Chapter 4: Agricultural Issues

Corrections were made to this workbook through January of 2003. No subsequent modifications were made.

ISSUE 1: SHARED-APPRECIATION AGREEMENTS

In the 1980s, some farmers, who were suffering from financial distress, had their FmHA loans written down. Ten years later, the write-downs raise current income tax issues. In the Farm Credit Act of 1987, Congress addressed some farm financial distress issues. The Act instructed both the Farmers' Home Administration (FmHA), now Farm Services Agency (FSA) and the Farm Credit Services (FCS) to restructure some farm loans. These agencies were to avoid farm losses on loans, with priority consideration to writing down the loan principal and interest and setting aside debt, whenever those procedures would make it possible for a borrower to survive and remain on the ranch or farm. To be eligible for restructuring, certain requirements had to be satisfied, and a borrower was required to enter into a shared appreciation agreement for all write-downs involving real estate as collateral.

A borrower receiving restructuring assistance only need service the debt to the value of the collateral. The collateral value was typically below fair market value (FMV). Thus, a borrower's loan could be written down to the point that the "net recovery value" (NRV) of the restructured debt was equal to or greater than the NRV of the collateral securing the debt. A new promissory note was executed for each note rescheduled or re-amortized. A borrower then entered into a shared appreciation agreement (SAA) for all write-downs involving real properties as collateral. The SAA called for the borrower to pay 75% of any appreciation in FMV of the collateral if, within four years, the

- loan was paid off,
- borrower ceased farming, or
- borrower transferred the property.

The borrower was to pay 50% of any appreciation if the triggering event occurred after four years or, if no recapture-triggering event occurred, upon termination of the agreement (up to 10 years).

The total amount recoverable was capped at the dollar amount of the debt write-down.

Note. The SAA language concerning the recapture-triggering events has been the subject of litigation. In particular, a major issue is whether the expiration of the SAA at the end of the 10-year period is a recapture-triggering event. While the underlying statutory language and regulations make it clear that recapture occurs at the end of the term of the SAA, the actual language of the SAA is not at all clear. Indeed, several courts have held that the SAAs are "poorly drafted and confusing," but have upheld the recapture.

If a feasible debt restructuring plan could not be worked out with FSA, a debtor was permitted to buy the collateral at its NRV. However, the NRV of the secured property had to exceed the NRV of a restructured loan supported by the debtor's cash flow, and the debtor must execute an SAA. The debtor had to agree to pay in full the difference between the NRV of the property and the property's FMV (as of the date of the agreement) if within 10 years the property was conveyed for an amount greater than the NRV.

Observation. NRV is the value of the loan to USDA if it were to be liquidated. In essence, NRV is the market value of the property less the costs of liquidation.

The program is still available for some FSA borrowers, but it is seldom used.

TAX ISSUE — IRS POSITION

Debt write-down, but no SAA entered into. The IRS position is that if a write-down occurs and no SAA is entered into, the write-down results in **cancellation of indebtedness** for tax purposes.

There are five major exceptions to the general rule that discharge of indebtedness is taxable income:

1. **Debtors in bankruptcy.** I.R.C. §108(a)(1)(A). Indebtedness cancelled as a result of bankruptcy is not included in the debtor's income. Instead, the cancelled debt leads to a reduction in the income tax basis of the debtor's property or other "tax attributes" are reduced, or both. Because no income results, the taxpayer may not claim any loss from the sale of the property that was security for a discharged debt for less than its basis. *See Lewis v. Commissioner, T.C. Memo. 1989-78* (loss disallowed from foreclosure sale of property for less than taxpayer's basis where taxpayer had discharge of indebtedness income in bankruptcy).

2. **Insolvent debtors not in bankruptcy.** I.R.C. §108(a)(1)(B). Income from the discharge of indebtedness for an insolvent taxpayer is excluded from income. A spouse filing a joint return with an insolvent debtor does not realize discharge of indebtedness income from the debtor's discharge of indebtedness. *Traci v. Commissioner, T.C. Memo. 1992-708*. For partnerships, the determination of insolvency is made at the partner level where a partnership receives discharge of indebtedness income. See *Jasienski v. Commissioner, T.C. Memo. 1992-674* (no income to general partner in limited partnership on partial discharge of mortgage owed by limited partnership where partner insolvent before and after discharge).

The amount of income from the discharge of indebtedness that can be excluded from income is limited to the extent of the debtor's insolvency. If the amount of the debt discharged exceeds the amount of insolvency, income is recognized to the extent of the excess.

Note. The determination of insolvency is made **immediately before** the discharge of indebtedness. Insolvency is defined as the "excess of liabilities over the FMV of assets" I.R.C. §108(d)(3). The IRS position, until the summer of 1999, was that the value of property exempt under state exemption statutes was **not** included in the insolvency calculation. The IRS reversed course with Priv. Ltr. Rul. 199932013 (revoking PLR 9125010), FSA 199932019 and TAM 199935002 (revoking TAM 9130005). The Tax Court has now agreed with the new IRS position. *Carlson v. Commissioner, 116 T.C. No. 87 (2001).*

3. **Real property business debt.** I.R.C. §108(c). Taxpayers, other than C corporations, may elect to exclude from gross income amounts realized from the discharge of "qualified real property business indebtedness." The term does not include "qualified farm indebtedness."

4. **Solvent farm debtor.** I.R.C. §108(g). Discharge of indebtedness arising from an agreement between a person engaged in the trade or business of farming and a qualified person to discharge "qualified farm indebtedness" is treated under a special provision. A "qualified person" is defined as someone including state and federal agencies who is "actively and regularly engaged in the business of lending money" and who is not related to

the taxpayer, a person from whom the taxpayer acquired the property (or a related person), or a person who receives a fee with respect to the taxpayer's investment in the property (or a related person).

5. **Purchase price adjustment.** I.R.C. §108(e)(5). In the event that the debt of an original purchaser of property is reduced by the original seller of the property, the adjustment is treated as a purchase price adjustment and not as discharge of indebtedness under the regular rules if the debtor is solvent and not in bankruptcy.

Example 1. Sally had $75,000 of FmHA debt written off in 1992. She was not required to execute an SAA. Sally realized $75,000 of debt-discharge income in 1992 and was required to determine if any of the exceptions for reporting debt-discharge income under I.R.C. §108 applied.

Note. Since Sally met none of the five exceptions to the general rule that canceled debt was taxable, she reported the $75,000 on line 21 (Other income) on her 1992 Form 1040.

No restructuring plan, but debtor allowed to buy back property at NRV. The IRS position is that a borrower recognizes discharge of indebtedness income in the year of the buy-back of the collateral, and the Tax Court agrees. The rationale is that the taxpayer's repayment obligation is contingent upon whether the taxpayer disposed of the property within 10 years.

☐ CORRECTED (if checked)

CREDITOR'S name, street address, city, state, and ZIP code Farm Service Agency 101 Towne St Anytown, WI 55555			OMB No. 1545-1424 2002 Form 1099-C	**Cancellation of Debt**
CREDITOR'S Federal identification number 11-1122334	DEBTOR'S identification number 555-222-3333	1 Date canceled 01/10/02	2 Amount of debt canceled $ 177,772.28	**Copy B** **For Debtor**
DEBTOR'S name Howard Jelle		3 Interest if included in box 2 $	4	This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if taxable income results from this transaction and the IRS determines that it has not been reported.
Street address (including apt. no.) 204 Farmers Road City, state, and ZIP code Anytown, WI 55555		5 Debt description 142.21 ac farm land Hansen Co. WI		
Account number (optional) 55-78945-963		6 Bankruptcy (if checked) ☐	7 Fair market value of property $	

Form 1099-C (keep for your records) Department of the Treasury - Internal Revenue Service

Question A. Mr. And Mrs. Jelle are Wisconsin dairy farmers that do not qualify for a debt write-down, but can avoid foreclosure by buying out the collateral (land) at its NRV. They received a bank loan and bought the land for $92,057 from FmHA. FmHA then wrote off the indebtedness balance of $177,772.28, and issued a Form 1099-C for that amount. They signed an SAA that required repayment if they sold the property within 10 years. Do the Jelles have discharge of indebtedness income in the year of the discharge?

Answer A. Yes. The Tax Court held that the Jelle's debt was discharged in the year the land was bought back because the possibility of repayment was entirely within their control. Thus, the transaction involved a present cancellation with only a contingent future obligation to pay. *Jelle v. Commissioner, 116 T.C. No. 63 (2001).*

Debt write-down, and SAA entered into. Where a SAA is required, the IRS position is that the indebtedness is considered discharged for tax purposes to the extent of the write-down. The SAA is not considered a substitute debt and is considered too contingent to preclude discharge of indebtedness from occurring. *Letter, Office of Chief Counsel, IRS to FmHA Farmer Program Division, May 22, 1989.*

Observation. This outcome seems questionable if one of the events triggering recapture is the expiration of the agreement at the end of 10 years. That makes the indebtedness a certainty and would likely preclude discharge of indebtedness from occurring in the year of the write-off.

Note. The issue of whether the expiration of the SAA is a recapture-triggering event has been the subject of litigation, with the courts holding that the end of the 10-year period triggers recapture. See, e.g., *Stahl v. Veneman, No. A-3-01-85, 2002 U.S. Dist. LEXIS 9534 (D. N.D. May 20, 2002) (recapture triggered on expiration of agreement; Israel v. USDA, 282 F.3d 521 (7th Cir. 2002), aff'g, 135 F. Supp.2d 945* (W.D. Wis. 2001)(same); In re *Moncur, 1999 WL 33287727 (Bank. D. Idaho 1999)(same); Viers v. Glickman, 2000 WL 33363197 (S.D. Iowa 2000)(same); Curtis v. USDA, 2001 WL 822413 (W.D. Mich. 2001)*(same); *Wright v. USDA, 2001 WL 822417 (W.D. Mich. 2001)*(same); *Pandora Farms v. USDA, No. 00-1753-A (E.D. Va. July 5, 2001)*(same).

Note. A more complete explanation of this issue is contained in Chapter 11: Financial Distress.

SSAs and the 2002 Farm Bill

I.R.C. §5314 of the 2002 Farm Bill authorizes the restructuring of recapture amounts that were amortized at the time the amounts became due. Existing regulations authorize restructuring provided the borrower has other program loans, for a term not exceeding 25 years from the original amortization agreement. Thus, the provision expands existing regulations to allow restructuring of recapture amounts for individuals who do not have other program loans outstanding.

INCOME TAX CONSEQUENCES OF DEBT REDUCTION AND PAYMENT OF RECAPTURE TAX

In essence, when debt is discharged and repayment is made at a later date, the tax consequences of the repayment constitute a reversal of the tax consequences of the write-off in the earlier year. These issues were covered extensively in the *2001 Farm Income Tax Workbook* on pages 115-118. The key guidance on the issue is contained in a letter from the Department of the Treasury, Internal Revenue Service, to the Farmer Program Division, Farmers Home Administration, dated May 22, 1989, page 7.

ISSUE 2: GAINS AND LOSSES FROM COMMODITY FUTURES

Farmer-Producers often enter into commodity futures contracts and/or options on futures contracts. The difficult task of tax preparers is to determine how to report these transactions for income tax purposes.

A **"hedge"** is defined in terms of **managing risk, generally price** or interest rate fluctuations in the ordinary course of the taxpayer's business. I.R.C. §1256(e)(2). Gains and losses from bona-fide hedges that generate ordinary income and loss are not subject to the capital loss limitation rules and the "mark-to-market" provisions that apply to speculative transactions. Transactions that do not involve contracts primarily for sale to customers in the ordinary course of business generate capital gains and losses.

Note. The difference in the tax treatment makes the line between hedging and speculation very important to understand and, if the farming business is conducted through multiple entities, it is vital that the hedging transactions be carried on by the correct entity. In *Pine Creek Farms, Ltd. v. Commissioner*, *T.C. Memo. 2001-176*, a farming operation was held among several entities with the taxpayer engaged in producing corn, soybeans and cattle and a hog operation handled by two other corporations. The taxpayer had hedging losses and the portion of the losses attributable to the hog hedges was held to be capital losses even though a shareholder of the taxpayer was engaged in hog production through the other two entities. See pages 406-407 of the *2001 Farm Income Tax Workbook* for an analysis of this court case.

1994 FINAL REGULATIONS

Under the 1994 final regulations, a taxpayer may hedge any part or all of its risk for any part of the period during which it has risk. In addition, the frequent entering into and termination of hedging positions are not relevant to whether transactions are hedges. For a hedging program undertaken to reduce the overall risk of the taxpayer's operation, the taxpayer generally does not have to demonstrate that each hedge entered into under the program reduced overall risk. In addition, a transaction is a hedge only if the transaction is identified as a hedge on the taxpayer's books before the close of the day on which the taxpayer enters into the transaction, and the taxpayer makes a substantially contemporaneous identification of the items or risks being hedged within 35 days after entering into the hedge.

Note. The final hedging regulations can be found at Treas. Reg. §1.1221-2. Also on pages 48-55 of the *1995 Farm Income Tax Workbook* and pages 164-167 of the *1996 Farm Income Tax Workbook.* Correction: on page 165 of the *1996 Farm Income Tax Workbook* the end of 1c: should read "After crop is harvested and sold."

Observation. The identification requirement can be troublesome for farmers who do not keep good records. If proper identification is not made, the loss will not be an ordinary loss, and the "mark-to-market" rules apply.

COURT TESTS

The courts have emphasized two tests in evaluating commodity futures transactions as hedges or as speculation.

The insurance test: If the taxpayer uses futures trading to offset price changes in actual commodities, the transactions are ordinarily treated as hedges. Even if the taxpayer did not own the actual commodities, futures trading is hedging and not speculation if the commodity transactions were an integral part of the taxpayer's business and the taxpayer produced or bought the actual commodities in the course of business.

Observation. This test would allow hedging transactions before a crop is planted or before feeder animals are purchased in order to lock in a price. However, once the crops or purchased feeder animals are sold, there is no need to hedge that commodity. Since the asset is sold, the taxpayer is no longer at risk. Thus, "hedging" after the commodity is sold would be speculation.

The direct relation test: There must be a reasonable quantitative relationship between the taxpayer's involvement with the actual commodities and the commodity market transaction. The amount of futures trading in the particular commodity involved and the timing of purchases and sales must be related to the position of the taxpayer in the actual commodities.

Example 2. Harry reasonably expects to raise 100,000 bushels of corn in 2002. If he sells short 70,000 bushels of November 2002 corn futures contracts in May 2002 in order to lock in a price, Harry is hedging. If he sells 120,000 bushels of November 2002 corn futures contracts in May 2002, Harry is hedging for 100,000 bushels and speculating for the excess 20,000 bushels.

NEW IRS REGULATIONS

On March 20, 2002, the IRS issued regulations that revised the hedging regulations to reflect changes made by the Ticket to Work and Work Incentives Improvement Act of 1999. The final regulations have been restructured to implement the **risk management standard** of I.R.C. §1221(b)(2)(A). **No definition of risk management is provided, but instead, the rules characterize a variety of classes of transactions as hedging transactions because they manage risk.** Risk-reducing transactions still qualify as one class of hedging transactions but there are also others. In addition, specific provision is made for the recognition of additional types of qualifying risk management transactions through published guidance or private letter rulings. **Under the final regulations, transactions entered into for speculative purposes will not qualify as hedging transactions** [67 Fed. Reg. 12863 (March 20, 2002), amending Treas. Reg. §1.1221-2].

> **Note.** The new regulations do not discuss the tax treatment of farmers entering into so-called store-on-the-board transactions. If a farmer sells a commodity and purchases an equivalent amount of commodity futures contracts, it is likely that the farmer is not hedging because risk is not reduced and the farmer no longer owned the commodity at the time of purchase of the futures contract. The market-to-market rules would likely apply and the farmer would report the transaction on Form 6781 using information obtained from Form 1099-B provided by the broker [Treas. Reg. §1.221-2(c)(1)(vii)].

