before and after income averaging for 2001 are as follows:

	Before	After
Tentative minimum tax on exclusion items (line 13 of Form 8801)	$ 19,970	$ 19,970
Regular tax for 2001 (line 27 of 2001 Form 6251)	21,852	19,409
Net minimum tax on exclusion items (line 15 of Form 8801)	$ –0–	$ 561
2001 AMT (line 16 of Form 8801)	$ 6,296	$ 8,739
Net minimum tax on exclusion items (line 17 of Form 8801)	$ –0–	$ 561
Minimum tax credit (line 18 of Form 8801)	$ 6,296	$ 8,178

Therefore, income averaging increased the Fields' AMT credit carried to 2002 by $8,178 – $6,296 = $1,882.

SHARE RENT LANDOWNERS

Share rent landowners who materially participate in the farming business can apparently treat their income for the farming business as electible farm income since it is reported on Schedule F (Form 1040). The instructions for the 2000 Schedule J (Form 1040) include Schedule F in the list of forms on which electible farm income is reported.

The treatment of share rent income for a non–materially participating landowner is not as clear. The instructions for the 2000 Schedule J (Form 1040) state that some share rent income reported on Form 4835 may be electible farm income. They refer to Treas. Reg. §1.1301-1, which has not yet been released in final form.

The only guidance in the proposed regulations is in Prop. Treas. Reg. §1.1301-1(b), which defines an individual engaged in a farming business as including "a sole proprietor of a farming business, a partner in a partnership engaged in a farming business and a shareholder of an S corporation engaged in a farming business."

Until final regulations give further guidance, taxpayers could make the following arguments to justify including income from Form 4835 in electible farm income.

1. The definition of an individual engaged in farming in the proposed regulations is not limited to the three categories listed, which leaves open the argument that other categories—such as landowners who receive share rent—can be included.
2. Landowners who receive share rent share in the risk of the farming business, even if they are not materially participating.
3. Share-rent landowners who do not materially participate are treated as being in a farming business for purposes of the soil and water conservation rules under I.R.C. §175 and the estimated tax penalty rules under I.R.C. §6654(i).
4. A rental activity is a trade or business for purposes of the self-employment tax rules of I.R.C. §1402 even though rent from real estate is excepted from that tax.

FORMER SPOUSES BOTH ENGAGED IN FARMING

There is no clear guidance in the proposed regulations on the calculation of tax liability in the case of two former spouses who are both engaged in farming after the divorce. If both of them elect income averaging for election years that have a base year in common and they filed a joint return for that base year, there is no clear guidance on how much of the base year bracket is used by each of the former spouses.

Example 7. Pete and Sally Bogg filed a joint return in 1998, showing $34,350 of taxable income, which is $8,000 below the beginning of the 28% income tax bracket. They divorced in 1999 and each filed a return as a single individual in 1999, 2000, and 2001. In 2000, Pete has $30,000 of ordinary elected farm income and, in 2001, Sally has $45,000 of ordinary elected farm income on their respective income tax returns.

When Pete filed his 2000 income tax return, he was allowed to use the full remaining $8,000 of their joint 1998 income tax bracket when computing his tax liability on his Schedule J (Form 1040) [Prop. Treas. Reg. §1.1301-1(f)(2)]. That is likely to increase their 1998 taxable income for purposes of Sally's income averaging calculation on her 2001 income tax return. Prop. Treas. Reg. §1.1301-(d)(2) states,

> If a base year for a current farm income averaging election was previously a base year for another farm income averaging election, the base year's section 1 tax is determined after increasing the base year's taxable income by the elected farm income allocated by that prior election.

That language does not limit the effect on the base year taxable income to an election made by the same taxpayer. Therefore, since Pete made the election for an earlier year, the proposed regulation can be can be read to say that the $10,000 portion of his elected farm income that is allocated to 1998 will increase their 1998 taxable income for purposes of Sally's later election. While that result seems unfair to Sally, the IRS is not likely to allow both of them to use the remaining $8,000 of their joint 1998 15% bracket for income averaging calculations.

If former spouses make the income averaging election for the same year, there is no clear order in their use of the unused tax brackets from a base year for which they filed a joint return.

Example 8. Assume the same facts as in Example 7, except that Pete made his income averaging election in 2001 rather than 2000. Since they have made the election for the same year, neither election has priority for use of the remaining $8,000 of their joint 1998 15% bracket. It would be logical to divide the remaining $8,000 of their 1998 15% bracket evenly between them so that Pete could use $4,000 of it and Sally could use $4,000 of it in their respective Schedule J calculations. That would push $6,000 ($10,000 – $4,000) of Pete's elected farm income and $11,000 ($15,000 – $4,000) of Sally's elected farm income into their joint 1998 28% bracket.

> **Practitioner Note.** A practitioner representing both spouses should consider potential conflicts of interest and ethical issues.

ISSUE 2: SELF-EMPLOYMENT TAX

APPLICABLE LAW

Under I.R.C. §1402(a)(1), rent received on land is included in self-employment income if two conditions 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.

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. 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 that a partnership agreement or an employment agreement with the entity is such an arrangement.

2. The landowner materially participates in the farming business.

Authority in Support of the IRS Position

Beginning in 1995, the IRS successfully argued its position in four cases: *Mizell v. Commissioner*, T.C. Memo 1995-571; *Bot v. Commissioner*, T.C. Memo 1999-256; *Hennen v. Commissioner*, T.C. Memo 1999-306; and *McNamara v. Commissioner*, T.C. Memo 1999-333. Beginning in 1996 the IRS issued a letter ruling and three field service advisory opinions in support of its position: Ltr. Rul. 9637004, dated May 1, 1996; FSA 199917008; FSA 199917005; and FSA 199917006.

Authority in Support of the Taxpayer Position

In December 2000, the 8th Circuit Court of Appeals reversed and remanded the *McNamara, Bot,* and *Hennen* cases listed above [*McNamara v. Commissioner*, 87 AFTR 2d 2001-310 (8th Cir. 2000)]. In that case, the court rejected some of the taxpayer's arguments, but agreed with the taxpayer's argument that the rent must include compensation for the services that were required by the employment contract in order to make the rent subject to self-employment tax.

The case was remanded to the Tax Court for a finding on whether the rent paid was a fair rental amount. If it was a fair rental amount, then no part of the rent was compensation for services and the rent is not included in self-employment income.

How to Report Rental Income from an Entity

What position should a tax preparer take on a take return given the above authority?

It is important to note that **the only taxpayer argument that has found support in the court cases is the argument that the lessor-lessee relationships should stand on their own apart from the employer-employee relationships**. Consequently, facts that show the rent is not in excess of a fair rental rate are critical to the use of the 8th Circuit opinion in *McNamara* as support for a position on an income tax return.

Example 2. John Brown operates his farm business as a sole proprietorship. He pays his wife, Mary, $125 per acre cash rent for land she inherited from her parents. He also pays Mary a reasonable wage for keeping the books for his business. If John can show that $125 per acre is a fair rental rate for the farmland, the 8th Circuit opinion in *McNamara* is authority for reporting the rent as a deduction on John's Schedule F (Form 1040) and as rental income on Mary's Schedule E (Form 1040), where it is not subject to self-employment tax.

The 8th Circuit **rejected the following taxpayer arguments** in *McNamara*:

1. That I.R.C. §1402(a)(1) applies only to rental payments derived from sharecropping or share-farming.
2. That the instructions accompanying Form 4835 (Farm Rental Income and Expenses) contradict and therefore override I.R.C. §1402(a)(1).
3. That the Tax Court clearly erred in concluding, as a factual matter, that Mrs. McNamara, Mrs. Bot, and Mrs. Hennen were required—by their respective employment agreements or by more informal "arrangements"—to materially participate in agricultural production and management, and that all three did in fact materially participate in those activities.

Taxpayers in the Eighth Circuit. The IRS and the Tax Court are bound by the holding of the 8th Circuit Court of Appeals Taxpayers opinion in *McNamara* with respect to taxpayers who are in the jurisdiction of the 8th Circuit (North Dakota, South Dakota, Nebraska, Minnesota, Iowa, Missouri, and Arkansas). Consequently, taxpayers in the 8th Circuit have substantial authority for excluding rental income from self-employment tax if the rent is a fair rental rate. That means they will not be subject to an underpayment penalty for not disclosing their position on a tax return by filing Form 8275 even if the IRS is ultimately successful on this issue and assesses a self-employment tax liability for the rent.

Example 3. Assume John and Mary Brown from Example 2 live in the 8th Circuit. They report the rental income on Mary's Schedule E (Form 1040) as not being subject to self-employment tax. The IRS successfully litigates its position in other circuits and the U.S. Supreme Court resolves the conflict between the 8th Circuit and the other circuits in favor of the IRS. Based on the Supreme Court opinion, the IRS successfully assesses self-employment tax liability on Mary's rental income. John and Mary are not subject to the 20% penalty under I.R.C. §6222 because they had substantial authority for their position when they reported it on their income tax return [Treas. Reg. §1.6222-4(d)(1)].

Taxpayers Outside the Eight Circuit. The IRS and the Tax Court are not bound by the holding of the 8th Circuit Court of Appeals Taxpayers opinion in *McNamara* with respect to taxpayers who are outside the jurisdiction of the 8th Circuit Court of Appeals. Consequently, taxpayers who are outside the 8th Circuit and follow the holding of the 8th Circuit opinion in M*cNamara* may be challenged by the IRS, and the Tax Court could rule in favor of the IRS as it did in *Bot*, *Hennen,* and *McNamara.* If taxpayers in other circuits lose in the tax court, they can appeal to the Circuit Court of Appeals for their circuit.

Taxpayers outside the 8th Circuit can argue that the 8th Circuit opinion in *McNamara* is substantial authority for not including rent in self-employment income on their income tax returns. Even though the Tax Court opinion is not overruled outside the 8th Circuit, Treas. Reg. §1.6222-49d)(3)(iv)(B) says the taxpayer's residence is not to be 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 the 8th Circuit can weigh the authority of the Tax Court opinions and the 8th Circuit opinions when deciding whether there is substantial authority for their position. Since the 8th Circuit is a higher court, there is clearly substantial authority for a position that is consistent with the 8th Circuit opinion.

Example 4. Assume John and Mary Brown from Example 2 live outside the 8th Circuit. They report the rental income on Mary's Schedule E (Form 1040) as not being subject to self-employment tax. The IRS challenges that position in the Tax Court, and the Circuit Court of Appeals for the circuit in which John and Mary live upholds the Tax Court opinion. John and Mary are not subject to the 20% penalty under I.R.C. §6222 because they had substantial authority for their position when they reported it on their income tax return [Treas. Reg. §1.6222-4(d)(1)].

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 are 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 exception to self-employment tax in I.R.C. §1402(a)(1) for rent paid for real estate 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 in I.R.C. §1402(a)(1) 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 only include 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 are not subject to self-employment tax even if the material participation requirements are met.

Example 5. Assume John and Mary from Example 4 lose on their argument that Mary's rent is not subject to self-employment tax but that part of the rent is for buildings on Mary's land. The rent for the buildings should be excluded from self-employment income because it is rent received for real estate, but it is not rent received for land used in agricultural production.

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 the 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.

CONSERVATION RESERVE PROGRAM (CRP) PAYMENTS

Materially Participating Landowners

For several years, the IRS has taken the position that Conservation Reserve Program (CRP) payments are subject to self-employment tax if the recipient is materially participating in a farm business. See Ltr. Rul. 9637004 (May 1, 1996) and 1997 IRS Publication 225, *Farmer's Tax Guide,* p. 17. That position was quite widely accepted by tax practitioners and commentators. 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 taxpayer that CRP payments received by a materially participating farmer are not subject to self-employment tax. In that case, the taxpayers had been farming for approximately 20 years. In 1991 they put 214 acres of their land into the CRP program and continued to farm other land under a sharecrop rental arrangement. Mr. Wuebker used his equipment to establish the required ground cover on the CRP land and performed minimal upkeep on the land each year.

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

Having determined that the CRP payments are rental payments, the *Wuebker* court then applied I.R.C. §1402. 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.

Reporting Obligations: Returns Filed Before the 6th Circuit Opinion. Some taxpayers amended prior years' 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* (2000), states at page 16,

> 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. §6662 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. §6662, even if the taxpayer does not amend the return.

Example 6. 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 7. 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 not substantial authority at the time she filed the amended return or at the end of the tax year.

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.

Substantial authority. If there is substantial authority for the contrary position, then the taxpayer is not subject to a penalty under I.R.C. §6662 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. §6662 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.

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. §6662 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.

Observation. 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.

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 8. 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 9. 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.

ISSUE 3: OPTIONAL METHOD FOR SELF-EMPLOYMENT TAX

The farm optional method under I.R.C. §1402(a) allows farmers to pay self-employment (SE) tax on two-thirds of gross farm income, if gross farm income is not more than $2,400.

Example 1. Ima Peach has $2,100 of gross farm income in 2001. Her net farm income is ($1,000). The regular method of computing self-employment tax results in no SE tax liability. Ima can elect to report $1,400 (two-thirds of $2,100) as her self-employment income. She will owe $214 ($1,400 × .153) of self-employment tax on that income.

The farm optional method also allows farmers to pay self-employment tax on $1,600 of income if gross income is greater than $2,400 and net earnings from farm self-employment is less than $1,733.

Example 2. Ima Peach from Example 1 had $2,500 of gross farm income in 2001 and her net farm income was $1,000. The regular method of computing self-employment tax results in $141 ($1,000 × .9235 × .153) of SE tax liability. Ima can elect to report $1,600 as her self-employment income. She will owe $245 ($1,600 × .153) of self-employment tax on that income.

Incentive for the Election

The incentive to pay self-employment taxes when none would otherwise be due is to meet the qualifications for social security benefits.

To be eligible for disability benefits from social security, a farmer who is age 31 or older must be fully insured (40 quarters of coverage) or currently insured (20 quarters of coverage in the 10 years or 40 quarters immediately before death or disability). Before 1985, the deemed $1,600 of income under the farm optional method resulted in four quarters of coverage. In 1985, the amount needed for a quarter of social security coverage increased to $410; thus paying on the deemed $1,600 of income under the farm optional method provided the farmer only three quarters of coverage. In 1991, the amount needed for a quarter of coverage increased to $540; thus the deemed $1,600 of income under the farm optional method yielded only two quarters of coverage. In 2001, a quarter of coverage increased to $830; thus only one quarter of coverage is obtained from the deemed $1,600 of income under the farm optional method. Since the deemed $1,600 of income under the farm optional method has not changed since 1956, farmers are increasingly at risk of not being eligible for social security disability benefits.

> **Observation.** Another incentive for using the optional method is to increase income for purposes of the earned income credit.

Example 3. John and Mary Farmer were married and started a farming operation in 1991. John was born on July 14, 1969; thus he was 22 years old when he began farming in 1991. Son John Jr. was born in 1994 and daughter Marie was born in 1996. John used aggressive tax planning in profitable years and had several years of losses during the first 10 years of farming. Consequently, he showed no farm profits for the first 10 years. His gross farm income and net farm profit for 1998 through 2001 are shown below:

Year	Gross Farm Income	Net Farm Profit or (Loss)
1998	$25,158	$(8,968)
1999	37,289	(5,662)
2000	28,305	(7,421)
2001	64,222	3,400

John did not elect the farm optional method for the years 1991–1999 and received no quarters of social security coverage. On December 14, 2001, John was killed in an automobile accident.

