Chapter 6: Agricultural Issues

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Corrections were made to this workbook through January of 2004. No subsequent modifications were made.

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ISSUE 1 — PROPER REPORTING OF COMMODITY CREDIT CORPORATION (CCC) LOANS

OVERVIEW

Proper reporting of CCC loans can be very confusing. There are three features to the loan program that create the confusion:

1. Farmers can elect to have CCC loans treated as loans or as income. CCC loans are the vehicle for two of the three ways program benefits are delivered to farmers and landowners.

Note. A farmer may use agricultural commodities as collateral for a loan from the CCC. The loans are nonrecourse. If the loan plus interest is not paid upon maturity, the commodity may be forfeited to the CCC as full payment for the loan. If the election under IRC §77 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 for the loan. If the election is made, the CCC loan is treated as income in the taxable year in which the loan is received, and a tax basis in that commodity is available for a deduction when the crop is disposed. For a discussion of the mechanics of IRC §77, see pages 211–217 of the *2002 University of Illinois Income Tax Workbook.*

2. The subsidies are delivered to eligible participants in four distinctly different systems of payments:
   - Loan deficiency payment (LDP)
   - Marketing loan gains
   - Prepayment of the CCC loan with commodity certificates
   - Forfeiture of the commodity to the CCC
3. Dollar limitations on payments have been imposed by Congress.

Observation. In recent years, Congress has provided a way to avoid the payment limitations through the use of a special statute-based procedure which involves commodity certificates. Evidence indicates that the principal use of commodity certificates is for cotton and rice, with a modest use for soybeans. Relatively little use of commodity certificates has been observed for corn and wheat.

OPTIONS FOR RECEIVING SUBSIDIES

Loan Deficiency Payment (LDP)

Federal farm subsidies involving the production of "program commodities" (those for which a payment is provided) are made available to producers under three mutually exclusive options. The LDP is the most widely used.

Example 1. John Smith is a cotton farmer in Mississippi. His upland cotton loan rate (set by Congress) is 52¢ per pound. Instead of obtaining a CCC loan for 52¢ per pound of eligible cotton, John receives an LDP based upon the amount by which the loan rate exceeds the Adjusted World Price (AWP).

Note.

1. An "eligible participant" for LDP purposes is a farm tenant, owner-operator, or share-rent landowner.
2. For most commodities, the reference is to the Posted County Price (PCP) on the date the loan is obtained.

Assuming the AWP is 32¢ per pound of cotton, John will receive a payment of 20¢ per pound. He will be **ineligible** for the other three options, but will still be able to benefit from the CCC program if the crop is sold before harvest or is forward contracted.

Note. The LDP must be applied for between the date of harvest and the date of title transfer, but not later than the final loan availability date. For corn and soybeans this is May 31, and for wheat the date is March 31.

Result. The 20¢ per pound payment will be reported to the IRS and to John on a Form CCC-1099-G, *Information Return*. John will report the payment on his Schedule F as an agricultural program payment. The payment will also be subject to the $75,000 payment limitation for combined marketing loan gains and LDPs.

Use of a "Marketing Loan"

The second option, for eligible participants, is to use a "marketing loan," which may produce a "marketing loan gain."

Example 2. Assume the same facts as in **Example 1**, except John obtains a loan at 52¢ per pound and repays the loan at 32¢ per pound. This produces a marketing loan gain of 20¢ per pound of cotton.

Result. Again, the 20¢ per pound payment will be reported to the IRS and to John on a Form CCC-1099-G, *Information Return*. In general, John will report the gain on his Schedule F for the year in which the loan is repaid. The payment will also be subject to the payment limitation for combined marketing loan gains and LDPs of $75,000.

For those who elect to treat CCC loans as income, there is some support for the argument that taxability of the marketing loan gain can be deferred until the year the commodity is sold. This gives the commodity a basis since the amount of the commodity equal to the loan amount is reported as income. Under IRC §1016(a)(8), deferral is accomplished by reducing the income tax basis for the commodity by the amount of the marketing gain.

Note. Neither IRS Pub. 225, *Farmers' Tax Guide*, nor the IRS MSSP for Grain Producers is entirely clear on this point.

The issuance of a Form CCC-1099-G can be confusing. The gain reported will either represent gain to the producer for the entire loan amount (income in the year received), or gain from the repayment of the loan at less than the original loan amount (income in the year repaid). Thus, the producer will have gain to report whenever there is repayment of a CCC loan for less than the original loan amount. This is true whether the loan is repaid with cash or with marketing certificates. Practitioners should be careful to properly report the gain. A Form CCC-1099-G will be issued for the marketing loan gain.

It is important to understand that there are two amounts of gain involved:

1. Gain on disposition of the commodity
2. Gain from repaying the CCC loan at less than the original loan amount based on the commodity loan rate

Observation. For producers that repay the loan when the world price is lower than the loan rate, the difference between that repayment amount and the loan rate is market gain. Producers receive a Form CCC-1099-G showing the market gain realized if the loan was repaid in cash. Producers will not receive a Form CCC-1099-G if the loan was repaid using marketing certificates. **However, the tax treatment of the two transactions is identical.**

Special Procedure for Commodity Certificates

The third option is to use a special procedure for commodity certificates. The details of this procedure were developed by the U.S. Department of Agriculture (USDA) several years ago. Commodity certificates are available for wheat, upland cotton, rice, feed grains, and oilseeds. With this procedure, eligible participants can obtain a CCC loan for the commodity at the loan rate. In essentially the same transaction, the participant can purchase a commodity certificate of a size needed to repay the loan with the AWP or PCP that is less than the loan rate.

Example 3. Use the same facts as in **Example 1**, except John repays the CCC loan at 32¢ per pound, producing a loan gain of 20¢ per pound of cotton.

Result. The 20¢ per pound gain is **not** reported to the IRS and does **not** count against the payment limitation.

Observation. The third option, involving commodity certificates, is typically used when the eligible participant expects to encounter the payment limitation. Congress specifically authorized the fact that the gain from this option does not count against the payment limitation.[1] This gain is called "Certificate Exchange Gain."

The Form CCC-1099-G provides a summary of all of the activity a producer has had during the year. A sample CCC-1099-G follows.

U.S. DEPARTMENT OF AGRICULTURE
Farm Service Agency - Commodity Credit Corporation

CERTAIN GOVERNMENT PAYMENTS

Brown County FSA Office
101 E. Green St.
Anytown, MS 66660

IDENTIFICATION NO.	CALENDAR YR
11-1234567	2003

PRODUCER (Name & Address)

John Smith
217 Hill Rd.
Anytown, MS 66660

TYPE OF PAYMENTS	REPORTABLE INCOME	REFUNDS FROM PRODUCER
LOAN DEFICIENCY	20,615.02	194.33
INTEREST PAYMENTS	50.97	0.00
MARKET GAINS	38,771.12	1,253.41
PRODUCTION FLEXIBILITY	27,468.00	0.00
MARKET LOSS ASSISTANCE	29,848.00	0.00
OILSEED PROGRAM	5,043.00	0.00
TOTALS	$121,796.11	$1,447.74

CCC-1099-G (01-04-2000) REPORT OF PAYMENTS TO PRODUCERS FORM APPROVED OMB NC 1545-0120

Forfeiture

A fourth option is to forfeit the commodity under loan to the CCC. Forfeiture gains are not subject to the payment limitation ($75,000), but are reported to the IRS on Form 1099A, *Abandonments*. The reporting is done manually at the county level in accordance with the *FSA Handbook* (pages 2–54).

Example 4. Alfred received a $12,656 loan on barley he produced in 2002 on November 1, 2002. He treats CCC loans as loans, not as income. He forfeited the loan to CCC on September 15, 2003 because:

- The Posted County Price on September 15, 2003 was $1.83, and
- His elevator cash bid for barley on September 15, 2003 was only $1.80.

Alfred will receive a 2003 Form CCC-1099-A from USDA. Since he treats CCC loans as loans, Alfred will report the $12,656 forfeited CCC loan amount on lines 7b and 7c on his 2003 Schedule F.

Alfred's 2003 Form CCC-1099-A from USDA and his 2003 Part 1, Schedule F follow:

U.S. DEPARTMENT OF AGRICULTURE
FARM SERVICE AGENCY
COMMODITY CREDIT CORPORATION

CCC-1099-A	Report of Loan Forfeiture, Settlement, and Abandonment to Producer			* Original * Corrected	Read Attached Important Information
Producer's Name and Address				Producer's ID Number	Calendar Year
ALFRED E RAINER 248 LR 32 ASHVILLE AR 77777-1111				555 55 5555 S	2003
				Lender's Federal ID Number	County/State
				43-0951685	McLean, IL
Loan Number	Date of Acquisition	Balance of Principal Outstanding		Fair Market Value of Property	Commodity
1	2	3	4	5	6
2000/00001	9-15-2003	12,656		12,656	BRLY
TOTALS		$12,656		$12,656	
*CED Signature				*Date	

* Print CED Signature and Date blocks only when corrected form is printed.
* Print "Original" for forms printed Jan. 1-Feb. 29. Print "Corrected" on forms printed July 1-Aug. 31.

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For Example 4

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
2003
Attachment Sequence No. 14

Name of proprietor: Alfred
Social security number (SSN): 555 55 5555

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

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

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

D Employer ID number (EIN), if any

E Did you "materially participate" in the operation of this business during 2003? 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	
6a	Agricultural program payments (see page F-2)	6a		6b Taxable amount	
7	Commodity Credit Corporation (CCC) loans (see page F-3):				
a	CCC loans reported under election			7a	
b	CCC loans forfeited	7b	12,656	7c Taxable amount	12,656
8	Crop insurance proceeds and certain disaster payments (see page F-3):				
a	Amount received in 2003	8a		8b Taxable amount	
c	If election to defer to 2004 is attached, check here ▶ ☐			8d Amount deferred from 2002	
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.

COMPARING RESULTS OF THE FOUR APPROACHES

In all three instances, if John actually sells the upland cotton for 35¢ per pound, he receives a 20¢ per bushel subsidy and realizes (and recognizes) 35¢ per pound on the actual sale of the commodity for a total of 55¢ per pound of cotton. Other than for the relief from the payment limitations, the economic benefit under the four options is comparable if John properly reports the 20¢ per pound of gain on the exchange in the third option.

> **Note.** The issue is not simply one of whether the loan has been included in income under IRC §77. The problem is much broader than that. It is important to remember there are two types of gain on each one of these transactions: gain from the crop and gain from repaying the CCC loan at less than the loan rate.

Key questions are:

1. Why does USDA not report the gains under the third option to the IRS, as is done with the other three?
2. What are behavioral consequences of having three options in which the gain is reported to the IRS and one that is not reported?

FORMAL GUIDANCE

1987 Ruling

Key guidance on the handling of commodity certificates appears in Rev. Rul. 87-103, 1987-2 C.B. 41, **revoking** Rev. Rul. 87-17, 1987-1 C.B. 20. This ruling was issued in response to questions raised about an earlier version of commodity certificates. Under the program from 1983, eligible participants who idled their land were issued commodity certificates in partial payment with the commodity certificates reported into income at their face value (**not** FMV). The commodity certificates could then be used to acquire commodity stocks held by CCC. The object was to reduce the level of CCC commodity inventory.

The IRS ruled, in Rev. Rul. 87-103, that an eligible participant who elected to treat their CCC loans as income could reduce the income tax basis of the commodity acquired. The basis is reduced by the gain in the commodity certificates.

Example 5. Renee purchases a $10,000 commodity certificate and uses it to repay $12,000 of a CCC wheat loan that is reported as income. The $2,000 gain could be subtracted from the $12,000 basis in the wheat rather than being reported as income. This would result in the commodity having an income tax basis of $10,000. Renee sold the wheat for $13,000.

The gain on the certificate is delayed until the commodity is sold. Renee's taxable income is $15,000 ($12,000 + $13,000 – $10,000 = $15,000).

For eligible participants who treat their CCC loans as loans, the $2,000 gain on the commodity certificate is taxable and the sale of the commodity produces a gain of $13,000 (zero basis on the grain). In both situations, the ultimate amount of gain is the same, or $15,000. However, the timing of gain differs depending on the date of sale of the commodity.

Implications for the Commodity Certificate Approach

Applying Rev. Rul. 87-103 to **Example 3** produces the following results:

For those Treating CCC Loans as Income. Obtaining the CCC loan would result in 52¢ per pound of cotton reported as income in that year. Assuming the IRS accepts the Rev. Rul. 87-103 procedure for this type of commodity certificate usage, the 20¢ per pound of gain on loan repayment (52¢ – 32¢ = 20¢) could be used to reduce the basis in the cotton from 52¢ to 32¢ per pound. When the cotton is sold the following year for 35¢ per pound, John would have a gain of 52¢ per pound in the year of the loan and 3¢ per pound in the later year of sale for a total gain of 55¢ per pound.

For those Treating CCC Loans as Loans. If John is treating CCC loans as loans, there is no income in the year the CCC loan is taken out. However, John would trigger a 20¢ per pound gain on repayment of the CCC loan. In the later year of sale, for 35¢ per pound, with a zero basis for the cotton, John would have a gain of 35¢ per pound in that year. In total, John would have 20¢ plus 35¢, or 55¢ per pound of gain on the cotton.

> **Observation.** Both situations (treating CCC loans as loans or treating CCC loans as income) are treated the same overall. The only difference is the timing of the gain.

CONSEQUENCES OF NOT REPORTING GAIN

There is no known authority to excuse reporting of gains to the IRS. Concerns regarding not reporting gains are:

1. The behavioral impact on taxpayers who know gain from options 1, 2, and 4 are reported to the IRS and the gain from option 3 is not. Not reporting gain in option 3 really relates to the rate of compliance with tax law, that is, whether the gain is properly reported by the taxpayer to the IRS even though the USDA (through the Farm Service Agency) did not report the gain as a matter of information reporting.
2. Perceptions of unfairness by taxpayers who are treated differently for essentially the same government benefit.

CONCLUSION

Additional guidance from the IRS is needed:

- To make clear the applicability of Rev. Rul. 87-103 to the contemporary use of commodity certificates.
- Whether information reporting of gain by the government agency providing the subsidy is required. The importance of this matter is underscored by the fact that nearly $2 billion in commodity certificates were issued for use in 2001.

CHANGING A CCC LOAN REPORTING ELECTION

The IRC §77 election, once made, applies to all subsequent taxable years unless the taxpayer obtains IRS permission to change back to treating loans as loans. In early 2002, the IRS ruled that a change in reporting methods from treating CCC loans as income to reporting CCC loans as loans has been modified and relaxed.[2] Using the accounting rule change, a taxpayer who has been reporting CCC loans as income may shift at any time to reporting CCC loans as loans.