Example 3. If a farmer participates in the commodities or option market, he will receive a Form 1099-B at year end. A typical 1099-B might look like the following:

☐ CORRECTED (if checked)

PAYER'S name, street address, city, state, ZIP code, and telephone no. **XYZ Commodity Brokers** **123 Main** **Chicago, IL 11122**	**1a** Date of sale **1b** CUSIP no.	OMB No. 1545-0715 **2002** Form **1099-B**	**Proceeds From Broker and Barter Exchange Transactions**
	2 Stocks, bonds, etc. $	Reported to IRS ☐ Gross proceeds ☐ Gross proceeds less commissions and option premiums	
PAYER'S Federal identification number **37-1234567** / RECIPIENT'S identification number **111-22-3333**	**3** Bartering $	**4 Federal income tax withheld** $	**Copy B For Recipient**
RECIPIENT'S name **George Farmer**	**5** Description		This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported.
Street address (including apt. no.) **2025 North Road** City, state, and ZIP code **CBOT, IL 66645**	**Regulated Futures Contracts** **6** Profit or (loss) realized in 2002 $ **(368586.78)**	**7** Unrealized profit or (loss) on open contracts—12/31/2001 $ **(114952.50)**	
Account number (optional)	**8** Unrealized profit or (loss) on open contracts—12/31/2002 $ **(48650.00)**	**9** Aggregate profit or (loss) $ **(302284.28)**	

Form **1099-B** (keep for your records) Department of the Treasury - Internal Revenue Service

Some firms use a proforma form that may look like the following:

For Example 3

1099-B Proceeds from Broker & Barter Exchange Transactions — OMB.1545.0715
-Regulated Futures Contracts-

	Converted Amt.
6. → Profit/(Loss) Realized on Futures Contracts in USD for 2002	(365,919.03)
→ Profit/(Loss) Realized on Futures Options in USD for 2002	(2,667.75)
*** Total Reported for Line 6 in USD for 2002	(368,586.78)
7. Total Unrealized P/L Converted to USD of Futures - 12/31/01	(114,952.50)
*** Total Reported for Line 7 in USD for 2002	(114,952.50)
8. Total Unrealized P/L Converted to USD on Futures - 12/31/02	(45,550.00)
Total Unrealized P/L Converted to USD on Options - 12/31/02	(3,100.00)
*** Total Reported for Line 8 in USD for 2002	(48,650.00)
9. Aggregate Profit or (Loss) from Lines 6, 7, and 8	(302,284.28)

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: **George Farmer**
Social security number (SSN): **111 22 3333**

A Principal product. Describe in one or two words your principal crop or activity for the current tax year. **Grain**
B Enter code from Part IV ▶ **111100**
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 2001? If "No," see page F-2 for limit on passive losses. ☑ Yes ☐ No

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

1	Sales of livestock and other items you bought for resale	1		
2	Cost or other basis of livestock and other items reported on line 1	2		
3	Subtract line 2 from line 1		3	
4	Sales of livestock, produce, grains, and other products you raised		4	
5a	Total cooperative distributions (Form(s) 1099-PATR)	5a	5b Taxable amount 5b	
6a	Agricultural program payments (see page F-2)	6a	6b Taxable amount 6b	
7	Commodity Credit Corporation (CCC) loans (see page F-3):			
a	CCC loans reported under election		7a	
b	CCC loans forfeited	7b	7c Taxable amount 7c	
8	Crop insurance proceeds and certain disaster payments (see page F-3):			
a	Amount received in 2001	8a	8b Taxable amount 8b	
c	If election to defer to 2002 is attached, check here ▶ ☐		8d Amount deferred from 2000 8d	
9	Custom hire (machine work) income		9	
10	Other income, including Federal and state gasoline or fuel tax credit or refund (see page F-3)		10	(368,587 78)
11	**Gross income.** Add amounts in the right column for lines 3 through 10. If accrual method taxpayer, enter the amount from page 2, line 51 ▶		11	(368,587 78)

For Example 3

Form **6781** Department of the Treasury Internal Revenue Service	**Gains and Losses From Section 1256 Contracts and Straddles** ▶ **Attach to your tax return.**	OMB No. 1545-0644 2001 Attachment Sequence No. 82
Name(s) shown on tax return **George Farmer**		**Identifying number** **111-22-3333**

Check all applicable boxes (see instructions). **A** ☐ Mixed straddle election **B** ☐ Straddle-by-straddle identification election **C** ☐ Mixed straddle account election **D** ☐ Net section 1256 contracts loss election

Part I **Section 1256 Contracts Marked to Market**

	(a) Identification of account		(b) (Loss)	(c) Gain
1	RFC-Hog Futures XYZ Commodity Brokers		(302,284 28)	
2	Add the amounts on line 1 in columns (b) and (c)	2	(302,284 28)	
3	Net gain or (loss). Combine line 2, columns (b) and (c)	3		(302,284 28)
4	Form 1099-B adjustments. See instructions and attach schedule	4		
5	Combine lines 3 and 4	5		(302,284 28)
	Note: *If line 5 shows a net gain, skip line 6 and enter the gain on line 7. Partnerships and S corporations, see instructions.*			
6	If you have a net section 1256 contracts loss and you checked box D above, enter the amount to be carried back	6		
7	Subtract line 6 from line 5	7		(302,284 28)
8	Short-term capital gain or (loss). Multiply line 7 by 40% (.40). Enter here and include on the appropriate line of Schedule D (see instructions)	8		(120,913 71)
9	Long-term capital gain or (loss). Multiply line 7 by 60% (.60). Enter here and include on the appropriate line of Schedule D (see instructions)	9		(181,370 57)

HEDGE-TO-ARRIVE (HTA) CONTRACTS

The use of fixed-price forward grain contracts has gained popularity in recent years among grain producers. The contracts are of several types, but one of the more popular types involves a sale agreement that binds the farmer to deliver a specified amount of grain at a future date. The farmer takes the risk that the commodity price will not rise (usually not a problem) before the delivery date, and the buyer covers the price risk by selling an identical amount of the commodity to a third party or by use of hedges in the futures market. HTA contracts contain a provision that allows the transaction to be rolled forward several months when prices are expected to be lower. If the market continues to climb during this period, some buyers (elevators) may experience a severely weakened liquidity position and may exhaust their line of credit for margin calls.

Thus far, no specific guidance has emerged for handling gains and losses from HTA contracts for income tax purposes. However, it appears likely that contracts purporting to sell more commodity than what was in storage plus what was expected to be produced in the current production cycle are speculative in nature. They are not hedges, unless actually hedged under a commodity futures contract in a futures market.

ISSUE 3: SELF-EMPLOYMENT INCOME

Self-employment tax is imposed on net earnings from self-employment, defined as net earnings from a trade or business carried on by the taxpayer [I.R.C. §1402(a)]. Rentals from real estate are excluded, but rentals involving the production of agricultural or horticultural commodities are subject to self-employment tax if the taxpayer **materially participates** in the production of the farm products on the land.

> **Note.** The activities of an agent on behalf of the farmland owner do not constitute self-employment activities.

Example 4. Mabel is an 85-year-old widow of Sam, who was a farmer. The farm she inherited from him is crop-share rented to an unrelated tenant. The Farm Management Department of the local bank makes all management decisions for Mabel. Mabel will report her farm rental income and expenses on Form 4835. Her rental profit is not subject to self-employment tax.

Observation. For many farmers, the 15.3% self-employment tax exceeds the amount of income tax paid. Therefore, the self-employment tax looms large in tax planning for farmers and ranchers.

FARM-PROGRAM PAYMENTS — GENERAL RULE

In general, all agricultural program payments in cash or in materials or services are includible in income. The *Farmer's Tax Guide* (IRS Publication 225) states: "Report the agricultural program payment on the appropriate line of Part 1 of Schedule F." Agricultural program payments received under a crop share or livestock share lease are considered to be self-employment income if the landlord materially participates under the lease. The rule is that government payments are handled as other farm income from the operation.

Note on Constructive Receipt. The time at which an amount is made available to the taxpayer is ordinarily the time the payments are to be included in income. Amounts are "made available" in the year in which program requirements have been met, regardless of whether an application had been signed to receive final payment.

Under the 2002 Farm Bill, a producer may **elect** to receive up to 50% of the direct payment **in advance** for any of the 2003 through 2007 crop years. This provision allows farmers, who make the election, to receive the advance payment for a crop year in December of the previous year. I.R.C. §1601(d) of the 2002 Act negates the application of the constructive receipts rule to farmers who do not make this advance election. Therefore, any agriculture subsidy payment **will be taxed in the tax year of receipt** rather than in an earlier tax year in which it **could** have been received.

Additional information can be found in Chapter 1: New Tax Legislation.

CONSERVATION RESERVE PROGRAM (CRP) PAYMENTS

For retired landowners that are not materially participating, the IRS position is that CRP payments are not considered net income from self-employment. *Ltr. Rul. 8822064* (no tenant involved; landowner's activities under CRP did not constitute material participation). The Commissioner of Social Security has agreed. Thus, CRP payments are reported properly on either Schedule E or Form 4835.

Example 5. Ken retired from farming and successfully bid his entire farm into the CRP. He paid a neighbor to establish the cover crop and pays the neighbor to maintain weed control. Because Ken is not materially participating, his CRP income and related expenses are reported on Schedule E. Since Ken did not share his CRP payments with a tenant, he should not report his farm income and expenses on Form 4835.

Tax preparers should note the agricultural program payments reported by Farm Services Agency on Form 1099 are likely to be matched by the IRS to amounts reported on Schedule F, line 6 and Form 4835, line 3. Taxpayers that report CRP payments on Schedule E may receive an inquiry from the IRS under the Form 1099 matching program.

The rental amount should be reported on Form 1040, line 21, Other Income, and identified as personal property rental income. Deductible expenses related to income reported on line 21 from rental of personal property engaged in for profit should be reported on Form 1040, line 32 and identified as "PPR."

Example 6. If Ken establishes the cover crop and maintains weed control, he is still not materially participating in the trade or business of farming and the CRP rents are not subject to self-employment tax. The Social Security Administration has indicated that material participation in the production or management of the production of crops or livestock is required for self-employment income [SSR 67-1].

For landowners who are not retired from materially participating in the farming business at the time the land was bid into the CRP, and do not retire during the length of the CRP contract, the IRS position (supported by the Tax Court and the Sixth Circuit Court of Appeals) is that the CRP payments are subject to self-employment tax. *Priv. Ltr. Rul. 963700; Ray v. Commissioner, T.C. Memo. 1996-436; Wuebker v. Commissioner, 205 F.3d 897 (6th Cir. 2000).* Thus, for these clients, the CRP payments must be reported on Schedule F.

For landowners who retire during the period of the CRP contract, there is a split of authority. Some authorities have focused on the taxpayer's status at the time the agreement was entered into. *See Notice 87-26, 1987-1 C.B. 470 (dairy termination payments); Rev. Rul. 60-32, 1960-1 C.B. 23 (soil bank payments).* Other authorities suggest that it is the taxpayer's status at the time the payment is received that determines liability for self-employment tax. *Soc. Sec. Rul. 67-42 (cropland adjustment income; dictum).*

Observation. The 2002 Farm Bill reauthorizes the CRP through the 2007 calendar year, raises the acreage cap from 36.4 million acres to 39.2 million acres and directs the Secretary of Agriculture to permit wind turbines on CRP land, whether commercial in nature or not, in a manner which does not interfere with wildlife.

Note. The key to understanding the proper self-employment tax treatment of CRP payments received by a client involves the level of the client's participation in the farming operation.

Note. The U.S. Senate is considering legislation that would specify that "net earnings from self-employment" does not include CRP payments. *S. 312. The Tax Empowerment and Relief for Farmers and Fishermen Act.*

RENTS FROM PERSONAL PROPERTY — FARM MACHINERY RENTS

A note in Part 1 of Schedule E, Form 1040 states: If you are in the business of renting personal property, use Schedule C or C-EZ. This has raised concerns about the proper reporting of retired farmers' rentals from personal property, such as farm machinery, rented to children or others. Several high profile audits, in which examining agents have taken a relatively aggressive stance, have added to the concerns.

Note. I.R.C. §1402 imposes self-employment tax on "net earnings from self-employment derived by an individual... during the taxable year..." Excluded from this definition are "rentals from real estate and from personal property leased with real estate..." The statutory language does not provide an exclusion for the rental of personal property apart from the real estate. But, that does not mean that income from personal property rented apart from real estate is included in self-employment income and subject to self-employment tax. **The statute requires that an individual be engaged in a trade or business in order for income to be self-employment income.**

A retired farmer renting machinery and equipment in a passive lease arrangement should not be considered as carrying on a trade or business and should not have self-employment income to report on Schedule C or F.

Example 7. Clem, a retired farmer, rented his grain drill to a neighbor for $5 per acre. The neighbor used the drill to plant 600 acres of soybeans. Clem should report the $3,000 received for rent of his grain drill on Form 1040, line 21. Clem is not engaged in the trade or business of renting farm machinery or equipment.

Practice Pointers

- For clients who rent farm machinery to others, **the key is whether the client, as lessor, is carrying on a trade or business.** If the client is carrying on a trade or business, rentals should be included in the client's self-employment income and should, therefore, be reported on Schedules C or F. If the client is not carrying on a trade or business, the rentals involved should not be included in self-employment income.
- For retired clients renting both machinery and land, including both in the same lease should strengthen the argument that the amounts received are not subject to self-employment tax. The statutory language of I.R.C. §1402 should be strong enough to specifically exclude the rental income from self-employment tax if the taxpayer is not materially participating.
- For clients who rent personal property but do not want self-employment income, the lease should be drafted to place responsibility on the lessee for maintenance and repair of the rental property. The client, as lessor, should avoid involvement in management or decision making relative to the property under the lease. The net income should then be reported on the "other income" line of Form 1040 (or on Form 4835 or Schedule E) with the income reported as "net income from passive rental activity."

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RENTING LAND TO A FAMILY — THE "MIZELL" PROBLEM

Mizell v. Commissioner, T.C. Memo. 1995-571, involved an Arkansas farmer who rented 731 acres of farmland to a family partnership operated with his three sons. The father owned a 25% interest in the partnership and the partnership agreement specified that each partner had an equal vote in the management of the partnership operation and in the conduct of the farming business. Each partner was required to devote full time to the operation. The father was active in the partnership in the years in question, and reported the distributive share of partnership income as net earning from self-employment. The lease was on a 25% crop-share basis with the partnership paying all of the crop expense.

The father treated the lease as a non-material participation lease and did not report the rental amounts as self-employment income. The Tax Court focused on the language in I.R.C. §1402(a)(1) providing an exception to the general rule that rentals from real estate are excluded from net earning from self-employment if there is an **"arrangement" with material participation by the owner in the "production or the management of the production" of agricultural commodities.** The court noted that the father was materially participating in the partnership operations, and the statutory language referring to "an arrangement" necessarily included the father's involvement in the partnership, as well as under the lease. Thus, the rental income under the lease was subject to self-employment tax. The type of lease, the court reasoned, was immaterial where the lessor was materially participating in the lessee entity.

SUBSEQUENT RULINGS AND CASES

In three cases decided in 1999, the Tax Court applied *Mizell* and imposed self-employment tax on rents from land rented to a family farming operation. *Bot v. Commissioner, T.C. Memo. 1999-256; Hennen v. Commissioner, T.C. Memo. 1999-306; McNamara v. Commissioner, T.C. Memo. 1999-333.* Also, three IRS Field Service Advice memoranda from 1998 reaffirmed the National Office position. *FSAs 199917005; 199917006; 199917007.* On appeal, the three Tax Court cases were consolidated and were reversed in late 2000. *McNamara v. Commissioner, 236 F.3d 410 (8th Cir. 2000).* **The Eighth Circuit held that the lessor-lessee arrangements should stand on their own, apart from any employment relationship, and that if the rentals were "consistent with market rates for agricultural land" the rents were not "derived under an arrangement" and, therefore, self-employment tax was not due.** The court pointed out that "the mere existence of an arrangement requiring and resulting in material participation in agricultural production does not automatically transform rents received" into self-employment income. The court pointed out that rents consistent with market rates "very strongly suggest" that the rental arrangement stands on its own as an independent transaction and cannot be said to be part of an arrangement for participation in agricultural production.

The court remanded the cases to the Tax Court to provide an opportunity for the IRS to show a connection between rents and the "arrangement."

- On July 15, 2002, the Tax Court rendered its remand opinion holding that the rental arrangements reflected FMV and that no self-employment tax could be imposed.

Note. Based on the Eighth Circuit's opinion in *McNamara*, and the Tax Court's remand opinion, it is imperative that taxpayers, potentially subject to challenge, set the rental rates in keeping with rates in the area for comparable land. In addition, it is important that evidence of rental rates be preserved for use in any later audit.

Practice Pointers

- For taxpayers occupying a dual status as lessor and lessee, it is important for the lease to be in writing with standard terms and conditions calling for a reasonable rental. Also, it is important for the status as partner, employee or LLC member to be formally established and maintained.
- The key, outside the Eighth Circuit, is to make sure that the taxpayer is not on "both sides of the equation" as both lessor and lessee. In the IRS view, supported by the Tax Court opinion in *Mizell*, the question is whether the taxpayer's combination of involvement as lessor and lessee rises to the level of material participation. In the Eighth Circuit (Arkansas, Iowa, Minnesota, Missouri, Nebraska, North Dakota, and South Dakota) the key is to make sure the rental rate is representative of a fair market rental for comparable land.
- Another approach may be to transfer the land to a non-participating spouse. The spouse would lease the land to the farm business under a passive lease. How the courts would rule on this issue is unknown.