Question 1. Are Mary and her children eligible for social security survivor's benefits based on John's record?

Answer 1. For Mary and her children to be eligible for survivor's benefits, John must have been either fully insured or currently insured when he died.

To be fully insured, John must have had the lesser of:

1. 40 quarters of coverage (the general rule), or
2. 10 quarters of coverage (one quarter for each year after age 21 (not counting the year of death), with a minimum of six quarters of coverage)

To be currently insured, John must have credit for having worked 20 quarters (that is, the number of quarters required for workers age 31 through 42).

John earned four quarters of coverage in 2001 with his $3,400 of net farm profit ($3,400/$830 is more than 4). Therefore, based on the returns he has filed, he was neither fully nor currently insured on the day he died.

Question 2. Is there anything Mary can do to receive benefits?

Answer 2. Yes. Mary can elect the farm optional method of paying self-employment tax on timely filed amended returns. If she amends John's returns for 1997 through 1999 and elects the optional method, John will be treated as having $1,600 of earned income in each of those three years, which will give him two quarters of coverage for each of those years.

1998: $1,600 / $700 = 2.289
1999: $1,600 / $740 = 2.16
2000: $1,600 / $780 = 2.05

Those additional six quarters of coverage give John a total of 10 quarters of coverage, which makes him fully insured at the time he died. Consequently, Mary and her children qualify for survivor's benefits.

Practitioner Note. If John had a farm loss in 2001 and died in 2002, the amendment of his previous three year's returns (1999, 2000, and 2001) would result in only five additional quarters of coverage because the optional method for 2001 would give him only one quarter of coverage.

ISSUE 4: SHARED APPRECIATION AGREEMENTS

Farmers who have loans from the Farm Service Agency are eligible for a write-down of the loan if they meet certain criteria. As a condition for the write-down, the FSA is allowed to require the farmer to enter into a Shared Appreciation Agreement that obligates the farmer to repay part or all of the debt write-down if the land appreciates in value from the time of the restructuring to the occurrence of a recapture event. The recapture events are set out in 7 U.S.C. §2001(e)(4) as follows:

> (4) Time of recapture
>
> Recapture shall take place at the end of the term of the agreement, or sooner—
>
> (A) on the conveyance of the property;
> (B) on the repayment of the loans; or
> (C) if the borrower ceases farming operations.

A Shared Appreciation Agreement raises the income tax question of whether there is discharge of indebtedness income at the time the debt is restructured.

Example 1. In 1996, Sarah Songbird owed the FSA $270,000 and was delinquent on her payments. The FSA offered to let her buy out the debt for the $92,000 net recovery value of her farm if she agreed to a Shared Appreciation Agreement. Under the Shared Appreciation Agreement, the FSA can recapture 75% of the appreciation in value of Sarah's farm if a recapture event occurs within four years of the date of the write-down or 50% of the appreciation in value if the recapture event occurs more than four years after the date of the write-down. Sarah accepted the offer and borrowed $92,000 from a local bank to pay the FSA. The FSA wrote off the remaining $178,000 of debt.

The income tax question is whether the Shared Appreciation Agreement delays the discharge of indebtedness until the recapture event. If so, then Sarah has no discharge of indebtedness income in 1996. If not, $178,000 debt write-down is discharge of indebtedness in 1996.

IRS Position

In a letter to Chet Bailey, Farmer Program Division, Farm Service Agency, dated May 22, 1989, Peter K. Scott, Acting Chief Counsel of the Internal Revenue Service, states that farmers must treat the debt write-down as discharge of indebtedness in the year of the write-down. That conclusion was based on the reasoning that the Shared Appreciation Agreement is so contingent that it is impossible to estimate whether and when any amount will be paid under the Shared Appreciation Agreement.

Example 2. Under the IRS interpretation, Sarah in Example 1 realized $178,000 of discharge of indebtedness income in 1996.

Tax Court Position

In *Jelle v. Commissioner*, 116 T.C. 63 (2001), the Tax Court reached the same conclusion. However, that conclusion was based on a different interpretation of the Shared Appreciation Agreement. In *Jelle*, the Shared Appreciation Agreement had only one recapture event–the sale of any part or all of the real estate within 10 years of the agreement. If taxpayers chose not to dispose of their property, then no further payments would be due. Based on that agreement, the Tax Court concluded that "whether and when the [taxpayers] would ever be required to make any further payments to FmHA (the predecessor to the FSA) rested totally within their own control." Consequently, the court found that the taxpayer's obligation was "highly contingent" and followed prior case law in holding that the debt write-down was discharge of indebtedness income in the year of the write-down.

Alternative Position

Taxpayers could argue that the Shared Appreciation Agreement results in no discharge of indebtedness income in the year of the agreement since the agreement may require part or all of the write-down to be repaid to the FSA. The discharge, if any, occurs when there is no longer a potential recapture of the write-down.

Example 3. Under this argument, Sarah in Example 1 has no discharge of indebtedness income in 1996. She will have discharge of indebtedness only if the Shared Appreciation Agreement expires without triggering an obligation to repay all of the write-down. There could be several different scenarios resulting in part, with all or none of the write-down becoming discharge of indebtedness income.

Scenario 1. Sarah does not trigger a recapture event before the end of the 10-year agreement. At the end of the 10 years, her land has appreciated by $400,000. Sarah is required to recapture $178,000, which is the lesser of:

1. The $178,000 debt write-down, or
2. 50% of the$400,000 appreciation, which is $200,000

Since Sarah is required to repay all of the write-down, she has no discharge of indebtedness income in 2006 or in any other year.

Scenario 2. Sarah sells the land for its $292,000 fair market value in 2001. That triggering event requires her to recapture $100,000, which is the lesser of:

1. The $178,000 debt write-down, or
2. 50% of the $200,000 appreciation ($292,000 – $92,000), which is $100,000

Since Sarah will never have to repay $78,000 ($178,000 – $100,000) of the write-down, she has $78,000 of discharge of indebtedness income in 2001. She has no discharge of indebtedness income in any other year.

Scenario 3. Sarah quits farming in 1998, when her land is still valued at $92,000. That triggering event requires her to recapture nothing since there is no appreciation. Her recapture amount is the lesser of:

1. The $178,000 write-down, or
2. 75% of the zero appreciation ($92,000 – $92,000), which is zero

Since Sarah will never have to repay any of the debt write-down, she has $178,000 of discharge of indebtedness income in 1998.

Which Position Is Best for the Taxpayer?

On its face, the alternative position discussed above appears to be the best for the taxpayer because it postpones the recognition of discharge of indebtedness income and may result in never recognizing discharge of indebtedness income. That will be true in some cases.

Example 4. Assume the same facts as in Example 3, Scenario 3, and in addition, assume that Sarah did not qualify for any of the I.R.C. §108 exceptions to recognizing discharge of indebtedness income in 1996 or in 1998.

Under the IRS position, Sarah is required to report $178,000 of discharge of indebtedness income in 1996. Under the alternative position, she is required to report $178,000 of discharge of indebtedness income in 1998.

However, some taxpayers may be better off under the IRS interpretation because they may qualify for an exception to recognizing the discharge of indebtedness income in the year of the agreement and not qualify for an exception in the year of recapture.

Example 5. Assume the same facts as Example 3, Scenario 2, and in addition, assume that Sarah was $200,000 insolvent when she entered into the agreement in 1996, but was solvent when she triggered the $100,000 recapture in 2001. Also assume that the FSA debt was her only debt and that her only tax attribute was $100,000 of basis.

The IRS position would allow Sarah to realize the $178,000 of discharge of indebtedness in 1996 when she is insolvent and not have to recognize any of it as income. She does have to reduce tax attributes as a consequence of not recognizing the income. That requires her to reduce her basis by $8,000 down to the $92,000 of debt that remains after the discharge. After that reduction, there is no further reduction of tax attributes as a consequence of not recognizing the $178,000 of discharge of indebtedness income.

The alternative position would require Sarah to recognize the $78,000 discharge of indebtedness income in 2001.

Practitioner Note. In some cases, the IRS position will allow taxpayers to restore tax attributes that are reduced as a result of the discharge of indebtedness income when the taxpayer is required to repay the FSA. See the discussion of recapture below.

Which Position Is Likely to Prevail?

Based on current case law, it is difficult to predict which position will prevail. Although the Tax Court ruled in favor of the IRS in *Jelle*, *supra*, the facts in that case can be distinguished from most Shared Appreciation Agreements. The only recapture event in *Jelle* was sale of the property within 10 years of the agreement. As the *Jelle* court noted, the taxpayer had considerable control over that recapture event. By contrast, most Shared Appreciation Agreements will include three more recapture events over which the taxpayer has less control. The taxpayer has some control over two of them–cessation of farming and default on the loan. The taxpayer has no control at all over the third recapture event—expiration of the 10-year period. Consequently, *Jelle* is not a strong precedent for the IRS with respect to Shared Appreciation Agreements that include expiration of the 10-year period as a recapture event.

Whether the recapture is triggered by the expiration of the 10-year period is itself the subject of litigation. In *Israel v. USDA*, 135 F. Supp. 2d 945 (W.D. Wis.), the farmers who had entered into a Shared Appreciation Agreement argued they did not owe the recapture amount at the end of the 10-year period because the Shared Appreciation Agreement was ambiguous and they had relied on oral statements from FSA employees that they would not owe any recapture amount at the end of the agreement. The trial court held that the expiration of the 10-year period was a recapture event and required the farmers to pay the recapture amount. *Israel* has been appealed to the 7th Circuit Court of Appeals and other cases on this issue are pending in other courts. Therefore, the ultimate interpretation of the Shared Appreciation Agreements could go either way.

If the Shared Appreciation Agreements are ultimately held to **not** require recapture at the end of the 10-year period, then the IRS position is more likely to prevail on the tax issue. If the Shared Appreciation Agreement is ultimately held to require recapture at the end of the 10-year period (as the FSA argues) then the IRS could still prevail on the tax issue, but it is less likely to prevail.

In order to prevail on the tax issue, the IRS must convince the court that the recapture provision in the Shared Appreciation Agreement is "highly contingent." The application of the test was described as follows in *Zappo v. Commissioner,* 81 T.C. 77 (1983), at page 90:

> When an obligation is highly contingent and has no presently ascertainable value, it cannot refinance or substitute for the discharge of a true debt. The very uncertainty of the highly contingent replacement obligation prevents it from reencumbering assets freed by discharge of the true debt until some indeterminable date when the contingencies are removed. In a word, there is no real continuation of indebtedness when a highly contingent obligation is substituted for a true debt. Consequently, the rule in *Kirby Lumber* applies, and gain is realized to the extent the taxpayer is discharged from the initial indebtedness.

Taxpayers can argue that the date the contingency is removed is determinable in a Shared Appreciation Agreement for which expiration is a recapture event since it can be no later than the expiration date. They can also argue that the asset was never free of the encumbrance and the true debt continues until a recapture event occurs. Given that the value of land is very likely to increase in a 10-year period, in almost all cases, the taxpayer must repay part of the write-down and in many cases they will repay all of the write-down.

Practitioner Note. Shared Appreciation Agreements entered into after August 18, 2000 have a five year period. The end of the five-year period is a recapture event.

To illustrate the income tax consequences of the recapture payment under the Shared Appreciation Agreement, we begin with an example of the income tax consequences of the debt reduction.

Example 6. On May 1, 1991, Matthew Horton owed FmHA $150,000 of principal plus $15,000 accrued interest. At that time, he entered into a buy-out agreement with FmHA under which he paid $125,000 (the fair market value of the farm at the time of the workout) and the FmHA terminated his obligation to pay $15,000 of accrued interest and $150,000 of principal on his farm loan. Under the terms of the loan, payments are first applied to accrued interest and then to principal. Therefore, the workout agreement resulted in a discharge of $15,000 of interest and $25,000 of principal.

The workout included a Shared Appreciation Agreement that requires Matthew to pay the FSA 50% of the appreciation in value of the collateral on the earlier of:

1. The end of the agreement, which is May 1, 2001
2. The date the borrower transfers the property, defaults on the debt, or ceases farming

The total amount recoverable under the Shared Appreciation Agreement is limited to the $40,000 of debt written down.

Before the workout, Matthew's total debt was $338,000, his assets were worth $300,000, and his adjusted basis in assets was $302,000. After the workout, his debt was $298,000 and his assets were still worth $300,000. The debt was not qualified farm indebtedness because Matthew did not meet the requirement that 50% or more of his gross receipts were from farming for the three preceding tax years [I.R.C. §108(g)(2)(B)].

On his 1991 income tax return, Matthew followed the IRS position and reported the following on Form 982:

1. The $15,000 of interest was not reported as income. It is excluded from income under I.R.C. §108(e)(2) because Matthew could have claimed a deduction if he had paid that interest.
2. After the $15,000 of interest was discharged, Matthew had $323,000 of debts and $300,000 FMV of assets. Therefore, the first $23,000 of the $25,000 discharged principal was excluded from income under the insolvency exception [I.R.C. §108(a)(1)(B)]. Matthew reduced tax attributes as follows:
   a. NOLs were reduced by $16,000. That paid the price for $16,000 of the $23,000 that was excluded under the insolvency exception leaving, $7,000 to be accounted for.
   b. Bases of assets were reduced by $4,000. Bases were not reduced any further because the $4,000 reduction brought Matthew's aggregate bases in assets down to an amount that is equal to his remaining debt after the discharge ($298,000). That paid the price for another $4,000 of the $23,000 that was excluded under the insolvency exception, leaving $3,000 to be accounted for.
   c. No attributes were reduced for the remaining $3,000 of discharged debt that was not recognized under the insolvency rules because Matthew exhausted all available attributes.
3. The remaining $2,000 of discharged debt was recognized as income (since Matthew was solvent to the extent of $2,000 after the discharge).

See the 1999 *Farm Income Tax School Book*, Chapter 16, pages 557–563 for a detailed discussion of reduction of tax attributes as a result of discharge of indebtedness.

TAX CONSEQUENCES OF THE RECAPTURE

The tax consequences of recapture depend on the position the taxpayer took in the year of the agreement.

IRS Position

Under the IRS position, taxpayers must reverse the income tax consequences of the debt discharge when the taxpayer is required to repay part or all of the discharged debt. That means the taxpayer begins at the bottom of the list of tax consequences and reverses those consequences in the year of the repayment until the repayment amount is accounted for.

Example 7. Assume the same facts as in Example 6. When the workout agreement terminated in 2001, Matthew's farm was worth $185,000, which was a $60,000 increase over the value of the farm at the time of the workout. Consequently, Matthew was required to repay $30,000 (50% × $60,000) of the $40,000 debt reduction.

That repayment reverses the tax consequences that were reported on Matthew's 1990 income tax return. Therefore, Matthew starts at the bottom of the list of tax consequences in Example 6 and reverses them until he has accounted for the $30,000 of discharged debt that he repaid.