Note. Prior to 2002, application for permission to change had to be filed within 90 days after the beginning of the taxable year to be covered by the return. Effective for taxable years ending on or after December 31, 2001, the IRS ruled taxpayers 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. The 2002 IRS guidance specifies that the change is made on a "cut-off" basis and therefore requires no IRC §481(a) adjustment.

To take advantage of the automatic consent procedure, a taxpayer must file Form 3115, *Application for Change in Accounting Method*, with the return for the year of the change. In addition, a copy of Form 3115 must be sent to the IRS national office (see the *University of Illinois Agricultural Tax Issues, August 2002*, pages 70–74). The user fee is also waived. Also, there is no restriction on a taxpayer who uses the automatic consent procedure to later elect to treat CCC loans as income.

Observation. The change can be very helpful for those wishing to shift back to treating CCC loans as loans late in the taxable year. Since the change can be made after the tax year has closed, this can be a great tax management tool.

ISSUE 2 — SELF-EMPLOYMENT TAX

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.[3] 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 or management of production on the land.

One issue is whether income from an annual spring sale of yearling bulls and/or heifers will generate self-employment income. The IRS will closely examine how the taxpayer promotes the sale. For example, in *Hillman*,[4] the taxpayers owned and operated a cattle ranch. The taxpayers held an annual yearling sale of bull and heifer calves, and claimed the heifers offered for sale were culled from the breeding herd as undesirable for their breeding operation. Thus, the taxpayers argued, the sold calves were held for breeding purposes only and the sale proceeds were not self-employment income. The taxpayers sought a summary judgment on the issue. The court held that summary judgment was not proper because, although the taxpayers claimed that the sold heifers were culled, the heifers were advertised as their best heifers and as "top of the breed." That, the court noted, bolstered the IRS argument that the taxpayers were in the trade or business of selling yearling heifers.

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

Example 6. 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 can be a significant portion of the total 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, materials, or services are includable in income on line 6a or 6b of Part 1 of Schedule F. Ag 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. Under the 2002 farm program provisions, producers may receive agricultural program payments that may be required to be repaid later that year or in subsequent years. To best assist the IRS with the 1099 matching program, gross agricultural program payments should be reported on line 6a of Schedule F and the final taxable portion should be listed on line 6b. An alternative method is to report all amounts received on the income section of Schedule F combined with a deduction on line 34, "other farm expenses."

> **Note.** 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. Section 1601(d) of the 2002 Act negates the application of 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.

CONSERVATION RESERVE PROGRAM (CRP) PAYMENTS

The historic position of the IRS concerning the self-employment tax treatment of CRP payments has been tied to whether the taxpayer is materially participating in a farming operation.

For retired landowners that are not materially participating, the historic IRS position has been that CRP payments are not considered net income from self-employment.[5] The Commissioner of Social Security has agreed. Thus, for landowners that are not materially participating in a farming operation, CRP payments are properly reported on Schedule E or Form 4835.

Example 7. 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 rental income is not subject to self-employment tax.

Tax preparers should note that the agricultural program payments reported by the Farm Service Agency on Form 1099-G 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.

Example 8. Ken in **Example 7** 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.

Observation. The result would be the same for individuals that buy land subject to a CRP contract, but do not materially participate in farming operations on other land.

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.[6] For these clients, the CRP payments are 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.[7] Other authorities suggest that it is the taxpayer's status at the time the payment is received that determines liability for self-employment tax.[8]

2003 DEVELOPMENT

On June 23, 2003, the IRS released a Chief Counsel's letter ruling on the taxability of CRP payments for self-employment tax purposes. In CCA Ltr. Rul. 200325002 (May 29, 2003), the IRS took the position, **directly contrary** to Priv. Ltr. Rul. 8822064 (March 7, 1988), that a landowner's activities under a CRP contract amount to material participation and the payments **should** be reported on Schedule F, not Schedule E or Form 4835. That is now the Chief Counsel's position for **retired landowners** as well as those conducting a farming business and those who are not conducting a farming business.

The ruling addresses two hypothetical scenarios. In the first scenario, an active farmer enrolled eligible land in the CRP. In line with the historic position of the IRS in this setting, the ruling notes that the farmer continued to be engaged in the trade or business of farming (the CRP payments replace what would have been income from the active conduct of a farming operation). In the second scenario, a taxpayer purchased land that had been previously enrolled in the CRP. The taxpayer was not engaged in the trade or business of farming at any time before buying the CRP land. Surprisingly, and **contrary** to previous IRS rulings and cases, the IRS stated that the taxpayer became engaged in the trade or business of farming by personally fulfilling the taxpayer's obligations under the terms and conditions of the CRP contract.

The CCA Ltr. Rul., with respect to the second scenario, runs directly counter to Priv. Ltr. Rul. 8822064, Priv. Ltr. Rul. 9637004, and a prior pronouncement of the Associate Chief Counsel, Technical. The new letter ruling establishes where the farm operator or owner is **materially participating** in the farm operation, CRP payments constitute receipts from farm operations includable in net earnings from self-employment.[9] The Commissioner of Social Security agrees with the conclusion reached in CCA Ltr. Rul. 200325002.

The CCA Ltr. Rul. also runs counter to *Ray*[10] where the Tax Court held that CRP payments in the hands of a **materially participating** landowner are subject to self-employment tax. The U.S. Court of Appeals for the Sixth Circuit in *Wuebker*[11] embraced the Tax Court's approach in *Ray*.

More importantly, the ruling, as to the second scenario, is contrary to the position that the IRS took in *Hasbrouck*.[12] In this case, the taxpayers who were not engaged in farming purchased land that had previously been enrolled in the CRP. The IRS took the position in the case that the taxpayers were **not** engaged in the trade or business of farming simply by fulfilling their obligations under the CRP contract. The Tax Court agreed with the IRS position, holding that participation in the CRP program and receipt of CRP payments does not establish that the taxpayers were actively engaged in the trade or business of farming. As such, the taxpayers were not entitled to claim Schedule F deductions.

> **Observation.** The current IRS position announced in CCA Ltr. Rul. 200325002, states all CRP payments are subject to self-employment tax. The status of whether the recipient is materially participating in a farming operation is no longer relevant. However, the ruling runs counter to two prior IRS Ltr. Ruls., a pronouncement of the Associate Chief Counsel, Technical, of the IRS, two U.S. Tax Court cases, and a U.S. Court of Appeals case. The ruling was a surprise considering it did not refer to all of the authority mentioned above, misapplies the authority it references, and does not specifically state it is overruling any prior authority. Still, considering the level within the IRS that the ruling was issued, it demands attention. Clearly, the ruling is not the last word on the issue. The ruling could spawn additional litigation on the issue and could even generate additional IRS pronouncements on the matter.

> **Note.** In early 2003, the U.S. Senate considered legislation specifying that "net earnings from self-employment" does not include CRP payments by defining CRP payments as "rents from real estate."[13] The provision failed to be included in the Jobs and Growth Tax Relief Reconciliation Act of 2003. The 2003 CCA Ltr. Rul. may create greater incentive for the Congress to deal legislatively with the issue.

It is also important to note the IRS position taken in the ruling has application beyond CRP rental income. In the ruling, the IRS stated:

Furthermore, participation in a USDA land diversion program and in the devotion of such land to conservation purposes under such programs will be treated as material participation in the operation of a farm with respect to the diverted acres.

Consequently, the ruling would have application to payments received by taxpayers under the Conservation Reserve Enhancement Program, the Emergency Conservation Program, the Emergency Watershed Protection Program, the Wetlands Reserve Program, the Grassland Reserve Program, the Conservation Security Program, and other similar government programs.

RENTS FROM PERSONAL PROPERTY — FARM MACHINERY RENTS

A note on 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 raises 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 on the issue have added to the concerns.

> **Note.** IRC §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 exclusion for the rental of personal property apart from the real estate. **The statute requires an individual to be engaged in a trade or business in order for income to be self-employment income.** For a taxpayer to be engaged in a trade or business, he must be engaged in an activity for the primary purpose of producing income or profit and must be involved in the activity with continuity and regularity.

When a farmer retires, he may decide to rent his machinery and equipment for a period of time rather than sell it and face depreciation recapture in the year of sale. If he is retired and the equipment is not leased with his farmland, the IRS may question whether he is in the trade or business of renting equipment. If the IRS determines he is in the trade or business, the rental income is subject to self-employment tax. He must report the income and any related expenses on Schedule C or F.

If he is not in the trade or business, the rent is not subject to self-employment tax and the rent will be reported on Form 1040, line 21 (other income) and identified as personal property rental income. Deductible expenses related to income 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 9.** 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. If Clem rents the grain drill to his neighbor **every year,** the IRS may make the case that Clem is in the trade or business of renting grain drills.

Practice Pointers

For clients who rent farm machinery to another, **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 IRC §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." Even in this case, the IRS may argue that the rental is a trade or business.

RENTING LAND TO A FAMILY ENTITY — THE MIZELL PROBLEM

The *Mizell*[14] case 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, and 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 nonmaterial participation lease and did not report the rental amounts as self-employment income. The Tax Court focused on the language in IRC §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 CASES AND RULINGS

A 1996 technical advice memorandum[15] reached the same conclusion with a cash rent lease to a corporation. Three Field Service Advice rulings in 1998 were in accord.[16]

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.[17] On appeal, the three Tax Court cases were consolidated and were reversed in late 2000.[18] 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 10, 2002, the Tax Court rendered its remand opinion holding that the rental arrangements reflected FMV and that no self-employment tax should be imposed.

> **Note.** Based on the Eighth Circuit's opinion in *McNamara*, 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.

Remember, while *Mizell* involved a partnership, a more general solution to the problem may be to convey the land to another type of entity (such as an LLC or LP); however, the regulations on handling self-employment income for such pass-through entities are still in limbo.

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 nonparticipating spouse and have the spouse lease the land to the farming business under a passive lease. There are several other income tax and estate tax implications to consider with this approach.

> **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.[19] This case is scheduled for trial September 8, 2003. Another case appealable to the Eighth Circuit[20] involves the cash leasing of land by a family partnership to a corporation controlled by the same individuals. The IRS argued that the partnership rental income was subject to self-employment tax. On January 28, 2003, a stipulated decision was entered. The IRS entirely dropped the assessment of self-employment tax. This case was within the same jurisdiction as McNamara and the taxpayer obtained independent verification each year that rental amounts were similar to other rents in the area.

> **Note.** In early 2003, the U.S. Senate considered legislation that would constrain the IRS to examining only the lease agreement to determine if sufficient material participation under the lease is present.[21] However, the provision was not included in the Jobs and Growth Tax Relief Reconciliation Act of 2003.

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.

CASES AND RULINGS

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.[22] 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*,[23] 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 in the Tax Court's opinion.[24] However, the IRS indicated that if the Form 4835 (or presumably any other form for reporting rental income) reveals that the taxpayer actively participated in the farming operation, that could indicate a nexus with grain production which could support a conclusion that the farmer was in the trade or business of grain processing.

In 2002, the Tax Court decided *Bot*,[25] 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 that 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, inasmuch as the value-added payments were directly related to the volume of corn delivered to the cooperative, the value-added payments had a direct nexus 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 by the Bots in the operation and the involvement of their sons. But, the statute bars imputation of activities by an agent to a principal as property owner under a lease (involving the production of agricultural or horticultural commodities) for self-employment tax purposes. In *Bot*, the only apparent business relationship of the Bots and their sons was through the crop-share lease.

Observation. *Bot* is unlikely to be the last word on the subject, but 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 "RENTAL" 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 retain 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 involving material participation by the producer should be reported on Schedule F.

Example 10. Fred has a contract to grow hogs with Big Pork. 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. Since he is materially participating in the operation, Fred should report the payment and his expenses for 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 may report 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.

SELF-EMPLOYMENT TAX ON RENTED LAND

Cash and Nonmaterial Participation Leases

If land is rented under a cash rent or nonmaterial participation share lease, the rental income is not subject to self-employment tax.

Material Participation Share Leases

If land is rented under a material participation share lease, self-employment tax is due.

Combination Situations

Applicable Statutory Language. If some land is rented under a cash rent or nonmaterial participation share lease, and other land is operated or rented under a material participation share lease, the outcome is not as clear. Under the statute, self-employment tax is imposed on "net earnings from self-employment." That is defined as "gross income derived by an individual from any trade or business carried out by such individual. . . ." The Code also indicates if someone else carries on the business, FICA tax may be due.[26]

> **Note.** IRC §1402 (a)(2) excludes rentals from real estate, but includes amounts paid "under an arrangement" involving the production of agricultural or horticultural commodities where there is material participation under the lease. The statute is silent on the self-employment tax liability of a taxpayer who is carrying on a trade or business, but is also carrying on a rental activity.

Applicable Case Law. In *Stevenson,*[27] the taxpayer was engaged in the business of purchasing portable advertising signs for rental or for resale. The taxpayer personally assembled and stored at a rental warehouse all new portable advertising signs, and stored all used portable advertising signs, repaired them and held them for sale or rental. The taxpayer argued that the income from the rental of the signs was excluded from self-employment income on the basis that the statutory language excluding rentals from real estate and from personal property leased with real estate was only illustrative as to what was to be excluded.

The Tax Court held that the rental and sale of advertising signs was, overall, a trade or business and the rental income could not be excluded. The court acknowledged that payments for the use of space where the labor involved was incidental to the realization of the return on an investment was not subject to self-employment tax, but held that no part of the taxpayer's income from the sign business fell within that exception.

In 1996, the Tax Court decided *Ray.*[28] Under the facts of the case, a farmer acquired 1,022 acres that had been bid into the Conservation Reserve Program (CRP) by the prior owner. The question was whether the CRP payments were subject to self-employment tax in the hands of the farmer. The Tax Court applied a "direct nexus" test to determine whether the CRP income was subject to self-employment tax. Thus, if the court could find a connection between the land in question and the farm business, self-employment tax would be due. The court noted that the farmer applied herbicide to the CRP land and "shredded" natural grasses on the tract, apparently using his equipment and employees. The land was also located in the same general area as the farm business. Consequently, the Tax Court found a "direct nexus" to the farmer's trade or business of farming, and the CRP payments were subject to self-employment tax.