Observation. The IRS continues to litigate "Mizell"-type situations. A case involving an upstate New York apple tree and produce farm is currently pending in the Tax Court and would be appealable to the Second Circuit. *Fowler Farms v. Commissioner, No. 013920-01 filed Dec. 11, 2001.* Another pending case involves a Nebraska farmer that leased land he owns to his controlled farming corporation held in a family partnership. The IRS is claiming that self-employment tax applies based on the lessor's employment role with the tenant corporation. The rent levels between the partnership and the controlled corporation are representative of market rates in the area. Consequently, the case appears to be solidly in line with *McNamara. Milton v. Commissioner, No. 013594-01, filed Dec. 4, 2001.*

Note. The U.S. Senate is considering legislation that would constrain the IRS to examining only the lease agreement to determine if sufficient material participation under the lease is present. *S. 312, The Tax Empowerment and Relief for Farmers and Fishermen Act.*

DISTRIBUTIONS FROM VALUE-ADDED COOPERATIVES

In the typical scenario, an individual subscribes to ownership units that require the individual either to deliver bushels of grain grown on the individual's farm or to purchase an equivalent amount for delivery to the cooperative. At the end of the production year, the individual receives a "value-added payment" for a share of the cooperative's profit. Clearly, the value-added payment is ordinary income to the recipient, but the question remains as to whether the payment is also subject to self-employment tax.

RULINGS AND CASES

In 1996, the IRS ruled that the value-added payments represented a part of the recipient's farming business and were, therefore, subject to self-employment tax. *Tech. Adv. Memo. 9652007.* Under the facts of the ruling, the taxpayer was a grain grower that was obligated to deliver stated quantities of grain to the cooperative for processing three times annually. The farmer could satisfy the obligation by delivering grain grown on the farm, by delivering "pooled" grain maintained by the cooperative, or by delivering grain purchased from other growers. For the most part, the farmer satisfied his obligation by delivering grain grown by others. Grain that was grown on the farm was primarily used as livestock feed. Indeed, the farmer stated that except for one year, all of the raised grain was fed to the farmer's livestock and that he had not raised sufficient amounts of grain to provide a full year's supply of grain for the livestock. Consequently, the farmer purchased grain from other local farmers to feed the livestock. While the farmer indicated that he joined the cooperative as an investor with the intent of purchasing the grain that he would need to deliver to the cooperative rather than producing it on his own farm, the IRS determined that the value-added payments to the farmer were subject to self-employment tax because he remained an active farmer.

In *Hansen v. Commissioner, T.C. Summary Op. 1998-91,* a Minnesota farmer, while actively farming, had become a member of a value-added cooperative and apparently reported distributions from the cooperative as net earnings from self-employment. After retirement, the farmer no longer produced corn to meet the delivery requirement to the cooperative and fulfilled his obligation out of the cooperative's pool. The farmer took the position that the distributions were investment income not subject to self-employment tax, and the Tax Court agreed.

Note. The *Hansen* case is a summary opinion of the Tax Court and cannot be cited as precedent.

Observation. In 1999, the IRS acquiesced to the Tax Court's opinion. *Chief Counsel Notice N(36)000-3, April 21, 1999.* However, the IRS indicated if the Form 4835 (or presumably any other form for reporting rental income) reveals that the taxpayer actively participated in the farming operation, it could indicate a connection with grain production. This could support a conclusion that the farmer was in the trade or business of grain processing.

In 2002, the Tax Court decided *Bot v. Commissioner, 118 T.C. No. 138 (2002),* a case involving a retired farmer and his wife who were members of a value-added cooperative, and had been members before their retirement from farming. The Bots retired to a crop-share lease with their sons as tenants. The court held that the Bots had to report the value-added payments from the cooperative as self-employment income. The court noted the *Hansen* case could not be cited as precedent, and held that the Bots were engaged in the trade or business of producing, marketing and selling corn and corn products in their relationship with the cooperative and were liable for self-employment tax. The court determined that, since the value-added payments were directly related to the volume of corn delivered to the cooperative, the value-added payments had a direct connection to their trade or business and must be included in self-employment income.

Note. The Tax Court stated that its conclusion was reached in light of the involvement of the Bots in the operation and the involvement of their sons. However, the statute does not allow the actions of an agent to be imputed to the property owner, under a lease involving crop of livestock production, for self-employment tax purposes. In *Bot*, the only apparent business relationship between the Bots and their sons was through the crop-share lease.

Observation. *Bot* is unlikely to be the last word on the subject. It is becoming clear that retired members of value-added cooperatives need to watch their involvement with the cooperative if self-employment tax is to be avoided.

CONTRACT PRODUCTION PAYMENTS

Many farmers enter into contract farming agreements with canneries, seed companies and livestock packers. The arrangements tend to leave the farmer with less economic risk, less management input and no marketing options.

> **Observation.** For contract producers, it may be critical to maintain as many characteristics of a farming business as possible to retain the favorable tax treatment "farmers" enjoy in many areas of the Code.

Production contract payments should be reported on Schedule F.

Example 8. Fred has a contract with Big Pork to grow hogs. Under the contract terms, Fred will provide the facilities and labor to grow the hogs. Big Pork delivers piglets to Fred and supplies the feed, vaccines and medication necessary to raise the hogs. A Big Pork representative also supervises Fred's activities and has 24-hour access to the facilities. Big Pork pays Fred for the pounds of hogs that are delivered to Big Pork's processing plant based on a formula specifying a certain rate per pound depending on Fred's efficiency.

Question A. How should Fred report the payment?

Answer A. Fred should report the payment (along with any expenses he incurs in growing the hogs) on Schedule F. He should also include interest paid on money borrowed to build the facilities, depreciation on those facilities, and property taxes as farm expenses.

> **Note.** A processor sometimes reports the payment on Form 1099-MISC by entering the amount in the "Rent" box. However, it will typically be difficult for a grower to report the payment on Schedule E because the grower is likely to be materially participating.

INCOME FROM COMMODITY TRADES

For persons conducting business as a commodities trader on the Chicago Board of Trade (CBOT), income from the trading activity is subject to self-employment tax. In a recent case, the Tax Court also subjected to self-employment tax commodity trading income conducted through a broker. The taxpayer was a commodities futures trader who had originally made the trades on the taxpayer's own account on the CBOT. However, for the tax year involved, the taxpayer did all of his trading through another broker because of an investigation of his own trading activities. The taxpayer claimed all gains made in that year as capital gains, reported them on Schedule D, and deducted expenses for the trades on Schedule C. The court held that the gains were self-employment income because the trades were made within the normal scope of the taxpayer's business as a commodities trader, even though made through a broker. *Rudman v. Commissioner, 118 T.C. No. 21 (2002).*

ISSUE 4: CAPITAL ASSETS AND FARM PROPERTY

The taxation of capital gains was changed substantially for years beginning after 1996. Those new rules have been covered in-depth in the tax workbook in recent years and are not covered here. This issue only deals with selected capital gain issues for farm and ranch clients.

WHAT IS A CAPITAL ASSET?

I.R.C. §1221 specifies that capital assets are all property held by the taxpayer except:

1. Stock in trade or other property properly included in inventory, if on hand at the close of the taxable year which includes property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business;
2. Property used in the trade or business of a character subject to depreciation;

3. Real property used in the trade or business;
4. A copyright, a literary, musical or artistic composition, a letter or memorandum, or similar property held by one who created it, or for whom such property was prepared or produced, or in whose hands the property has a substituted basis from the creator or preparer;
5. Accounts or notes receivable acquired in the ordinary course of business or trade for services rendered, or from the sale of property mentioned in points 1 and 2 above;
6. Certain publications of the United States government.

LONG-TERM AND SHORT-TERM GAINS AND LOSSES

Gains and losses from sales or exchanges of capital assets held more than one year produce long-term gain or loss. Short-term items are those held for less than the long-term period, and they are separately computed. The separate computations produce a net short-term gain or loss and a net long-term gain or loss.

Practice Pointers

1. A net short-term loss in excess of net long-term gain offsets $3,000 of ordinary income (or the taxable income for the year, if less) for an individual taxpayer.
2. A net short-term loss is applied against ordinary income.
3. The aggregate of the deduction of the total net short-term loss and net long-term loss in any year cannot exceed the lesser of $3,000 or the taxable income for the year.
4. Any excess losses may be carried forward indefinitely to offset capital gains in future years.
   - The carry-over losses are treated as short-term or long-term according to their origin and are applied first to offset corresponding short-term and long-term gains of the carry-over year.
   - Any remaining short-term loss carry-over is applied against $3,000 of ordinary income in the carry-over year and then long-term loss is applied to the remainder of ordinary income, up to the $3,000 limit.
   - Any remaining loss that has not been offset by capital gains or the $3,000 of ordinary income, is carried forward to the subsequent year. It continues to carry until it is fully offset against capital gains and $3,000 of ordinary income of the later years.

Note. If a married couple files separately, the amount allowed to each of them is one-half of the amounts mentioned above. For corporations, capital losses allowed may not exceed capital gains for the year. Any excess may be carried back three years and forward five years. The unused carryover losses are not deductible for deceased individuals and terminated corporations. A partnership or S corporation allocates the losses to its partners or shareholders, and an estate or trust only distributes carry-overs to beneficiaries in the year of termination.

INSTALLMENT SALES

Gain from installment sales is characterized by the holding period and kind of property involved when the sale occurred. If the sale of the property produces both gain that falls in the 10% and 20% brackets, and also unrecaptured I.R.C. §1250 gain, the installment payment must be divided between the two categories of gain. The proposed regulations require that gain first be allocated to the unrecaptured I.R.C. §1250 gain and taxed at 25%.

Recapture income from personal property is immediately subject to tax at the time of sale (I.R.C. §453(h)). It cannot be deferred under the installment sale rule, and it will be taxed at ordinary income rates.

> **Note.** A different rule applies to the sale of real estate improvements that have been depreciated and thus produce unrecaptured I.R.C. §1250 gain. The gain is deferred in accordance with the installment sale rules, but subject to a 15% tax (for low-bracket taxpayers) and a 25% tax for higher bracket taxpayers. Thus, for payments received after May 6, 1997, it is necessary to go back to the original calculations, compute the "unrecaptured I.R.C. §1250 gain," and report the portion of payments received after May 6, 1997, attributable to unrecaptured I.R.C. §1250 gain at the maximum rate of 25%. For pre-May 6, 1997 sales, the recaptured I.R.C. §1250 gain is considered to have been reported first, ahead of regular capital gain, with only that remaining as of May 6, 1997, reported at a maximum 25% rate. See Chapter 13: Practitioner Q and A for an example.

For assets on which expense method depreciation has been claimed, that are disposed of by installment sale, all payments received under the contract are deemed to have been received in the year of sale. This rule applies to the extent of expense method depreciation claimed on the property.

Dealers are not allowed to use installment reporting of gain from the sale of personal property sold in the course of business. While an exception under I.R.C. §453(l)(2)(A) exists for farm property, one court has held that the exception applies only to farmers who sell personal property used by both the buyer and seller in a farming business. As such, a company that manufactured, sold and leased irrigation equipment could not use installment reporting. *Thom v. United States, 2002 U.S. Tax Cas. (CCH) ¶50,293 (8th Cir. 2002), aff'g, 134 F. Supp. 2d 1093 (D. Neb. 2001).*

MISCELLANEOUS DEVELOPMENTS CONCERNING "CAPITAL ASSETS"

Question A. Frank Krook forged his signature, as agent, on Polly Smith's power of attorney and entered into an oil and gas lease of Polly's lands with Frank collecting the royalties. Polly sued Frank and was awarded both compensatory and punitive damages, with the compensatory portion being more than what Polly would have received as royalties. How should Polly report the portion of the compensatory award that exceeded anticipated royalties?

Answer A. The excess amount should be treated as representing the sale or exchange of a capital asset because Polly was involuntarily forced to give up the right not to convert the gas to money. *Gail v. United States, 58 F.3d 580 (10th Cir. 1995).*

> **Note.** Corporate stock is generally a capital asset, but for securities dealers it can be a non-capital asset. See, e.g., *Cenex, Inc. v. United States, 38 Fed. Cl. 331 (1997).* Also, a stockbroker who traded stock options on his own account has been held to have incurred capital losses. The options were not held as inventory or as property for sale to customers in the ordinary course of business, and the stockbroker was not a dealer as to the options. *Kelly v. Commissioner, T.C. Memo. 1996-529; Bielfeldt v. Commissioner, 231 F.3d 1035 (7th Cir. 2000).*

In *Gladden v. Commissioner, 262 F.3d 851 (9th Cir. 2001),* the court held that a portion of the cost basis in land purchased by the landowners' partnership could be allocated to water rights that were expected, but not legally vested, at the time the land was purchased. Under the facts of the case, an irrigation district was formed in the 1960s to acquire water rights and distribute irrigation water to the area. In 1968, the Congress authorized a water project to bring water into the area from the Colorado River. In 1976, the plaintiffs' partnership purchased farmland in the same area, and in 1983 the irrigation district was allocated rights to redistribute water and the partnership became eligible to receive a quantity of water each year. At that time, the landowners could sell the water rights, but only as part of a sale of their land. In 1993, the taxpayers received $543,566 in exchange for their water rights, and reported the transaction as a capital gain, thereby offsetting the gain by a portion of the original purchase price for the land that they claimed was paid for the expectation of the water rights. The IRS took the position that the taxpayers' share of the sale of the water rights was ordinary income with no offset for any price paid for an expectancy of water rights. The Tax Court held that the gain was capital in nature, but that the taxpayers could not apply any of their tax basis in the land to the sale of water rights because the water rights were acquired in a "separate transaction" that occurred after the original land purchase, resulting in no cost basis in the rights.

On appeal, the Ninth Circuit reversed. The court noted that while the water rights were not vested at the time the partnership bought the land, the purchase was made with a realistic expectation that water rights would eventually attach to the land. Thus, the taxpayers could apportion some of their cost basis in the land to the later sale of water rights belonging to that land. Because the Tax Court ruled against the taxpayers on summary judgment, the record was undeveloped as to what portion of the cost of the land may have been a premium paid for the water rights later acquired by the partnership, or whether it was impracticable or impossible to determine what that premium may have been. Thus, the case was remanded to the Tax Court for such a determination.

THE IMPORTANCE OF SCHEDULE D AND FORM 4797

Sorting out capital assets and I.R.C. §1231 assets for the farm client's transactions can be a tedious process. If all of the transactions result only in long-term gains, it actually will not make a difference if capital assets and I.R.C. §1231 assets are mixed together, even though technically they should not be mixed.

Observation. Form 4797 is for reporting the sale of I.R.C. §1231 assets and Schedule D is for reporting the sale of I.R.C. §1221 assets.

Practice Pointers

I.R.C. §1231 items are aggregated and the determination is made of the net gain or net loss from all such items. Each capital asset is an individual item.

If a long-term capital gain from the sale of a capital asset winds up in the I.R.C. §1231 computation, it is immaterial if the aggregate from I.R.C. §1231 assets is a gain. But, if the I.R.C. §1231 aggregate is a loss, the addition of the capital loss might be improper because of the limitation on capital losses. If the I.R.C. §1231 aggregate gain is less than the capital loss, the capital loss could offset it. The excess loss would fall within the limitations on the use of capital losses against ordinary income.

- Do not list sales of capital assets on Schedule F.
- Personal assets (e.g., household items, personal residence, auto used for personal purposes) should not be included on Schedule D if a loss would be shown on the sale. It may be prudent, however, to report the sale price and cost basis on the schedule with a notation that the amounts were not taken into account in the totals because the losses were not deductible.

ISSUE 5: COMMODITY CREDIT CORPORATION (CCC) LOANS

An eligible taxpayer may use agricultural commodities as collateral for a loan from the CCC. The loans are non-recourse, so at maturity, if the loan plus interest is not paid, the commodity may be forfeited to the CCC as full payment for the loan.

NO ELECTION MADE

If the election has not been made to treat CCC loans as income when the loan proceeds are received, the taxpayer has no taxable income until the commodity serving as collateral for the loan is sold or forfeited to the CCC as payment on the loan. Thus, the mere taking out (and payment of) a CCC loan does not in itself have income tax consequences. Income tax is due on forfeiture of the commodity to CCC or sale of the commodity after discharge of the CCC loan.