1. Since the last $2,000 that was discharged was recognized as income in 1991, Matthew claims a $2,000 deduction in 2001 when he repays the discharged debt. (That accounts for $2,000 of the $30,000 repaid, leaving $28,000.)
2. Since the next to last $3,000 that was discharged was not recognized as income and did not cause tax attributes to be reduced, Matthew has no deduction nor any attribute restoration for that $3,000 that he repaid. (That accounts for another $3,000 of the $30,000 he repaid, leaving $25,000.)
3. The next $4,000 (in reverse order) of the $40,000 discharge resulted in reduction in the bases of assets in 1991. Therefore, Matthew adds $4,000 to the bases of his assets in 2001. (That accounts for another $4,000 of the $30,000 repaid, leaving $21,000.)
4. The next $16,000 (in reverse order) of the $40,000 discharge resulted in reduction of NOLs in 1991. Therefore, Matthew increases his NOLs in 2001 by $16,000. (That accounts for another $16,000 of the $30,000 repaid, leaving $5,000.)
5. The remaining $5,000 of the $30,000 that was repaid was part of the $15,000 on interest that was discharged in 1991. Since that interest was not claimed as a deduction in 1991, Matthew can claim an interest deduction when that discharged interest is repaid in 2001.

Alternative Position

Taxpayers who took the alternative position at the time of the FmHA debt reduction do not have any tax consequences to reverse when they make a recapture payment under the Shared Appreciation Agreement. However, they may have debt discharge income to be reported at the termination of the Shared Appreciation Agreement because there is no longer any obligation to repay any debt that was not repaid at the end of the agreement.

Example 8. Assume the same facts as in Example 6 except that Matthew Horton took the alternative position on his income tax return.

Matthew reported no attribute reduction and no discharge of indebtedness income in 1991 because the Shared Appreciation Agreement could require him to repay all of the debt reduction.

Example 9. Assume that Matthew followed the alternative method of reporting the debt reduction in 1991 as in Example 6 and paid the same $30,000 recapture amount in 2001 as in Example 7.

Matthew has no tax consequences to reverse in 2001 because he reported no discharge of debt in 1991. However, he does have $10,000 discharge of debt to account for in 2001 since his debt was written down by $40,000 in 1991 and he has repaid only $30,000 in 2001. Since that $10,000 was accrued interest that could have been deducted if it had been paid, Matthew has no income tax consequences for the discharge of that debt in 2001.

> **Practitioner Note.** Some taxpayers who used the alternative method of reporting the debt reduction at the time of the FmHA workout agreement will have discharged debt that must be reported at the termination of the Shared Appreciation Agreement.

Example 10. Assume the same facts as in Example 9 except that Matthew Horton was required to repay $18,000 (rather than $30,000) of the debt reduction at the end of the Shared Appreciation Agreement. Since Matthew's obligation to repay the remaining $22,000 of the $40,000 debt reduction in 1991 is terminated when the Shared Appreciation Agreement terminates in 2001, he must account for that $22,000 debt discharge in 2001.

As in the previous examples, the first $15,000 of the debt discharge is accrued interest and does not have to be reported as income because Matthew could have claimed a deduction if he had paid that interest.

The remaining $7,000 is discharge of indebtedness income to Matthew in 2001 unless it fits within one of the other exceptions under I.R.C. §108. In this example, Matthew does not qualify for any of the exceptions, so he must report $7,000 of discharge of indebtedness income in 2001.

ISSUE 5: PREPAID EXPENSES: CHANGE OF PLANS

GENERAL RULES FOR PREPAID EXPENSES

Farm producers who use the cash method of accounting are allowed to deduct the cost of supplies purchased during the year even if the supplies will not be used until the following year if they meet the requirements of two sets of rules.

One set of rules comes from case law and IRS rulings. The general rule is stated in *Grynberg v. Commissioner,* 83 T.C. 255 (1984), and is applied to feed expenses in Rev. Rul. 79-229 1979-2 C.B. 210. This rule requires the producer to meet the following three conditions to claim a deduction in the year of the expenditure:

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

The other set of rules is set out in I.R.C. §464(f). Those rules limit a taxpayer's deduction for prepaid expenses to 50% of deductible expenses other than the prepaid expenses unless the taxpayer is a "qualified farm related taxpayer." A "farm related taxpayer" is any taxpayer:

1. Whose principal residence is on a farm
2. Whose principal occupation is farming, or
3. Who is a member of the family of a taxpayer who meets the requirements of 1 or 2 above

To be "qualified," the farm related taxpayer must meet one of the following two requirements:

1. Aggregate prepaid farm supplies for the prior three years must be less than 50% of the aggregate deductible farming expenses other than prepaid expenses, or
2. Extraordinary circumstances (such as a flood or a drought) caused prepaid expenses to exceed 50% of farming expenses other than prepaid expenses in the current year.

Example 1. Patty Producer uses the cash method of accounting. In December 2000, she paid $20,000 to Supply Cooperative for fertilizer to be applied in the spring of 2001 on her corn crop. Patty's deductible expenses for 2000 other than this purchase of fertilizer was $100,000. She purchased the fertilizer in December for two reasons. First, she was offered a discount for purchasing in December rather than the following spring. Second, she was concerned that fertilizer may be difficult to buy at any price the following spring.

Patty is allowed to deduct the $20,000 she paid for the fertilizer on her 2000 income tax return. She meets the three requirements of the general rule. I.R.C. §464(f) does not limit her deduction for two reasons. First, she is a qualified farm related taxpayer, so the 50% limit does not apply to her. Second, she has not exceeded the 50% limit.

EFFECT OF CHANGE IN PLANS

After purchasing supplies for the following year, a producer's plans may change. He or she may decide not to produce the crop or raise the livestock for which the supply was purchased. Such producers must address the tax consequences of that change in plans.

Example 2. Assume the same facts as in Example 1, except that the price of corn dropped dramatically before Patty planted her crop and the cost of fertilizer increased significantly. Consequently, Patty decided to sell the fertilizer she had purchased and plant an alternative crop that does not require fertilizer. She found a buyer that paid her $25,000 for the fertilizer.

What are the income tax consequences of Patty's change in plans?

Law and Analysis

Deduction on 2000 Tax Return. A potential consequence of Patty's change in plans is a denial of the $20,000 deduction on her 2000 income tax return.

In Rev. Rul. 82-208, 1982-2 C.B. 58, the prepayment rules were applied to a payment of estimated state income taxes on December 31, 1981. The IRS noted that estimated state income taxes are deductible in the year they are paid if the amount of the payment is reasonably determined in good faith at the time of the payment. In that ruling, the IRS held that the taxpayer had no reasonable basis to believe that he owed any additional state income taxes and did not allow the estimated payment to be deducted on the 1981 income tax return.

Applying the principle of Rev. Rul. 82-208 to the facts in Example 2, the IRS is not likely to challenge Patty's deduction of the $20,000 on her 2000 income tax return. At the time she made the payment, she in good faith thought that she would use the fertilizer on her 2001 corn crop.

Income on 2001 Tax Return. The sale of the fertilizer in 2001 results in taxable income for 2001. Since Patty deducted the cost on the fertilizer on her 2000 income tax return, she has a zero basis in the fertilizer. Therefore, Patty must report the full $25,000 that she received for the fertilizer on her 2001 income tax return. The other income line of Schedule F (line 10 on the 2001 Schedule F) is the logical place to report this income since it was neither purchased for resale (Schedule F, line 1) nor raised (Schedule F, line 4).

Other Supplies

The same tax consequences are likely to follow from the purchase and sale of other farm supplies so long as there is a good faith expectation the supply will be used in the farm business when it is purchased and there is a genuine change in plans that results in a sale of the supply. The following supplies are likely to qualify for the above tax consequences for the reasons listed with each supply.

Supply	Reason for Sale
Feed	Drought forced sale of livestock
Seed	Weather conditions or market caused producer to not plant the crop
Pesticides	Weather conditions or market caused producer to not plant the crop
Fuel	Weather conditions or market caused producer to not plant the crop

Return of Supplies to Seller for a Credit

If the supplies are returned to the seller for a credit, the taxpayer must be careful to not trigger the deposit rule. If the supply is returned to the seller for a credit equal to the original amount paid, the original transaction could appear to be a deposit rather than a purchase. The taxpayer should document the negotiations that result in a credit for the taxpayer.

Example 3. Assume the same facts as in Example 2, and in addition assume that Patty sells the fertilizer back to Supply Cooperative and receives cash for the sale. These facts do not jeopardize Patty's argument that the original purchase was a purchase and not a deposit.

If Patty received a credit from Supply Cooperative that could only be used to purchase other supplies from the cooperative, the IRS could argue that her original payment was a deposit and not a purchase. However, since Patty negotiated a different price for the fertilizer, she can show that she faced the risk of a price change. Therefore, she is likely to prevail on her argument that the original payment was a purchase.

If Patty received a credit from Supply Cooperative that is exactly equal to her original purchase price, it is more difficult for her to show that her original payment was not a deposit. She should document her negotiations with Supply Cooperative so that she can prove that she faced the risk of a price change and that the credit was the same as the original purchase price only because the value of the fertilizer when she returned it was the same as the cost of the fertilizer when she purchased it.

ISSUE 6: PROMISSORY NOTE TO SUPPLIER

If a farm producer pays for a farm input by giving the supplier a promissory note, the producer cannot claim a current deduction for the inputs. If a farmer purchases seed and signs a promissory note with the seller, or purchases feed for cattle being fed in a commercial feedlot by signing a promissory note with the feed yard, the expense is deductible only when the notes are paid. (See Rev. Rul. 77-257, 1977-2 C.B. 174, and *Chapman v. United States*, 527 F. Supp. 1053, D. Minn. 1981.)

However, the actual payment of an expense with funds borrowed from a third party does give rise to a current deduction (Rev. Rul. 77-257). For example, if a farmer purchases inputs from a vendor with funds borrowed from a third-party lender, a current deduction is allowed. However, if a farmer purchases inputs financed by a **lending subsidiary of the vendor,** the IRS could argue that the promissory note to the lending subsidiary should be treated as a loan from the vendor, and therefore no deduction could be claimed until the note is paid. In Rev. Rul. 77-257, the IRS treated a promissory note to one branch of a partnership for services provided by another branch of the same partnership as a note to the entity that provided the services. Therefore, deductions could be claimed only when payments were made on the note.

Example 1. Cash Poor purchases seed costing $15,000 from Pilgrim Seed Company, paying with the proceeds of a loan obtained from Last Chance National Bank. Cash can deduct the seed expense in the year of payment (assuming he satisfies the requirements of I.R.C. §464 and Rev. Rul. 29-229).

Example 2. Cash Poor purchases seed costing $15,000 from Pilgrim Seed Company. He signs a promissory note directly with Pilgrim Seed Company for the $15,000 amount of the purchase. He makes no cash payment in the year of purchase. According to Rev. Rul. 77-257 and *Chapman*, Cash Poor will not be able to deduct the $15,000 cost of the seed until the note is paid in cash.

Example 3. Cash Poor purchases seed costing $15,000 from Pilgrim Seed Company. He signs a promissory note with Mayflower Finance Company, a lending subsidiary of Pilgrim Seed. He makes no payment on the note in the year of purchase. If Pilgrim were a partnership and Mayflower were a branch of that partnership, Cash Poor would not be allowed to deduct the cost of the seed in the year of the payment. He could claim a deduction in future years as payments are made on the promissory note.

Since Pilgrim is a corporation and Mayflower is a wholly owned subsidiary of Pilgrim, it is not clear whether Cash Poor can deduct the cost of the seed in the year of purchase. Cash Poor may be able to successfully distinguish these facts from Rev. Rul. 77-257 since Pilgrim and Mayflower are separate corporate entities. However, the IRS could argue that Pilgrim's ownership of Mayflower requires the note to Mayflower to be treated the same as a note to Pilgrim.

Practitioner Note. If Mayflower were not a subsidiary of Pilgrim, but the two corporations were owned by the same shareholders, the IRS could argue that a note to Mayflower should be treated the same as a note to Pilgrim, but that argument is not as likely to succeed as the IRS argument in the above example.

Acquisitions and Improvements of Depreciable Assets

In a recent district court case (*Owen v. United States*, 34 F. Supp. 2d 1071, W.D. Tenn. 1999), the question of when payment occurs for a cash basis taxpayer was addressed with regard to improvements to office condominiums paid with promissory notes. The court determined that the taxpayers could not increase their basis in the year of acquisition for debt obligations that were not paid until a later year. Basis could be increased only as payments were made on the notes.

It would appear that expenditures for building improvements or major equipment overhauls financed with a promissory note will not add to the tax basis of the property until the note is paid. Thus, no depreciation will be allowed until payment is actually made. If the funds are borrowed from a third party, as indicated earlier, basis will result, and depreciation deductions will be allowed (Rev. Rul. 77-257).

Because of the Supreme Court decision in *Commissioner v. Tufts* (461 U.S. 300, 1983), the above restriction does not apply to promissory notes issued in connection with **an initial purchase of an asset**. In *Tufts*, the court ruled that the taxpayer was permitted to include the amount of a loan in determining his basis in the financed property. Because of *Tufts,* farmers who finance purchases of farm equipment using dealer financing or manufacturer subsidiary financing are allowed to utilize the entire basis of the asset in determining depreciation deductions.

Transactions in Doubt

Based on Rev. Rul. 77-257 and *Owen,* it appears that the transactions in doubt with regard to producing immediate basis for depreciation deductions are transactions for additions or improvements to property *after* the initial acquisition.

ISSUE 7: GOVERNMENT PROGRAM PAYMENTS

GENERAL RULE

Generally, farm government program payments are treated as a replacement of farm income and therefore taxed the same as other farm income. Generally, that means the program payments are ordinary income for purposes of the income tax.

Example 1. Nina Christianson received a $3,000 production flexibility contract payment from the FSA in 2001. The FSA included the $3,000 on Form 1099-G for 2001. Nina must include the $3,000 in ordinary taxable income and self-employment income by reporting it on lines 6a and 6b of Schedule F (Form 1040).

CONSTRUCTIVE RECEIPT

Generally, payments must be included in income in the earlier of:

1. The year they are received, or
2. The year they are available for payment to the taxpayer [Rev. Rul. 68-44, 1968-1 C.B. 191]

Under this constructive receipt rule, taxpayers who have the option of receiving a government payment in the current year or waiting to receive it the following year must report it as income in the current year whether they receive it in the current year or the following year. However, there is an exception for farm production flexibility program payments made under the Federal Agricultural Improvement and Reform Act of 1996. Section 2012(a) of Tax and Trade Relief Extension Act of 1998 provides that the option to receive the production flexibility payment on December 15 or January 15 is disregarded in determining the tax year for which the payment is reported. Consequently, those payments are reported in the year they are actually received.

Example 2. Nina from Example 1 had the option of receiving one-half of her payment on December 15, 2000 or January 15, 2001. The other half will be received no later than September 30, 2001. Nina chose to receive the first half of her payment on January 15, 2001. Both halves are included in her 2001 income.

EXCEPTIONS TO THE GENERAL RULE

There are some exceptions to the general rule. If an exception applies, the payment should be reported on line 6a of Schedule F (Form 1040) but not on line 6b.