> **Note.** The Tax Court cited Rev. Rul. 60-32, 1960-1 C.B. 23 for the source of the "direct nexus" test. However, in the ruling, the IRS only stated that Soil Bank Program payments were includible in net earnings from self-employment if the taxpayer "operates his farm personally or through agents or employees," or others operate the farm and the taxpayer materially participates in the production of commodities or the management of production.

What is the Anticipated Outcome Generated by a "Nexus"?

Creation of the direct nexus test seems to mean that where some land is rented under a cash rent or nonmaterial participation share lease and other land is included in a farming business (or rented under a material participation share lease), the cash-rented land (or land under a nonmaterial participation share lease) is **subject to self-employment tax if there is a direct connection** with the farm business. Conversely, if a direct connection is not present, self-employment tax is not imposed on the net income from the land that is cash rented or rented under a nonmaterial participation share lease. That leaves open the possibility that rented land, owned by a farmer, could be considered an investment asset with the result that the rents from the leased land would not be subject to self-employment tax.

> **Observation.** The direct nexus test seems to be heavily dependent upon proximity in location and use of the equipment and personnel from the farm business to maintain the land rented under a nonmaterial participation lease arrangement.

TRUSTS AND SELF-EMPLOYMENT TAX

In early 2003, the IRS issued two Technical Advice Memoranda (TAMs) addressing the issue of self-employment tax liability for trust distributions. The issue is an important one because of the increased use of trusts in recent years for estate planning and other purposes.

Is the Trustee Liable for Self-Employment Tax?

The long-standing position of the IRS is that professional fiduciaries are in the trade or business of being fiduciaries and are treated as receiving self-employment income.[29] For instance, in Priv. Ltr. Rul. 9107009 (November 14, 1990), an attorney who was trustee for 12 trusts and coexecutor of an estate was considered to be a professional fiduciary for self-employment tax purposes. Those serving as executor or administrator of an estate in isolated instances as a non-professional fiduciary are treated as receiving income from a trade or business only if there is a trade or business among the assets of the estate unless the estate requires extensive management involvement.

Distributions from Irrevocable QTIP and Bypass Trusts

In TAM 200305001 (July 24, 2002), the IRS addressed a situation where farm income was paid from an irrevocable QTIP trust and a unified credit bypass trust to an individual who was both the trust's beneficiary and trustee. A couple owned a farm and created a revocable intervivos trust and named themselves as trustees. The trust was funded with farmland. At the husband's death, three trusts were created:

- A survivor's trust,
- A QTIP trust, and
- A unified credit bypass trust.

The wife, as the surviving spouse, was the sole beneficiary and fiduciary of the survivor's trust. The QTIP and unified credit trusts were irrevocable. Distributions from those two trusts were reported on the surviving spouse's Schedule E and self-employment tax was not paid. The wife, as surviving spouse, reported the distributions from the survivor's trust as self-employment income and paid self-employment tax.

The IRS pointed out that trust income derived from a farming activity and distributed to the surviving spouse as beneficiary is not necessarily considered to be self-employment income subject to self-employment tax. However, the IRS noted that in the event distributions were payments for services the surviving spouse provided to the trust as part of a trade or business, those amounts generally would be considered net earnings from self-employment and subject to self-employment tax. The IRS indicated a question could arise over whether the surviving spouse received adequate compensation for the services performed for the trusts.

Implications of TAM 200305001 — self-employment tax liability seems to depend on:

- The nature of the lease or other arrangement between the trust and the tenant or operator,
- The adequacy of the rental amount or other payment, and
- The identity of the tenant or operator.

For a cash-rent lease to a tenant who is also a beneficiary or the beneficiary of the trust, there should be no self-employment tax liability provided the rental is a fair market rental. That should be the outcome at least in the Eighth Circuit.[30] If the rental is not representative of a fair market rental, a portion of the distribution could be subject to self-employment tax. If the trust property is rented under a nonmaterial participation crop share lease to an unrelated tenant, there should be no self-employment tax on trust distributions. In the event the trust property is rented under a nonmaterial participation crop share lease to a beneficiary or the beneficiary of the trust, the question would seem to be whether the rental reflects a fair market rental.

> **Note.** TAM 200305001 does not address the consequences of a custom farming operation or material participation crop share lease, both of which ordinarily would not produce self-employment tax liability for the beneficiaries of the trust. But, the IRS warned that a trust resembling a business entity could be treated as a business entity with respect to self-employment tax liability.

Distributions from a Testamentary Trust

A second TAM released in 2003[31] involved farm income paid from an irrevocable testamentary trust to individuals who were both trust beneficiaries and trustees. When the decedent died, the surviving spouse and son became co-trustees and were also the trust's beneficiaries. The son was paid a fee by the trust for managing the farm operations and the surviving spouse was paid a fee for maintaining the farm records. The spouse and son reported the fees as subject to self-employment tax, but the distributions by the trust were not reported as self-employment income.

The IRS agreed that the distributions were not considered net earning from self-employment. However, the IRS pointed out that if the distributions from the trust were payments for any services the surviving spouse and son provided to the trust as part of their trade or business, those amounts would be considered net earnings from self-employment. **The IRS stated that it was appropriate to focus on the adequacy of payments for services rendered.** That means that if the payments to the son represented inadequate compensation for services rendered, at least a portion of the distribution to the son is likely to be treated as net earnings from self-employment for the son.

> **Note.** The IRS warned in both TAMs that arrangements that are denominated as trusts but resemble business entities would be treated as business entities for purposes of self-employment tax liability.

ISSUE 3 — SELECTED LIKE-KIND EXCHANGE ISSUES

LIVESTOCK EXCHANGES

While exchanges of livestock are less common than exchanges of real estate or machinery, they do occur. Except for the statutory bar for exchanges of livestock of different sexes,[32] the rules governing exchanges are less well known. However, regulations adopted in 1991 provide guidelines for like-kind exchanges of livestock and other assets.

FORMAL GUIDANCE

1991 Regulations (Treas. Reg. §1.1031(a)-2(b)(1))

Depreciable tangible personal property can satisfy the like-kind requirement in two ways:

1. Showing that the property in question is exchanged for property that is of a **like class**
2. By showing that the property in question is exchanged for property of a **like kind**

In determining whether property meets the test of being "like kind," all facts and circumstances are to be considered. Depreciable tangible personal property can satisfy the like kind requirement if it is exchanged for property of a like class. Depreciable tangible personal property is a "like class" to other depreciable tangible personal property if the exchanged properties are either within the same general asset class or the same product class. Livestock are not listed in the 13 general asset classes.

As for product classes, the regulations specify that a single property cannot be classified within more than one product class and that the property's product class is determined as of the date of the exchange. A product class consists of depreciable personal property that is listed in a product class in the *Standard Industrial Classification (SIC) System Manual* (1987), prepared by the Office of Management and Budget. Using the SIC system, an exchange of beef cows (0212) for dairy cows (0241) is not a like-kind exchange.

The SIC system has been replaced with the North American Industrial Classification System (NAICS). However, the IRS has not issued guidance on using the NAICS for federal income tax purposes and has advised taxpayers to continue using the four-digit SIC system until guidance is published.

Other classifications under the four-digit SIC system include:

Property	Classification
Beef cattle	0212
Dairy cattle	0241
Hogs	0213
Poultry	0259
Sheep and goats	0214
Horses	0272
Rabbits, fur-bearing animals	0271

Cases Predating the Regulations

In *Woodbury,*[33] the parties entered into a multi-party, multistep transaction whereby 225 cows and calves and 425 mixed yearlings were exchanged. The Tax Court agreed that the 225 cows with calves by side were held for breeding purposes rather than for sale, but only 103 of the mixed yearlings received were held for breeding purposes. The remainder of the mixed yearlings was held primarily for sale.

In *Wylie*,[34] the taxpayer traded 49 head of steer calves ranging in age from 7 to 11 months. These calves were not held for sale in the ordinary course of business. He traded them for registered Aberdeen-Angus cattle. The court held that income was not realized, or recognized on the exchange.

In *Rutherford*,[35] half-blood heifers and three-quarter-blood heifers were held to qualify as like kind. The taxpayer agreed to deliver 12 three-quarter-blood heifers in exchange for 12 half-blood heifers. The three-quarter-blood heifers were the offspring of artificial insemination of the 12 half-blood that had been received earlier. Since the taxpayer deducted the costs of raising the three-quarter-blood heifers, giving the animals a zero basis, the half-blood heifers received in exchange were ineligible for an investment tax credit, despite the higher value placed on the three-quarter blood heifers. The court said the FMV of the three-quarter blood heifers was without significance.

Note. For livestock, the major concern is being able to access the classification reference, the *Standard Industrial Classification System Manual* (1987). After the IRS issues guidance, the problem will be in accessing the North American Industrial Classification System (2002). That manual can be ordered at www.ntis.gov.

IRC §1245 PROPERTY

Depreciable tangible personal property held for productive use in a trade or business or for investment may be exchanged for property of a like kind or of a like class.[36] However, underlying business assets consisting of intangible personal property are not allowed to be aggregated as a single asset for the purpose of determining whether an exchange of two businesses qualifies as like kind.[37]

The regulations do not define "depreciable tangible personal property," and it is not clear to what extent state law governs in the meaning of the term. The term "personal property" is defined for purposes of IRC §1245 as:

- tangible personal property (as defined in paragraph (c) of §1.48-1, relating to the definition of 'section 38 property' for purposes of the investment credit), and
- intangible personal property.[38]

As used in IRC §1031, the term "personal property" does not appear to embrace the "other property" branch of IRC §1245. But, the term "tangible personal property" as defined for purposes of "section 38 property" has acquired meaning through regulations and cases. Items determined to be "tangible personal property" are:

- Air conditioning
- Propane storage tanks
- Photo labs
- Bulk tanks and storage tanks used in bulk petroleum distribution and retail operations
- Fire extinguishers
- Fixed or floating docks (but not pilings)
- Construction site trailers
- Billboards
- Signs
- Lighting fixtures
- Detachable poles at retail stations (but not concrete foundations)
- Bank vault doors
- Record vault doors
- Night depository facilities and walk-up and drive-up teller's windows (but a drive-up teller's booth is a building)

Property is of a like class to other depreciable tangible personal property if the properties exchanged are within the same general asset class or the same product class. Depreciable tangible personal property is classified into 13 general asset classes. The classes are listed in IRS Pub. 544, *Sales and Other Dispositions of Assets*, for determining classification for depreciation purposes as asset classes 00.11 through 00.28 and 00.4 and are as follows:

- Office furniture, fixtures, and equipment
- Information systems
- Data handling equipment
- Airplanes (other than commercial airliners or freight carriers)
- Automobiles and taxis
- Buses
- Light general-purpose trucks
- Heavy general-purpose trucks
- Railroad cars and locomotives, except those owned by railroad transportation companies
- Tractor units for over-the-road use
- Trailers and trailer-mounted containers
- Vessels, barges, tugs, and similar water transportation equipment, except those used in marine construction
- Industrial steam and electric generation and/or distribution systems

Depreciable tangible personal property that is not classified with any general asset class is classified into four-digit product classes. Property within the same product class generally is of a like class. Much of the personal property used in a farm business is included in product class 3523, Farm Machinery and Equipment.

If IRC §1245 property is disposed of in a like-kind exchange, IRC §1245 recapture must be recognized to the extent of the FMV of property acquired that is not IRC §1245 property. That is the case even if no gain is recognized under the like-kind exchange rules. Recapture income is also recognized to the extent that gain is recognized under the like-kind exchange rules. The instructions for Form 8824, line 21, restate this rule and provide a location on the form for calculating the IRC §1245 recapture to the extent non-IRC §1245 property is received in exchange. An exchange solely of depreciable personal property for like-kind depreciable personal property does not result in recognition of gain under the like-kind exchange rules or the recapture rules.

Note. Recapture income that is not recognized is considered additional depreciation that is carried over to the basis of the asset acquired. If property that is not depreciable personal property is received in the exchange, basis is first allocated to that property to the extent of its FMV. Any remaining basis is allocated to the depreciable personal property received in the exchange.

REPORTING LIKE-KIND EXCHANGES

The tax-free exchange treatment of IRC §1031 is not elective. If an exchange meets the requirements, the taxpayer must postpone reporting the gain or loss realized on the property transferred and adjust the basis of the property received. Form 8824 must be filed for the year the like-kind exchange property was transferred. **If the property was transferred to a related party, Form 8824 must be filed for the two years following the year of the transfer.**

Gain that is postponed by a like-kind exchange is recognized on the sale of the asset received in the like-kind exchange. If there was potential depreciation recapture included in the postponed gain, that recapture must also be recognized upon sale of the assets received in the like-kind exchange.

Note. For machinery trades, the instructions to Form 4797 require the taxpayer to include the depreciation claimed on the property transferred in a like-kind exchange for the property that is currently being sold. However, the depreciation that must be included from the transferred asset is limited to the gain that is rolled over into the asset acquired. But, IRS Notice 2000-4, I.R.B. 2000-3 complicates the reporting requirements on machinery and equipment trades as well as other property placed in service on or after January 3, 2000. See pages 198–199 of the *2000 University of Illinois Income Tax Workbook* for a discussion of the IRS Notice and *University of Illinois Agricultural Tax Issues, August 2002,* pages 6–44 for a comprehensive review of IRC §1031 information. See Chapter 13, Depreciation, for a discussion on how to handle the depreciation if the 30%/50% bonus depreciation was taken on the new asset.

ISSUE 4 — CHARITABLE CONTRIBUTIONS OF COMMODITIES

BASIC RULES

For gifts by farm operators and materially participating landlords, the gifts of crops, livestock, and other items of inventory do not trigger gain on contribution to the charity. Instead, the contribution is limited to the donor's income tax basis for gifts of grain and other "ordinary income property."[39] For charitable gifts of grain or raised livestock, the costs of production are deductible as trade or business expenses under IRC §162. That is the result regardless of whether the contribution occurs in the year of production or a later year.[40] Conversely, for gifts of grain, livestock, or other items of inventory to noncharitable donees, gifts made after the year of production do not require that production expenses associated with the gift be reduced in terms of deductibility.[41]

Example 11. In 2003, Amanda Smith donated 1,000 bushels of soybeans to her church. The donation represented the production from 15 acres. Amanda's cost of production was $4,000, and the FMV at the time of the donation was $5,000. For 2003, Amanda was on the cash method of accounting.

Result. IRC §170 allows a deduction of the lesser of FMV or basis in property given to a charitable organization or to a state government or subdivision of a state government if the gift was for a public purpose. Because Amanda does not have a basis in the grain, she is not entitled to a charitable deduction. However, Amanda is allowed to claim the $4,000 of production expenses on her Schedule F as an IRC §162 deduction.