With the advent of the Market Gain and Loan Deficiency Payment procedures, forfeited CCC loans are a rare occurrence. For example, McLean County (IL) USDA Farm Service Agency office typically experiences six or less forfeited CCC loans annually. When this does happen, the farmer will receive a Form CCC-1099-A from the USDA for the amount of the forfeited CCC loan.

Example 9. Brian received a $40,000 loan on corn he produced in 2001 on November 1, 2001. He treats CCC loans as loans, not as income. He forfeited the loan to CCC on July 3, 2002 because:

- the Posted County Price on July 3, 2002 was $1.80; and
- his elevator cash bid for corn on July 3, 2002 was only $1.78.

Brian will receive a 2002 Form CCC-1099-A from USDA. Since he treats CCC loans as loans, Brian will report the $40,000 forfeited CCC loan amount on lines 7b and 7c on his 2002 Schedule F.

Brian's 2002 Form CCC-1099-A from USDA and his 2002 Part 1, Schedule F are shown below:

☐ CORRECTED (if checked)

LENDER'S name, street address, city, state, ZIP code, and telephone no. U.S. DEPARTMENT OF AGRICULTURE MCLEAN COUNTY FSA OFFICE 402 NORTH KAYS DRIVE NORMAL, IL 61761		OMB No. 1545-0877 2002 Form 1099-A	**Acquisition or Abandonment of Secured Property**
LENDER'S Federal identification number 43-0951685 — BORROWER'S identification number 111-11-1111	1 Date of lender's acquisition or knowledge of abandonment 07-03-2002	2 Balance of principal outstanding $ 40000.00	**Copy B For Borrower**
BORROWER'S name Brian	3	4 Fair market value of property $ 40000.00	This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if taxable income results from this transaction and the IRS determines that it has not been reported.
Street address (including apt. no.)	5 Was borrower personally liable for repayment of the debt? ☒ Yes ☐ No		
City, state, and ZIP code	6 Description of property CCC (Corn)		
Account number (optional) Loan Number 200103247			

Form CCC-1099-A (keep for your records) Department of the Treasury - Internal Revenue Service

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 — 2002 — Attachment Sequence No. 14

Name of proprietor: Brian — Social security number (SSN): 111 11 1111

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

B Enter code from Part IV ► 111100

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 2002? If "No," see page F-2 for limit on passive losses. ☑ Yes ☐ No

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

1	Sales of livestock and other items you bought for resale	1		
2	Cost or other basis of livestock and other items reported on line 1	2		
3	Subtract line 2 from line 1		3	
4	Sales of livestock, produce, grains, and other products you raised		4	
5a	Total cooperative distributions (Form(s) 1099-PATR)	5a	5b Taxable amount 5b	
6a	Agricultural program payments (see page F-2)	6a	6b Taxable amount 6b	
7	Commodity Credit Corporation (CCC) loans (see page F-3):			
a	CCC loans reported under election		7a	
b	CCC loans forfeited	7b 40,000 00	7c Taxable amount 7c	40,000 00
8	Crop insurance proceeds and certain disaster payments (see page F-3):			
a	Amount received in 2002	8a	8b Taxable amount 8b	
c	If election to defer to 2003 is attached, check here ► ☐	8d Amount deferred from 2001	8d	
9	Custom hire (machine work) income		9	
10	Other income, including Federal and state gasoline or fuel tax credit or refund (see page F-3)		10	
11	**Gross income.** Add amounts in the right column for lines 3 through 10. If accrual method taxpayer, enter the amount from page 2, line 51 ►		11	

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

ELECTION MADE TO TREAT CCC LOAN AS INCOME

A taxpayer may elect to report CCC loans as income in the taxable year in which the loan is received. The election, once made, applies to all subsequent taxable years unless permission is obtained from the IRS to change back to treating CCC loans as loans. The election applies to all commodities for that taxpayer. The elected loan amounts are reported on line 7a (CCC loans reported under election) of Schedule F.

Note. When a farmer receives a CCC loan, there is no reporting of it on Form CCC-1099-G.

Observation. The tax treatment of CCC loans was discussed in detail on pages 127-134 of the *2001 Farm Income Tax Workbook*.

2002 DEVELOPMENT

In early 2002, the IRS issued a Revenue Procedure that allows a change in reporting methods from treating CCC loans as income to reporting CCC loans as loans. *Rev. Proc. 2002-9, I.R.B. 2002-3.* **Under the procedure, a taxpayer who has been reporting CCC loans as loans may shift at any time to reporting CCC loans as income.**

Effective **for taxable years ending on or after December 31, 2001**, a taxpayer reporting CCC loans as income **can switch automatically** to treating CCC loans as loans. For the year of change, all loans that year are reported as loans. Loans taken out previously continue to be treated as if the election to report loans as income was still in effect. As the 2002 guidance states, the change is made on a "cut-off" basis.

The change can be very helpful for those wishing to shift back to treating CCC loans as loans late in the taxable year.

Example 10. Mary has always treated her CCC loans as income in the year received. However, she does not wish to include the loan proceeds in her 2001 gross income. Therefore, she must follow the procedure set forth in Rev. Proc. 2002-9. Mary's completed Form 3115 is shown on the next few pages:

For Example 10

Form **3115** (Rev. May 1999) Department of the Treasury Internal Revenue Service

Application for Change in Accounting Method

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

OMB No. 1545-0152

Name of applicant (If a joint return is filed, also give spouse's name.) **Mary Farmer**	Identification number (See page 3 of the instructions.) **111-22-3333**
Number, street, and room or suite no. (If a P.O. box, see page 3 of the instructions.) **201 Farmer Road**	Tax year of change begins (mo., day, yr.) and ends (mo., day, yr.) **01/01/01, 12/31/01**
City or town, state, and ZIP code **Champaign, IL 61821**	District director's office having jurisdiction **Chicago, IL**
Name of person to contact (If not the applicant, a power of attorney must be submitted.) **Tom Tax Preparer**	Contact person's telephone number/Fax number (**555**) **555-1111** / (**555**) **555-1212**

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

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

Check the appropriate box to indicate the type of accounting method change being requested. (See page 3 of the instructions.)

- ☐ Depreciation or Amortization
- ☐ Financial Products and/or Financial Activities of Financial Institutions
- ☑ Other (specify) ▶ **§77 CCC Method**

Part I Eligibility To Request Change (All applicants complete Parts I through IV.) (See page 2 of the instructions.)

		Yes	No
1	Is the applicant changing its method of accounting under a revenue procedure or other published guidance that provides for an automatic change? (See page 1 of the instructions.)	✔	
	If "Yes," enter the citation of the revenue procedure or other published guidance ▶ **Rev. Proc. 2002-9**		
2	Is the applicant changing its method of accounting under sections 263A, 447, 448, 460, or 585(c) for the first tax year the applicant is required to change?		✔
	If "Yes," the applicant is required to make the change in accounting method under the automatic change procedures set forth in the applicable regulations.		
3a	Does the applicant have any Federal income tax returns under examination by the IRS? See section 3.07 of Rev. Proc. 97-27, 1997-1 C.B. 680		✔
	If "Yes," complete line 3b.		
b	Is the method of accounting the applicant is requesting to change: (i) an issue under consideration or (ii) an issue placed in suspense by the examining agent(s)? See sections 3.08(1) and 6.01 of Rev. Proc. 97-27.		
	If "Yes," the applicant is not eligible to request the change in accounting method. If "No," complete lines 3c through 3e.		
c	Indicate the "window period" the applicant is filing under or state if the change is being requested with the consent of the district director. ▶ ______ See section 6.01 of Rev. Proc. 97-27.		
d	Has a copy of this Form 3115 been provided to the examining agent(s) for all examinations that are in process? See section 6.01 of Rev. Proc. 97-27.		
e	Enter the name(s) and telephone number(s) of the examining agent(s). ▶ ______ See section 6.01 of Rev. Proc. 97-27.		
4a	Is the applicant before an appeals office with respect to any Federal income tax return issue?		✔
	If "Yes," complete line 4b.		
b	Is the method of accounting the applicant is requesting to change an issue under consideration by the appeals office? See sections 3.08(2) and 6.02 of Rev. Proc. 97-27		
	If "Yes," the applicant is not eligible to request the change in accounting method. If "No," complete lines 4c and 4d.		
c	Has a copy of this Form 3115 been provided to the appeals officer? See section 6.02 of Rev. Proc. 97-27		
d	Enter the name and telephone number of the appeals officer. ▶ ______ See section 6.02 of Rev. Proc. 97-27.		

Signature—All Applicants *(See page 3 of the instructions.)*

Under penalties of perjury, I declare that I have examined this application, including accompanying documents, and, to the best of my knowledge and belief, the application contains all the relevant facts relating to the application, and such facts are true, correct, and complete. Declaration of preparer (other than applicant) is based on all information of which preparer has any knowledge.

Applicant	Parent corporation (if applicable)
Officer's signature and date	Parent officer's signature and date
Mary Farmer — Name and title (print or type)	Name and title (print or type)
2/1/02 — Signature(s) of individual or firm preparing the application and date	**Tax Preparers, Inc.** — Name of firm preparing the application

For Privacy Act and Paperwork Reduction Act Notice, see page 1 of the instructions. Cat. No. 19280E Form **3115** (Rev. 5-99)

For Example 10

Form 3115 (Rev. 5-99) Page **2**

Part I Eligibility To Request Change (continued)

		Yes	No
5a	Is the applicant before a Federal court with respect to any Federal income tax issue? If "Yes," complete line 5b.		✔
b	Is the method of accounting the applicant is requesting to change an issue under consideration by the Federal court? See sections 3.08(3) and 6.03 of Rev. Proc. 97-27. If "Yes," the applicant is not eligible to request the change in accounting method. If "No," complete lines 5c and 5d.		
c	Has a copy of this Form 3115 been provided to the counsel for the government? See section 6.03 of Rev. Proc. 97-27.		
d	Enter the name and telephone number of the counsel for the government. ▶ See section 6.03 of Rev. Proc. 97-27.		
6a	Is the applicant a member of an affiliated group filing a consolidated return for the year of change?		✔
b	If "Yes," attach a statement listing the parent corporation's (1) name, (2) identification number, (3) address, and (4) tax year.		
c	Has the applicant ever been a member of a consolidated group other than the current group? If "Yes," complete line 6b for each group of which the applicant was formerly a member.		✔
d	If the applicant is (or was formerly) a member of a consolidated group, is any consolidated group under examination, before an appeals office, or before a Federal court for a tax year(s) that the applicant was a member of the group? See sections 3.07(1) and 4.02(5) of Rev. Proc. 97-27. If "Yes," complete lines 3b through 3e, 4b through 4d, or 5b through 5d (whichever are applicable).		
7	If the applicant is an entity (including a limited liability company) treated as a partnership or an S corporation for Federal income tax purposes, is the method of accounting the applicant is requesting to change an issue under consideration in an examination of a partner, member, or shareholder's Federal income tax return or an issue under consideration by an appeals office or by a Federal court with respect to a partner, member, or shareholder's Federal income tax return? See sections 3.08 and 4.02(6) of Rev. Proc. 97-27 . **N/A** If "Yes," the applicant is not eligible to request the change in accounting method.		

Part II Description of Change

		Yes	No
8	Is the applicant requesting to change its **overall** method of accounting?		✔

If "Yes," check the appropriate boxes below to indicate the applicant's present and proposed methods of accounting. Also complete Schedule A on page 4 of the form.

Present method: ☐ Cash ☐ Accrual ☐ Hybrid (attach description)

Proposed method: ☐ Cash ☐ Accrual ☐ Hybrid (attach description)

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

a The item being changed.

b The applicant's present method for the item being changed.

c The applicant's proposed method for the item being changed.

d The applicant's present overall method of accounting (cash, accrual, or hybrid).

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

11 Attach a description of the applicant's trade or business, including the goods and services it provides and any other types of activities it engages in that generate gross income.

12 Attach a copy of all documents directly related to the proposed change. (See page 3 of the instructions.)

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

14a Attach an explanation of whether the proposed method of accounting will be used for the taxpayer's books and records and financial statements. (Insurance companies, see page 3 of the instructions.)

b Attach an explanation of whether the proposed method of accounting conforms to generally accepted accounting principles (GAAP) and to the best accounting practice in the applicant's trade or business.

		Yes	No
15a	Does the applicant have more than one trade or business as defined in Regulations section 1.446-1(d)?		✔
b	If "Yes," is each trade or business accounted for separately? If "Yes," for each trade or business, attach a description of the type of business, the overall method of accounting, whether the business has changed any accounting method in the past 4 years, and whether the business is changing any accounting method as part of this application or as a separate application.		
16	If the applicant is a member of an affiliated group filing a consolidated return for the year of change, do all other members of the consolidated group use the proposed method of accounting for the item being changed? If "No," attach an explanation.		

17 If the applicant is changing to the cash method, or to the inventory price index computation (IPIC) method under Regulations section 1.472-8(e)(3), or is changing its method of accounting under sections 263A, 448, or 460, enter the gross receipts for the 4 tax years preceding the year of change. (See page 3 of the instructions.)

1st preceding year ended: mo. yr.	2nd preceding year ended: mo. yr.	3rd preceding year ended: mo. yr.	4th preceding year ended: mo. yr.
$	$	$	$

4

For Example 10

Form 3115 (Rev. 5-99) Page **3**

Part II **Description of Change** (continued)

18 Attach a statement addressing whether the applicant has entered (or is considering entering) into a transaction to which section 381(c)(4) or (c)(5) applies (e.g., a reorganization or merger) during the tax year of change determined without regard to any (potential) closing of the year under section 381(b)(1). Also include in the statement an explanation of any changes in method of accounting that resulted (or will result) from the transaction(s). **N/A**

Part III **Section 481(a) Adjustment** **N/A : CUT - OFF BASIS**

		Yes	No
19	Enter the net section 481(a) adjustment for the year of change. Indicate whether the adjustment is an increase (+) or a decrease (-) in income. ▶ $ ________		
20	Has the section 481(a) adjustment been reduced by a pre-1954 amount?		
21a	If the section 481(a) adjustment is less than $25,000 (positive or negative), does the applicant elect to take the entire amount of the adjustment into account in the year of change?		
b	If "No," (or if the applicant declines to elect to take the entire amount of the adjustment into account in the year of change), enter the applicable period over which the applicant proposes to take the adjustment into account. ▶ ________		
22	Is any part of the section 481(a) adjustment attributable to transactions between members of an affiliated group, a controlled group, or other related parties? If "Yes," attach an explanation.		

Part IV **Additional Information**

		Yes	No
23	Has the applicant, its predecessor, or a related party requested or made (under either an automatic change procedure or a procedure requiring advance consent) a change in accounting method or accounting period in the past 4 years?		✔
	If "Yes," attach a description of each change and the year of change. If the application was withdrawn, not perfected, or denied, or if a Consent Agreement was sent to the taxpayer but was not signed and returned to the IRS, or if the change was not made, include an explanation.		
24	Does the applicant, its predecessor, or a related party currently have pending any request for a private letter ruling, a request for change in accounting method or accounting period, or a request for technical advice?		✔
	If "Yes," for each request, indicate the name(s) of the taxpayer, the type of request (private letter ruling, request for change in accounting method or accounting period, or request for technical advice), and the specific issue in the request.		
25	Has the applicant attached **Form 2848,** Power of Attorney and Declaration of Representative? (See the instructions for line 25 and "Person To Contact" on page 3 of the instructions.)	✔	
26	Does the applicant request a **conference of right** at the IRS National Office if the IRS proposes an adverse response?		✔
27	Enter the amount of **user fee** attached to this application. ▶ $ **None** (See page 2 of the instructions.)		
28	If the applicant qualifies for a reduced user fee for identical accounting method changes, has the information required by section 15.07 of Rev. Proc. 99-1, 1999-1 I.R.B. 6, been attached?		

For Example 10

Mary Farmer
111-22-3333
Attachment to Form 3115
For the period ended December 31, 2001

Part II

Question 9
(a) I.R.C. §77 method for reporting Commodity Credit Loans.
(b) Income method under prior §77 election.
(c) Loan method.
(d) Cash.

Question 10
Appendix Section 1.01 of Rev. Proc. 2002-9 permits a taxpayer to automatically change from the income method of reporting CCC loans under §77 to the loan method.

Question 11
The Taxpayer is a grain farmer.

Question 12
None

Question 13
The taxpayer is changing the method of reporting CCC loans in order to have more flexibility in reporting gross income. This will allow the taxpayer to utilize CCC loans in conjunction with other government farm programs. The taxpayer is filing this application under the automatic consent provisions of Rev. Proc. 2002-9, Appendix Section 1.01.