Payments That Do Not Replace Income

If a government payment does not replace ordinary income of the recipient, the payment does not have to be reported as ordinary income. For example, in Notice 87-26, 1987-1 C.B. 470, the IRS concluded that the portion of payments under the Dairy Termination Program that compensates the milk producer for the sale of cattle at a lower price is reported on Form 4797 rather than on Schedule F (Form 1040). Refunds of reductions in price received by eligible producers under the Dairy Refund Repayment Program are included in income only if the reduction that is refunded was claimed as an expense and gave the recipient a tax benefit in the prior year.

Disaster Payments

There are several income tax rules that allow preferential treatment of gains and losses realized as a result of weather conditions.

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

Generally, these rules apply when crops cannot be planted or are damaged or destroyed by natural disaster such as a drought or a flood. Under the statutory language, the exception applies to crop insurance proceeds; disaster payments received from the federal government under the Agricultural Act of 1949, as amended; and disaster payments received under the Disaster Assistance Act of 1988 [I.R.C. §451(d)]. Under the regulatory language, the provision applies to all federal payments received after December 31, 1973, for losses due to a natural disaster [Treas. Reg. §1.451-6(a)].

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

> **Observation.** Crop revenue insurance may provide payments to farmers if prices are below specified levels when there is little or no physical crop loss. These payments do **not** qualify for the exception.

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

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

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

Example 3. Daisy Petal normally sells her soybean and cotton crops in the year after they are produced. In 2001, her soybean and cotton crops were damaged by drought. She received a $5,000 disaster assistance payment from the government for the soybeans and $11,000 for the cotton in November 2001.

Question 3A. How is this transaction reported?

Answer 3A. Daisy can postpone reporting the $16,000 of income by attaching the following statement to her 2001 return. She then reports the $16,000 on line 8a of her 2001 Schedule F and excludes it from line 8b. She cannot postpone reporting the payment for one crop unless she postpones reporting the payment for both.

Election under I.R.C. §451(d) to
Postpone Recognition of Crop Insurance Proceeds
Daisy Petal 000–00–0001
Route 2, Box 2
Bitterweed, MS 38000

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

Crop Destroyed or Damaged	Cause	Date of Destruction or Damage	Payment Received	Date of Payment
Soybeans	Drought	7-10-01	$ 5,000	10-15-01
Cotton	Drought	7-10-01	$11,000	10-15-01

> **Observation.** Some farmers have deferred disaster payments from 2000 to be reported in 2001. Those payments should be reported on line 8d of the 2001 Schedule F (Form 1040).

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

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

Question 3B. Assume the facts are the same as Example 3, except that Daisy normally sells her soybeans at harvest time. How are the insurance payments reported?

Answer 3B. **Likely tax consequence.** Rev. Rul. 74-145 seems to say that the insurance payments received for the cotton and soybeans must be treated the same and would be eligible for the I.R.C. §451(d) election only if the sales from both crops that are normally postponed are more than 50% of the total.

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

Example 4. In 2000, Clay Fields receives $8,000 of crop insurance proceeds due to hail damage on his wheat crop and also receives $14,000 of disaster payments as a result of drought damage to his corn crop.

Question 4A. Can Clay elect to include in income the crop insurance proceeds for his wheat and defer the disaster payment for his corn, since one payment is crop insurance and the other payment is a disaster payment?

Answer 4A. No, both crop insurance proceeds and disaster payments must be aggregated in determining whether to defer the income reporting or to include the payment in current year income. Crop disaster payments are specifically identified as equivalent to crop insurance proceeds, and thus both types of payments are to be reported in a consistent manner. Therefore Clay must decide between reporting the entire amount of payments ($8,000 + $14,000) in 2000 or deferring both payments to 2001, assuming he meets the requirement of normally selling more than 50% of his crops in the following year.

Question 4B. Assume that Clay Fields, the taxpayer in Example 4, had received the $8,000 of crop insurance proceeds for the wheat loss in his sole proprietorship grain farm and had received the

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

Answer 4B. Yes, the two separate farming operations in which Clay participates do not have to make the same election. If a taxpayer has more than one farming business, he or she makes a separate election for each such business. Separate farming businesses are those for which the taxpayer keeps separate books and is allowed to use different methods of accounting.

Cost-Sharing Payments

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

1. The cost-sharing payment must be for capital expenditures. If the payment is for an expense that can be deducted in the current year, such as a soil and water conservation expense, the payment must be reported as income. While the deduction will offset the income for purposes of net Schedule F (Form 1040) income, inclusion of the payment will increase gross income from farming for purposes of the two-thirds test for a taxpayer to qualify as a farmer for purposes of the estimated tax payments. If the payment is a rental payment to the farmer rather than a reimbursement for a capital expenditure, the payment cannot be excluded under this exception.
2. The payment must not substantially increase the taxpayer's gross receipts from the property that was improved. An increase in gross receipts is substantial if it exceeds the greater of:
   - **a.** 10% of the average annual gross receipts derived from the property for the three years prior to the improvement, or
   - **b.** An amount equal to $2.50 times the number of affected acres
3. The Secretary of Agriculture must certify that the payment was made primarily for conserving soil and water resources, protecting or restoring the environment, improving forests, or providing a habitat for wildlife.

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

- The water bank program authorized by the Water Bank Act
- The rural abandoned mine program authorized by the Surface Mining Control and Reclamation Act of 1977
- The emergency conservation measures program authorized by Title IV of the Agricultural Credit Act of 1978
- The agricultural conservation program authorized by the Soil Conservation and Domestic Allotment Act
- The Great Plains conservation program authorized by §16 of the Soil Conservation and Domestic Policy Act, except for payments for practices GPB17 and GPB28
- The forestry incentives program authorized by §4 of the Cooperative Forestry Assistance Act of 1978
- The watershed protection and flood prevention program, a small-watershed program authorized by the Watershed Protection and Flood Prevention Act
- The experimental rural clean water program, a small-watershed program, authorized by the Agriculture, Rural Development, and Related Agencies Appropriations Acts for fiscal years

1980 and 1981, for payments made for approved conservation practices after February 20, 1980, to projects that qualify as a small watershed (a small watershed is a watershed or subwatershed that does not exceed 250,000 acres and does not include any single structure providing more than 12,500 acre-feet of floodwater detention or more than 25,000 acre-feet of total capacity)

- Wetlands Reserve program, authorized by Title XII of the Food Security Act of 1985 and reauthorized by the Federal Agriculture Improvement and Reform Act of 1996 (the 1996 Farm Act)
- Environmental Quality Incentives Program (EQIP), authorized by the 1996 Farm Act
- Wildlife Habitat Incentives Program (WHIP), authorized by the 1996 Farm Act

Several state programs have been approved by the Secretary of Agriculture.

Calculating the Income Exclusion. Under I.R.C. §126, the amount included in income is the value of the §126 improvement reduced by the taxpayer's share of the cost of the improvement and reduced by the excludable portion.

The value of the I.R.C. §126 improvement is the fair market value of the improvement multiplied by the following fraction:

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

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

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

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

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

Gain in excess of the excluded payment is treated as capital gain.

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

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

Example 5. Oscar Paterson spent $40,000 to build a soil conservation project on his 80-acre farm. The project increased the value of Oscar's property by $30,000 and was worth $10,000 to landowners downstream. His state government paid him $16,000 under a cost-sharing program. Oscar had average annual gross receipts of $36,000 for the past three years from his farm. The Secretary of Agriculture certifies that 100% of the $16,000 cost-share payment was primarily for the purpose of protecting the environment. How much of the cost-sharing payment can Oscar exclude from income under §126?

Following the formula in Temp. Reg. §16A.126-1(g), Oscar first calculates the "value of the §126 improvement" by multiplying the "value of the improvement" ($30,000) by the "§126 cost" ($40,000) and dividing by the cost of the improvement ($40,000).

Therefore, the "value of the §126 improvement" is $30,000.

From that amount Oscar subtracts the "excludable portion and his $24,000 share of the cost of the improvement.

The "excludable portion" is the present fair market value of the greater of:

1. $3,600 (10% of $36,000), or
2. $200 ($2.50 × 80 acres).

Therefore, Oscar must calculate the present fair market value of $3,600. To do that, he divides $3,600 by his opportunity cost of capital, which he estimates to be 8%. Therefore, his excludable portion is $45,000 ($3,600/.08).

The formula is applied as follows:

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

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

If Oscar's income from the farm had been $2,000 or less, he could have used the $2.50 per acre amount to determine the excludable portion. The present fair market value of $200 at 8% interest is $2,500. Therefore, Oscar would have to report $3,500 of income.

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

CCC MARKETING LOANS AND LOAN DEFICIENCY PAYMENTS

Producers continue to use Commodity Credit Corporation (CCC) loans and loan deficiency payments (LDPs) to increase the amount they receive for their crops and to affect the timing of their income. As market prices for commodities fall below the marketing assistance loan rates offered by the CCC, producers can realize more income by taking advantage of one or more of the government options. Those options and the income tax consequences are as follows.

CCC Nonrecourse Marketing Assistance Loan

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

Producers who have made the I.R.C. §77 election in the current year or any previous year must report the loan as income.

Example 6. Red Durham pledged 10,000 bushels of his 2001 wheat harvest as collateral for a $25,000 CCC loan at the rate of $2.50 per bushel. If Red has made the I.R.C. §77 election to treat CCC loans as income in 2001 or any previous year, Red must report the $25,000 as income on line 7a of his 2001 Schedule F (Form 1040).

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

Example 7. If Red from the previous example has not made the I.R.C. §77 election to treat CCC loans as income, the $25,000 loan is treated the same as any other loan—it is not income in the year it is received.

If Market Prices Rise Above the Loan Rate. If market prices rise above the loan rate, producers will choose to repay the loan, with interest, and then sell the commodity for more than the loan. If the I.R.C. §77 election has been made, the producer has a basis in the commodity equal to the amount of the loan. That basis is subtracted from the sale price to determine the gain or loss on sale.

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

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

Example 8. If Red makes the I.R.C. §77 election for the loan on his 2001 wheat crop, repays the loan (including $1,000 of interest), and sells the wheat for $30,000 in 2001, he must report as shown on the following 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
2001
Attachment Sequence No. 14

Name of proprietor: *Red Durham (Example 8)*
Social security number (SSN): *001 77 1040*

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

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

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

D Employer ID number (EIN), if any

E Did you "materially participate" in the operation of this business during 2000? If "No," see page F-2 for limit on passive losses. ☐ Yes ☐ No

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

1	Sales of livestock and other items you bought for resale	1	*30,000*		
2	Cost or other basis of livestock and other items reported on line 1	2	*25,000*		
3	Subtract line 2 from line 1			3	*5,000*
4	Sales of livestock, produce, grains, and other products you raised			4	
5a	Total cooperative distributions (Form(s) 1099-PATR)	5a		5b Taxable amount 5b	
6a	Agricultural program payments (see page F-2)	6a		6b Taxable amount 6b	
7	Commodity Credit Corporation (CCC) loans (see page F-3):				
a	CCC loans reported under election			7a	*25,000*
b	CCC loans forfeited	7b		7c Taxable amount 7c	

22	Insurance (other than health)	22		b		34b	
23	Interest:			c		34c	
a	Mortgage (paid to banks, etc.)	23a		d		34d	
b	Other	23b	*1,000*	e		34e	
24	Labor hired (less employment credits)	24		f		34f	

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

Example 9. If Red does not make the I.R.C. §77 election, repays the loan (including $1,000 of interest), and sells the wheat for $30,000 in 2001, he must report the $30,000 on line 4 and $1,000 on line 23b of his 2001 Schedule F (Form 1040).

If Market Prices Do Not Rise Above the Loan Rate. If market prices do not rise above the loan rate, producers will choose to redeem the commodity by paying the posted county price (PCP) to the CCC. By making that payment, the producer is no longer obligated on the loan and can keep the difference between the loan rate and the PCP.

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

Practitioner Note. If the commodity is not sold until 2002, the producer does not have to report the sale until 2002 and will simply have the commodity on hand at the end of the year with a basis equal to the loan amount (if the §77 election has been made) or zero (if the §77 election has not been made).

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

Example 10. If Red Durham makes the I.R.C. §77 election on his $25,000 loan, redeems the commodity by paying $22,000 to the CCC when the PCP is $2.20 per bushel, and sells the wheat for $23,000, he will receive a Form CCC-1099-G for $3,000 from the CCC, and he must report the following on his 2001 Schedule F (Form 1040):

Line 1	23,000	
Line 2	22,000	
Line 3		1,000
Line 6a & b	3,000	
Line 7a		25,000

A producer who redeems the commodity by paying the PCP will receive a Form CCC-1099-G from the CCC for the difference between the loan rate and the PCP. That amount must be reported on line 6a of the producer's 2001 Schedule F (Form 1040). If the producer has not made the §77 election, the difference between the loan rate and the PCP is reported on line 6b of Schedule F (Form 1040), since the loan has not been reported on line 7a. The producer has a zero basis in the commodity.

Example 11. If Red Durham does not make the I.R.C. §77 election, redeems the commodity by paying $22,000 to the CCC when the PCP is $2.20 per bushel, and sells the wheat for $23,000, he will receive a Form CCC-1099-G for $3,000 from the CCC, and he must report the following on Schedule F (Form 1040):

Line 4		23,000
Line 6a & b	3,000	3,000

Observation. Although the reporting procedure differs, the amount received for the crop and the total taxable income is exactly the same in Examples 10 and 11. When income is reported will depend on specific situations.

Loan Deficiency Payment

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

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

Example 12. Red claimed his LDP when the loan rate was $2.50 per bushel and the PCP was $2.20 per bushel instead of taking out a CCC loan. He received a $3,000 LDP from the CCC and a Form CCC-1099-G reporting that $3,000. Red sold his wheat for $23,000. Red must report the following on his 2001 Schedule F (Form 1040):

Line 4		23,000
Line 6a & b	3,000	3,000

MARKETING LOAN GAIN

Characteristics of Marketing Loans

Marketing loans allow repayment of the nine-month nonrecourse price support loan at less than the loan rate plus accrued interest charges and service fees. Commodities that are eligible for marketing loans include cotton, wheat, feed grains, rice, and oilseeds. The marketing loan gains for all commodities are subject to a $150,000 per person payment limitation. This payment limitation is separate from the $40,000 per person limitation for market transition payments.

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

IRS Guidance

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

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

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

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

Example 13. Bud Bolls, a cash-method, calendar-year farmer, has deducted all of the expenses incurred in producing an eligible commodity and has a zero basis. In 2000, Bud pledges 1,000 pounds of the commodity as collateral for a $500 CCC price support loan at 50¢ per pound. Bud redeems the commodity in 2001 by paying the then-prevailing world market price of 42¢ per pound, or $420. Later in 2001, Bud sells the commodity for 60¢ per pound.

As a result of the redemption of the commodity, Bud receives a Form CCC-1099-G from the CCC showing a marketing gain in 2001 of $80. This is calculated as the difference between the original loan rate (50¢ per pound) and the subsequent repayment rate (42¢ per pound) multiplied by the pounds of the commodity redeemed (8¢ × 1,000). The proper reporting of the $80 marketing gain on Bud's 2001 return, however, depends on whether Bud has made the I.R.C. §77 election.