Observation. Prior workbooks have indicated that if the contribution was made in the year the commodity was produced, the donor would not be able to deduct the production costs as an IRC §162 expense. Based on Treas. Reg. §1.170A-1(c)(4), the deduction is properly taken on Schedule F as an IRC §162 deduction.

Had Amanda been able to claim a charitable deduction, she would be required to file a Form 8283 for any noncash charitable deduction exceeding $500. In that event, the charity must complete a Form 8282 to report the later sale of the commodity.

Note. The IRS will be able to compare the actual sale price of a noncash contribution with the value the taxpayer reported on Form 8283.

GIFTS BY LANDLORDS

Early Thinking

Beginning in the 1940s, the IRS initially took the position, via the assignment of income doctrine, that a farmer's gift of commodities to a charity caused the FMV of the commodities to be included in the farmer's gross income. As to the timing of reporting the income, in Rev. Rul. 63-66, 1963-1 C.B. 13, the IRS ruled that when a taxpayer makes a gift of crop shares, the taxpayer must include in gross income the amounts received by the donee for the crop shares **in the taxable year in which the donee reduces the crop shares to money or the equivalent of money.** The holding was based on *Helvering,*[42] where the Supreme Court held that if a donor makes a gift of unrealized income, the donor must recognize income at the time the donor would have realized it (upon receipt) had the donor not given the item of unrealized income away.

Treasury Regulations

The treasury regulations grant a special privilege to sharecrop landlords of deferring recognition of the rental income until the sharecrop amounts are converted to money or its equivalent. For instance, Treas. Reg. §§1.61-4(a) and (b) states, "Crop shares (whether or not considered rent under State law) shall be included in gross income as of the year in which the crop shares are reduced to money or the equivalent of money."

Note. The passage in the regulations is worded the same for farmers on either the cash or accrual methods of accounting, and is viewed as a rule of administrative convenience made necessary by the absence of cash with which to pay the tax before a sale.

However, **when crop shares are donated to charity,** the continuation of the deferral privilege does not serve the purpose of providing cash with which to pay the landlord's tax obligation. It is the donee, not the landlord that will eventually convert the crops to cash. Consequently, there is no reason to continue the preferential treatment accorded crop shares if they are donated to charity.

Change in IRS Position

In Rev. Rul. 75-11, 1975-1 C.B. 27, a farmer-landlord (who filed on the calendar-year basis) donated crop shares received by him as rent to a charity. The following year, the charity sold the crop share for cash. The IRS noted that the farmer had made a gift of realized income, which by virtue of administrative convenience he had not yet been required to recognize. Since it was the charity that converted the crops to cash, the deferral privilege was no longer necessary, and the farmer had to recognize rental income in an amount equal to the FMV of the crop shares **as of the time of contribution to the charity.** The IRS also ruled that the farmer-landlord would be treated as having made simultaneously a charitable contribution in the same amount.

In the ruling, the IRS also dealt with the issue of a farmer-landlord that uses crop share rents as feed in the farming operation. The IRS viewed the feeding of crop share rents as the equivalent of converting the crop share amounts into cash since the farmer would not have to procure feed from other sources. Accordingly, the IRS ruled that if crop share rents are received in one taxable year and fed to livestock in another taxable year, the landlord must include in income an amount equal to the FMV of the share rents at the time the crop share rents are fed to livestock.[43] An offsetting deduction under IRC §162 is available at the same time.

> **Note.** Although an offsetting feed deduction is available, including share rents in income is important for purposes of determining net income from self-employment under the optional gross income method and other provisions based on the taxpayer's gross income.

Relevant Caselaw

The courts have generally upheld the IRS position (set forth in Rev. Rul 75-11) on the contribution of commodities to landlords as triggering gain to the landlord on transfer of the commodities to the charity. Unfortunately, the courts have not drawn any distinction as to whether the landlord was a materially participating or nonmaterially participating landlord.

In *Tatum,*[44] the taxpayer was a crop-share landlord who shared in fertilizer and insecticide costs and "materially planned the amount and location of crops and the application of fertilizer, insecticide, and water." The tenant performed all the labor and paid all other expenses. The taxpayer made donations of crops to charities using negotiable warehouse receipts and "cotton classing cards." The taxpayer did not include in income the value of the crops donated, but claimed a charitable deduction for the amounts received by the charitable donees on sale of the crops. The court held that crop shares are potential income assets, not property, and that a landlord may not avoid taxation by assigning rights to the income prior to the reduction of crop shares to money or its equivalent.

> **Observation.** The court noted if the donation had been made by a farmer who was not a landlord, the donation would have been considered an assignment of appreciated property which would shift the tax to the donee.

> **Note.** Negotiable warehouse receipts are viewed by the IRS to be the equivalent of cash.[45]

The Tenth Circuit Court of Appeals, in *Parmer,*[46] dealt with a situation involving a married couple who were farmers, but had much land operated by tenants. The couple received warehouse receipts for grain crops and donated the receipts to their church, but did not include the value of the crops as income. The church then converted the warehouse receipts into cash. In affirming the Tax Court, the Tenth Circuit held the taxpayers were landlords and the commodity was a crop rental instead of farm products. As a result, the rentals were the same as money and had to be reported into the taxpayers' income.

> **Note.** The same outcome was reached in *Cullison*[47] and in *Tompkins*.[48] However, another federal district court has held that for share rents given to charity, the FMV of the commodity did not need to be included in the taxpayers' income.[49]

Nonmaterial and Material Participation Landlords

The cases are not clear on whether the landlords involved were materially participating or nonmaterially participating under the lease agreement. But, the *Tatum* court did refer to *Davison*,[50] which stands for the proposition that share rents under a material participation lease are treated the same as crops of a farmer with the result that growing crops and stored crops produced under such a lease receive a new income tax basis at death.[51] Upon donation of farm products of a farmer to a charity, no income is triggered to the farmer.

However, share rents under a nonmaterial participation lease that are gifted to a charitable organization should be characterized as crop rentals. That would make them taxable to the donor on transfer to the charity.

> **Note.** If crop shares are true rents, the income is recognized to the donor and the donor has a charitable deduction in the same amount. If the crop shares are not rents, the regular rules of IRC §170(e) apply and there is no income recognized, but the charitable deduction is limited to basis, which is ordinarily zero.

> **Observation.** For farm clients interested in donating crop share rents to charity, a written lease agreement clearly specifying the roles of the landlord and tenant will aid in the proper determination of the tax treatment of donated amounts.

ISSUE 5 — TAX ISSUES FOR TIMBER PRODUCERS

TIMBER AS AN IRC §1231 ASSET

A taxpayer that disposes of timber held for more than one year is eligible for capital gains treatment if the taxpayer:

1. Sells or exchanges timber that is a capital asset,
2. Disposes of the timber under a royalty contract in which the taxpayer retains an economic interest, and
3. Cuts standing timber, the taxpayer may elect to treat the cutting as a sale or exchange eligible for capital gains treatment.

Conversely, timber held primarily for sale is not a capital asset and is reported as ordinary gain or loss.

> **Note.** Evergreen trees, including pine, spruce, fir, hemlock, cedar, and other coniferous varieties count as "timber" for purposes of IRC §631 if they are **more than six years old** at the time of severance and are sold for ornamental purposes, such as Christmas trees. Tops and other parts of standing timber are not evergreen trees.[52]

Sale of Timber under Royalty Contract

If timber is sold under a royalty contract in which the owner retains an economic interest, the gain or loss on sale is treated as if it resulted from a sale of the property used in the taxpayer's trade or business.[53] Gain or loss from the timber is the difference between the amount received in the year and the adjusted basis for depletion of the timber sold.[54]

Observation. Most of the commonly used "cutting contracts" are drafted to qualify under these provisions.

Note. IRC §631(b) applies only to a person who owns an interest in the timber, including a sublessee and a holder of a contract to cut timber. The taxpayer must have a right to cut the timber for sale on the taxpayer's own account or for use in the taxpayer's own trade or business.[55] Also, the provisions of IRC §631(b) are mandatory and do not involve an election. So, if the timber is held by the owner for more than one year, disposal of the timber under a contract in which the seller retains an economic interest is covered by the statute, regardless of the nature of the taxpayer's business or the purpose for which the timber was held.[56]

Timber contract payments that are not contingent upon the severance of trees do not create capital gains.

Example 12. Tyler Pine agreed to sell to a paper company all the timber standing and growing on his land for a period of 20 years. The contract between Tyler and the paper company indicates that the paper company will pay for the timber according to a base price per cord and obligates the paper company to pay for at least 2,000 cords per year regardless of the actual annual harvest. If the paper company cuts more than 2,000 cords in any one year, the contract indicates the compensation for the excess is payable at the end of the year. If less than the guaranteed minimum is severed, the contract contains a "timber backlog" clause that allows the paper company to harvest the timber paid for in advance at any time before the contract expires. When the right to cut expires, the taxpayer retains as liquidated damages advance payments not credited against the timber yield.

Result. The contract allows Tyler to retain the consideration previously paid under the terms of the contract without obligating Tyler to make a refund for the uncut timber. As such, it is a guaranteed annual income for Tyler for the life of the contract, and the contract payments are not contingent on the severance of the trees. Accordingly, Tyler would not be entitled to capital gain treatment.[57]

Sales of Christmas trees by a Christmas tree farmer likely does not qualify for capital gain treatment under the provisions of IRC §631(b). There is no contract between the buyer and seller which causes the customer to have both a right and an obligation to cut timber.

Example 13. Nicholas raises Christmas trees on his Michigan farm. Marley came to the farm shortly before Christmas to select a tree for his family. Marley selected a 7-year-old tree and had it tagged with his name. After the tree was cut, Marley took the tree to a barn and paid for it at the checkout stand. Nicholas did not make an election under IRC §631(a).

Result. Nicholas should report the gain from the sale as ordinary income and not as capital gain. Marley did not, by having a tree tagged with his name, enter into a contract to buy the tree under which Nicholas retained an economic interest that existed until the tree was cut.[58]

Note. The Senate, in its spring of 2003 tax bill, would have eliminated the requirement that a taxpayer retain an economic interest under IRC §631(b) in order to treat the gain as capital gain. However, the conference agreement on H.R. 2 (Jobs and Growth Tax Relief Reconciliation Act of 2003) did not include the Senate provision.

Treatment of Cut Timber as an IRC §1231 Sale

Under IRC §631(a), a taxpayer may **elect** to treat the cutting of timber during a tax year as an IRC §1231 sale or exchange as opposed to an actual disposition. To qualify for the election, the timber must be cut for sale or use in the taxpayer's trade or business and the taxpayer must own or have a contract right to cut the timber as of the first day of the tax year for which the election is made and for more than one year before the cutting.

> **Observation.** The election allows the owner or cutter to achieve capital gain treatment on the increase in the value of the timber until the time of severance. Any later sale results in ordinary income or loss. Normally, an election would not be made when a loss would be involved.

Right to Sell or Use

The timber must be cut for sale or for use in the taxpayer's trade or business. Taxpayers that have a contract right to cut timber must have an unrestricted right to sell the timber or use the timber in the taxpayer's trade or business. Sometimes it can be difficult to determine from the terms of a cutting contract whether the taxpayer has the right to cut, remove, and sell timber personally, or whether the taxpayer is acting on behalf of the timber owner. If not structured properly, the IRS may view a cutting contract as a logging contract between the owner and a logger who receives a selling commission for disposing of the timber for the account of the timber owner. This situation would result in the logger not being entitled to capital gain treatment.[59]

Example 14. Seth is a carpenter and he uses wood products in his business. Seth also cuts timber, with his compensation tied to the amount of sales of the timber that was owned and sold by another party.

Result. Under this arrangement, Seth would not be able to treat the cutting of the timber as an IRC §1231 sale because he does not have the right to sell the timber on his own account. To achieve capital gain treatment, Seth would need a contract provision that grants him the right to sell timber for his own account or to use the timber in his carpentry business.

For partnerships, the election under IRC §631(a) is at the partnership level. The election is not treated as an election by any of the partners as to the partner's own timber, and does not affect the right of an election in any other partnership in which a partner may be involved.

Example 15. Bob and Mary operate a Christmas tree farm as a partnership. Bob and Mary file their tax return as married filing jointly. On their individual return, Bob and Mary make an IRC §631(a) election to treat the cutting of Christmas trees as a disposal for capital gain purposes.

Result. The election is not be available to Bob and Mary because it was not made on the partnership return. The election must be made by the partnership under IRC §703(b).

Computation of Gain, Loss, and the Depletion Deduction

The amount of gain or loss eligible for IRC §1231 treatment is the difference between the FMV at the beginning of the year of cutting and the adjusted basis for depletion in the taxpayer's hands. To compute the adjusted basis for depletion, the taxpayer must allocate to the timber a fair portion of the total price paid for the real estate. This amount is then reduced to depletion units (e.g., cords or board feet) so when the timber is cut, the unit costs can be determined.[60]

To establish basis, when timber land is purchased the taxpayer should allocate the purchase price between the land and the timber. It may be useful to create separate timber subaccounts for merchantable timber, young growth, and plantations.

IRS Form T, *Forest Activities Schedules*, should be used to report the allocation. Form T must be filed by a taxpayer that claims a deduction for depletion of timber or for depreciation of improvements related to timber accounts, or who makes an election under IRC §631(a). If basis is not established at time of purchase, the basis will have to be determined after the fact by using current information on comparable land.

> **Observation.** In order to claim the depletion deduction, a taxpayer must have an economic interest in standing timber. The interest can be acquired by investment or can take the form of a legal right to income from the cutting of the timber to which the taxpayer must look for a return of capital investment.

> **Note.** A farmer can make an election to currently deduct fertilizer and lime expenses. Generally, that election is not available to timber producers because the growing of timber is not treated as a farming business. That means the cost of fertilizer and lime would have to be amortized over its useful life. Consequently, for timber producers, the cost of fertilizer can be deducted from income over the useful life of the fertilizer.

However, it might be useful in some instances to allocate the cost to the basis of the percentage of the total timber that was cut during the tax year.

Example 16. Ryan paid $200,000 for land on which there was standing timber on January 5, 2002. Of the purchase price, $120,000 was allocated to standing timber. Ryan hires an expert who determines that Ryan has 1,000,000 board feet of timber available. Ryan's cost basis is 12¢ per board foot or $120 per 1000. Ryan must attach Schedule B of Form T to his tax return in the year of purchase. Ryan's Form T Schedule B follows.