Question 14
(a) The taxpayer's books and records will reflect the loan method of reporting CCC loans.
(b) The loan method of reporting CCC loans conforms to generally accepted accounting principles and best accounting practices of farmers.

Part III

Question 19
A §481(a) adjustment is not required under the provisions of Rev. Proc. 2002-9, Appendix Section 1.01. This change is accomplished on a cut-off basis.

ISSUE 6: ADDITIONAL DEPRECIATION ALLOWANCE

The Job Creation and Worker Assistance Act of 2002 authorized a special 30% depreciation allowance on the adjusted income tax basis of qualifying property for **both** regular income tax and alternative minimum tax purposes.

ELIGIBLE PROPERTY

A. **Property with a MACRS recovery period of 20 years or less.** This necessarily includes:

1. 3-year property (which includes breeding hogs and some horses);
2. 5-year property (which includes business automobiles, light trucks and breeding and dairy animals);
3. 7-year property (which includes farm machinery and equipment, grain bins, farm fences and other property not specifically classified in another depreciation group);
4. 10-year property (which includes single purpose agricultural and horticultural structures and trees and vines producing fruits and nuts);
5. 15-year property (which includes non-farm fences, tile lines, and other land improvements); and
6. 20-year property (which includes farm buildings).

B. **Computer software.**

C. **Water utility property.**

D. **Qualified leasehold property.** See Chapter 1: New Tax Legislation for information regarding the special 30% depreciation allowance on leasehold improvements.

E. **New property.** The property must be **new** property (the **original use** must commence with the taxpayer after September 10, 2001, and before September 11, 2004). **That means used equipment, "used" breeding or dairy animals and buildings, fences, tile lines and other improvements on the purchase of a farm are not eligible.** The Joint Committee on Taxation (JCT) has taken the position that additional capital expenditures incurred to recondition or rebuild acquired property (or owned property) will satisfy the "original use" requirement. But, unconditioned or rebuilt property that the taxpayer purchases does not qualify.

> **Note. "Original use"** means the **first use** to which the property is put, whether or not by the acquiring taxpayer.

Example 11. In 2002, Ralph built a house on his farm that was occupied by his crop share farm tenant. A question exists whether the new house qualifies for the special 30% depreciation allowance because it may be 27.5-year property instead of 20-year property. See discussion of the depreciation rules for farm buildings and tenant-occupied residences in Issue 10.

Example 12. In 2002, George liquidated his dairy herd and sold some of the herd to Ima. Ima purchased unbred yearling heifers as well as some of George's milk-producing cows. The unbred heifers will qualify for the special 30% depreciation because their original use will begin with Ima. But, the milk-producing cows are "used" property with an original use by George (or someone else) and, thus, do not qualify for the special 30% depreciation.

F. **Passenger automobiles.** Passenger autos subject to the depreciation limits are eligible for an extra special depreciation allowance of $4,600 if they are placed in service after September 11, 2001. For qualifying electric cars, the limit is increased by $13,800 the first year.

Example 13. In 2002, Ben paid $35,000 for a half-ton pick-up truck that he uses 90% in his farming business. If Ben does not claim the I.R.C. §179 deduction on the truck, his 2002 depreciation is calculated as follows:

1.	Lesser of the sum of:	
	a. The 30% additional first-year depreciation on 90% of the basis (.90 × $35,000) × .30	$9,450.00
	b. MACRS depreciation on remaining balance ((.90 × $35,000) – $9,450) × .15	3,307.50
	TOTAL	$12,757.50
2.	90% of passenger auto limit:	
	Limit for 2002	$3,060.00
	Additional $4,600 amount	4,600.00
		$7,660.00
	Less nonbusiness use (.10 × $7,660)	(766.00)
	TOTAL	$6,894.00

Thus, Ben can claim $6,894 worth of depreciation in 2002 on the half-ton pick-up truck.

Caution. "Listed property" that is used 50% or less in a trade or business, as well as property for which the taxpayer is required to use the Alternative Depreciation System (ADS) is not eligible for the special 30% depreciation allowance. This is also an important point for clients electing to deduct pre-productive period expenses rather than capitalizing them. Under I.R.C. §263A(e)(2), the election requires the use of the ADS on all assets used in the farming business.

ORDER OF DEDUCTION

The Joint Committee on Taxation in its "Blue Book" states that the special 30% depreciation allowance is claimed **after** expense method depreciation is claimed (which is limited to $24,000 in 2001 and 2002 and $25,000 thereafter).

In the supplement to IRS Pub. 946 *"How to Depreciate Property,"* released on May 15, 2002, the following instructions were issued:

> *The allowance is an additional deduction of 30% of the property's depreciable basis. To figure the depreciable basis, you must first multiply the property's cost or other basis by the percentage of business/investment use and then reduce that amount by any I.R.C. §179 deduction and certain other deductions and credits for the property.*

The following examples are then given:

Example 14. On November 1, 2001, Brad bought and placed in service in his business qualified property that cost $100,000. Brad did not elect to claim an I.R.C. §179 deduction. He can deduct 30% of the cost ($30,000) as a special depreciation allowance for 2001. He uses the remaining $70,000 of cost to figure his regular depreciation deduction for 2001 and later years.

Example 15. The facts are the same as in **Example 14**, except that Brad chose to deduct $24,000 of the property's cost as an I.R.C. §179 deduction. He uses the remaining $76,000 of cost to figure his special depreciation allowance of $22,800 ($76,000 × 30%). He uses the remaining $53,200 of cost to figure his regular depreciation deduction for 2001 and later years.

EFFECTIVE DATE

The property must be acquired by the taxpayer after **September 10, 2001, and before September 11, 2004.** Property acquired pursuant to a written binding contract in effect before September 11, 2001 is not eligible. Most property must be placed in service before January 1, 2005. If a taxpayer makes an election with respect to any class of property, the new provision does not apply to all property in that class (which would otherwise be the case).

Example 16. Bob visited his local implement dealership in late 2001 and purchased a combine on December 7, 2001. Earlier in the year, he had entered into a written contract with the same dealer to buy a planter. That contract was executed on August 15, 2001. The special 30% depreciation is available for use on the combine because it was purchased after September 10, 2001. However, Bob **cannot** claim the special 30% depreciation on the planter because a binding written contract for its acquisition was executed before September 11, 2001.

REPORTING FOR 2001 — CLAIMING THE ADDITIONAL ALLOWANCE

Two Options

The IRS has issued revised Form 4562, Depreciation and Amortization, and Form 2106, Employee Business Expenses, for reporting the special 30% depreciation. For taxpayers who had already filed their 2001 returns, an amended return can be filed using Form 1040-X or 1120-X. The amended return, using the revised forms, must be filed on or before the due date (excluding extensions) of the return **for the next succeeding tax year** (that would be the due date for the 2002 return in most instances). The amended return is to include the statement, "Filed Pursuant to Rev. Proc. 2002-33" at the top.

Another option is to file a Form 3115, Application for Change in Accounting Method, with the taxpayer's federal tax return for the next succeeding taxable year (the 2002 return in most instances). In that case, the Form 3115 is to be filed in accordance with the automatic change in method of accounting, and should include the statement, "Automatic Change Filed under Rev. Proc. 2002-33." A signed copy of Form 3115 must be filed with the IRS National Office no later than when the original Form 3115 is filed with the return. The deduction is claimed entirely in the year of change.

Question A. Susan purchased a subsoiler for $25,000 in October of 2001 for use in her farming business. She filed her 2001 tax return on March 1, 2002. Susan did not claim the special 30% depreciation allowance on the subsoiler, but did claim $2,678 ($25,000 × .1071) of regular depreciation. Susan would now like to claim the special depreciation. How can Susan do this?

Answer A. Susan can claim the special $7,500 ($25,000 × .30) allowance by filing an amended return for 2001 on or before April 15, 2003, the due date of her 2002 return. Susan must write at the top of the amended return "Filed Pursuant to Rev. Proc. 2002-33. As an alternative, Susan could file Form 3115 with her 2002 return and claim the special allowance on it.

Note. By claiming the $7,500 special allowance, Susan's regular depreciation on the subsoiler will decrease to $1,874 (($25,000 – $7,500) × .1071). This is a decrease of $804 ($2,678 – $1,874).

Question B. Mary files as an individual on a calendar-year basis. She placed property that would qualify for the special 30% depreciation in service during December of 2001. When she filed her 2001 return, she claimed expense method depreciation on a particular asset, but now would like to claim the additional depreciation on that asset and claim the expense method amount on a different asset. Can she do this?

Answer B. Unfortunately, neither the statute, the JCT explanation, nor the IRS in Rev. Proc. 2002-33 address this issue. The regulations state that the I.R.C. §179 election can be revoked only with IRS consent and that consent will not be granted unless extraordinary circumstances are present. A question exists as to whether the 2002 Act presents an extraordinary circumstance.

REPORTING FOR 2001 — NOT CLAIMING THE ADDITIONAL ALLOWANCE

For returns filed before June 1, 2002 (for 2000 fiscal years ending after September 10, 2001, and 2001 calendar and fiscal years), the IRS has specified in Rev. Proc. 2002-33 that the election **not** to deduct the special 30% depreciation allowance is considered made on a class by class basis if:

- the taxpayer made the election by the due date of the return or within the six-months extension as required by the Form 4562 instructions (the Form 4562 instructions require a statement indicating the class of property for which the taxpayer is electing not to deduct the 30% depreciation allowance); or
- made the election by the due date of the return or within the six-month extension and attached a statement to the effect that the taxpayer is not deducting the 30% depreciation. A "deemed election" applies if the taxpayer did not claim the 30% depreciation deduction on the return and does not file an amended return to claim the 30% depreciation allowance.

Therefore, for returns filed before June 1, 2002, the taxpayer need do nothing if:

- the 30% allowance was not claimed; and
- the taxpayer does not want to claim the amount.

RETURNS FILED ON OR AFTER JUNE 1, 2002

Taxpayers wanting to claim the special 30% allowance use Form 4562. For taxpayers not wanting to claim it, an election must be made not to deduct the depreciation as required by the Form 4562 instructions (attach a statement to the return indicating the class of property for which the taxpayer is electing not to deduct the special 30% allowance). If the original return is timely filed, a taxpayer is allowed an automatic extension of six months from the original due date to make the election not to deduct the special 30% allowance.

Caution. For returns filed on or after June 1, 2002, a taxpayer is treated as claiming the special 30% allowance unless an election is made not to have the provision apply. If the election out is not made, the basis of eligible property is reduced as though the special allowance amount had been taken.

Question A. Tom purchased a combine on April 20, 2002, for $132,000 and elected to claim $24,000 as expense method depreciation under I.R.C. §179. Tom did **not** elect out of the special 30% allowance provision. How is Tom's MACRS depreciation deduction for the combine calculated for 2002?

Answer A. See the following table.

Purchase price of combine	$132,000.00
Less I.R.C. §179 maximum amount	(24,000.00)
Depreciable basis	$108,000.00
Less 30% additional allowance ($108,000 × .30)	(32,400.00)
Remaining basis	$75,600.00
First-year MACRS rate (150% declining balance - half year convention)	.1071
First-year MACRS depreciation ($75,600 × .1071)	$8,097.00
Tom's total depreciation deductions for 2002:	
I.R.C. §179 deduction	$24,000.00
Special 30% allowance	32,400.00
Regular MACRS depreciation	8,097.00
TOTAL	$64,497.00

Note. Tom could elect out by attaching a statement to his 2002 return stating that he is electing **not** to claim the special 30% allowance. If Tom does **not** claim the special allowance, and does **not** elect out, he must still **reduce his basis** in the combination by the $32,400 special allowance amount.

For Question A

Form **4562** — Department of the Treasury, Internal Revenue Service

Depreciation and Amortization (Including Information on Listed Property)

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

OMB No. 1545-0172 — **2002** — Attachment Sequence No. 67

Name(s) shown on return	Business or activity to which this form relates	Identifying number
Tom	Farming	111-00-0000

Part I Election To Expense Certain Tangible Property Under Section 179
Note: *If you have any listed property, complete Part V before you complete Part I.*

1	Maximum amount. See page 2 of the instructions for a higher limit for certain businesses	1	$24,000
2	Total cost of section 179 property placed in service (see page 3 of the instructions)	2	132,000
3	Threshold cost of section 179 property before reduction in limitation	3	$200,000
4	Reduction in limitation. Subtract line 3 from line 2. If zero or less, enter -0-	4	0
5	Dollar limitation for tax year. Subtract line 4 from line 1. If zero or less, enter -0-. If married filing separately, see page 2 of the instructions	5	24,000

	(a) Description of property	(b) Cost (business use only)	(c) Elected cost
6	Combine	132,000	24,000
7	Listed property. Enter the amount from line 29	7	

8	Total elected cost of section 179 property. Add amounts in column (c), lines 6 and 7	8	24,000
9	Tentative deduction. Enter the **smaller** of line 5 or line 8	9	24,000
10	Carryover of disallowed deduction from line 13 of your 2001 Form 4562	10	
11	Business income limitation. Enter the smaller of business income (not less than zero) or line 5 (see instructions)	11	24,000
12	Section 179 expense deduction. Add lines 9 and 10, but do not enter more than line 11	12	24,000
13	Carryover of disallowed deduction to 2003. Add lines 9 and 10, less line 12 ▶	13	

Note: *Do not use Part II or Part III below for listed property. Instead, use Part V.*

Part II Special Depreciation Allowance and Other Depreciation (Do not include listed property.)

14	Special depreciation allowance for qualified property (other than listed property) placed in service during the tax year (see page 3 of the instructions)	14	32,400
15	Property subject to section 168(f)(1) election (see page 4 of the instructions)	15	
16	Other depreciation (including ACRS) (see page 4 of the instructions)	16	

Part III MACRS Depreciation (Do not include listed property.) (See page 4 of the instructions.)

Section A

17	MACRS deductions for assets placed in service in tax years beginning before 2002	17	
18	If you are electing under section 168(i)(4) to group any assets placed in service during the tax year into one or more general asset accounts, check here ▶ ☐		

Section B—Assets Placed in Service During 2002 Tax Year Using the General Depreciation System

(a) Classification of property	(b) Month and year placed in service	(c) Basis for depreciation (business/investment use only—see instructions)	(d) Recovery period	(e) Convention	(f) Method	(g) Depreciation deduction
19a 3-year property						
b 5-year property						
c 7-year property		75,600	7	HY	150% DB	8,097
d 10-year property						
e 15-year property						
f 20-year property						
g 25-year property			25 yrs.		S/L	
h Residential rental property			27.5 yrs.	MM	S/L	
			27.5 yrs.	MM	S/L	
i Nonresidential real property			39 yrs.	MM	S/L	
				MM	S/L	

Section C—Assets Placed in Service During 2002 Tax Year Using the Alternative Depreciation System

(a) Classification of property	(b)	(c)	(d)	(e)	(f)	(g)
20a Class life					S/L	
b 12-year			12 yrs.		S/L	
c 40-year			40 yrs.	MM	S/L	

Part IV Summary (see page 6 of the instructions)

21	Listed property. Enter amount from line 28	21	
22	**Total.** Add amounts from line 12, lines 14 through 17, lines 19 and 20 in column (g), and line 21. Enter here and on the appropriate lines of your return. Partnerships and S corporations—see instr.	22	64,497
23	For assets shown above and placed in service during the current year, enter the portion of the basis attributable to section 263A costs	23	

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 12906N Form **4562** (2002)

REVOKING ELECTIONS NOT TO DEDUCT

An election not to deduct the special 30% allowance for a class of property is revocable only with the consent of the Commissioner. *Rev. Proc. 2002-33, Sec. 3.04, I.R.B. 2002-20, 963.* A request to revoke the election is subject to a user fee.

> **Note.** Additional information regarding the special 30% depreciation allowance can be found in Chapter 1: New Tax Legislation.

ISSUE 7: INCOME AVERAGING FINAL REGULATIONS

The final regulations for the income averaging provisions for farmers were issued on January 7, 2002. *T.D. 8972, 67 Fed. Reg. 817* (Jan. 7, 2002).

FARM LANDLORDS

The proposed regulations did not address the question of whether crop-share landlords were eligible for income averaging. The final regulations provide that they **do** apply if one very important requirement is met beginning January 1, 2003. That requirement is shown below.