If the I.R.C. §77 election has been made. Bud recognized income of $500 in 2000 (line 7a, Part I, Schedule F). The commodity is repurchased by Bud for $420 when redeemed by repayment of the CCC loan, but no gain or loss is recognized. Subsequently, Bud has income of $180 in 2001 attributable to the sale of the commodity ($600 sale price less $420 basis). Since Bud has already included the $500 CCC loan in 2000 income, the inclusion in income of the $80 marketing gain shown on the 2001 Form CCC-1099-G would overstate Bud's income by $80. Therefore, for 2001, Bud should report the $80 marketing gain as an agricultural program payment on line 6a of Part I of Schedule F, but should not report the $80 marketing gain as a taxable amount on line 6b of Part I of Schedule F. Exhibit 1 compares Bud's document reporting trail, cash received, and taxable income.

Without the §77 election. Bud has $80 of marketing gain income in 2001, and the sale of the commodity generates additional income of $600 (sale price less zero basis). Bud should report as income in 2001 both the $600 attributable to the sale and the $80 marketing gain. The $80 marketing gain should be reported on both lines 6a and 6b of Part I of Schedule F. Exhibit 2 summarizes the transaction.

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

Exhibit 1. Farmer with §77 Election Redeems Commodity

Transaction	Document Reporting Trail	Cash Rec'd by Farmer	Farmer's Taxable Income	Schedule F Year	Schedule F Lines
Receipt of loan proceeds	$ 500	$ 500	$ 500	2000	7a
Cash redemption of commodity	(420)	(420)			
Marketing gain reported on CCC-1099-G	80	0	0	2001	6a
Sale of commodity	600	680	180	2001	1–3
Totals	$ 760	$ 680	$ 680		

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

Exhibit 2. Farmer without §77 Election Redeems Commodity

Transaction	Document Reporting Trail	Cash Rec'd by Farmer	Farmer's Taxable Income	Schedule F Year	Schedule F Lines
Receipt of loan proceeds	$ 500	$ 500	0	No	
Cash redemption of commodity	(420)	(420)			
Marketing gain reported on CCC-1099-G	80	0	80	2001	6a, 6b
Sale of commodity	600	600	600	2001	4
Totals	$ 760	$ 680	$680		

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

Example 14. The facts are the same as in the preceding example, except that later in 2000 a merchant pays Bud 5¢ per pound for the option to purchase the 1,000 pounds of the commodity. The merchant also gets a power of attorney with authority to repay the loan on the farmer's behalf. In 2001, the merchant exercises the option, repaying the loan at 42¢ per pound and redeeming Bud's commodity. Bud will receive a Form CCC-1099-G for 2001 from the CCC showing marketing gain of $80. Again, the proper reporting of the marketing gain depends on whether Bud has made an I.R.C. §77 election.

With the §77 election. In 2000 Bud has income of $500 from the CCC loan and also has $50 of income from the option. The $50 of income from the option is reported on line 10 (Other income) of Schedule F. Bud is treated as having repurchased the commodity for 42¢ per pound when the merchant repays the CCC loan, and recognizes no income. Since Bud has already included the $500 CCC loan in income, the $80 marketing gain shown on the 2001 Form CCC-1099-G would overstate Bud's income, as shown in Exhibit 3. Therefore, for 2000, Bud should report the $500 CCC loan on line 7a of Part I of Schedule F. For 2001, Bud should report the $80 marketing gain as a agricultural program payment on line 6a of Part I of Schedule F, but should not report the $80 marketing gain as a taxable amount on line 6b of Part I of Schedule F.

If the §77 election is not in effect. The commodity is not treated as sold when it is pledged as collateral for the CCC loan. Bud still has $50 of income from the option in 2000. The sale of the commodity to the merchant in 2001 generates income of $420 (sale price less zero basis) to Bud. As shown in Exhibit 4, Bud should report the $50 attributable to the option as income in 2000. The $420 from the sale of the commodity and the $80 marketing gain shown on Form CCC-1099-G are income in 2001. The $80 marketing gain should be reported on both lines 6a and 6b of Part I of Schedule F.

Exhibit 3. Farmer *with* §77 Election Sells Option

Transaction	Document Reporting Trail	Cash Rec'd by Farmer	Farmer's Taxable Income	Schedule F Year	Schedule F Lines
Receipt of loan proceeds	$500	$500	$500	2000	7a
Sale of equity	50	50	50	2000	10
Payment of CCC loan by merchant	0	0	0	No[1]	
Marketing gain reported on CCC-1099-G	80[2]	0	0	2001	6a
Totals	$630	$550	$550		

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

Exhibit 4. Farmer *without* §77 Election Sells Option

Transaction	Document Reporting Trail	Cash Rec'd by Farmer	Farmer's Taxable Income	Schedule F Year	Schedule F Lines
Receipt of loan proceeds	$500	$500	$ 0	No	
Sale of equity	50	50	50	2000	10
Payment of CCC loan by merchant	0	0	420[1]	2001	4
Marketing gain reported on CCC-1099-G	80	0	80[2]	2001	6a, 6b
Totals	$630	$550	$550		

[1]Treated as redemption by farmer for $420 and sale to merchant for $420 (basis of zero).
[2]$500 CCC loan proceeds received less $420 repayment = $80.

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

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

If the farmer makes the I.R.C. §77 election, the marketing gain will not be taxable regardless of whether the farmer redeems and sells the commodity or sells the equity and allows the merchant to redeem the commodity. **If there is no election, however, the marketing gain will be a taxable receipt.** Such treatment does not create a problem if the farmer redeems and sells the commodity, but can lead to transaction tracing and reporting problems if the farmer sells the equity and the merchant redeems the commodity.

SELF-EMPLOYMENT TAXES

If government program payments are included in ordinary income for purposes of income taxes, they will also be included in self-employment income for purposes of the self-employment tax if the recipient of the payments materially participates in a farming business.

In its early rulings on self-employment taxation of government program payments, the IRS included payments in self-employment income if the recipient was materially participating in a farm business at the time the payments were received. For example, in Rev. Rul. 60-32, 1960-1 C.B. 23, the IRS concluded that payments and cost-sharing benefits attributable to the acreage reserve program of the Soil Bank Act, Title I of the Agricultural Act of 1956, 7 U.S.C. 1801, are included in self-employment income if the recipient materially participates in the farming business but are not included in self-employment income if the recipient does not materially participate. In Rev. Rul. 65-149, 1965-1 C.B. 434, the IRS held that grain storage fees received from the government are included in self-employment income if the recipient materially participates but are not included in self-employment income if the recipient does not materially participate.

The IRS made a subtle, but significant, change in language used in earlier rulings when it issued Notice 87-26, 1987-1 C.B. 470. In that notice, the IRS for first time used the past tense in describing the taxpayer's activities that determine whether payments are included in self-employment income. In Notice 87-26 the IRS held that Dairy Termination Program payments are included in self-employment income "if the milk producer *operated* the milk production unit . . . or if the milk production unit was *operated* by others and the milk producer *participated* materially in the production of the milk or in the management of the milk production unit." (Emphasis added.) The change is significant because it shifts the application of the material participation test from the year the payment is received to the year the recipient enters the program. That shift means that a taxpayer who is materially participating when he or she begins a government program must include the payments in self-employment income even if he or she retires from farming while still receiving the payments.

Example 15. Tom Gould actively farmed his 400 acres of farmland in Ohio from 1965 through 1998. In 1999, he put half of his land into the Conservation Reserve Program and he continued to farm the other half. In 2001, he retired from farming and cash rented his land that is not in the CRP program to his neighbor. If Tom's material participation at the time he entered the program determines the self-employment tax consequences of his CRP payments, then they are all included in self-employment income. If his material participation at the time of receiving the payments determines the self-employment tax consequences of his CRP payments, then his payments in 1999 and 2000 are included in self-employment income, and his payments in 2001 and thereafter are not included in self-employment income.

Conclusion. The shift in language in Notice 87-26, may affect only Dairy Termination Program payments and not payments from other government programs. However, even if the IRS does apply that reasoning to other government payments, it will affect only taxpayers who are materially participating at the time they enter the government program and are not materially participating at the time they receive the payment.

DIRECT PAYMENTS TO TOBACCO PRODUCERS AND TOBACCO QUOTA HOLDERS

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 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 determination as to how these payments are to be reported depending on his/her activity relative to the payments.

Phase 2 Tobacco Payments

Example 16. Sunnie Fields grows and sells tobacco. Sunnie has received $32,500 of Phase 2 payments in January 2001 for the 2000 payment year. Attached to this payment is a 2001 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.		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
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*

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

Example 17. Resting Fields owns a 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 2001 for the 2000 payment year for the quota he holds. Attached to this payment is a 2001 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 6, Other income, of Form 4835.

Form **4835** | **Farm Rental Income and Expenses** | OMB No. 1545-0187
(Crop and Livestock Shares (Not Cash) Received by Landowner (or Sub-Lessor))
(Income not subject to self-employment tax)
Department of the Treasury Internal Revenue Service (99) | ► Attach to Form 1040. ► See instructions on back. | 2000 Attachment Sequence No. 37

5	Crop insurance proceeds and certain disaster payments. See instructions:		
a	Amount received in 2001 . . . . **5a** | **5b** Taxable amount	**5b**	
c	If election to defer to 2002 is attached, check here ► ☐ **5d** Amount deferred from 2000 .	**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 from a tobacco quota with no material participation is not subject to SE tax.

Replacement of Income. 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 15 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, 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 compensation for disposition of a quota and are not eligible for capital gain or loss treatment.

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 Phase 2 payments discussed above.

Market Loss Assistance Payments

Beginning in October 1999, Congress has periodically allocated additional financial relief to farmers. Part of the relief package was in the form of Market Loss Assistance Payments (MLAPs). 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.

These payments do not qualify for deferral because they were not for a loss from a natural disaster such as a drought or a flood. MLAPs do not qualify for income deferral to the year after they were received under Treas. Reg. §1.451-6(a)(1).

Tobacco producers and quota holders receiving MLAPs report the amount received on line 6a and 6b of Schedule F (Form 1040). The amount of the MLAP will be included on the Form 1099-G issued by FSA.

ISSUE 8: CONSERVATION PROGRAMS

INCOME TAX ISSUES

Conservation programs provide payments to producers and/or landowners and often require the producer and/or landowner to pay some expenses. The income and expenses associated with these programs potentially raise three different income tax issues.

Deductible Business Expense

The expenses are deductible as ordinary and necessary business expenses if they are incurred in the course of a trade or business and the expense is not for an asset that has a useful life of more than one year.

Soil and Water Conservation Expenses

The expenses may be deductible as soil and water conservation expenses under I.R.C. §175. Expenses that are deductible without regard to I.R.C. §175 and expenses that are for improvements that can be depreciated cannot be claimed as a deduction under I.R.C. §175. The expenses must be consistent with a plan approved by the Natural Resources Conservation Service (NRCS) of the Department of Agriculture or a soil conservation plan of a comparable state agency.

Deductible conservation expenses are those made for land that the owner or the owner's tenant are using, or have used in the past, for farming. They include, but are not limited to

1. The treatment or movement of earth, such as leveling, conditioning, grading, terracing, contour furrowing, or restoration of fertility
2. The construction, control, and protection of diversion channels, drainage ditches, irrigation ditches, earthen dams, watercourses, outlets, and ponds
3. The eradication of brush
4. The planting of windbreaks [I.R.C. §175(c)(1) and Treas. Reg. §1.175-2(a)(1)]

Limit. The current year deduction cannot be more than 25% of gross income from farming. If the total of these expenses is more than 25% of gross income from farming, the qualified taxpayer may deduct the excess in later years, again subject to the 25% of gross income from farming limitation [I.R.C. §175(b)].

Recapture. A taxpayer who claims a soil and water conservation expense deduction under I.R.C. §175 is subject to a recapture provision under I.R.C. §1252. The recapture provision applies if the land on which the conservation improvement was installed is sold within 10 years of the date the land was purchased (not the date the improvement was installed). The recapture provision requires the taxpayer to report gain from the sale of the land as ordinary income to the extent of the I.R.C. §175 exclusion. The recapture amount is reduced by 20% of the amount excluded for each year the land is held more than 5 years.

Exclusion of Cost-Sharing Payments

Cost-sharing payments are eligible to be excluded from income under I.R.C. §126 if they meet the following three tests and are payments from an authorized list of programs:

1. The cost-sharing payment must be for capital expenditures.
2. The improvement for which the payment was received must not substantially increase the taxpayer's gross receipts from the property that was improved.
3. The Secretary of Agriculture must certify that the payment was made primarily for conserving soil and water resources, protecting or restoring the environment, improving forests, or providing a habitat for wildlife.

Exclusion Amount. The amount that can excluded is the present value of the greater of:

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

> **Practitioner Note.** No deduction or credit is allowed for any expense that is associated with any amount excluded from gross income under I.R.C. §126 [I.R.C. §126(d)].

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

See Issue 7: Government Program Payments in this chapter for more information on the income tax treatment of cost sharing payments.

CONSERVATION PROGRAMS

Environmental Quality Incentives Program (EQIP)

The Environmental Quality Incentives Program (EQIP) was established in the 1996 Farm Bill to provide a voluntary conservation program for farmers and ranchers whose land faced serious threats to soil, water, and related natural resources. Nationally, the program provides technical, financial, and educational assistance, primarily in designated priority areas—half of it targeted to livestock-related natural resource concerns and the remainder to other significant conservation priorities.

Four of the USDA's former conservation programs were combined in EQIP: the Agricultural Conservation Program, Water Quality Incentives Program, Great Plains Conservation Program, and Colorado River Basin Salinity Control Program.

EQIP offers financial, educational, and technical help to install or implement structural, vegetative, and management practices called for in 5- to 10-year contracts for most agricultural land uses.

EQIP Cost-Sharing Payments vs. Incentive Payments. Cost sharing may pay up to 75% of the costs of certain conservation practices, such as grassed waterways, filter strips, manure management facilities, capping abandoned wells, and other practices important to improving and maintaining the health of natural resources in the area. Incentive payments may be made to encourage a producer to perform land management practices such as nutrient management, manure management, integrated pest management, irrigation water management, and wildlife habitat management. These payments may be provided for up to three years to encourage producers to carry out management practices they may not otherwise use without the program incentive.

Income Tax Consequences. EQIP is an eligible program under I.R.C. §126. Therefore, cost-sharing payments that meet the three tests for the I.R.C. §126 exclusion can be excluded under that provision. However, incentive payments that are made to encourage ongoing maintenance practices are not eligible for exclusion, since such payments are for an expense that is allowed as a deduction in the current year.

Example 1. Wise Tiller, a farmer, receives the following payments from the EQIP program in 2001:

Cost-sharing payment for establishing waterways and terraces	$ 6,000
Incentive payment for nutrient management	1,600
Total payment	$ 7,600

The cost-sharing payment of $6,000 is not eligible for the I.R.C. §126 exclusion since it qualifies for the I.R.C. §175 deduction. Similarly, the incentive payment of $1,600 is for an expense that can be currently deducted, and is not eligible for exclusion. The deductions will offset the income that must be reported.

Conservation Reserve Program (CRP)

The Conservation Reserve Program (CRP) reduces soil erosion, protects the nation's ability to produce food and fiber, reduces sedimentation in streams and lakes, improves water quality, establishes wildlife habitat, and enhances forest and wetland resources. It encourages farmers to convert highly erodible cropland or other environmentally sensitive acreage to vegetative cover, such as tame or native grasses, wildlife plantings, trees, filterstrips, or riparian buffers. Farmers receive annual rental payment for the term of the multi-year contract. Cost sharing is provided to establish the vegetative cover practices.