> **Observation.** Taxpayers for whom the cutting or sale of timber would be a major income factor should use the method indicated in **Example 16**.

For Example 16

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

Schedule B **Acquisitions**

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

3 Name of block and title of account [1] **Smith Walnut Grove**

4 Location of property (by legal subdivisions or map surveys)
NE1/4SW1/4, Sec. 12, T27N R32E WM or WM, T27N, R 32E, Sec. 12, NE1/4 SW1/4

5a Name and address of seller or person from whom property was acquired
Tom Smith
204 Woodland Road
Seattle, WA 33333

b Date acquired **1/5/2002**

6	Amount paid: **a** In cash	**198,000**
	b In interest-bearing notes	
	c In non-interest-bearing notes	
7a	Amount of other consideration	
b	Explain the nature of other consideration and how you determined the amount shown on line 7a:	
8a	Legal expenses	**500**
b	Cruising, surveying, and other acquisition expenses	**1,500**
9	Total cost or other basis of property (add lines 6a through 8b)	**200,000**

10 Allocation of total cost or other basis on books:	**Unit**	**Number of units**	**Cost or other basis per unit**	**Total cost or other basis**
a Forested land	Acre	**100**	**800**	**80,000**
b Other unimproved land	Acre			
c Improved land (describe) ►	Acre			
d Merchantable timber (Estimate the quantity of merchantable timber present on the acquisition date. (See Regulations section 1.611-3(e).) Details of the timber estimate, made for purposes of the acquisition, should be available if your return is examined.)	**Bd Ft**	**1,000,000**	**.12**	**120,000**
e Premerchantable timber. (Make an allocation here only if it is a factor in the total cost or value of the land.)				
f Improvements (list separately)				
g Mineral rights				
h Total cost or other basis (same as line 9)				**200,000**

[1] You must include your timber in one or more accounts. Generally, each account must include all your timber that is located in one "block." A block may be **(a)** an operational unit that includes all timber that would logically go to a single point of manufacture, **(b)** a logging unit that includes all timber that would logically be removed by a single logging development, or **(c)** an area established by the geographical or political boundaries of logical management areas. Timber acquired under a cutting contract may not be included in part of a block, but should be kept in separate accounts. For exceptional cases, the timber in a given block may be divided into two or more accounts. See Regulations section 1.611-3(d) for more information.

Example 17. During 2003, Ryan cut 15% of his standing timber. His depletion basis for the timber would be 15% of the $120,000 (or $18,000) that he paid for all the timber on the land. Ryan will attach Schedule C of Form T in the year of sale. The completed form follows.

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

Schedule C **Profit or Loss From Land and Timber Sales**

Generally, report all dispositions during the tax year (such as ... lines 15, 19, and 20 only for amounts that must be reported

14a	Purchaser's name and address **Bird Brothers Hardware, Inc.** **212 Treetop Rd.** **Chester, WA 33332**	**b** Date of sale **8/30/2003**
15	Amount received: **a** In cash	**25,000**
	b In interest-bearing notes	
	c In non-interest-bearing notes	
16	Amount received in other consideration	
17	Explain the nature of other consideration and how you determined the amount shown on line 16 ▶	
18	Total amount received for property (add lines 15 and 16)	**25,000**

19 Cost or other basis of property:	Unit	Number of units	Cost or other basis per unit	Total cost or other basis
a Forested land	Acre			
b Nonforested land	Acre			
c Improved land (describe) ▶	Acre			
d Merchantable timber. (Estimate in detail the quantity of merchantable timber on the date of sale or exchange. Include the quantity of timber in each species of timber by diameter at breast height (DBH) classes. State the log rule used if the unit of measure is thousand board feet (MBF), log scale.)	**Bd Ft**	**150,000**	**.12**	**18,000**
e Premerchantable timber				
f Improvements (list separately)				
g Mineral rights				
h Total cost or other basis				**18,000**
i Direct sale expenses (cruising, marking, selling)				**700**
20 Profit or loss (line 18 less the total of lines 19h and 19i)				**6,300**

Depletion occurs when standing timber is cut. It is computed using the cost method (multiplying the number of timber units cut by the taxpayer's depletion unit).

Annual Depletion Unit Computation:

$$\text{Total Cost for Depletion} = \begin{array}{c}\text{Cost or Adjusted Basis}\\\text{of the Timber on Hand}\\\text{at the Beginning of the Year}\end{array} + \begin{array}{c}\text{Cost of Any Units Acquired}\\\text{during the Year and}\\\text{Any Additions to Capital}\end{array}$$

$$\text{Total Units} = \begin{array}{c}\text{Number of}\\\text{Units Acquired}\\\text{During the Year}\end{array} + \begin{array}{c}\text{Number of Units on Hand}\\\text{in the Account at}\\\text{the Beginning of the Year}\end{array} \pm \begin{array}{c}\text{Any Correction to the Estimate}\\\text{of the Number of Units}\\\text{Remaining in the Account}\end{array}$$

$$\text{Annual Depletion Unit} = \frac{\text{Total Cost for Depletion}}{\text{Total Units}}$$

Note. The depletion allowance is claimed as a deduction in the year of sale or other disposition of the products cut from the timber, unless the cutting is treated as a sale or exchange.

Note. Taxpayers claiming depletion of timber must attach a map and statement (Form T, Timber) to the return.[61] As a practical matter, Form T requires a great deal of information and is the primary reason that many taxpayers hesitate to make use of the option to treat the cutting of timber as an IRC §1231 sale. Treas. Reg. §1.611-3(f) adds additional detail on how to value timber. Taxpayers with a primary occupation other than timber that use a forester to make management and marketing decisions, and who have infrequent timber sales are treated as an investors. For these taxpayers, timber sales, are reported on Schedule D, and a Form T is not filed.

When more than one taxpayer owns an economic interest in a single tract of timber, the depletion deduction must be apportioned among the owners.[62] For timber held in a life estate/remainder arrangement, the life tenant is entitled to the depletion deduction for life. Basis remaining after the life tenant's death entitles the remaindermen to the deduction. For timber held in trust, the depletion deduction is apportioned between the income beneficiaries and the trustee on the basis of the trust timber income allocable to each. If the trust (or state law) requires or permits the trustee to maintain a depletion reserve, the deduction is first allocated to the trustee to the extent that income is set aside for a depletion reserve. Any excess is apportioned between the income beneficiaries and the trustee on the basis of the trust income allocable to each. For timber held by an estate, the depletion deduction is apportioned among the estate and the heirs, legatees, and devisees in proportion to the amount of the estate's timber income allocable to each.

The condition of timber on the date of cutting is used to determine the FMV of the timber for purposes of the election. Typically, an expert with experience in buying or selling timber in the area will need to be hired to value the timber. The statute and regulations require taxpayers to make the determination of value on the return in the light of the most reliable and accurate information available with reference to the property's condition **as it existed on the first day of the year** in accordance with the willing buyer–willing seller test.[63]

Note. Where trees are of premium grade on the day of cutting, but of lesser quality as of January 1, one court has held that capital gain is to be measured by the value for the premium grade. The court noted that the regulation was inconsistent with the statute inasmuch as the statute could be construed to allow FMV to be determined with regard to the condition of the trees at the time of cutting. Such a construction, the court noted, resulted in capital gain treatment for all increase in value due to growth and treats as ordinary income gain from subsequent processing and marketing.[64]

The election is to be based on the market value of the standing trees and assumes that all of the value is allocated to sawtimber content.[65] That means proceeds from the sale of branches, limbs, and tops for pulpwood purposes should not be taken into account when computing FMV of standing timber, nor added after cutting.

Note. If, upon appraisal, the value of tops and limbs is included in the value in addition to the sawtimber value, the total value exceeding depletion basis becomes capital gain. If the value to tops and limbs is left out and the tops and limbs are later sold, the proceeds are ordinary income, and there would be no basis unless an allocation of the original basis had been made.

Technically, while gain or loss under the election occurs in the year of cutting, the IRS considers timber to be cut in the year in which, in the ordinary course of business, the quantity of timber felled is first definitely determined rather than at the time of felling.[66] The reason for the IRS position is to account for problems that can be experienced in obtaining an accurate measurement. Typically, the quantity of timber felled will be determined first at the truck scale. However, the IRS has ruled that if the cutting rights are acquired under a Forest Service contract requiring scaling (the procedure used to measure logs to determine board feet content) by a Forest Service scaler, timber is considered cut when the scaler does so at the mill deck in the ordinary course of business.[67] In the ruling, the IRS noted that the mill deck scale is the first time the logs are identified by species, measured, and their quantity in logs is first determined.

MECHANICS OF THE IRC §631(A) ELECTION

The election is made on the tax return for any year in which the taxpayer wants the election to begin. The taxpayer simply includes in income the gain or loss on the cutting and shows a computation of the gain or loss and computes the tax under the provisions of IRC §631. The election cannot be made on an amended return, nor can it be revoked for any subsequent year without IRS consent.[68] To make the election, the timber must have been held on the first day of the year and for more than one year before the cutting. The holding period of timber begins to run the day following the date of acquisition. Once the election is made, it applies to all timber owned or subject to contract rights, whether acquired before or after the election.

Observation. It is important to preserve records of the date of acquisition and the date of sale.

Example 18. Paul Bunyan had a contract to cut timber and deliver it to Larry, the buyer. Larry had the right to enter and cut only if Paul defaulted in producing the timber.

Result. Because Paul retained the primary right to cut the timber, there was no disposal of cutting rights under IRC §631(b). Thus, Paul would need to make a timely election to treat the cutting as a disposal to be entitled to capital gains treatment under IRC §631(a).

PROPER REPORTING OF SALE OF TIMBER

Once the election has been made to treat the cutting of timber as a sale, the profit from the sale of the timber (either in the form of timber or in the form of some product manufactured from the timber) must be reported. The profit reportable is the difference between price received and the taxpayer's new cost basis (the FMV on the first day of the year in which the timber was cut). The profit is ordinary income not subject to IRC §1231 treatment.

The sale of cut timber could be reported on the "Other Farm Income" line on Schedule F. The cost basis would then be deducted as an expense. It may be preferable, however, to report the sale on the schedule headed "Sales of Livestock and Other Items You Bought for Resale," lines 1 and 2 of Schedule F.

The date of disposal is the date the timber is cut. The taxpayer may choose to treat the date of payment as the date of disposal if payment is received before the timber is cut. The choice applies only to computing the holding period. The choice is made by attaching a statement to the timely filed return, including extensions, for the year payment is received.

Basis recovery rules apply to the sale of timber. If all of the taxpayer's timber is sold, the entire basis in the timber account may be deducted. If only a part of the taxpayer's timber is sold, the basis must be allocated between the portion sold and the portion retained.

PROPER HANDLING OF GROWING EXPENSES

Expenses That Must Be Capitalized

Preparation of the woodlot, including the expenses of brush removal performed within a reasonable amount of time (likely within the first two years) after planting, cost of seedlings, labor, and tool expense (including depreciation of equipment used in planting) are capital expenditures that must be capitalized. Labor and tool expense includes all costs involved in planting seedlings, including all amounts expended for transportation, supervision and labor, equipment rental and depreciation of owned equipment, and tools used in connection with the planting. A pro rata portion of the depreciated cost of the equipment is added to the basis of the seedlings proportionate to the use of the equipment or tools in planting as compared with the use of such equipment in other activities.

Similarly, the cost of land improvements such as road grading, ditching, and firebreaks should be capitalized into the land. However, if the land improvements have a determinable useful life, they may be depreciated. Otherwise, the cost is added to the basis of the land.

Currently Deductible Expenses

Expenses incurred for shearing and basal pruning of Christmas trees are deductible business expenses. Likewise, expenses incurred for silvicultural practices, such as weeding, cleaning, or noncommercial thinning, are also deductible business expenses.

OUTRIGHT SALE OF TIMBER

When a farmer (or other woodlot owner) that is not in the timber business sells a stand of timber for a fixed amount, the sale is regarded properly as the sale of a capital asset. Thus, the gain or loss should be aggregated with IRC §1231 items. If land is sold with the timber, a determination must be made concerning whether the tract was land used in the trade or business to which IRC §1231 would apply or whether it was held for investment in which case IRC §1231 would not apply. The difference between timber held as investment and timber held for use in the trade or business depends on the presence of certain factors. Those factors include:

- The purpose for which the timber was acquired, whether for sale or investment;
- The number, continuity and frequency of sales;
- The promotional activity of the seller with respect to timber sales; and
- The extent or substantiality of the transaction.

Owners of small woodlot acreages typically do not hold the timber for sale in the ordinary course of business. These taxpayers can choose the manner of sale that is most beneficial personally. Many will likely use the lump-sum method of selling timber. This method involves the sale of standing timber for a fixed price agreed upon in advance with the value determined by estimating the volume of usable wood products from standing timber.

Example 19. Mary made a lump-sum sale of timber for $50,000. Mary incurred $5,000 in selling costs. The timber was on a tract of land that Mary bought 10 years ago for $40,000. Upon purchase, Mary allocated $25,000 to the land and $15,000 to the cost of the merchantable timber.

Question. How would Mary compute gain or loss on sale?

Answer.

Amount received on sale	$50,000
Less selling costs	(5,000)
Less amount allocated to timber	(15,000)
Gain on sale	$30,000

Because Mary held the timber for more than one year, the $30,000 gain qualifies as long-term capital gain reportable on Schedule D. If the sale occurred after May 5, 2003, the applicable capital gain tax rate would be 15% if Mary's individual marginal income tax bracket was above 15%. Otherwise, the applicable capital gain rate would be 5%. If the sale occurred before May 6, 2003 and after December 31, 1997, the applicable capital gain rates would be 20% and 10% respectively.

Note. Mary could sell the timber under a contract calling for selective cutting and still achieve capital gain treatment if the timber is held for investment.

HANDLING TIMBER LOSSES

The IRS Position

Under Treas. Reg. §1.165-7(b)(2), a casualty loss to timber is determined by reference to a "single identifiable property" (SIP) damaged or destroyed by the casualty. In Rev. Rul. 66-9, 1966-1 C.B. 39, which dealt with timber destroyed in a hurricane, the IRS defined SIP as the quantity of timber in standing trees (measured in board feet, log scale, cords, or other units) rendered unfit for use. In the ruling, the IRS regarded only total destruction of the timber as sufficient to incur a casualty loss. Similarly, in Rev. Rul. 73-51, 1973-1 C.B. 75, the IRS addressed the allowance of an IRC §165 casualty loss from an ice storm and repeated the definition of SIP used in Rev. Rul. 66-9, ruling that physical damage (broken crowns or root damage) did not result in timber being rendered unfit for use.