After December 31, 2002, the landlord's share of a tenant's production (crop-share rental income) **must be set in a written rental agreement entered into before the tenant begins significant activities.**

The final regulations make it clear that a landlord is not eligible for farm income averaging in the following situations:

A. The rental income is a fixed cash amount (cash rent).

B. For amounts received on or after January 1, 2003, the rental income, including crop-share rents, is determined under either:

  1. an **unwritten** agreement; or

  2. a written agreement entered into **after** the tenant began significant farming activities on the landlord's land.

> **Note.** The final regulations specify that whether the landlord materially participates in the tenant's farming business is irrelevant in determining eligibility. Therefore, non-materially participating landlords who use Form 4835 are eligible for income averaging if the requirements shown previously are met. Therefore, it is imperative that crop-share leases be in writing.

ELIGIBILITY OF WAGES

The **proposed** regulations stated that, in general, income items passed through to partners or other owners in a pass-through entity, were eligible for income averaging. For S corporations, the character of income from corporate distributions continues in the hands of the shareholders who are eligible to average their incomes. However, under the **proposed** regulations, farm income **did not** include "wages."

The **final** regulations state specifically that "a shareholder of an S corporation engaged in a farming business" may treat compensation received from the corporations that is attributable to the farming business as farm income. Therefore, the wages are eligible for farm income averaging.

> **Note.** The summary to Treasury Decision 8972, but not the final regulations themselves, states that the income attributable to a farming business carried on by a partnership can be averaged without regard to the partner's level of participation in the partnership or the size of the ownership interest.

NEGATIVE TAXABLE INCOME

The final regulations follow the IRS change in position, first announced in the *2000 Farmers Tax Guide* and in the Schedule J instructions, allowing a base year's taxable income to be negative. However, amounts such as a net operating loss or capital loss that may have been deducted in one or more previous taxable years, in the form of a carryback or carryforward, must be added back in computing negative taxable income. See pages 96-100 in the *2001 Farm Income Tax Workbook* for a thorough analysis of this issue.

CHANGE IN THE FILING STATUS

The final regulations follow the proposed regulations and allow an individual to make an averaging election even though the individual's filing status is not the same as in the base years. However, the final regulations do not provide guidance on how the remaining bracket amounts are to be divided between the spouses if both spouses have elected farm income in a year following a divorce.

AMENDING RETURNS

The **proposed** regulations did not allow an individual to make a late election, change an election or revoke an election unless there had been an adjustment to taxable income or tax liability or the Commissioner had consented. The **final** regulations eliminate that requirement, and state that an election can be made on a "late or amended return if the period of limitations on filing a claim for credit or refund has not expired..." and that a previous election can be changed or revoked if the period of limitations has not expired.

> **Note.** The final regulations are effective for taxable years beginning after December 31, 2001, except that the written lease agreement requirement will apply for amounts received on or after January 1, 2003.

ALTERNATIVE MINIMUM TAX

The IRS interpretation is that farm income averaging does **not** apply for purposes of calculating alternative minimum tax**.** Therefore, a taxpayer will lose part of the benefit of farm income averaging if the averaging rules reduce regular tax liability below the tentative minimum tax. The election to use Schedule J has the effect of increasing the alternative minimum tax liability by the same amount as it reduces the regular tax liability.

> **Note.** The U.S. Senate is considering proposed legislation that would eliminate the negative AMT impact on income averaging. *S. 312, Tax Empowerment and Relief for Farmers and Fishermen Act.*

ISSUE 8: WAGES PAID IN-KIND TO AGRICULTURAL LABOR

In general, wages paid in-kind to agricultural labor are not subject to FICA and FUTA tax. I.R.C. §§3121(a)(8), 3306(b)(11). Wages paid to agricultural labor are exempt from withholding under I.R.C. §3401(a)(2) except as the payments constitute "wages" as defined in I.R.C. §3121(a). Wages paid "in any medium other than cash for agricultural labor" are exempt from the term "wages." The FMV of the in-kind payment is income to the recipient. In-kind wages remain subject to income tax and must be reported on the employee's Form W-2, but are not included in Box 3 (Social Security wages).

PROPER STRUCTURING OF IN-KIND WAGE ARRANGEMENTS

For in-kind wage payments to be exempt from FICA, FUTA and income tax withholding, **two** fundamental principles must be observed:

- the payment must not be in a form readily converted to cash; and
- the employee must exercise dominion and control over the payment.

1994 IRS Guidelines. In late 1994, the IRS issued guidelines concerning the proper structuring of in-kind payment arrangements. Under the guidelines, the validity of a plan for paying wages in-kind is dependent upon a facts and circumstances test. Important factors are whether:

- the commodity is properly identified;
- there is documentation of the transfer of the item;
- the commodity was acquired solely for the purpose of paying wages in-kind;
- the in-kind payment was not intended to be a substitute for cash;
- the employee negotiated the subsequent sale of the item;
- the risk of gain or loss is shifted to the employee after the payment;
- the time interval between the employee's receipt of the commodity and sale of the commodity by the employee. There is no specific time but the employee must show that dominion and control were exercised over the commodity; or
- the employee bears the costs incident to ownership of the item (i.e., storage, feeding, insurance, marketing and maintenance costs).

Example 17. A shareholder/employee of a family-owned farm corporation was paid $6,000 of cash wages and 20% of live market weight butcher hogs. The result was total compensation of $6,000 in cash and $34,941 in hogs in one year and $11,000 in cash and $41,272 in hogs in another year.

Result. In Ltr. Rul. 9322003 (Feb. 25, 1993), the IRS ruled that **all compensation was considered to be equivalent to the payment of cash compensation**. In addition, the employment contract was structured to eliminate the FICA taxes on a substantial portion of the employee's compensation. See pages 341-343 in the *1993 Farm Income Tax Workbook* for a thorough analysis of this Letter Ruling.

Example 18. Bob Jones is the sole shareholder of a farming corporation. The corporation pays him in grain that is not segregated from the corporation's grain, but is stored in the corporation's grain bins. Bob does not pay the corporation for storing the grain.

Result. In Ltr. Rul. 9403001 (Aug. 17, 1993), the IRS ruled under similar facts that the wages were subject to FICA taxes. See pages 342-343 in the *1994 Farm Income Tax Workbook* for more details on this Letter Ruling.

Example 19. A president/shareholder/employee of a family owned farm corporation is compensated with a percentage of the annual corn and soybean production. The employee waits a relatively short period of time to sell the commodities.

Result. In 1994, but before the publication of the guidelines, the IRS ruled that the transaction was in substance a **payment of cash**, constituting wages for FICA purposes (Ltr. Rul. 9428003 (April 5, 1994)). In the ruling, the employee and spouse were the sole shareholders and were, therefore, able to control the form of compensation paid. See pages 5-12 and 340-342 in the *1994 Farm Income Tax Workbook* for more details on this Letter Ruling.

Example 20. Michelle Smith is employed as a herd manager on a dairy farm. Part of her compensation is paid in milk and meat that her family consumes.

Result. In 1982, the IRS ruled favorably on similar facts (Ltr. Rul. 8252018 (Sep. 17, 1982)). Now, it is a facts and circumstances test. For milk, the big problem is in establishing dominion and control by the employee over the employee's portion of the milk. Some work out an arrangement with the purchaser of the milk to treat every fifth or tenth shipment, for example, as the employees' milk.

Example 21. J.C. Biggs owns and operates a livestock farm. He also works part-time for his neighbor. At the end of each month, J.C. is paid three bushels of corn for every hour of work in accordance with the employment agreement. J.C. transports the grain to his farm and places it in his grain bins from which he feeds his own livestock.

Result. The commodity wages appear to satisfy all of the IRS factors. Again, it is a facts and circumstances test.

Example 22. John Grady has incorporated his farrow-to-finish hog operation, and employs his daughter, Jane. The corporation compensates Jane with five slaughter hogs for each month she works on his farm. Each month Jane's hogs are marked and placed in a pen with the corporation's hogs. When the corporation decides to sell hogs, Jane's hogs are marketed with the corporation's hogs and Jane receives a check from the packing company for her hogs.

Result. The IRS will likely challenge this arrangement since Jane does not have dominion and control over her hogs and does not independently decide when to market her hogs.

Note. Payment in the form of commodity storage receipts has been treated as payment in cash where the value of storage receipts equaled the amount that the employees would otherwise receive and the employer immediately redeemed the employees' receipts for cash [Rev. Rul. 79-207, 1979-2 C.B. 351].

Observation. To avoid having in-kind wage payments subjected to FICA and FUTA tax, the commodity should either be produced in the trade or business or be acquired for use in the trade or business. Likewise, the commodity should not be sold back to the employer.

REPORTING RULES

The employer must report the FMV of the in-kind payment as income and may deduct an equal amount of wage expense.

Since the FMV of the in-kind payment is included in the employee's income as W-2 income, the employee has a basis in the commodity equal to that value. A subsequent sale of the commodity will trigger a taxable gain or loss depending on whether the sale price exceeds, equals, or is less than the basis of the commodity. That gain or loss should be reported on Schedule D if the employee is not a dealer in the commodity and does not sell the commodity in the course of a farm business. If the employee is a dealer or a farmer, the sale should be reported on Schedule C or Schedule F, respectively. If the employee uses the commodity in his farming operation (i.e., corn used for feed) he is entitled to a Schedule F deduction for the basis.

Example 23. Gary White made the following in-kind payments of soybeans to his unrelated employee, Randy Brown during 2002. Assume that the 1994 IRS guidelines favor Gary. Therefore, his in-kind payments are exempt from FICA, FUTA and income tax withholding.

Date	Amount (bushels)	Fair Market Value
10/01/02	1200	$5,360

For Example 23

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
2002
Attachment Sequence No. 14

Name of proprietor: **Gary White**
Social security number (SSN): **333 33 3333**

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: **3 7 3 3 3 3 3 3 3**

E Did you "materially participate" in the operation of this business during 2002? If "No," see page F-2 for limit on passive losses. ☑ Yes ☐ No

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

1	Sales of livestock and other items you bought for resale	1	
2	Cost or other basis of livestock and other items reported on line 1	2	
3	Subtract line 2 from line 1	3	
4	Sales of livestock, produce, grains, and other products you raised	4	5,360
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	
b	CCC loans forfeited 7b ____ 7c Taxable amount	7c	
8	Crop insurance proceeds and certain disaster payments (see page F-3):		
a	Amount received in 2001 8a ____ 8b Taxable amount	8b	
c	If election to defer to 2002 is attached, check here ▶ ☐ 8d Amount deferred from 2000	8d	
9	Custom hire (machine work) income	9	
10	Other income, including Federal and state gasoline or fuel tax credit or refund (see page F-3)	10	
11	**Gross income.** Add amounts in the right column for lines 3 through 10. If accrual method taxpayer, enter the amount from page 2, line 51 ▶	11	

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

12	Car and truck expenses (see page F-4—also attach **Form 4562**)		25	Pension and profit-sharing plans	
13	Chemicals		26	Rent or lease (see page F-5):	
14	Conservation expenses (see page F-4)		26a	Vehicles, machinery, and equipment	
15	Custom hire (machine work)		26b	Other (land, animals, etc.)	
16	Depreciation and section 179 expense deduction not claimed elsewhere (see page F-4)		27	Repairs and maintenance	
17	Employee benefit programs other than on line 25		28	Seeds and plants purchased	
18	Feed purchased		29	Storage and warehousing	
19	Fertilizers and lime		30	Supplies purchased	
20	Freight and trucking		31	Taxes	
21	Gasoline, fuel, and oil		32	Utilities	
22	Insurance (other than health)		33	Veterinary, breeding, and medicine	
23	Interest:		34	Other expenses (specify):	
23a	Mortgage (paid to banks, etc.)		34a		
23b	Other		34b		
24	Labor hired (less employment credits)	5,360	34c		
			34d		
			34e		
			34f		

35	**Total expenses.** Add lines 12 through 34f ▶	35	
36	**Net farm profit or (loss).** Subtract line 35 from line 11. If a profit, enter on **Form 1040, line 18,** and **also** on **Schedule SE, line 1.** If a loss, you **must** go on to line 37 (estates, trusts, and partnerships, see page F-6)	36	

37 If you have a loss, you **must** check the box that describes your investment in this activity (see page F-6).
- If you checked 37a, enter the loss on **Form 1040, line 18,** and **also** on **Schedule SE, line 1.**
- If you checked 37b, you **must** attach **Form 6198.**

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

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 11346H **Schedule F (Form 1040) 2002**

For Example 23

a Control number		OMB No. 1545-0008	Safe, accurate, FAST! Use IRS e-file	Visit the IRS Web Site at www.irs.gov.
b Employer identification number 37-3333333			1 Wages, tips, other compensation 5360.00	2 Federal income tax withheld
c Employer's name, address, and ZIP code Gary White			3 Social security wages	4 Social security tax withheld
			5 Medicare wages and tips	6 Medicare tax withheld
			7 Social security tips	8 Allocated tips
d Employee's social security number 777-77-7777			9 Advance EIC payment	10 Dependent care benefits
e Employee's first name and initial / Last name Randy Brown			11 Nonqualified plans	12a See instructions for box 12
			13 Statutory employee / Retirement plan / Third-party sick pay	12b
			14 Other	12c
f Employee's address and ZIP code				12d

15 State	Employer's state ID number	16 State wages, tips, etc.	17 State income tax	18 Local wages, tips, etc.	19 Local income tax	20 Locality name
IL		5360.00				

Form **W-2** Wage and Tax Statement **2002** (Rev. February 2002)

Department of the Treasury—Internal Revenue Service

Copy B To Be Filed with Employee's FEDERAL Tax Return.
This information is being furnished to the Internal Revenue Service.

Randy sold the 1200 bushels of in-kind soybeans to the elevator on November 12, 2002 for $6,000. He paid no storage as the 1200 bushels were stored on his father's farm at no cost. Randy will report a $640 (sales price of $6,000 - cost basis of $5,360) short term capital gain on his 2002 Schedule D.

SCHEDULE D (Form 1040)

Department of the Treasury
Internal Revenue Service (99)

Capital Gains and Losses

▶ Attach to Form 1040. ▶ See Instructions for Schedule D (Form 1040).
▶ Use Schedule D-1 to list additional transactions for lines 1 and 8.

OMB No. 1545-0074
2002
Attachment Sequence No. **12**

Name(s) shown on Form 1040: **Randy Brown**
Your social security number: **777 77 7777**

Part I Short-Term Capital Gains and Losses—Assets Held One Year or Less

(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see page D-5 of the instructions)	(e) Cost or other basis (see page D-5 of the instructions)	(f) Gain or (loss) Subtract (e) from (d)
1 1200 bu. soybeans	10-1-02	11-12-02	6,000	5,360	640

Note. If Randy had paid $500 in storage costs associated with the 1,200 bushels of in-kind soybeans, the $500 paid would increase his basis in the grain and would decrease his short-term gain to $140.

OTHER CONSIDERATIONS

In-kind wage payments are compensation for purposes of an IRA contribution. Ltr. Rul. 9202003.

Payment of wages in-kind may threaten eligibility for disability benefits and reduce or eliminate Social Security benefits for the recipient. But, for those taxpayers in retirement, in-kind wages are not considered "wages" for purposes of determining the amount of earnings in retirement [20 C.F.R. I.R.C. §§4.04.429(c)(3), 404.1055].

RECENT CASE

In *Highway Farms, Inc. v. United States, 2002-1 U.S. Tax Cas. (CCH) ¶50,281 (S.D. Iowa 2002),* the taxpayer was a family farm corporation that made payments of hogs to two officers as bonus compensation for labor performed for the corporation. The officers were brothers and the hogs transferred to them were scheduled to be sold by the corporation shortly after the transfer to the brothers. The brothers did not market the hogs separately from the corporation. Instead, the hogs were transported to market and sold in the same batch as the corporation's hogs and sold to the same buyer on the same terms. The court held that the transfer of the hogs to the brothers was a disguised cash transfer with the sole purpose of tax avoidance. Thus, the value of the hogs was wages to the brothers and subject to FICA tax and withholding.

> **Caution.** This case demonstrates that IRS examiners are still raising this issue following the 1994 IRS Guidelines.

ISSUE 9: HANDLING JOINT TENANCIES AT DEATH

PROPERTY LAW POINTERS

A "fee simple absolute" is the largest ownership interest possible in land. A fee simple denotes ownership of potentially infinite duration. The owner is entitled to the entire property, with unconditional power of disposition during his life, and descending to his heirs at death.

Example 24. Sam owns Blackacre and conveys it to Sid under an instrument that states, "from Sam to Sid in fee simple absolute." Sid now owns Blackacre in fee simple absolute.