Income Tax Consequences. The annual rental payments and the cost-sharing payments must be reported as ordinary income. The cost-sharing payments do not qualify for the I.R.C. §126 exclusion because the CRP is not an eligible program under I.R.C. §126. However, in most cases, the income from the cost-sharing payment will be offset by a deduction for the expense for which the cost-sharing payment was made. Expenses that are not otherwise deductible and are not for an asset that is depreciable qualify for the I.R.C. §175 deduction if the expenditure is consistent with an approved conservation plan.

Practitioner Note. See Issue 2 above for a discussion of self-employment taxes on CRP payments.

Example 2. Clarice Covercrop owns 40 acres of land that she rented to a farm operator until she put it in the CRP in 1999. She paid $600 in 1999 to establish a cover crop and received a $300 payment for 50% of that cost from the CRP program. She receives $1,200 per year in rental payments from the CRP. Clarice incurs the following expenses annually:

Mowing the cover crop	$200
Property taxes	320
Property insurance	150
Total	$ 870

On her 1999 tax return, Clarice properly reported the $300 cost-sharing payment and the $1,200 rental payment as ordinary income, and her $600 cost of seed and $870 of annual expenses as deductions on Schedule E (Form 1040). After 1999, she must report her $1,200 annual rent and $870 of annual expenses on Schedule E (Form 1040).

Conservation Reserve Program (CRP) Continuous Signup Enhancements

Participation rates for certain practices in the CRP program have fallen short of USDA goals. Consequently, beginning May 1, 2000, producers have been allowed to make offers at their local USDA Service Center for a continuous signup for CRP contracts for the following targeted practices:

- Filter strips
- Riparian buffers
- Grassed waterways
- Field windbreaks
- Shelter belts
- Living snow fences

To encourage participation in these practices, the following signup enhancements were added to the program for participants who agree to implement one or more of the above practices:

1. An up-front CRP signing incentive payment (CRP-SIP) of $100 per acre for 10-year contracts and $150 per acre for 15-year contracts for eligible participants who enroll in selected practices
2. A practice incentive payment (PIP) equal to 40% of the eligible installation costs
3. Higher rental rates for marginal pastureland to better reflect the value of such lands to farmers and ranchers

Practitioner Note. The above enhancements are in addition to the 50% cost-sharing payments and annual rental payments under the CRP program. They are not retroactive for CRP contracts that were in place before the enhancements were available.

Income Tax Consequences. The CRP-SIPs and PIPs must be reported as ordinary income. They do not qualify for the I.R.C. §126 exclusion. Expenses for conservation measures that are consistent with an approved conservation plan qualify for the I.R.C. §175 exclusion.

Example 3. Calvin Cattle owns 300 acres of land that he uses in a beef cow-calf operation. In 2001, Calvin put 70 acres of his pastureland in the CRP continuous signup program under a 10-year contract. He agreed to establish and maintain riparian buffers along a stream running through his property. The improvements are consistent with a conservation plan approved by the NRCS. He incurred the following expenses:

Site preparation	$2,800
Shrubs and tree planting	3,500
Fencing (to restrict livestock access)	1,500
Property taxes	500
Insurance	150
Total	$8,450

Under the CRP contract, he received the following:

50% cost-sharing	$ 3,900
PIP (40% of $7,800)	3,120
CRP-SIP (70 acres × $100)	7,000
Annual rental payments	2,520
Total	$16,540

Calvin cannot exclude any of the cost-sharing payments under I.R.C. §126. Therefore, he must report the full $16,540 of payments that he received as ordinary income. The $2,800 for site preparation and the $3,500 for planting trees and shrubs are eligible for the I.R.C. §175 deduction, subject to the 25% of gross income from farming limitation. The $1,500 cost of the fence can be deducted under I.R.C. §179 or it can be depreciated as 7-year recovery property. Calvin can deduct the property taxes and insurance on his Schedule F (Form 1040).

Practitioner Note. If Calvin was a cash rent landowner instead of a farmer, he would not be allowed to claim the I.R.C. §175 deduction or the I.R.C. §179 deduction.

Conservation Reserve Enhancement Program (CREP)

The Conservation Reserve Enhancement Program (CREP) provides a flexible and cost-effective means to address agricultural resource problems by targeting federal and state resources to specific geographic regions of particular environmental sensitivity over a 10- to 15-year period for the Conservation Reserve Program.

The primary CREP objectives are: (1) to create an opportunity where the resources of a state government and the CRP can be targeted in a coordinated manner to address specific conservation and environmental objectives of that state and the nation; and (2) to improve water quality, erosion control, and wildlife habitat in specific geographic areas that have been adversely impacted by agricultural activities, with emphasis on addressing non–point source water pollution and habitat restoration in a cost-effective manner.

In addition to the cost-sharing payments, incentive payments, and annual rental payments discussed above under the CRP, CREP payments can include a payment for temporary or permanent easements.

Income Tax Consequences. The cost-sharing payments, incentive payments and annual rental payments are treated the same as those payments received under the CRP. A payment for a permanent conservation easement will result in the same income tax treatment as the purchase of a utility easement. (See Issue 9 later in this chapter.) The payment is treated first as a return of basis and to the extent it exceeds the basis in the land, it is gain that qualifies as long-term capital gain if the land has been held for more than a year. A payment for a temporary easement that lasts 30 years or more is arguably treated the same as a permanent easement. A payment for an easement that lasts less than 30 years is likely to be treated as ordinary income.

Wetlands Reserve Program (WRP)

The Wetlands Reserve Program is a voluntary program to restore wetlands. Participating landowners can establish conservation easements of either permanent or 30-year duration or can enter into restoration cost-share agreements where no easement is involved. In exchange for establishing a permanent easement, the landowner receives payment up to the agricultural value of the land and 100% of the restoration costs for restoring the wetland. The 30-year easement payment is 75% of what would be provided for a permanent easement on the same site and 75% of the restoration cost. The voluntary agreements are for a minimum 10-year duration and provide for 75% of the cost of restoring the involved wetlands. Easements set limits on how the lands may be used in the future. Restoration cost-share agreements establish wetland protection and restoration as the primary land use for the duration of the agreement. In all instances, landowners continue to control access to their land.

Income Tax Consequences. A WRP payment for a permanent conservation easement will result in the same income tax treatment as a payment for a permanent easement under the CREP program discussed above. Cost-sharing payments under the WRP are eligible for the I.R.C. §126 exclusion.

Emergency Conservation Program (ECP)

The Emergency Conservation Program (ECP) provides financial assistance to farmers and ranchers for the restoration of farmlands on which normal farming operations have been impeded by natural disasters. ECP also helps with funds for carrying out emergency water conservation measures during periods of severe drought. Emergency conservation assistance is available for removing debris and restoring permanent fences, terraces, diversions, irrigation systems, and other conservation installations. Conservation problems that existed before a disaster are not eligible.

Income Tax Consequences. The ECP is an eligible program under I.R.C. §126. Therefore, cost-sharing payments under the ECP that are paid for permanent improvements are eligible for the I.R.C. §126 exclusion. Expenses for permanent improvements that are not depreciable are eligible for the I.R.C. §175 deduction to the extent they are not compensated by cost-sharing payments that are excluded under I.R.C. §126. Payments for the cost of removing debris are not eligible for the I.R.C. §126 exclusion since the cost of removing debris is a deductible expense. The deduction offsets the income that must be reported.

Emergency Watershed Protection Program (EWP)

The Emergency Watershed Protection (EWP) program is designed to reduce threats to life and property in the wake of natural disasters. It provides technical and cost-sharing assistance. Assistance includes establishing vegetative cover; gully control; installing streambank protection devices; removing debris and sediment; and stabilizing levees, channels and gullies. In subsequent storms, EWP projects protect homes, businesses, highways, and public facilities from further damage. Floodplain easements under EWP may be purchased to help prevent future losses due to natural disasters.

Income Tax Consequences. The WRP is also an eligible program under I.R.C. §126. Therefore, the tax consequences are the same as for the Emergency Conservation Program discussed above.

Small Watershed Program

The Small Watershed Program works through local government sponsors and helps participants solve natural resource and related economic problems on a specific watershed. Project purposes include watershed protection, flood prevention, erosion and sediment control, water supply, water quality, fish and wildlife habitat enhancement, wetlands creation and restoration, and public recreation in watersheds of 250,000 or fewer acres. Both technical and financial assistance are available.

Income Tax Consequences. The Small Watershed Program is an eligible program under I.R.C. §126 with respect to assistance from the federal government. Several state and local programs are also eligible programs. For information about the status of state programs, contact the state offices of the Farm Service Agency (FSA) and the Natural Resources Conservation Service (NRCS).

Expenditures for practices that protect farmland and that are consistent with an approved conservation plan qualify for the I.R.C. §175 deduction if the expenditure is not currently deductible, is not for an asset that is depreciable, and was not compensated by a cost-sharing payment that was excluded under I.R.C. §126.

Example 4. Wally Watershed received a $10,000 cost-sharing payment from the Small Watershed Program to help pay the cost of $25,000 of soil erosion improvements he installed on his farmland. The improvements are consistent with a conservation plan approved by the NRCS. Wally had $10,000 of average gross income from the 100 affected acres in the previous three years. The "value of the §126 improvement" is $20,000.

Wally's excludable portion of the cost-sharing payment is the present value of the greater of:

1. 10% of the average annual gross receipts (10% of $10,000 = $1,000) or
2. $2.50 per acre ($2.50 × 100 acres = $250)

Assuming an 8% discount rate, Wally's excludable portion is $1,000 ÷ .08 = $12,500.

The portion of the $10,000 cost-sharing payment that Wally must include in income is calculated as follows:

Value of the §126 improvement	$20,000
Less excludable portion	12,500
Less Wally's contribution	15,000
Amount included in income	$ -0-

Therefore, Wally can exclude all of the cost-sharing payment from income. He can claim an I.R.C. §175 soil and water conservation deduction for the remaining $15,000 cost of the improvements, subject to the 25% of gross income from farming limitation.

Wildlife Habitat Incentives Program (WHIP)

The Wildlife Habitat Incentives Program provides financial incentives to develop habitat for fish and wildlife on private lands. Participants agree to implement a wildlife habitat development plan, and the USDA agrees to provide cost-share assistance for the initial implementation of wildlife habitat development practices. The USDA and program participants enter the 5- to 10-year cost-share agreements for wildlife habitat development.

Income Tax Consequences. WHIP is an eligible program under I.R.C. §126. Expenses incurred for improvements under this program are not likely to be eligible for the I.R.C. §175 deduction because they are not incurred to protect land used in farming.

Forestry Incentives Program (FIP)

The Forestry Incentives Program (FIP) supports good forest management practices on privately owned, non-industrial forestlands nationwide. FIP is designed to benefit the environment while meeting future demands for wood products. Eligible practices are tree planting, site preparation for natural regeneration, and related activities. The program was authorized in 1978 and pays up to 65% of the cost of tree planting, timber stand improvements, and related practices.

Income Tax Consequences. FIP is an eligible program under I.R.C. §126. Since the cost of planting trees and the cost of related activities are treated as capital expenditures, the cost sharing payments for those expenses are eligible for the I.R.C. §126 exclusion. However, in many cases, the land will not have produced annual income in the past three years, so the limit on the I.R.C. §126 exclusion will be the present value of $2.50 per acre.

Example 5. Patty Pine received a $6,500 cost-sharing payment for the $10,000 cost of planting trees and related improvements on her 100 acres of forestland under the Forest Incentives Program in 2001. She had no income from the land in the previous three years. She elects to exclude the payment from income under I.R.C. §126. Assuming an 8% discount rate, the present value of $2.50 per acre is (100 acres × $2.50) ÷ .08 = $3,125. The amount that she must report in income is calculated as follows:

Value of the §126 improvement	$10,000
Less excludable portion	3,125
Less Patty's contribution	3,500
Amount included in income	$ 3,375

If Patty had sold $30,000 of timber from the land in the previous three years, her excludable portion would be the present value of the greater of:

1. 10% of the average annual gross receipts (10% of $10,000 = $1,000), or
2. $2.50 per acre ($2.50 × 100 acres = $250)

Therefore, assuming an 8% discount rate, Patty's excludable portion would be $1,000 ÷ .08 = $12,500. The amount she must include in income would be calculated as follows:

Value of the §126 improvement	$10,000
Less excludable portion	12,500
Less Patty's contribution	3,500
Amount included in income	$ -0-

Practitioner Note. Since Patty is engaged in the commercial production of timber, I.R.C. §194 provides an election for a taxpayer to amortize over 84 months up to $10,000 of qualifying capitalized reforestation expenditures per year. The reforestation expenditures eligible for the amortization election are eligible for the investment tax credit [I.R.C. §48(b)(1)].

ISSUE 9: UTILITY EASEMENTS

The sale of a utility easement raises income tax questions.

The general rule is set out in Treas. Reg. §1.61-6(a) as follows:

> When a part of a larger property is sold, the cost or other basis of the entire property shall be equitably apportioned among the several parts, and the gain realized or loss sustained on the part of the entire property sold is the difference between the selling price and the cost or other basis allocated to such part. The sale of each part is treated as a separate transaction, and gain or loss shall be computed separately on each part. Thus, gain or loss shall be determined at the time of sale of each part and not deferred until the entire property has been disposed of.

When an easement is sold, there are two issues of allocating basis:

1. Property affected—the allocation of basis between the portion of the property that is subject to the easement and the rest of the property.
2. The allocation of basis between the rights created by the easement and the rest of the rights in the property.

Property Affected

Taxpayers have argued unsuccessfully that the entire basis in property from which an easement is acquired should be compared with the sale price of the easement. For example, in *Iske v. Commissioner,* 39 T.C.M. 1161 (1980), *aff'd* 8th Cir. (unpublished opinion 11/18/80), the taxpayer argued that his entire basis in two parcels of land should be compared with the amount he received for an easement across the property. The court agreed with the IRS and held that only the basis allocable to the immediate acreage covered by the easement may be utilized.

Example 1. A power company purchased an easement for $5,000 along the southern boundary of Ken Kilowatt's farm for the construction and maintenance of a pole line. The easement covered approximately 20 acres of Ken's 600-acre farm, in which he had a basis of $100 per acre.

Question 1A. What is Ken's reportable gain or loss on the sale of the easement?

Answer 1A. The $5,000 paid for the easement can be offset by only the $2,000 basis allocable to the 20 acres affected by the easement. It cannot be compared to the basis of the entire 600 acres. Therefore, Ken must report $3,000 of I.R.C. §1231 gain from the transaction (Rev. Rule 68-291, 1968-1 C.B. 351).

Entire Property Affected. By contrast, when the entire property is affected by the easement, taxpayers have successfully argued that the amount received for the easement reduces the basis in the entire property before any gain must be reported.

Example 2. Buck Pleuston executed easement deeds granting nine separate and distinct easements to the Army Corps of Engineers for highway access to a dam for a price of $7,200. The easements covered 48 acres and bisected Buck's ranch. The Corps of Engineers built fences along each side of the easements and put numerous gates in the fences so that Buck could move his cattle along and through the easements. Buck's basis in his ranch is $70,000.