View of the Courts and IRS Change of Position

The courts have not supported the IRS's narrow definition of SIP. In *Westvaco*,[69] the court held that SIP damaged or destroyed by storms and fires included all the standing timber in the "depletion block" directly affected by the casualty and not just the units in the trees "suffering mortal injury." The court ruled that the appropriate SIP is any unit of property that has "an identifiable basis and that is reasonable and logical and identifiable in relation to the area affected by the casualty." In *Weyerhaeuser*,[70] the Federal Circuit held that SIP damaged or destroyed by several forest fires and a volcanic eruption was equal to the depletion block. Consequently, the court allowed a casualty loss for trees damaged, but not destroyed.

Based on the *Westvaco* and *Weyerhaeuser* rulings, the IRS issued Rev. Rul. 99-56, 1999-2 C .B. 676, revoking Rev. Rul. 66-9 and Rev. Rul. 73-51. In Rev. Rul. 99-56, the IRS held that for purposes of calculating a casualty loss to timber, the SIP damaged or destroyed includes all of the taxpayer's standing timber in a district or block that is directly affected by the casualty, rather than just the units of timber contained in trees that suffered a fatal injury. Under Rev. Rul. 99-56, a casualty loss may be allowed for trees that are damaged, but not rendered worthless.

TIMBER SALES AND ESTIMATED TAX

IRC §6654 (i)(2)(B) contains an exception to the estimated tax penalty for a "farmer." To qualify for the exception, two-thirds of gross income must come from the farming operation during the tax year or the immediately preceding tax year. Consequently, practitioners with farm clients that have timber sales must determine whether the exception has been satisfied. If not, the client will be subject to an estimated tax penalty unless quarterly estimated tax payments are made. Timber sales reported on Form 4797 or Schedule F will be added to gross income from farming for purposes of the estimated tax threshold.

RULES FOR CHRISTMAS TREE GROWERS

If Christmas trees are more than six years old at the time of cutting, they qualify as "timber" under IRC §631 and gain on sale is capital in nature if the owner is an investor and held the trees for more than one year. Christmas trees less than six years old at the time of cutting do not count as "timber" and are subject to the IRC §263 uniform capitalization rules. That means all costs of raising the trees must be added to the basis of the trees rather than deducted as they are incurred, unless the taxpayer elects out of the rules. If such an election is made, upon sale of the trees, an amount equal to the costs that would have been capitalized is subject to recapture under IRC §1245 and alternative depreciation (straight line over the class life) must be used for depreciating all assets in the farming business. However, the IRC §1245 rule is immaterial for taxpayers in the business of raising trees because all of the gain from sale of trees would be ordinary income before the recapture rules apply.

Note. The age of a Christmas tree is measured from the date the seed is planted, not the time a seedling is purchased.

Example 20. In 2002, Michael purchased a Christmas tree farm as an investment. Michael paid $100,000 for the farm and allocated $30,000 of the purchase price to the trees and $70,000 to the land. At the time of purchase, the trees were eight years old and ready for harvest. In 2003, Michael paid a cutter $5,000 to harvest the trees and sold them for $45,000 in a lump-sum sale to a local retail outlet.

Question. How would Michael compute the gain on the sale?

Answer.

Amount realized	$45,000
Less basis in trees	(30,000)
Less expenses of sale	(5,000)
Gain on sale	$10,000

The gain would be treated as capital gain because Michael is an investor and is not in the business of raising and selling Christmas trees.

Note. If Michael were in the business of raising and selling Christmas tress, the gain would be ordinary income unless the sale contract qualified under IRC §631(b) or Michael elected to report the sale under IRC §631(a). If Michael retained an economic interest in the trees, then all of the gain is capital gain under IRC §631(b). If Michael elects to report the gain under IRC §631(a), then the difference between the value of the trees at the beginning of the tax year and the basis in the trees is IRC §1231 gain. To determine the gain that is allocated between ordinary gain and IRC §1231 gain, Michael must determine the value of the trees at the beginning of the tax year in which they are cut.

Example 21. Assume the same facts as in **Example 19** except the trees were four years old or less at the time of cutting. Michael would still be able to report the gain as capital gain because the trees were held for investment. If Michael was engaged in the trade or business of raising and selling Christmas trees all of the gain would be ordinary income. The IRC §631(a) election would not be available since the trees do not qualify as "timber."

ISSUE 6 — DEDUCTIBLE LOSSES FOR FAILED COOPERATIVES

OVERVIEW

The failure, merger, or bankruptcy reorganization of several farm cooperatives in recent months has raised questions concerning the character of losses for income tax purposes, what Code section applies, and when such losses may be claimed. Pages 236–237 of the *2002 University of Illinois Income Tax Workbook* addressed the proper characterization of the equity interest relinquished by the patron and whether losses are ordinary or capital in nature. In this section, the issue of timing is dealt with. When may a loss on a cooperative interest be deducted?

APPLICABLE CODE SECTION

The appropriate Code section for the deduction of losses depends on whether the loss is properly characterized as a loss from worthless securities[71] or a bad debt.[72] The two provisions are mutually exclusive inasmuch as the bad debt deduction provision is specifically made inapplicable to a debt which is evidenced by a security as defined in the worthless securities provision.

Worthless Securities

Although the regulations do not provide guidance on whether stock in a cooperative is subject to treatment as a worthless security, the Tax Court in *Morton*[73] and in *Peake*[74] has allowed losses on cooperative stock to be deducted under the worthless security rules. Under the worthless securities rules, the cost or other basis of stock is deducted in the year that the stock becomes totally worthless. They are treated as though they were sold on the last day of the tax year, which may affect whether the loss is long or short term. No deduction is allowed for partially worthless stock. That is the result required by IRC §165(g)(1) and Treas. Reg. §1.165-5(c).

> **Note.** A loss from a worthless stock that is a capital asset is generally subject to the limitation on capital losses. For any security that is not a capital asset that becomes wholly worthless during the year, the loss is an ordinary loss.

Thus, it would seem that stock in a cooperative that was acquired as an investment, and which does not involve retained patronage is a capital asset and is subject to treatment as a worthless security. However, whether an interest in a cooperative representing retained patronage is subject to the worthless securities rules depends upon whether the interest is a capital asset. The fact that the IRS in Rev. Rul. 70-64, 1970-1 C.B. 36, allowed ordinary loss treatment on such an interest would indicate that an interest in a cooperative representing or including retained patronage is not considered a capital asset. The IRS, in the ruling, specifically noted that the ordinary loss in that ruling was deductible under the worthless securities provision of IRC §165.

> **Observation.** The ruling was issued well before the U.S. Supreme Court chastised taxpayers and the IRS in *Arkansas Best Corp.*[75] for ignoring the plain meaning of the statutory definition of capital asset, which is that everything is considered to be a capital asset except assets specifically excluded.

Bad Debt

An interest in a cooperative may not be considered subject to the worthless securities rules. This could occur if the interest in the cooperative that represents retained patronage is not a "security" within the meaning of the worthless securities provision. Therefore, any loss would be allowable as a bad debt deduction under IRC §166(a).

In that event, a deduction is available if the debt becomes wholly worthless during the year. Only a bona fide debt qualifies for a bad debt deduction.[76] A bona fide debt is a debt arising from a debtor–creditor relationship based upon a valid and enforceable obligation. For a partially worthless bad debt, a deduction is allowed "not in excess of the part charged off" within the taxable year. However, nonbusiness bad debts must be totally worthless; partially worthless nonbusiness bad debts are not deductible.[77]

Note. A business bad debt, which can be deducted directly from gross income, relates to operating a trade or business and is mainly the result of credit sales to customers or loans to suppliers, client, employers, or distributors. Nonbusiness bad debts include debts other than debts created or acquired in connection with a trade or business of the taxpayer or a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business. To be deductible, nonbusiness bad debts must be totally worthless; partially worthless nonbusiness bad debts are not deductible.

Farm cooperatives typically provide their owners/investors/members with certificates of ownership to represent an equity interest in the business. Generally a creditor interest does not exist. Another form of investment is for the cooperative to sell bonds, debentures, or another form of debt instrument. It is important to understand what type of investment (equity or debt) the taxpayer has made with the cooperative.

WHEN THE LOSS IS DEDUCTIBLE

For losses involving worthless securities, only the basis of "wholly worthless" securities is deductible in a taxable year. Losses involving a cooperative in reorganization bankruptcy (Chapter 11) would seem **not to be deductible until there is a formal determination that the securities are indeed worthless.**

It would seem that losses on interests in a cooperative representing retained patronage may be classified as business bad debts. While partially worthless bad debts are deductible as business bad debts, it is necessary to show that the deductible amount was "charged off" during the year. Bankruptcy is generally good evidence that at least part of a debt is worthless. Indeed, the regulations state:

In bankruptcy cases a debt may become worthless before settlement in some instances; and, in others, only when a settlement in bankruptcy has been reached.[78]

Thus, for a cooperative in reorganization bankruptcy, a bad debt deduction may not be claimable until formal action is taken by the bankruptcy court declaring that the debt has, indeed, been "charged off."

Note. The point is bolstered by two recent court opinions. In *In re Steffen,*[79] the taxpayer had invested in a corporation that eventually was terminated after losing several lawsuits. The taxpayer argued that the taxpayer's stock in the corporation became worthless in 1989 when several court actions in the cases indicated that the stock was worthless. However, the court noted that the court actions in 1989 did not resolve all of the lawsuits and that some value remained until 1993 when the final lawsuit was resolved against the corporation. The court held that the loss on the stock could not be claimed as a deduction until 1993.

Similarly, in *Wagner,*[80] the court denied a worthless stock deduction for the year a corporation was dissolved because the stock retained value after the dissolution date.

Observation. The inability to claim a current year loss on a cooperative interest may be a particularly bitter pill to swallow for a member-cooperative of a cooperative in reorganization bankruptcy that has had several successive years of patronage allocation deductions.

ISSUE 7 — HANDLING OF CONSERVATION EXPENDITURES

DEDUCTION FOR SOIL AND WATER CONSERVATION EXPENSES

Taxpayers engaged in the business of farming can deduct soil and water conservation expenditures in the year incurred, under a onetime election, rather than having to capitalize the expenditures.[81] Conservation expenses for land in a foreign country do not qualify.

Eligibility for the Election

To make the election to treat soil and water conservation expenditures as current deductions, the taxpayer must be engaged in the business of farming. The regulations specify that a taxpayer who "cultivates, operates, or manages a farm for gain or profit, either as owner or tenant" is engaged in the business of farming.[82] A landowner under a crop-share or livestock-share lease is engaged in the business of farming.[83] However, a landowner under a cash-rent lease is engaged in the business of farming only if the landowner "participates to a material extent in the operation or management of the farm." That means that the landowner must participate to a significant degree in the growing process and be at substantial risk of loss from the growing process.

> **Note.** A nursery engaged in the raising of ornamental plants is considered to be in the business of farming.[84] However, a taxpayer engaged in forestry or the growing of timber is not in the business of farming.[85] The regulations also specify that a person cultivating or operating a farm for recreation or pleasure rather than for profit is not in the business of farming.[86]

What Expenses Qualify for the Deduction?

Expenditures for which an income tax deduction is permitted are those "paid or incurred for the purpose of soil or water conservation in respect of land used in farming, or for the prevention of erosion on land used in farming, but only if such expenditures are made in furtherance of the business of farming."[87] If the purpose of an expenditure is solely to increase a farm's productivity, a deduction will not be allowed.

The following are categories of expenditures that qualify for the deduction:

- Earth leveling, conditioning, grading, terracing, contour furrowing, and restoration of soil fertility
- Cost of establishing Coastal Bermuda Grass to prevent soil erosion
- Construction, control and protection of diversion channels, drainage ditches, irrigation ditches (but not irrigation pipe), earthen dams, water courses, outlets, and ponds
- The eradication of brush
- The planting of windbreaks

> **Note.** If an earthen dam has a definite life, the costs of constructing the dam are depreciable. If a pond has an indeterminate life, the costs of constructing the pond are not deductible.

- Assessments by soil and water conservation or drainage districts which, if paid by the taxpayer directly, would be deductible as a soil or water conservation expense. However, the deductible assessment may not exceed 10% of the total assessment made against all members of the district to pay the costs of acquiring depreciable property. The costs in excess of 10% must be added to the income tax basis of the property involved. The maximum amount that can be deducted in one year is the 10% share previously described above. However, if the 10% share is less than 10% plus $500, the entire amount may be deducted in the first year. This deduction is also subject to the 25% of gross income from farming limitation.

Conversely, expenditures for the purchase, construction, installation, or improvement of "structures, appliances, or facilities subject to the allowance for depreciation" are not eligible for the election to deduct currently.

Land Must Be Used in Farming

To be deductible under the soil and water deduction provision, expenditures must pertain to land used in farming. In general, the land must be used for the production of crops, fruits, or other agricultural products (including fish) or for the sustenance of livestock.

> **Note.** The term "livestock" includes cattle, hogs, horses, mules, donkeys, sheep, goats, captive furbearing animals, chickens, turkeys, pigeons, and other poultry. Grazing land is considered used for the "sustenance of livestock."[88]

For land used in farming by the previous owner, the taxpayer is considered to be using the land in farming when soil and water conservation expenditures are made if the taxpayer's use of the land is substantially a continuation of its use in farming, whether for the same farming use as that of the previous owner or any of the other permissible uses. If only part of a tract of land has been used for farming, only soil and water conservation expenses allocable to the part actually farmed are deductible. The allocation is made on the basis of the area actually used in farming compared to the total area of the tract unless some other method of allocation is shown to be more reasonable.

25% Limitation

The deduction may not exceed 25% of the taxpayer's "gross income derived from farming" in any taxable year.[89] Any excess above the 25% level is deductible in succeeding taxable years, in order of time, but the carryover utilized in any year plus any soil and water conservation expenses paid or incurred that year may not exceed 25% of the gross income from farming in that year. If the amount of soil and water conservation expense is less than the 25% limit, all must be claimed; the taxpayer may not deduct only part of the expense in order to carry forward the rest to a year in which the income from farming is expected to be greater.

> **Note.** The term "gross income from farming" is calculated under the taxpayer's regular accounting method and includes gain from the disposition of livestock held for draft, dairy, breeding, or sporting purposes. However, gains from the sale of other IRC §1231 assets such as machinery and land, are not included.