A fee-simple interest in land may be held in co-ownership either as tenancy in common, joint tenancy, tenancy by the entirety or as community property. Ten states (AK, AZ, CA, ID, LA, NV, NM, TX, WA and WI) are community property jurisdictions. In these states, all property acquired during marriage is considered to be owned equally by the spouses. Nineteen states (AR, DE, FL, IN, KY, MD, MA, MI, MO, NJ, NY, NC, OR, PA, RI, TN, VT, VA and WY) and the District of Columbia recognize tenancy by the entirety as a form of co-ownership. Essentially, tenancy by the entirety is a special form of marital joint tenancy that requires the consent of both spouses to sell either spouse's interest in the property.

For property held as joint tenants with right of survivorship, upon the death of a joint tenant, the survivors are the co-owners by virtue of the survivorship feature. The deceased joint-tenant's will does not control distribution of the decedent's interest in the property. For tenancy in common property, a deceased co-tenant's will controls passage of the decedent's interest in the property.

Before 1977, the value of joint tenancy property was subject to federal estate tax in the estate of the first to die except to the extent it could be proved that the survivor contributed to its acquisition. This became known as the "consideration furnished" rule.

> **Observation.** While property held jointly may not be included in the "probate estate" for probate purposes, the value of that property is potentially subject to federal estate tax and state inheritance tax or state estate tax to the extent the decedent provided the consideration for its acquisition. Consequently, the property could be taxed fully at the death of the first joint tenant to die (if that person provided the funds for acquisition) and again at the death of the survivor.

> **Note.** The decedent's estate bears the burden to prove that the survivor provided consideration. See, e.g., *Estate of Hatchett v. Commissioner, T.C. Memo. 1989-637* (estate met burden of proof to extent of one-quarter of value that was attributable to surviving spouse's inheritance from parent).

> **Observation.** Whatever portion of asset value is included in the decedent's gross estate also receives a new income tax basis at death. However, the portion of the property not included in the decedent's estate retains the survivor's income tax basis.

In 1976, the consideration furnished rule was amended to create a special rule for marital joint tenancies. The rule was defective as enacted and had to be amended twice, last time in 1981. Under that rule, one-half the value was included in the estate of the first to die without regard to which spouse furnished the consideration to acquire the jointly-held property. This became known as the "fractional share" rule. Moreover, one-half the value received a new income tax basis at death.

Example 25. Mark and Marcia, husband and wife, purchased a Michigan farm in 1980 for $400,000 and took title as joint tenants with rights of survivorship. Mark provided the funds for the purchase. Mark died in 2002, leaving Marcia as the surviving joint tenant. At the time of Mark's death, the farm was worth $700,000.

Under the "fractional share" rule, one-half of the date-of-death value ($350,000) was included in Mark's estate for federal estate tax purposes. Marcia now owns the full fee-simple interest in the farm, and her basis is $550,000 (one-half of the original purchase price basis of $200,000, plus the $350,000 amount included in Mark's estate and passing to her as the surviving joint tenant). **Therefore, if Marcia sells the farm for $700,000 shortly after Mark's death, she will trigger $150,000 of gain.**

> **Note.** Before 1982, the creation of husband-wife joint interests in land was not subject to federal gift tax unless reported on a timely filed gift tax return.

The key question has been whether the "consideration furnished" rule continued to apply in the case of deaths after 1976. In *Gallenstein v. United States*, 975 F.2d 286 (6th Cir. 1992), **the court ruled that the Congress had not repealed the "consideration furnished" rule for marital joint tenancies either expressly or by implication.** That meant that the surviving spouse received a full basis step-up because the decedent had provided full consideration for the property in question. **The court's opinion has been followed in five other court opinions.**

Example 26. Same facts as **Example 25**, except Mark's estate included the full date-of-death value of the farm ($700,000) under the *Gallenstein* rationale. Marcia's basis is $700,000 because that amount was included in Mark's estate. If Marcia sells the farm for $700,000 shortly after Mark's death, she will not trigger any gain.

HAHN V. COMMISSIONER

In *Hahn v. Commissioner*, 110 T.C. 140 (1998), the husband, who was the first of the joint tenants to die, in 1972 had signed an agreement to purchase shares in a tenants corporation. The shares represented a specific apartment. The shares were issued later to the husband and wife in joint tenancy. At the husband's death, in 1991, the wife became the sole owner of the shares. The federal estate tax return included 100% of the value of the shares in the husband's estate. That amount was covered by the federal estate tax marital deduction.

On later sale of the shares, the wife (as the surviving joint tenant) claimed a full basis step-up on the theory that the consideration furnished rule applied to the shares in the husband's estate. The IRS took the position that only 50% of the date-of-death value should have been included in the husband's estate. Therefore, only that amount should have received a new basis at the husband's death. **The Tax Court disagreed with the IRS position and held that the "fractional share" rule did not apply to spousal joint tenancies created before January 1, 1977.** In 2001, the IRS acquiesced to the Tax Court's opinion in *Hahn. AOD CC-2001-06.*

Note. The Tax Court ruled that the use of the "consideration furnished rule" is mandatory for pre-1977 marital joint tenancies. The IRS now agrees.

TO WHAT PROPERTY DOES *HAHN* APPLY?

Before 1977, only **three** classes of property did **not** involve a gift when acquired by a husband and wife in joint tenancy:

- The purchase of U.S. savings bonds, registered as payable to the one providing the consideration "or" another person did not (and still does not) constitute a taxable gift. Until and unless the one not providing the consideration redeems the bond during the lifetime of the other, without any obligation to account for the proceeds to the other owner, it is not a gift;
- The transfer of funds into a joint bank account did not (and still does not) produce a taxable gift until and unless the one not providing funds withdraws amounts for his or her own benefit; and
- Unless the donor elected to treat the transfer as a taxable gift, real property placed in a husband and wife joint tenancy, formed after December 31, 1954 and before 1982, and created by one of the spouses did not constitute a taxable gift at the time of transfer.

Observation. In most cases, the land exception is the most important. Also, it is necessary that the spouse, who provided the consideration, die first in order for the surviving spouse to benefit from a new basis for up to 100% of the value of the property.

Observation. If assets decline in value, such that the death of the first to die would result in a step-down in basis, the fractional share rule would result in a more advantageous result for the survivor. But, the Tax Court's opinion in *Hahn* states that the fractional share rule "does not apply to spousal joint interests created before January 1, 1977."

Example 27. Same facts as **Example 25**, except at the time of Mark's death, the farm had a FMV of $300,000. Under *Hahn* and the IRS acquiescence, $300,000 would be included in Mark's estate and that amount would be Marcia's basis in the property. Under the fractional share rule, Marcia's basis would be $350,000 (the $200,000 original cost basis attributable to Marcia's undivided one-half interest in the property, plus an additional $150,000 representing half of the date of death value of the interest included in Mark's estate).

The "consideration furnished" rule can be applied if the estate of the first to die is not large enough to require the filing of a federal estate return. However, an inconsistent treatment position may not be taken after the first death and the facts must otherwise support the "consideration furnished" rule.

An "inconsistent position" could possibly have been taken on a depreciation schedule as the schedule was adjusted after death of the first joint tenant to die or on a state inheritance tax return in a state with rules for joint tenancy taxation similar to the federal rules. Clearly further guidance from the IRS or the courts is necessary.

ISSUE 10: DEPRECIATION OF FARM RESIDENCES AND MOBILE HOMES

MACRS raises questions concerning the proper recovery period for farm and ranch residences. In addition, questions have existed concerning how to depreciate mobile homes and other types of temporary housing under MACRS.

THE GENERAL RULE FOR FARM BUILDINGS

Under MACRS, farm buildings are depreciable over 20 years under the 150% declining balance method, switching to straight line, in accordance with the half-year convention.

Determining the depreciable life of farm residences and mobile homes is difficult because the term "building" is not defined in the statute. "The term 'building' generally means any structure or edifice enclosing a space within its walls, and usually covered by a roof, the purpose of which is, for example, to provide shelter or housing, or to provide working, office, packing, display or sales space" [Treas. Reg. §1.48-1(e)(1),(2)].

Observation. The definition would seem to embrace the farm residence, particularly in light of the reference to "shelter or housing" although it would appear that the most likely classification for the farm or ranch residence is as "residential rental property."

"RESIDENTIAL RENTAL PROPERTY"

Depreciable residential rental property is depreciable over 27.5 years in accordance with a mid-month convention at a maximum of straight line depreciation. "Residential rental property" is defined as "any building or structure if 80% or more of the gross rental income from such building or structure for the year is rental income from dwelling units..." [I.R.C. §168(e)(2)(A)(i)]. The term "dwelling units" is defined as "a house or an apartment used to provide living accommodations in a building or structure but does not include a unit in a hotel, motel, inn or other establishment more than one-half of the units in which are used on a transient basis" [I.R.C. §168(e)(2)(A)(i)(I)].

TENANT-OCCUPIED RESIDENCES

What if a tenant farmer occupies the farm or ranch residence and does not pay the landlord any rent for its use? If a farm or ranch residence occupied by a non-rent paying tenant is not "residential rental property," as would appear to be the case, the property must either be:

- "nonresidential real property" (39-year property);
- a farm building (20-year property); or
- seven-year property (because it is not classified elsewhere).

It would seem that status as a farm building (depreciable over 20 years) is the most likely.

Note. The IRS has ruled that **the FMV** of a dwelling **occupied** by a tenant farmer does not **result in taxable income** for the tenant [Rev. Rul. 70-72, 1970-1 C.B. 15].

Caution. If the residence is rented, it ceases to be considered a farm building and is 27.5-year property. It does not matter whether the tenant is a farm employee.

DEPRECIATING MOBILE HOMES — *RUPERT V. COMMISSIONER*

In *Rupert v. Commissioner, T.C. Memo. 2001-179*, the taxpayer had purchased a 28-foot mobile home in 1982 for $36,000 for use on a lake site. The taxpayer removed the wheels and axles, placed the mobile home on foundation blocks and secured the structure with steel straps attached to ground anchors. The taxpayers also added improvements to the structure. The structure was used by the taxpayers occasionally as a vacation home from 1982-1985. Beginning in 1991, the structure was converted to rental property. The taxpayers claimed depreciation beginning in 1991 on the basis of a 10-year life (under the assumption that the property was placed in service in 1982 when it was purchased and installed as a vacation home and, therefore, could be depreciated over 10 years).

The IRS disagreed with the 10-year recovery period and insisted that the property had been placed in service in 1991 when conversion to rental occurred. The Tax Court agreed and held the structure was depreciable under MACRS over **27.5** years as residential rental property.

> **Note.** The Tax Court did not address the issue of whether the classification result under MACRS would have been the same had the mobile home not been installed permanently on the lake site. If it had been permanently installed, the question is whether it would be deemed a "building or structure" which is required for the property to be classified as "residential rental property." If it were not so classified, the property might well be deemed 7-year property on the basis that it "does not have a class life."

ISSUE 11: BUYING AND SELLING FRACTIONAL AND LESS-THAN-FEE INTERESTS IN LAND

PARTITION AND SALE OF LAND

Partition and sale of land is a legal remedy available if co-owners of land cannot agree on whether to buy out one or more of the co-owners or sell the property and split the proceeds. An important question is what tax consequences result from a partition and sale proceeding.

GENERAL RULE — ALL CO-OWNED INTERESTS SOLD TO NEW OWNERS

In general, a partition and sale, with all interests of co-owners divested in favor of new owners, is a taxable event and is not considered an involuntary conversion. To be an involuntary conversion, the property must be partially or totally destroyed, stolen, seized, condemned or threatened to be condemned. If one of those conditions is met, gain is not recognized if the proceeds are converted into other property similar or related in service or use to the converted property.

PURCHASE BY A SELLING CO-OWNER

If one of the co-owners of property subjected to a partition-and-sale action purchases the property at the partition sale, the IRS position is that the partition proceedings constitute a nontaxable transaction for federal income tax purposes. Rev. Rul. 55-77, 1955-1 C.B. 339. The co-owner who purchases the property realizes neither taxable gain nor a deductible loss on the sale of the interest owned before the partition-and-sale action. It is treated as if the purchasing co-owner sold nothing, with the sale merely establishing a price at which the taxpayer could buy the undivided interests of the other tenants or tenants-in-common.

> **Note.** In the 1928 Board of Tax Appeals case, *Hunnicutt v. Commissioner, 10 B.T.A. 1004 (1928), acq., C.B. VII-2, 19,* the owner of an undivided interest in farm and timber land sold at public auction did not incur a loss where the interest was purchased by the selling taxpayer. The co-owners could not get along, litigation looked likely, and they entered into a contract for public sale of the property. The court held that the taxpayer did not sell anything and merely purchased the remaining interest, and that the purpose of the auction was to set the purchase price of the undivided interest of the other co-owner.

The "related party rule" which limits sales within two years has three exceptions, one of which is that the IRS is satisfied that tax avoidance is not involved. Senate Report 101-56 to Pub. L. 101-239 states that the exception on tax avoidance includes:

1. Transactions involving an exchange of undivided interests in different properties that result in each taxpayer holding either the entire interest in a single property or a larger undivided interest in any of the properties.
2. Dispositions of property in nonrecognition transactions.
3. Transactions that do not involve the shifting of basis between properties.

Observation. The non-recognition treatment when a selling co-owner buys the property in a partition-and-sale proceeding or other public auction may be particularly important for heirs finding themselves faced with a co-owner who wants out of the co-ownership arrangement, but the parties cannot agree upon the terms of the sale.

SPLIT-INTEREST PURCHASES OF LAND

The rule used to be that a remainderman who purchased a term interest in property (a life estate or an interest for years) could claim an amortization deduction for income tax purposes with the cost amortized over the term of the interest. This rule encouraged the joint purchase of assets such as a farm with a parent typically purchasing a life estate or other term interest and a child purchasing the remainder interest. However, under the 1990 "freeze rules," if two or more members of the same family acquire property in a transaction whereby one acquires a term interest in a joint purchase, the person(s) acquiring the term interest are treated as having acquired the entire property. They are considered to have transferred their term interest to the other party. I.R.C. §2702.

For term interests acquired or created after July 27, 1989, the Revenue Reconciliation Act of 1989 specified that no depreciation or amortization deduction is allowed for a term interest in property for any period during which the remainder interest in the property is held, directly or indirectly, by a related person.

Note. I.R.C. §167(e) is the applicable Code section which denies a depreciation deduction for term interests in property where the remainder is held by a related person.

The taxpayer's basis in the term interest is reduced by the deductions disallowed by the provision. The remainderman's basis is increased by the amount of the disallowed deduction, reduced by any depreciation allowable to the term holder with respect to the underlying property. However, the remainderman's basis is not increased by any disallowed deductions attributable to periods during which the term interest was held by a:

- tax-exempt organization; or
- nonresident alien individual or foreign corporation if income from the term interest is not effectively connected with the conduct of a trade or business in the United States.

CASE LAW

In *Richard Hansen Land, Inc. v. Commissioner, T.C. Memo. 1993-248*, the sole shareholder of a corporation jointly purchased farmland with the corporation. The shareholder paid $12,835 for the remainder interest, using compensation he had received from the corporation as the source of the funds. The corporation paid $211,165 for a 30-year term interest. At issue was whether the corporation could claim depreciation on the estate for years that it had purchased. The IRS argued that the shareholder and the corporation were alter egos of each other and that a legitimate business purpose was lacking. However, the court viewed the matter as one **not of purpose**, but of whether the **split-fee transaction was in fact what it appeared to be** in form, and allowed the amortization. The keys to obtaining the deduction were that the shareholder's source of funds was wages that were paid him in a separate and distinct transaction, occurring in the normal course of the corporation's farming business. The jointly purchased land was used in the corporation's farming business. The amounts paid for the land actually moved into the hands of a third party.

Note: If the corporation buys a term interest in land and a related party purchases the remainder, it is deemed to be a purchase of the entire interest by the corporation followed by a transfer to the remainder holder [*Treas. Reg. §25.2702-4(c)*]. Thus, parties engaged in split purchase transactions as described above are likely to trigger a dividend from the corporation to a sole shareholder.

In *Kornfeld v. Commissioner, 137 F.3d 1231 (10th Cir. 1998), aff'g, T.C. Memo. 1996-472,* the taxpayer entered into agreements with his two adult daughters to jointly purchase tax-exempt bonds. The taxpayer ordered the bonds, determined the actuarial value of his life estate and paid the securities firm that amount. He gave his daughters the amount of the purchase price for their remainder interests, which they then used to purchase their remainder interests. After the change in I.R.C. §167 to deny a depreciation deduction would be allowed for a term interest in property, when the remainder interest is held by a related party, the taxpayer took further action. He persuaded his secretary to buy a second life estate to begin after the taxpayer's death and to buy the remainder interest, with all of the purchases made with funds provided by the taxpayer. The taxpayer reported gifts to his daughters and secretary, claiming annual exclusions and using his lifetime exemption to avoid paying tax. The tax-exempt bonds purchased had a combined face value of $1.5 million, and the actuarial value of the taxpayer's life estate was $1.26 million. For 1990 and 1991, the taxpayer wrote agreements between himself and the others with valuations not determined by market forces, but in accordance with IRS valuation tables.