Question 2A. What is Buck's reportable gain or loss?

Answer 2A. Because the easements affected the use of rest of the property in addition to the 48 acres subject to the easement, Buck should arguably be allowed to reduce the basis in his entire ranch by the $7,200 he received for the easement and therefore does not have to report any gain [*Bledsoe v. United States,* 67-USTC ¶9581 (N.D. Okla. 1967); *Conway v. United States,* 73-1 USTC ¶9318 (W.D. Ky. 1973)]. His basis is reduced to $62,800 ($70,000 – $7,200).

Rights Created by the Easement

The other basis allocation is between the rights retained by the taxpayer and the easement rights that are sold. Under Treas. Reg. §1.61-6(a), cited previously, the general rule is that the basis of the property must be allocated between the interest sold and the interest retained in the proportions that their respective fair market values bear to the fair market value of the entire property (Rev. Rul. 77-413, 1977-2 C.B. 298).

However, if it is impossible to allocate the basis of the entire property between the interest that is sold and the interest that is retained, then the amount received for the easement can be used to reduce the basis in the entire property affected (Rev. Rul. 77-414, 1977-2 C.B. 299).

Observation. In Example 1, Ken was not required to allocate the $2,000 basis in the 20 acres affected by the easement between the rights he retained in those 20 acres and the rights represented by the easement that he sold. Instead, according to Rev. Rul. 77-414, he is allowed to compare the amount he received for the easement with the entire basis in the 20 acres affected.

ISSUE 10: CHRISTMAS TREES

AGE OF CHRISTMAS TREES AFFECTS TAX RULES THAT APPLY

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

If the trees are more than 6 years old at the time they are cut, they are defined as timber under I.R.C. §631.

If the trees are 6 years old or less at the time they are cut, they are not treated as timber under I.R.C. §631 and they are subject to the I.R.C. §263A uniform capitalization rules.

Practitioner Note. The age of a tree is measured from the date the seed is planted. Therefore, if a producer buys 2-year-old seedlings, the 2 years is included in the age of the tree.

Observation. Christmas trees grown in the southern United States are often cut at 6 years of age or less. Christmas trees grown in the northern United States are often cut at more than 6 years of age.

TREES MORE THAN 6 YEARS OLD WHEN CUT

Treatment of Gain on Sale

As noted previously, Christmas trees that are more than 6 years of age when they are cut are treated as timber for purposes of I.R.C. §631. Therefore, if the owner of Christmas trees is an investor, the gain will be treated as capital gain under I.R.C. §1221.

Example 1. Sally Investor loaned $100,000 to Joe Grower and received a mortgage on Joe's Christmas tree farm as collateral. After paying $25,000 of the principal, Joe defaulted on the loan and Sally repossessed the farm. Sally allocated her $75,000 basis in the repossessed farm as follows:

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

The trees were more than 6 years old and ready for harvest, so Sally paid a cutter $3,000 to harvest the trees and sold them for $30,000 in a lump-sum sale to a local retailer.

Sally's gain on the sale is:

Amount realized	$ 30,000
Less basis	(25,000)
Less cost of sale	(3,000)
Gain on sale	$ 2,000

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

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

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

Example 2. Gary Grainger raises Christmas trees for sale in the wholesale market and harvests the trees when they are 7 years old. He uses the cash method of accounting, which allows him to deduct his operating expenses in the year they are incurred. However, the cost of establishing the trees must be capitalized and recovered at the time he sells the trees.

In 2001, Gary sold 10,000 trees for $40,000. His basis in the trees is $15,000. Gary computes his gain as follows:

Amount realized	$ 40,000
Less basis	(15,000)
Less cost of cutting	(2,000)
Gain on sale	$ 23,000

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

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

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

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

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

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

Example 3. If Gary Grainger in the previous example elected to report his gain under I.R.C. §631(a), part of the gain is treated as I.R.C. §1231 gain. To determine the gain that is allocated between ordinary income and §1231 gain, Gary must determine the value of the trees at the beginning of the tax year in which they are cut.

Assume that Gary can show the value of the trees to be $3.20 on January 1, 2001. The $23,000 of gain is then allocated as follows.

Calculation of I.R.C. §1231 Gain	
Value on 1/1/01: 10,000 trees × $3.20 per tree	$ 32,000
Less basis	(15,000)
I.R.C. §1231 gain	$ 17,000

Calculation of Ordinary Income	
Amount realized from sale	$ 40,000
Less value on 1/1/01	(32,000)
Less cost of cutting	(2,000)
Ordinary income	$ 6,000

Observation. As the results of Examples 2 and 3 illustrate, Christmas tree owners can dramatically reduce their ordinary income by making the I.R.C. §631(a) election.

Uniform Capitalization Rules

If the Christmas trees are more than 6 years old when they are harvested, they are not subject to the capitalization of preproduction expense rules [I.R.C. §§263A(c)(5)(A) and (e)(4)(B)].

TREES 6 YEARS OLD OR LESS WHEN CUT

Treatment of Gain on Sale

If Christmas trees are 6 years old or less when they are cut, they are not treated as timber under I.R.C. §631. Therefore, neither §631(b) nor §631(a) reporting can be used. Consequently, if the tree owner is in the business of raising and selling trees, all of the gain on sale is ordinary income.

Example 4. If the trees that Sally Investor repossessed in Example 1 had been 6 years old or less, she would still report her gain as capital gain since she held the trees as an investment rather than as inventory in a trade or business.

Example 5. If the trees Gary Grainger sold in Example 3 had been 6 years old or less, he would not be allowed to make the §631(a) election. Consequently, all of his gain must be reported as ordinary income as it was in Example 2.

Uniform Capitalization Rules

If the Christmas trees are 6 years old or less when they are harvested, they are subject to the capitalization of pre-production expense rules [I.R.C. §§263A(c)(5)(A) and (e)(4)(B)]. Under those rules, all costs of raising the trees must be added to the basis of the trees rather than deducted as they are incurred, unless the taxpayer elects out of the rules.

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

1. When the trees are sold, an amount equal to the costs that would have been capitalized is subject to the I.R.C. §1245 recapture rules.

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

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

Example 6. Assume that Gary Grainger from Example 3 cut and sold his trees when they were 5 years old. His cost of raising his trees was $1,200 per year and he did not elect out of the uniform capitalization rules.

Since the trees are cut at 6 years of age or less, Gary cannot make the I.R.C. §631(a) election and he is not allowed to deduct the $1,200 annual cost of raising the trees. Consequently, his ordinary income upon sale of the trees is as follows:

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

ISSUE 11: TAX-FREE EXCHANGE OF TIMBER

GENERAL RULES

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

For real property, "like-kind" is interpreted very broadly. Any real estate can be exchanged for any other real estate and qualify for I.R.C. §1031 so long as the relinquished property was, and the acquired property is, used in a trade or business or held for investment. Consequently, a farm can be exchanged for city real estate and improved real estate can be exchanged for unimproved real estate.

Question 1. Georgia Pine plans to sell her apartment building and wants to invest the proceeds in timberland. Can this exchange qualify as like-kind?

Answer 1. The timberland and apartment building are like-kind property. Therefore, if Georgia exchanges the apartment building for timberland, she does not have to recognize the gain on her apartment building.

TIMBER APPLICATIONS

The IRS has released several revenue rulings addressing exchanges of timberland under §1031.

1. In Rev. Rul. 72-515, 1972-2 C.B. 466, the taxpayer conveyed to the United States timberland containing some virgin and also substantial second growth timber in return for timberland supporting substantial virgin timber. The IRS ruled that the exchange was one of like-kind properties.
2. In Rev. Rul. 76-253, 1976-2 C.B. 51, the taxpayer corporation conveyed land to a state, reserving the timber rights. It received in return state-owned timberland of lesser value. The IRS ruled that the exchange was one of like-kind properties.
3. In Rev. Rul. 78-163, 1978-1 C.B. 257, the issue was whether the exchange of timberland for bare land constitutes an exchange of like-kind property. Citing the regulations, the IRS ruled that the exchange was, in fact, one of like-kind properties. The differences in the two properties concerned their grade and quality, not their nature or character.

The three revenue rulings indicate a progressively more liberal interpretation of the regulations to I.R.C. §1031 with respect to the meaning of the term "like-kind" as it concerns timber transactions.

The Tax Court in *Oregon Lumber Company v. Commissioner*, 20 T.C. 192 (1953), addressed the exchange of land for timber rights only. The taxpayer here conveyed to the United States cut over timberland (bare land) in exchange for the right to cut an equal value of national forest timber. The issue before the Court was whether a right to cut and receive standing timber is realty or personal property. The Tax Court looked to state law for the answer.

The Court concluded that when there is an agreement to cut and remove standing timber from the land immediately or within a reasonable time, the agreement is for the sale of goods only. In other words, the conveyance of standing timber in this situation is a transfer of personal property. Thus, the like-kind exchange requirements were not met.

In a recent letter ruling (Ltr. Rul. 9525002, 2-23-95), the IRS followed the decision in *Oregon Lumber Company*. The taxpayers exchanged standing timber owned by them for three tracts of timberland owned by a corporation. The timber deed stated that "all trees and timber which are cut and removed from said land shall be cut and removed therefrom within two (2) years from the date of the deed (by July 3, 1992) and all trees and timber not cut and removed from said land on or before said date shall be the property of [Taxpayers]."

The IRS stated that under I.R.C. §1031(a), a comparison of the properties exchanged is needed to determine whether or not their nature or character is substantially alike. In doing so, consideration must be given to the respective interests in the physical properties, the nature of the property conveyed, the rights of the parties, the duration of the interests, and any other factor bearing on the nature or character of the properties as distinguished from their grade or quality. Significantly, as the standard for comparison, §1031(a) refers to property of a like–not an identical–kind. The comparison should be directed to ascertaining whether the taxpayer, in making the exchange, has used his property to acquire a new kind of asset or has merely exchanged it for an asset of like nature or character.

The determining factor that rules out a like-kind exchange in this case is the duration of the interests. While the corporation was permitted to enter and remove all trees growing on taxpayers' land for a period of 2 years, it is also true that the corporation did not receive the right to remove an unlimited quantity of trees from the Taxpayers' property. Rather, the corporation was limited to removing only those trees situated on the Taxpayers' property during the 2-year period of their contract. In effect, taxpayers sold the timber existing on their property during the contract period. The contract period amounted to a *de facto* restriction on the number of trees that could be removed.

The IRS relied on the court's reasoning in *Oregon Lumber Company* that "the right to cut and remove (standing timber) is transient and depends upon the affirmative action of the holder of that right. The fee (interest in real property) is permanent and depends only on the original grant. The right to cut and remove timber is more in the nature of utilization of land; the fee is ownership of the land itself."

After the transaction, the taxpayers ended up with (1) the original land less the trees that were growing thereon, and (2) three additional tracts of timberland. The corporation, however, ended up with the trees situated on the Taxpayers' original property which it cut and removed in 1990. In effect, the taxpayers sold trees and bought land; the corporation sold land and bought trees. There was no continuity in the manner of investment contemplated by I.R.C. §1031(a). Thus, the like-kind exchange rules do not apply, and gain must be realized.

Question 2. Knox Pine enters into an agreement with Big Thicket Timber Company whereby he will transfer to Big Thicket 50 acres of timberland containing a mature stand of 35-year-old pine timber, and Big Thicket will transfer to Knox 300 acres of timberland that has an immature stand of 6-year-old pine timber. Does this exchange qualify as a like-kind exchange?

Answer 2. Yes, this exchange should qualify for like-kind treatment under §1031. Knox gives up a fee interest in real property and receives a fee interest in real property. The duration of the two interests are identical. Thus, §1031 like-kind exchange treatment applies.

Question 3. Wyoming Aspen enters into an agreement with Wiley Cruise Timber Company whereby she agrees to transfer to Wiley Cruise the standing timber on 100 acres of timberland, and Wiley Cruise will transfer to Wyoming 300 acres of timberland that has an immature stand of 6-year-old pine timber. Wyoming retains title to the 100 acres, but Wiley receives the right to remove all trees growing on the 100 acres for a period of 2 years. Does this exchange qualify as a like-kind exchange?

Answer 3. No, according to *Oregon Lumber Company* and Ltr. Rul. 9525002. The fact that the duration of the interest received by Wyoming (title to 300 acres of timberland) is not equal to the duration of the interest given (the right to cut timber on 100 acres for a period of two years) will prohibit like-kind exchange treatment. Wyoming is treated as having sold the standing timber on the 100 acres for an amount equal to the fair market value (FMV) of the timberland received in the transaction.

ARGUMENT FOR TREATING STANDING TIMBER AND TIMBERLAND AS LIKE-KIND

A recent Tax Court decision (*D.G. Smalley v. Commissioner,* 116 T.C. No. 29) appears to open the door (at least slightly) to a possible successful argument that an exchange of standing timber for a fee simple interest in timberland is like-kind. The court acknowledged that case law exists to support both the IRS argument against like-kind status and the taxpayer argument for like-kind status. However, relying on the language in *Oregon Lumber Company,* it would appear that the IRS has a strong argument against like-kind treatment based on the fact that the two interests (standing timber with time-limited cutting rights and timberland) are too "intrinsically different" to be like-kind, even if both interests are classified as "realty."

DIVISION OF TIMBER PROPERTY CO-OWNED BY RELATED PARTIES

In Ltr. Rul. 199926045 the IRS has determined that an exchange with a related party of an undivided interest in old growth timberlands held for investment for a 100% interest in one-half of the timberlands to be held for investment is a like-kind exchange. A husband and wife who owned timberlands held for investment divorced and the husband subsequently died. As a result, the wife and her ex-husband's estate held the property as tenants-in-common. A holding company, more than 50% owned by the wife, has an option to acquire the estate's undivided one-half interest in the timberlands.

After the holding company acquired the estate's interest, the parties proposed to enter into a like-kind exchange of portions of their undivided interests in the timberlands so that each party will be the sole owner of one-half of the timberlands. The holding company will harvest timber on its timberlands, but the wife plans to hold her property as an investment without harvesting timber.

The wife's exchange is a like-kind exchange. The transaction enables each party, as sole owner of their parcel, to determine whether to hold, use, or dispose of the property. The IRS further determined that the holding company's plan to cut timber on its acquired timberlands within 2 years of the exchange will not trigger recognition of gain or loss for the wife under I.R.C. §1031(f)(1).

Observation. The two-year rule of I.R.C. §1031(f)(1) for dispositions of property acquired from a related party does not apply to a subsequent disposition of property that is essentially acquired as a result of the partition of jointly owned property. The Service determined that the like-kind exchange transaction was governed by I.R.C. §1031(f)(2)(C), which provides that if neither the exchange nor the disposition had as one of its principal purposes the avoidance of federal income tax, then the gain recognition rule of §1031(f)(1) will not apply.

CONSERVATION EASEMENT

In Ltr. Rul. 9621012, the IRS determined that an exchange of a perpetual scenic conservation easement for a fee simple interest in replacement real property (timberland, farm land, or ranch land) will qualify as a like-kind exchange under §1031. The taxpayer granting the scenic conservation easement retained the right to continue to use the property for ranching and grazing, but gave up the right to develop the property.