If the deduction for any year creates a net operating loss for the year (as computed after the 25% limitation), the loss is available under the general carryback and carryforward rules for net operating losses even though the taxpayer has a 25% deduction for soil and water conservation expenditures in the year to which the loss is carried. The part of a net operating loss carryback or carryforward that is attributable to the soil and water conservation deduction is not subject to the 25% limitation in any year to which it is carried as a net operating loss.

If the taxpayer is also the beneficiary of a trust that is engaged in farming, the taxpayer **cannot** include the distributive share of trust income in determining "gross income from farming" for purposes of the 25% limitation on the taxpayer's deduction for soil and water conservation expense. If the trust has soil and water conservation expenditures exceeding the 25% limitation, the excess is not available as a deduction by the beneficiary, whether or not the beneficiary is engaged in farming. Upon trust termination, any loss carryover resulting from the allowable deduction of conservation expenses by the trust and any "excess deductions" from the last taxable year of the trust, including the allowable conservation expense deduction, are available to the beneficiary. However, any excess of the trust's soil and water conservation expense deduction over the 25% limit, which is allowable as a carryover by the trust so long as it is in existence, is not available to the beneficiary upon termination of the trust.

Mechanics of the Election

The election is made in the first year the taxpayer pays or incurs expenditures. One court, however, has held that the election could not be made in a year for which a return had not been filed.[90] The election does not require IRS consent and is made by entering the expenditures on the taxpayer's income tax return. The election is binding for all subsequent years unless the IRS consents to a change. A taxpayer, however, may request consent to capitalize or deduct soil and water conservation expenditures with respect to a special project of a single farm without disturbing the treatment of regularly occurring soil and water conservation expenditures. The consent applies only to expenses incurred after the effective date of the change. If the election is not made in the first year soil and water conservation expenses were incurred, the taxpayer may still apply for consent to deduct the expenses in a subsequent year. The consent does not, however, permit a deduction for items paid or incurred in a prior year.

> **Note.** Whenever consent is required for an adoption or change of method, the request must be made not later than the due date for the return for which the adoption or change is to be effective. The request must state the amount of all conservation expenditures incurred for that year and must state that the taxpayer "will make an accounting segregation in his books and records of the expenditures to which the election relates."[91]

In the event a taxpayer has not elected to deduct soil and water conservation expenses currently, the expenditures are added to the income tax basis of the property. However, expenditures that exceed the 25% limit do not increase the income tax basis of the property even if the property is sold before the deduction has been absorbed. For expenditures exceeding the limit, the carryover merely remains in abeyance until the taxpayer again has gross income from farming.[92]

For tax years after 1995, taxpayers claiming soil and water conservation expenses need not file Form 8645 with the return. The required information can be reported on Schedule F or Form 4835.

For S corporations (and, presumably, partnerships), the election is made at the entity level. In *Brown*,[93] shareholders of an S corporation that leased land to the S corporation could not claim deduction where the election was not made by the S corporation.

Recapture on Disposition

If land which the taxpayer has not held for 10 years is disposed of, part or all of the soil and water conservation deductions previously claimed may be recaptured with that part of the gain taxed as ordinary income.[94] The amount of the recapture is the lesser of the "applicable percentage" of soil and water conservation expense deductions made with respect to the land, or the amount realized (in the case of sale, exchange, or involuntary conversion), or the FMV of the land over its adjusted income tax basis (in the case of any other type of disposition).

> **Note.** Recapture is not based on the number of years since soil and water conservation expenditures were paid or incurred, but upon the number of years the taxpayer held the land. Recapture is also limited to the "applicable percentage" of deductions previously claimed.

For land held five years or less, 100% of the deductions are subject to recapture. For land held ten years or more, none of the deductions is recaptured. For land held between five years and ten years, a percentage of the deductions are recaptured as follows:

- In the sixth year after acquisition, 80% of the deductions is recaptured.
- In the seventh year after acquisition, 60% of the deductions is recaptured.
- In the eighth year after acquisition, 40% of the deductions is recaptured.
- In the ninth year after acquisition, 20% of the deductions is recaptured.

If only a portion of a parcel of land is disposed of, the deductions attributable to the entire parcel are allocated to each part in proportion to the FMV of each item at the time of disposition. For land disposed of with installment reporting of gain, income on each installment is first deemed to consist of gain attributable to recapture of soil and water conservation expense and land clearing expense deductions, until all of that gain has been reported. The remainder of the gain is ordinary income or capital gain depending on the type of property, holding period, and applicability of other recapture provisions.

In general, no gain is recognized from recapture of soil and water conservation expenses on disposition of land by gift (whether to a charitable donee or not), on transfer of land at death, or on tax-free exchange (except to the extent of gain recognized).

> **Note.** When land is gifted to a charitable organization, the donor's charitable deduction is reduced by the amount that would have been reported as ordinary income on sale.

THE POTENTIAL TO EXCLUDE COST-SHARE PAYMENTS

The USDA will pay a part or all of the costs associated with conservation projects that are primarily for conserving soil and water resources and other environmental concerns. The USDA will either pay the costs to the farmer directly or reimburse the farmer for the costs after the farmer has incurred the cost. In any event, the cost-share amounts will be reported to the farmer and the IRS on Form 1099-G, and should be included on Schedule F (for an active farmer).

Some cost-sharing amounts, however, can be excluded from gross income under IRC §126. For cost-share amounts to be excludable, the following requirements must be satisfied:

1. The USDA Secretary of Agriculture must determine that the payments were made "primarily for the purpose of conserving soil and water resources, protecting or restoring the environment, improving forests, or providing a habitat for wildlife."
2. The Secretary of the Treasury must determine that the payments are not "increasing substantially" the annual income from the property.
3. It was a capital expense and no part of the payment allowed to be deducted in the current tax can be excluded, such as rent for the property or for services of the recipient.

The following example illustrates the procedure used to determine whether (and to what extent) cost-share amounts can be excluded from income.

Example 22. Mindy owns a 640-acre farm in Indiana from which she received an income of $64,000 from crop production over each of the last five years. In 1996, Mindy had a grass waterway installed to comply with a soil and water conservation plan for the farm. The waterway (a nondepreciable land improvement) cost $48,000, and increased the value of her farm by $27,000. Mindy received a $24,000 cost-share payment from the local FSA office which she reported as a government payment. $2,000 of this payment was considered as a payment for services she provided to the project. Assuming Mindy meets all of the tests for excludability, how much of the $24,000 cost-sharing payment can she exclude from income?

For Example 22

☐ CORRECTED (if checked)

PAYER'S name, street address, city, state, ZIP code, and telephone no. U S Department of Agriculture 100 State St Kansas City, MO 44444	1 Unemployment compensation $ 2 State or local income tax refunds, credits, or offsets $	OMB No. 1545-0120 2003 Form 1099-G	Certain Government Payments
PAYER'S Federal identification number 11-1234567 RECIPIENT'S identification number 222-33-4444	3 Box 2 amount is for tax year	4 Federal income tax withheld $	Copy B For Recipient
RECIPIENT'S name Mindy Farmer Street address (including apt. no.) 20256 Hard Road City, state, and ZIP code Anytown, KS 66666	5 7 Agriculture payments $ 24000.00	6 Taxable grants $ 8 Box 2 is trade or business income ► ☐	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.
Account number (optional)			

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

Result. Mindy will have to work through the computation set forth in Temp. Reg. §16A.126-1(g). The primary question is whether the cost-share payments "increase substantially" the annual income from her property. Under the Temp. Reg., an increase in annual income is not substantial unless it:

a. exceeds the greater of $2.50 per acre; or

b. 10% of the average annual income derived from the property before the improvement.

Computation of the 10%, $2.50/acre limit:

a. $2.50/acre amount = $2.50/acre × 640 acres = $1,600

b. 10% amount = $64,000 × .10 = $6,400

Since (b) is greater than (a), part or all of the $22,000 cost-share amount is excludable if the annual income does not increase more than $6,400 because of the waterway.

How much of the $22,000 cost-share payment is excludable?

Step 1. Determine the IRC §126 cost

IRC §126 cost = cost of the improvement – non-IRC §126 payment

IRC §126 cost = $48,000 – $2,000 = $46,000

Step 2. Determine the value of the improvement.

FMV of the Improvement × (IRC §126 cost ÷ Cost of the improvement)

Value of the improvement = $27,000 × ($46,000 ÷ $48,000) = $25,875

Step 3. Determine the excludible portion (the present FMV of the greater of 10% of annual income or $2.50 times the number of acres affected).

$6,400 ÷ .06 = $106,667

Step 4. Determine Mindy's cost associated with the improvement.

Mindy's cost = $24,000

Step 5. Add the results of Steps 2 and 3.

$106,667 + $24,000 = $130,667

Step 6. If the result of Step 5 exceeds the value of the improvement, the entire amount of the cost-share payment can be excluded from income if annual income does not increase (in this example) more than $6,400.

If Mindy makes the election to exclude cost-share payments, she will be able to exclude the entire $22,000 cost-share amount. The additional $2,000 is not excludable because it is payment for work Mindy performed.

What if Mindy had not made the election to exclude the cost-share amount? How much of the cost-share amount would she include in income?

Value of improvement – Mindy's contribution = Includible amount

($27,000 – $22,000) = $5,000

Note. To the extent the exclusion applies, an attachment should be added to the tax return for the tax year the last improvement payment was received from the government. The dollar amount of the cost funded by the government, the value of the improvement, and the amount excluded should be stated on the attachment. The taxpayer must report the total cost-sharing payments on line 6a of Schedule F and the taxable amount on line 6b.

A taxpayer may elect not to have the exclusion rules apply to all or part of an improvement. The election is made by attaching a statement to the return indicating the dollar amount of the cost funded by a government payment, the value of the improvement, and the amount that is being excluded from income. The election must be made not later than the due date, including extensions, for filing the tax return. The exclusion is also available to lessors of property.

Note. The exclusion rule does not apply to government cost-share payments to the extent a deduction is allowed in the year paid or incurred. Also, if the exclusion is claimed, expenditures may neither be used to generate deductions or credits nor be added to the income tax basis of property acquired.

BASIS EFFECT OF THE EXCLUSION

For basis computation purposes for land on which the exclusion of cost-share payments has been made, the amount of the cost-share payments is subtracted from the capital costs. The basis cannot reflect any amounts excluded from income.

RECAPTURE PROVISION

If property acquired, improved, or otherwise modified by the application of payments excluded from gross income is disposed of within 20 years, part or all of the excluded payments are taxed as ordinary income. The amount taxable as ordinary income is the lesser of the:

- Gain realized on sale of the property, or
- Applicable percentage of the amount of the payment that had been excluded from income.

The applicable percentage for the first 10 years after the date the payments are received and excluded is 100%. Thereafter, the applicable percentage is reduced annually by 10 percentage points. After the nineteenth year, there is no recapture.

Note. The recapture rule does not apply to government cost-share payments to the extent a deduction is allowed in the year paid or incurred.

VARIOUS CONSERVATION PROGRAMS

Environmental Quality Incentive Program (EQIP)

EQIP is an eligible program for cost-sharing under IRC §126. Thus, payments meeting the tests of IRC §126 can be excluded. Incentive payments made to encourage ongoing maintenance practices are includable in income and can be offset with allowable deductions.

CRP Continuous Signup Enhancements

Since May 1, 2000, producers have been allowed to make offers at their local USDA Service Center for a continuous sign-up for CRP contracts for several "targeted" practices. Those targeted practices are:

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

An up-front CRP signing incentive payment (SIP) of $100 per acre for 10-year contracts and $150 per acre for 15-year contracts can be paid. These payments do not qualify for the exclusion under IRC §126 and are reportable as ordinary income. A practice incentive payment (PIP) equal to 40% of eligible installation costs can be paid. As with SIPs, these payments must be reported as ordinary income and are not eligible for the exclusion.

Note. The IRS ruled in Rev. Rul. 2003-59, 2003-24 I.R.B. 1014, that the CRP is substantially similar to the conservation programs described in IRC §126. Accordingly, all or a portion of the cost-share payments are eligible for exclusion from gross income to the extent permitted under IRC §126. However, the IRS did point out that CRP rental and incentive payments are **not** cost-share payments and are not eligible for exclusion from gross income.

Conservation Reserve Enhancement Program (CREP)

Under CREP, cost-sharing payments, incentive payments, and annual rental payments are provided. CREP payments can include a payment for temporary or permanent easements. The cost-sharing payments, incentive payments, and annual rental payments are treated the same as payments under CRP. For permanent easements, payments are treated first as a return of basis with remaining gain qualifying as long-term capital gain if the land has been held for more than one year. A payment for a temporary easement that lasts less than 30 years is apparently treated as ordinary income. Payments for a temporary easement that lasts 30 years or more appear to be treated the same as a permanent easement.

Wetlands Reserve Program (WRP)

WRP is a voluntary program to restore wetlands. Participating landowners can enter into conservation easements or restoration cost-sharing agreements where no easement is involved. For tax purposes, a WRP easement is treated the same as easements under the CREP program. Cost-sharing under the WRP is eligible for exclusion under IRC §126.

Emergency Conservation Program (ECP)

The ECP provides financial assistance to farmers and ranchers for the restoration of farmland or ranchland where normal farming operations have been impeded by natural disasters. The ECP is an eligible program under IRC §126 for permanent improvements. Expenses for permanent improvements that are not depreciable may be eligible for the soil and water conservation deduction to the extent they are not compensated by cost-sharing payments that are excluded under IRC §126. Payments in the nature of maintenance (such as the removal of debris) are reported as income which can be offset by any deductions.

Emergency Watershed Protection Program (EWPP)

The EWPP is designed to reduce threats to life and property in the wake of natural disasters. The program provides technical and cost-sharing assistance. EWPP is an eligible program under IRC §126.

Small Watershed Program (SWP)

The SWP provides both technical and financial assistance for various purposes including watershed protection, flood prevention, erosion and sediment control, water supply, water quality, fish and wildlife habitat enhancement, wetlands creation and restoration, and public recreation in watersheds of 250,000 acres or less.

SWP is an eligible program under IRC §126 for federal government assistance. Some state programs are also eligible.

Expenses for practices that protect farmland and that are consistent with an approved conservation plan can qualify as soil and water conservation expenses under IRC §175 if the expenditure is not:

- Currently deductible,
- For a depreciable asset, and
- Compensated by a cost-sharing payment that was excluded under IRC §126.

Example 23. Bill Payen received a $15,000 cost-sharing payment from SWP to help pay the costs of $30,000 of soil erosion improvements on 200 acres of land. Bill had average gross income of $15,000 from the affected area in the previous three years. The "value of the IRC §126 improvement" is $20,000.