In *CGF Industries, Inc., et. al. v. Commissioner, T.C. Memo. 1999-45*, two family corporations were used in an attempt to generate tax deductions by purchasing 10-year term interests in property at the same time as their shareholders purchased the remainder interests. The primary objective was to transfer property to future generations with minimal or no tax and extract corporate assets without incurring a dividend or capital gains tax. Investment limited partnerships were formed with the shareholders acquiring the .1% general partner interests. The limited partnership interests were jointly purchased by the involved corporation and its shareholders, under agreements as to how the limited partnership interests were to be owned. Under those agreements, the corporation owned a 10-year term interest in the limited partnership interests. At the end of 10 years, the limited partnership interests belonged to the shareholders. Thus, the corporation would receive all income allocable to the limited partnership interest for 10 years, and would thereafter be out of the picture. The shareholders obtained the cash they invested in the partnerships mainly from dividend distributions and stock redemptions from the corporations in amounts sufficient, after tax, to fund the amounts needed to buy the remainder interests. The amount contributed to the partnerships for the respective term and remainder interests was computed using the interest rates then found in the federal estate and gift tax regulations for valuing term and remainder interests.

The amortization deductions taken by the corporations for all the tax years in issue (1988-1993) exceeded the allocations of partnership income to the corporations. The IRS disallowed the deductions in their entirety for lack of business purpose. The corporations objected, arguing they had acquired expiring interests in property, that those interests had ascertainable costs and ascertainable terms during which they would produce income, that the prices paid were arms-length because they were based on present value tables contained in the federal regulations, and that under established tax law the corporations were entitled to those amortization deductions, relying heavily on the *Richard Hansen Land* case. However, the court found significant differences between the case at bar and Richard Hansen. Hansen's source of funds was wages that were paid him in a separate and distinct transaction that occurred in the normal course of the corporation's farming business. The corporations in CGF paid dividends and undertook redemptions as part of a plan to provide funds for the purchase of the remainder interests. Also, the land purchase in Hansen was used in the farming business. The corporations in CGF liquidated investments in U.S. government securities to fund the distributions to the shareholders, and then acquired a term interest in partnerships that invested their funds, directly or indirectly, in the same sort of government securities. Likewise, the amounts paid for the land in Hansen actually moved into the hands of a third party. All amounts in CGF remained within the family group.

Practice Pointers

It is not possible to split property already owned into income interests (for a set period of years or for life) and remainder interests and generate amortization deductions for the holders of those term interests.

- Certain related taxpayers cannot jointly acquire property with one taking a term or life interest and the other the remainder interest and get an amortization deduction for the term interest holder.
- Each party should have an independent source of funds. Remember, the ownership earnings from the land during the term will go only to the corporation.
- The transaction should have business or investment purposes beyond simply the creation of the split interest.
- The strategy seems to work best when the farm business is stable and the property is actually held for the length of the term. If the land is sold midterm, the term-certain percentage must be recalculated along with the remainder percentage based on a term with whatever the remaining number of years would be. Interest rate fluctuations can cause the recalculation and reallocation to have unexpected results. When interest rates are relatively low, the corporation will have a lower relative percentage for the term interest and the individual will have a higher relative percentage.
- Expect IRS scrutiny.

ISSUE 12: REPORTING GAINS AND LOSSES ON COOPERATIVE STOCK

The proper reporting of gains and losses on stock sales of cooperatives has risen in importance as some cooperatives have failed or merged resulting in cancellation of patronage equities. The primary question is the proper characterization of the equity interest relinquished by the patron and whether losses are ordinary or capital in nature.

IRS POSITION — TAXPAYER ENGAGED IN FARMING

In *Rev. Rul 70-64, 1970-1 C.B. 36*, a chicken farmer became a member of an agricultural cooperative for purposes of acquiring supplies and getting help with marketing eggs and chickens. The cooperative retained patronage dividends to augment capital and issued qualified written notices of allocation, which were normally redeemed within one or two years. In the year in question, the cooperative redeemed the qualified written notices of allocation, but at **less** than their stated amount on issuance. As a result, the taxpayer incurred **a loss** when the allocation was redeemed. The IRS ruled that the loss was **an ordinary loss**, measured by the difference between the stated amount included in income in the earlier year and the amount received upon redemption. An **ordinary loss** resulted, the IRS ruled, because the transaction that gave rise to the issuance of the notice of allocation arose in the **ordinary course** of the taxpayer's chicken farming business.

> **Observation.** The loss at issue in the ruling did not involve an equity investment by the taxpayer in the cooperative.

GAINS AND LOSSES FROM INVESTMENT IN COOPERATIVES

Sometimes, individuals acquire cooperative stock in transactions that do **not** involve allocated patronage dividends. It is most likely that any gains and losses would be **capital** in nature because the stock investment is likely a capital asset. The gain or loss would be reported on Schedule D.

> **Note.** Under I.R.C. §1221, all assets are considered to be capital assets unless specifically excluded. Cooperative stock does not seem to fit any of the enumerated exceptions under I.R.C. §1221.

IS AN EQUITY INTEREST IN A COOPERATIVE AN "I.R.C. §1231 ASSET"?

If an equity interest in a cooperative is an "I.R.C. §1231 asset," net losses can be treated as ordinary losses in Part II of Form 4797. However, I.R.C. §1231 narrowly defines "property used in the trade or business" as real property used in the trade or business and depreciable property. Cooperative stock and equity interests in cooperatives do not fit either definition. Therefore, cooperative stock losses should not be reported on Form 4797.

However, if such loss is attributable to stock acquired via patronage dividends reported on Schedule F, it would appear that the stock redemption loss should be shown as a negative figure on Line 10 (Other Income) of Schedule F.

Implications of the Farmland Bankruptcy Filing

Question A. On May 31, 2002, Farmland Industries, Inc. filed for reorganization bankruptcy under Chapter 11. Farmland is the nation's largest farmer-owned cooperative with a substantial number of farmer-owned members. How are any resulting losses to be reported?

Answer A. For member cooperatives that incur write-downs of equity, if the equity was based on patronage, then the nature of the loss is ordinary. However, Farmland had a certain amount of gain (and loss) from the sale of facilities. Losses on equity traceable to Farmland's sale of capital assets represent ordinary gain and loss to the extent the sale of the capital assets occurred in a transaction that either directly related to Farmland's enterprise or facilitated the accomplishment of Farmland's activities on behalf of its patrons. If that test is not satisfied, the write-down of equity traceable to the sale of capital assets constitutes a capital loss.

Note. The IRS has taken the position in litigation that capital gains and losses of nonexempt agricultural cooperatives are always to be classified as nonpatronage. However, in *Farmland Industries v. Commissioner, T.C. Memo. 1999-388*, the Tax Court rejected the IRS application of a "per se" test and held that the proper patronage classification test was whether each item of gain or loss was realized in a transaction that either directly related to the cooperative's enterprise or facilitated the cooperative's activities on behalf of its patrons. The IRS has acquiesced to the Tax Court's approach. *Acquiescence, I.R.B. 2001-13, 920.*

For members of member cooperatives, any loss on equity interests in a member cooperative is ordinary if it is associated with patronage in accordance with the taxpayer's trade or business of farming. However, Farmland had solicited investments that would pay approximately 7.5% interest. The investments were not tied to patronage, and associated losses are likely capital in nature.

Note. Examine carefully any paperwork that comes from Farmland that pertains to your client to distinguish properly the nature of any loss.

ISSUE 13: EASEMENTS

SALE OF AN EASEMENT

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. The realized gain or sustained loss 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. **Therefore, gain or loss shall be determined at the time of sale of each part and not deferred until the disposal of 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

If title to the land is retained, the payment for a permanent easement is applied against the basis of the land affected by the easement. If the payment exceeds the basis, gain will be realized. **If the entire tract is not affected, the entire basis in the property cannot be offset against the easement sale** [Rev. Rul. 72-255, 1972-1 C.B. 221].

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.

Observation. Any gain on sale of a perpetual easement is I.R.C. §1231 gain if the asset is an I.R.C. §1231 asset. Annual payments for rights-of-way are long-term capital gain. *See Gilbertz v. United States, 808 F. 2d 1374 (10th Cir. 1987), rev'g and remd'g, 574 F. Supp. 177 (D. Wyo. 1983) (annual payments received for rights-of-way long-term capital gain; easements not tied to production and contingent reversionary interest insufficient to defeat treatment as sale).*

Example 28. Edward bought a 240-acre farm in Nebraska in 1965. The purchase price was $110,000. Edward made the following allocation of the purchase price:

Asset	Allocated Cost
1. Farm buildings (barn and grain bins)	$24,000
2. Tile	3,000
3. Rental house	9,000
4. 240 acres of land	74,000
Total purchase price	$110,000

In 2002, a natural gas pipeline company paid Edward $11,500 for a perpetual (permanent) easement for a pipeline laid underneath the farm. The pipeline ran diagonally across the farm. It did not affect the surface, nor would it hinder crop production in the future. The pipeline was installed in the summer of 2002.

The area of the easement per the written contact was 50 feet wide and 2,123 feet long. In addition to the $11,500, Edward was paid $900 for the damage to the growing crops. Edward incurred $300 legal fees regarding the easement contract.

Question A. What are the tax consequences for Edward?

Answer A. The sale of the perpetual easement is treated as the sale of land. The difficult issue to determine is whether the easement affects the **entire** 240 acres, or only a **part** of it.

If the **entire** acreage is affected, Edward can use the net easement proceeds of $11,200 ($11,500 less legal fees of $300) to reduce his basis in the 240 acres of farmland to $62,000 ($74,000 less $11,200)

If only a **part** of the acreage is affected, Edward must make numerous computations to determine his cost basis in the easement.

Question B. From the facts given, what is the likely tax consequence for Edward?

Answer B. The easement contract specifies the exact area covered. It is 50 feet wide and 2,123 feet long. The pipeline company has no legal rights on Edward's land not included in that specific area. Therefore, per Rev. Rulings 73-161 (1973-1 C.B. 366) 72-255 (cited above), and the *Iske* Appeals Court Case (cited above), the IRS will in all likelihood insist that only **a part** of the 240 acres can be allocated to determine the cost basis in the easement.

Note. If Edward wishes to claim a larger basis deduction, he must prove that it is impossible to make an allocation. He might argue that the contract is ambiguous or silent regarding the area covered by the easement or due to the nature of the easement, allocation is not practical.

Conclusion. Edward is very unlikely to convince either the IRS or the courts that allocation is impossible or impractical.

Question C. What computations are necessary if allocation is required in order to calculate Edward's cost basis in the easement?

Answer C.

50 feet × 2,123 feet = 106,150 square feet covered by the easement.

One acre = 43,560 square feet.

106,150 square feet ÷ 43,560 = 2.44 acres.

The area covered by the easement is 2.44 acres.

Edward allocated $74,000 to the 240 acres of bare farmland, or $308.33 per acre.

Acres covered by easement × $308.33 per acre = $752.33 cost basis.

Question D. What is Edward's gain on the granting of the easement?

Answer D. It is $10,448, as shown in the following computation.

Easement proceeds	$11,500
Less:	
Legal fees (expense of sale)	(300)
Cost basis in the easement (rounded)	(752)
Gain on sale of business property (part 1, Form 4797)	$10,448

See completed Form 4797 on the following page.

Question E. Where should Edward report the $900 payment for the damaged 1995 growing crop?

Answer E. On the form Edward uses to report farm income and expenses (Schedule F or Form 4835).

For Example 28

Form **4797** — **Sales of Business Property**
(Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2))
► Attach to your tax return. ► See separate instructions.
Department of the Treasury Internal Revenue Service (99)
OMB No. 1545-0184
2002
Attachment Sequence No. 27

Name(s) shown on return: **Edward** — Identifying number

1 Enter the gross proceeds from sales or exchanges reported to you for 2002 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20 (see instructions) 1

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

(a) Description of property	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Gross sales price	(e) Depreciation allowed or allowable since acquisition	(f) Cost or other basis, plus improvements and expense of sale	(g) Gain or (loss) Subtract (f) from the sum of (d) and (e)
2 **2.44 acre easement**	**3-1-65**	**8-15-02**	**11,500**		**1,052**	**10,448**

The IRS approach assumes that each acre of an affected parcel is of equivalent value. If a reasonable argument can be made that the acreage affected is worth more than the retained acreage, basis should be allocated in proportion to values. But, establishing values can be difficult, time-consuming and costly.

Condemnation of an Easement

Condemnation of an easement generally involves an involuntary conversion eligible for I.R.C. §1231 treatment. If an easement is received through condemnation, the same issues concerning basis allocation arise as if the easement were purchased:

1. Determination of the land affected by the easement.
2. The basis to be allocated to the land.

As for the amount of the land affected, condemnation easements for public pipelines, sewer lines, power lines, phone lines, etc., will be viewed by the IRS as affecting only the land where the easement runs. Perhaps an argument can be made that the entire tract is affected by the easement if the easement separates or severs the tract.

What if an easement is sold in response to the threat of condemnation?

Example 29. Armon Legg owns a tract of farmland that contains numerous wetlands that provide good wildlife habitat. Much of the surrounding area has been developed in recent years. In response to the concern over loss of habitat, the Congress passed a law that allows the U.S. Army Corps of Engineers to control development in the area by buying nondeveloped land from "willing sellers" and to condemn easements that prohibit development. Armon refused to sell the Corps his land, and then received a letter from them that they would condemn two easements on his property. Armon believed that the easements would diminish the potential value of his farm as development property so he decided to sell the farm to the Corps.

Question A. What is the tax result to Armon of the sale of his farm under these circumstances?

Answer A. If the Corps' easements would be so restrictive of Armon's rights to use and control his property that he would be substantially deprived of the beneficial use of his farm, the sale would constitute an involuntary conversion under I.R.C. §1033. Armon would have three years to replace the property with qualified replacement property to avoid gain recognition on the sale to the Corps. *See Ltr. Rul. 200219006.*

Note. The IRS has also ruled that the exchange of a perpetual conservation easement on a cattle ranch for the fee interest in another cattle ranch that will be burdened with a perpetual conservation easement when received, qualifies as a like-kind exchange. *See Ltr. Rul. 200201007.*

Charitable Contribution of an Easement

The IRS has ruled that an open space or scenic easement deeded in perpetuity constitutes an undivided interest in the whole property. As a result, it is deductible as a charitable contribution. It is not disallowed under the partial interest rule of I.R.C. §170(f)(3)(A). *See, e.g., Rev. Rul. 73-339, 1973-2 C.B. 68; Ltr. Rul. 9318027.* The deduction is the difference in value before and after the easement is deeded with a reasonable additional amount for loss of developmental potential. *Nicoldis v. Commissioner, T.C. Memo. 1988-163.*

Question A. Bob owns a farm near an expanding urban area. When he bought the farm 30 years ago, the city limit was over seven miles away, but is now within a mile of his farm. Bob does not want his heirs to sell his farm to a developer for development of a subdivision. To prevent this, Bob donates an easement preventing the farm from being subdivided. What is the value of the easement?

Answer A. Bob should subtract the value of the farm subject to the easement from the value as a subdivision. The difference is the amount of the charitable deduction. See *Shapiro v. Commissioner, T.C. Memo. 1991-1.*

If farmland is owned by a partnership and the partnership grants a conservation easement to a conservation organization, each partner may take a charitable deduction for the partner's distributive share of the grant. Ltr. Rul. 200208019 (under state law the easement must be enforceable in perpetuity under state law and donation is made for protection of the environmental system under I.R.C. §170(h)(4)(ii)).

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 FMVs bear to the FMV 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].

Depreciation of Easements

If an easement that is sold is of an indefinite or perpetual nature, it cannot be depreciated or amortized because it does not have a definite useful life. But, if the easement is for a fixed term of years or its useful life can be determined, depreciation can be claimed.

Note. Any physical assets involved in the use of the easement should be separated from the intangible right of the easement. Separate assets include such things as pipes, cement, poles, etc. The IRS has ruled that oil and gas pipeline right-of-way easement costs and expenditures incurred in connection with the location and acquisition of the easement are depreciable over the life of the pipeline [*Rev. Rul. 7-1448, 1971-2 C.B. 130*].