This ruling was recently reinforced by Ltr. Rul. 9851039, in which two testamentary trusts that separately own two farms transferred a permanent agricultural conservation easement over both farms to a qualified intermediary. State law considers the easement to be an interest in land. The qualified intermediary then deeded the replacement property, a fee simple interest in a third farm, to the trusts in exchange for the easement. The trusts paid boot to complete the exchange since the farm's purchase price exceeded the sales price of the relinquished easement. The exchange was determined to be like-kind; thus no gain was recognized by the trusts.

ISSUE 12: INFORMATION RETURNS FOR TIMBER SALES

GENERAL REQUIREMENTS FOR FORM 1099

The importance of filing timely and accurate Forms 1099 cannot be overstated. Taxpayers required to file 1099s must furnish payees a 1099 by January 31 of the succeeding year and the IRS must receive the 1099s by February 28 of the succeeding year. The 1099 is used to report ordinary kinds of payments made, such as dividends, interest, retirement distributions, certain real estate transactions, and some *timber sales,* as well as various other payments and transactions [§6041(a)].

Question 1. Big Thicket Timber Company purchases a 50-acre tract of mature pine timber from Hardy Hickory for a lump-sum price of $150,000 in 2001. Should Big Thicket report this transaction on Form 1099-S?

Answer 1. No, a lump-sum purchase of timber is exempted from the reporting requirements under current rules for real estate transactions. (See Ltr. Rul. 9544005, Ltr. Rul. 8721050, and Ltr. Rul. 9104012.)

Question 2. Big Thicket Timber Company also purchases the timber on an adjoining 50-acre tract owned by Douglas Furr. This purchase is executed under a pay-as-cut contract, with payment of $140,000 made to Douglas in 2001. Should Big Thicket report this transaction on Form 1099-S?

Answer 2. Yes, disposal of timber with an economic interest retained is included as a royalty transaction. Therefore, this transaction should be reported on Form 1099-S and identified in box 3 as a "Pay-as-cut Timber Royalty." (See Ltr. Rul. 9544005, Ltr. Rul. 8721080, and Ltr. Rul. 9104012.)

Question 3. Can the timber transaction be reported on Form 1099-MISC, since this is the customary form used to report royalty payments?

Answer 3. No, the IRS has determined that since timber royalties often qualify for capital gain treatment and are classified as real estate for reporting purposes, such transactions should be reported on Form 1099-S (Announcement 90-129).

PAYMENTS TO INDEPENDENT LOGGING CONTRACTORS

If a wood products company makes payments to independent contractors for logging and hauling services, such payments are subject to reporting on information returns. However, if the company makes payments to a landowner on behalf of the independent contractor, such payments are not required to be reported by the company.

Question 4. Universal Wood Products Company is a major manufacturer of paper products. Universal purchases pulpwood from various sources. One of these sources is Busy Beaver Cutters, an independent logging and hauling service company. Busy Beaver buys timber and contracts with Universal to haul pulpwood to Universal's wood yard. Then Busy Beaver also contracts with Paul Bunyon to log and haul the wood to Universal's yards on Busy Beaver's behalf. Paul deals directly with the landowner and agrees to buy wood on a "pay-as-cut" contract.

Universal pays Busy Beaver Cutters for the loads delivered. Paul then provides Busy Beaver with a ticket for each load he delivers to Universal's woodyard, and finally Paul receives payment from Busy Beaver for his services. Busy Beaver writes two checks for each load—one check to Paul for the hauling service and a second check for the timber to the landowner on behalf of Paul. Who, if anyone, is responsible for information reporting, and what information returns should be filed?

Answer 4. Universal Woods Products Company has no Form 1099 reporting requirement with respect to Busy Beaver. The payments by Busy Beaver to Paul for the cutting and hauling services are subject to reporting by Busy Beaver on Form 1099-MISC as non-employee compensation. However, Busy Beaver does not have to file information returns (Form 1099-S) for the payments it makes to the landowners for the timber because Busy Beaver is only serving as a paying agent for Paul. However, since the timber was purchased by Paul under a pay-as-cut contract, Paul Bunyon is required to file a Form 1099-S for each landowner payment for timber purchased on the "pay-as-cut" basis (Ltr. Rul. 9643004).

PAYMENTS TO HAULER NOT SUBJECT TO INFORMATION REPORTING

In Internal Legal Memorandum (ILM) 199919032, the IRS concluded that payments for hauling timber are for freight and are not subject to information reporting under I.R.C. §6041. In the ILM, a logger who cuts the timber also contracts with a hauler to haul the logs. The hauler transports the timber for a fixed amount per mile or per trip. Since transportation is an integral part of the hauler's business, the IRS agent assumed the logger is really paying the hauler for services, not for freight. However, the IRS Assistant Chief Counsel concluded that the Service has no basis to distinguish, for information reporting purposes, between freight payments that are incidental to the business and those that are integral to the business of the logger. **Therefore, the payments to the hauler are not subject to information reporting.**

Observation. Ltr. Rul. 9634004 (discussed above) can be differentiated from ILM 199919032. In Ltr. Rul. 9643004 payments were made to an independent contractor for *both* cutting timber *and* hauling it to the yard owned by another party. Thus, the payments for cutting timber were compensation for services rendered. [There is no discussion of the exception in §1.6041-(3)(d) for payments for freight, even though the letter ruling concludes that payments for logging and hauling services are subject to information reporting under I.R.C. §6041.]

FORM 1099 REPORTING FOR TIMBER TRANSACTIONS

Summary of 1099 Reporting Requirements for Timber Transactions

Nature of Transaction	Type of Contract	Payment Made to	Form 1099 Required	Type of Form 1099
Purchase of timber	Lump-sum	1 or 2*	No	N/A
Purchase of timber	Pay-as-cut	2	Yes	Form 1099-S
Purchase of land with standing timber	Lump-sum	2	Yes	Form 1099-S for land
Payment for contract cutting of timber	Includes cutting only	3	Yes	Form 1099-MISC
Payment for contract cutting of timber	Includes both cutting and cost of timber	3	No	N/A
Payment for hauling timber	Includes hauling services only	1 or 3	No	N/A

*1 Corporation
2 Noncorporate landowner
3 Noncorporate contractor

POSSIBLE FUTURE REQUIREMENTS

The IRS has adopted regulations that provide guidance with respect to the information reporting requirements for real estate transactions (T.D. 8323, 12-12-90). The proposed version of these regulations stated that the IRS believes that the disparity in the reporting requirements for different forms of timber transactions may be inappropriate [Prop. Reg. 1.6045-4(c)(2)(i)]. However, this issue was not addressed in the public comments and was not considered at the public hearing concerning the regulations. Accordingly, the final regulations contain the exception from reporting for natural resource transactions, including standing timber. The IRS will open a new regulations project to consider the expansion of the reporting requirements to include sales and exchanges of standing timber. Any requirements for the reporting of standing timber will apply only to transactions occurring after the issuance of such requirements.

MISREPORTING ON FORM 1099-MISC

Question 5. River Burch holds timber as an investment. In 2001 he sells timber under a pay-as-cut contract to Paul Bunyan Timber Company and receives $110,000. Paul Bunyan's accountant is unaware of the requirement to file a Form 1099-S for a pay-as-cut timber transaction and instead issues a Form 1099-MISC reporting royalty payments to River of $110,000. How should River report the sale?

Answer 5. River can first ask Paul Bunyan Timber to file a corrected 1099-MISC showing a zero payment and a new 1099-S showing the correct amount. If this does not work, River should still report the sale in Part I of Form 4797 (and receive capital gain treatment). He should also attach an explanatory note to his return, stating that a Form 1099-MISC was incorrectly issued, rather than the correct Form 1099-S. He should include the name and EIN of the issuing entity and the amount of the transaction for document matching.

ISSUE 13: ALLOCATING TIMBER RECEIPTS TO LAND DAMAGES

During the harvesting of timber, damage often occurs to land. Such damages can include debris left on land and damages to the land itself, particularly if the land is wet at the time of harvest. Timberland owners have raised the following questions:

1. Can part of the timber sale proceeds be allocated to damage to land?
2. If the answer to the first question is yes, can the amount allocated to damage to land be treated as a non-taxable return of basis in the land?

ALLOCATION OF PROCEEDS TO DAMAGE TO LAND

While no cases dealing specifically with this issue as it applies to timber properties have been found, there are cases that deal with the loss of value in land due to dead citrus trees on the land.

Carloate Industries, Inc., 66-1 USTC ¶9156, 1966, and *Bessie Knapp,* 23 T.C. 716, 1955, deal with damage to land resulting from dead citrus trees subsequent to a freeze. Generally, the taxpayers were recognized as having incurred a casualty with regard to the land, due to the cost of removing the trees. The court held that there was a casualty loss to the land because the land cannot be reused until the trees and stumps are removed. Thus the land with dead trees and stumps is less valuable than bare land.

In those cases, however, the court upheld the IRS position that the trees and land are not to be considered as an integral unit in determining loss. In other words, the damage to the land value resulting from the dead trees must be separately determined. One way to determine this would be through comparable sales—have there been any property sales after a freeze that involved land with freeze-dead trees thereon? Another option is to estimate the cost to bulldoze, pile, and burn the dead trees, indicating the amount a potential seller would have to reduce the land price of citrus land with dead trees thereon.

These cases support the conclusion that timber sale proceeds can be allocated to damages to land if there is an identifiable loss, such as debris left on the land or damage to the land caused by harvesting equipment.

REDUCTION OF BASIS

Inja Land Company, Ltd. v. Commissioner, 9 T.C. 729 (1947) *acq.* 1948-1 C.B.2, is authority for applying amounts received for identifiable land damages to a reduction of basis in the land. In that case, the taxpayer received $50,000 for damage to property rights caused by contaminated seepage water, and for granting an easement to the City of Los Angeles. The court reasoned that the payment was, in reality, primarily for damages, with the easement provision included to release and discharge possible past, present, and future claims. The loss of past or future profit was not involved or considered. Since the sum received was less than the basis of the property, taxation was postponed until final disposition of the property. The court noted Inja Land Company's reliance on *R. J. Durkee,* 6 T.C. 773, *rev'd* 162 F. 2d 184, in which the circuit court said ". . . where the settlement represents damages for lost capital rather than for lost profits, the money received is a return of capital and not taxable."

PROBABLE IRS RESPONSE

The IRS has ruled that amounts received by a landowner as consideration for the right to conduct oil and gas exploration on the landowner's land are ordinary income, even though damages to the land may result from the activity [Letter to Condray, Pratas, and Smith, Lubbock, Texas, dated June 18, 1951 and signed E. I. McLarney, Deputy Commissioner, 1952 P.H. ¶75,166]. According to the letter, in such a case, no deductible loss is to be allowed and no part of the consideration received is to be treated as a return of capital. In determining that no loss is allowable, the IRS relied on *Pugh* 17 B.T.A. 429 (1929), *acq.* IX-1 C.B. 45, *aff'd* 49 F.2d 76 (CA-5, 1931), in which the Board of Tax Appeals found as a fact that damages of $50,000 had been caused to the surface of land due to seepage of oil and salt water from producing oil wells. The Board concluded that, even though there had been a shrinkage in the value of the land, the taxpayer was not entitled to a loss deduction in the absence of a sale or other disposition of the land. While the case is authority for the position that no loss deduction is allowable, it is not authority for the IRS position that consideration received for damages may not be treated as a return of capital. The *Pugh* case did not address the return of capital issue and restricted its discussion to the loss deduction issue.

INFERENCES FOR LAND DAMAGE PAYMENTS FOR TIMBERLAND

Based on the above authorities, it would appear that the taxpayer has a reasonable basis to argue that proceeds associated with a timber disposition may, under some circumstances, be partially allocated to land damages resulting from the timber harvesting process. The sales contract should specifically provide for compensatory payments for actual damages and not simply express such damages as a percentage of the sale proceeds. The damage payment should bear a reasonable relationship to the actual cost of restoring the land to a "bare land" status. It would appear, based on the authorities discussed above (particularly *Inja Land Company, Ltd.*), that such a payment could be treated as a nontaxable return of capital. If the payment exceeds the basis in the land, the excess would constitute taxable income.

Example 1. Woody Forest enters into a contract with C. Saw Timber Company for the sale of all standing timber on 50 acres of Woody's land. The lump-sum sale amount for the timber is $125,000. C. Saw Timber Company also agrees to pay Woody $3,000 for damages to the land caused by the harvesting equipment and the resulting debris left behind. Woody has a cost basis of $250 per acre in the land ($12,500 for the 50-acre tract). Assuming that actual damages result to the land, and that the $3,000 payment represents a reasonable measure of the damages, Woody can argue that he should be allowed to treat the $3,000 as a nontaxable return of capital. He would reduce his basis in the land by $3,000 to a new basis of $9,500.

Observation. If C. Saw Timber Company and Woody agree to a lump-sum price of $125,000 for the standing timber and Woody (with or without C. Saw's knowledge) simply decides to allocate a percentage of the sales proceeds to "damages," it is very likely that the IRS will be successful in treating the "damages" as taxable proceeds from the timber sale. In such a case, the payment is not likely to be classified as compensation for "lost capital," since the amount is based on a percentage of the sales contract amount and does not represent a bona fide calculation of projected actual damages.

Example 2. Woody Forest enters into a contract with C. Saw Timber Company for the sale of all standing timber on 50 acres of Woody's land. The lump-sum sale amount is $125,000. Woody decides to allocate 10% of the sales proceeds, or $12,500, to "damages." Woody has a cost basis of $250 per acre, or $12,500 in the land. Therefore, Woody reduces his cost basis to zero after applying the $12,500 in allocated "damages" to basis. He reports taxable proceeds from the sale of the remaining 90% of the lump-sum sale amount (or $112,500). The IRS, if it examines the return, will very likely reclassify the "damages" as taxable income.

SUBSEQUENT REFORESTATION OF DAMAGED LAND

If the taxpayer were to be successful in allocating a portion of a timber sales contract to land damages, the question remains as to how to treat subsequent site preparation costs incurred in the reforestation process. The taxpayer would obviously prefer to treat such site preparation costs as reforestation costs eligible for the investment tax credit and 7-year amortization under I.R.C. §194. The IRS may assert that such site preparation (for leveling and conditioning the land and for brush and stump removal) should be permanently capitalized as a restoration of the land basis previously reduced at the time of the prior timber sale. That would be consistent with the reasoning of Ltr. Rul. 9547002 regarding re-establishing disease infested vineyards.

The taxpayer may be able to counter this argument by using the reasoning of *Chief Counsel Advice* 199903030 (Nov 28, 1998), which concluded that a casualty loss does not include repair or restoration expenses. In this ruling, taxpayers in the Red River Valley of North Dakota and Minnesota were allowed to deduct casualty losses to property damaged by flooding, and to also treat expenses of restoration as repairs deductible under I.R.C. §162, or as capital expenditures under I.R.C. §263. An analogy could be made between the reduction of basis due to timber harvesting damage and the reduction of basis due to casualty loss. Allowing the compensatory damages to land to be offset against basis could be argued as being equivalent to allowing the taxpayer with a casualty loss to expense repairs to the property damaged by a casualty event. Site preparation is an integral part of reforestation costs eligible for I.R.C. §194 amortization in the same fashion as repairs are allowed under I.R.C. §162.