Result. Bill's excludible portion of the cost-sharing payment is the present value of the greater of:

- 10% of the average annual gross receipts ($15,000 × .10 = $1,500), or
- $2.50 per acre ($2.50 × 200 acres = $500)

At a 4% discount rate, the excludable portion would be $37,500 ($1,500 ÷ .04). Thus, the portion of the $15,000 cost-sharing payment that must be included in income is calculated as follows:

Value of the IRC §126 improvement	$20,000
Less the excludable portion	(37,500)
	$ 0
Less Bill's contribution	(15,000)
Amount included in income	$ 0

Wildlife Habitat Incentives Program (WHIP)

WHIP provides financial incentives to help develop habitat for fish and wildlife on private lands under 5- to 10-year cost share agreements for wildlife habitat development. WHIP is an eligible program under IRC §126. Expenses incurred under WHIP appear not to be eligible for soil and water conservation deduction[95] because the expenses are not incurred to protect land used in farming.

Forest Land Enhancement Program (FLEP) (formerly Forestry Incentives Program (FIP))

The FLEP supports good forest management practices on privately owned, nonindustrial forestlands. The program pays up to 65% of the cost of tree planting, timber stand improvement, and related practices. Payments under FLEP are eligible for the IRC §126 exclusion. However, if no annual income has been produced on the land in the last three years, the limit on the exclusion is the present value of $2.50 per acre.

Example 24. Samantha received $8,000 in cost-sharing payments for the $12,000 cost of planting trees and related improvements on 120 acres of forestland. Samantha had no income from the land for the last three years. The excludable portion would be the present value of $2.50 per acre. At a 4% interest rate the computation is (120 acres × 2.50) ÷ .04 = $7,500. The amount included in income would be:

Value of the IRC §126 improvement	$10,000
Less excludable portion	(7,500)
	$ 2,500
Less Samantha's contribution	(4,000)
Amount included in income	$ 0

Assuming Samantha had sold $40,000 of timber from the land in the previous three years, the excludable portion would be the present value of the greater of 10% of the average annual gross receipts ($10,000 × .10 = $1,000), or $2.50 per acre ($2.50 × 120 acres = $300). Again assuming a 4% discount rate, the excludible portion would be:

Value of the IRC §126 improvement	$10,000
Less excludable portion	(7,500)
	$ 2,500
Less the taxpayer's contribution	(4,000)
Amount included in income	$ 0

Conservation Security Program (CSP)

Most likely, cost-share payments for the adoption or maintenance of management and vegetative practices will not be excludible from income. The expenses for which the cost-share payment is received will be deductible either as an ordinary farm expense (currently deductible) or as soil and water conservation expense. However, cost-share payments for the adoption of land-based structural practices will be eligible for the IRC §126 exclusion if the practice is a capital improvement.

Grassland Reserve Program (GRP)

The GRP involves 10- to 20-year contracts or 30-year easements. Because the minimum easement period is 30 years, payments received for easements will first be used to reduce basis of the affected land. Payments in excess of basis should result in capital gain treatment. Cost-share payments, to restore the function and value of grasslands, will be includable in income unless the payment is a reimbursement for a practice covered under IRC §126. Expenses should be deductible as a trade or business expense or deductible as soil and water conservation expense.

Rural Clean Water Program (RCWP)

Cost-share payments received under the RCWP are eligible for exclusion under IRC §126.

STATE PROGRAMS

The excludible portion of payments made under any state program under which payments are made for the purpose of conserving soil, protecting or restoring the environment, improving forests, or providing for habitat for wildlife are excludable from gross income.[96] The following is a listing of state-level programs under which cost-share payments will qualify for the exclusion:

- Minnesota Soil and Water Conservation Board Cost-Share Payments
- Alabama Agriculture and Conservation Development Commission Program
- Wyoming Abandoned Mine Reclamation Program

- Wisconsin Animal Waste Water Pollution Grant Program
- Maryland Nonstructural Shore Erosion Control Program
- Wisconsin Nonpoint Source Water Pollution Abatement Program
- Illinois Forestry Development Program
- Colorado Inactive Mine Reclamation Program
- Iowa Financial Incentive Program for Soil Erosion Control
- Ohio Agricultural Pollution Abatement Program
- Virginia Agricultural Best Management Program
- Ohio Multiflora Rose Control Program
- Colorado River Basin Salinity Control Program
- Washington State Game Farm Alternative Program
- Florida Okeechobee Dairies Best Management Practices Program
- Wisconsin Petroleum Environmental Cleanup Fund Act
- New York State Agricultural Nonpoint Sources Abatement and Control Matching Grant Program

IMPORTANT POINT TO REMEMBER

In CCA Ltr. Rul. 200325002 (May 29, 2003), the Chief Counsel's Office of the IRS stated:

Furthermore, participation in a USDA land diversion program and in the devotion of such land to conservation purposes under such programs will be treated as material participation in the operation of a farm with respect to the diverted acres.

That language indicates that it is the position of the IRS that self-employment tax applies to payments received by taxpayers under various USDA land diversion programs beyond the scope simply of Conservation Reserve Program payments. Thus, the ruling applies to taxpayers under the CREP, ECP, EWPP, WRP, GRP, CSP, and similar government programs.

ISSUE 8 — AGRICULTURAL LABOR TAXATION

REPORTING REQUIREMENTS

Overview

The hiring of employees subjects the employer to many state and federal regulations and reporting requirements. In agriculture, many smaller operations are exempted. However, as farms increase in size and additional employees are hired, more requirements will apply.

REPORTING REQUIREMENTS

Determining Who is an "Employee"

For reporting requirements to apply, the person rendering the services for a farmer must be an employee as that term is defined either under state common or statutory law. In general, to be classified as an employee, the employer must exercise control over the method and manner in which the assigned task is to be carried out. If the person rendering the services controls how the services are to be performed, the person is likely to be classified as an independent contractor. The line between independent contractor and employee is ultimately a factual determination. For tax purposes, the key is that if an individual is determined to be an employee, the employer is responsible for withholding and paying employment taxes for the employee. That is not the case for independent contractors.

Many agricultural operations have employees that serve as farmworkers. That is the case particularly for operations that employ laborers to raise or harvest agricultural or horticultural products, or work in connection with the operation, management, conservation, improvement, or maintenance of the farm and its tools and equipment. Likewise, agricultural operations that process or package commodities on site typically hire laborers to perform the processing or packaging tasks. However, more than one half of the commodities must be produced on site. Also, household labor that is hired to do housework in the employer's private home located on a farm operated for profit is handled under the same rules.

Note. For the purpose of determining whether a person is a farmworker, the labor services must be rendered on a farm, including stock, dairy, poultry, fruit, fur-bearing animal, and truck farms. A "farm" also includes plantations, ranches, nurseries, ranges, greenhouses, or other similar structures used primarily for the raising of agricultural or horticultural commodities and orchards. However, "farmwork" does not include reselling activities that do not involve any substantial activity of raising agricultural or horticultural commodities, such as a retail store or a greenhouse used primarily for display or storage.

Employment Taxes

Cash wages paid to agricultural employees are subject to social security, Medicare taxes, and income tax withholding. Commodity wages are not cash wages and are not subject to social security, Medicare taxes, or income tax withholding. The employer must report the FMV of the in-kind payment as income and may deduct an equal amount of wage expense. The FMV of the in-kind payment is included in the employee's income as W-2 income, and the employee has a basis in the commodity equal to that value. When the employee later sells the commodity, gain or loss will be triggered depending on whether the sale price exceeds, equals, or is less than the basis of the commodity. The resulting gain or loss is 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 the employee's farming operation, the employee is entitled to a Schedule F deduction for the basis.

Note. In late 1994, an IRS task force published guidelines concerning the proper structuring of in-kind age payment arrangements. For a thorough discussion of the guidelines, see pages 224–229 of the *2002 University of Illinois Income Tax Workbook.*

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

Note. Meals and lodging furnished for the employer's convenience under IRC §119 are not wages for FICA or FUTA purposes. However, they are wages for FICA and FUTA purposes if they are not provided for the convenience of the employer.

In general, wages paid to family members as employees are subject to social security, Medicare, and income tax withholding, as well as FUTA tax. But certain exceptions may apply for a child, spouse, or parent of the taxpayer.

- Children as employees: Wages paid to children under age 18 that work for a parent in a trade or business are not subject to social security and Medicare taxes. If the child performs domestic work in the parent's home, the child's wages are not subject to social security and Medicare taxes until the child reaches age 21. In any event, the child's wages are not subject to FUTA tax until the child reaches age 21. Wages for nonfarm work, however, may still be subject to income tax withholding.
- Spouse employed by other spouse: Wages paid to a spouse that works for the other spouse in a trade or business are subject to social security and Medicare taxes, but not FUTA tax. If the wages are for domestic services in a private home, they are not subject to social security, Medicare, or FUTA tax.
- Special rules apply to wages for the services of a child or spouse if they are employed by a corporation controlled by the parent or spouse, a partnership if the child's parent is a partner (unless the only partners are the parents of the child), a partnership if the individual's spouse is a partner, or an estate if it is the estate of a deceased parent. In these situations, wages are subject to income tax withholding, social security, Medicare, and FUTA tax.

Note. Wages paid to a child of a sole proprietor or to a person who is a child of all partners in a partnership or all members of an LLC are not subject to social security and Medicare. The wages should be reported on Form W-2 with no wages or tax showing in the social security and Medicare boxes. They should not be reported on Form 1099.

Social Security and Medicare Taxes

All cash wages paid to agricultural labor paid during the tax year are subject to social security and Medicare taxes and income tax withholding if either:

1. Cash wages are paid to an employee of $150 or more in a year for farmwork (including all cash wages paid on a time, piecework or other basis), or
2. The total the employer pays for farmwork to all employees (cash and noncash) is $2,500 or more during the year.

However, the above tests do not apply if the farmworker is employed in agriculture as a hand-harvest laborer, is paid piece rates in an operation that is usually paid on a piece-rate basis in the region of employment, commutes daily from home to the farm, and had been employed less than 13 weeks in the preceding calendar year. Amounts paid to these workers do count toward the $2,500-or-more test to determine whether wages paid to other farmworkers are subject to social security and Medicare taxes. Also, cash wages paid to a household employee are counted in the $2,500 test, but are not subject to social security and Medicare taxes unless the employer has paid the worker $1,400 or more in cash wages.

Withholding Rules

In general, farmers and crew leaders must withhold Federal income tax from wages paid to farm workers if the wages are subject to social security and Medicare taxes. The amount to withhold is computed on gross wages paid without taking out social security and Medicare taxes, union dues, insurance, or other deductions. Form W-4 is used to compute withholding allowances and to report other vital employee information to the employer.

Note. See Chapter 9 regarding the preparation of the W-2 where the employer pays the employee share of the payroll taxes.

Deposit Requirements

Employers must deposit both the employer and employee social security and Medicare taxes and income tax withheld (minus any advance earned income credit payments) during the year by mailing or delivering a check, money order, or cash to an authorized financial institution or Federal Reserve Bank. Some employers must deposit by electronic funds transfer. An exception from the deposit requirement exists if the employer's net tax liability for the year is less than $2,500, or the employer is making a payment in accordance with the **Accuracy of Deposit** rules.

Federal Unemployment Tax Act (FUTA) Tax

In certain situations, agricultural employers are liable for FUTA tax. Employers who employ agricultural labor are subject to FUTA if they:

1. Paid cash wages of $20,000 or more in any calendar quarter during the current or preceding calendar year to persons employed in agricultural labor, or
2. Employed ten or more persons in agricultural labor for some portion of the day on each of 20 weeks during the current or preceding calendar year with each day being in a different calendar week.

Note. The spouse and children under age 21 of a farmer are not taken into account in determining whether the $20,000 of wages were paid or whether ten persons were employed in 20 different calendar weeks.

Observation. The FUTA tax rate is 8.0% on a wage base of $7,000. A credit is given for timely paid state employment taxes. Normally the net tax equals .8% or $56 per employee. The tax is reported on Form 940 or Form 940-EZ.

FUTA tax must be deposited with an authorized financial institution or the nearest Federal Reserve bank branch. Form 8109 must be submitted with each deposit.

FUTA tax liability must be computed on a quarterly basis to determine if a deposit must be made. Deposits must be made at the end of each calendar quarter only if the employer's aggregate undeposited FUTA tax liability for the calendar year exceeds $100.

Note. Employers of aliens admitted to the U.S. on a temporary basis to perform agricultural labor must pay FUTA tax with respect to income earned by the alien workers if the other conditions for FUTA tax liability are satisfied. But nonresident aliens lawfully admitted to the U.S. on a temporary basis are exempt from FUTA, federal income tax withholding, social security, and Medicare tax when performing agricultural labor.[97] These wages are included in the $20,000 and 20-week test.

Filing Requirement

Agricultural employers must file Form 943 on an annual calendar year basis. Form 943 is to be filed for all taxable wages paid to agricultural labor or to domestic employees. Employers employing nonagricultural labor must file Form 941 on a quarterly basis.

Note. Because the rules differ for agricultural and nonagricultural labor, make sure the correct form is used. The IRS attempts to send a Form 943 to each employer annually. The form is relatively simple to complete.

Example 25. Elmer Smith owns and operates his farm as a sole proprietorship. He employs Jeff on a full-time basis for $35,000 per year. Jeff works about 2,500 hours in a year. Elmer also hires part-time help on a seasonal basis. In 2002, Elmer hired five other persons who worked a total of 400 hours spread out over 30 days during a 10-week period. These additional workers were paid an hourly wage of $5.00 per hour and earned a total of $2,000 in 2002. Elmer expects to hire about the same number of additional workers (besides Jeff) for approximately the same amount of hours in 2003.

Are the additional workers independent contractors or employees? Without more facts, it is difficult to tell. The answer will turn on the type of work being done and whether Elmer controls the method and manner in which the tasks are to be completed. However, Jeff is likely Elmer's employee.

Must Elmer pay FICA tax on the wages? Because Elmer satisfies the $2,500 total payroll threshold, all of the wages he pays to all of his workers are subject to FICA taxes. While an exception for hand harvesters could possibly apply, it does not apply in this instance because Elmer does not pay his workers on a piece-rate basis. Therefore, Elmer will need to withhold 6.2% of the wages for the employee's share of OASDI and pay his 6.2% share of OASDI on the wages. Elmer must also withhold 1.45%of the wages for the employee's share of the Medicare portion and pay his 1.45% share.

Note. Elmer will also need to withhold federal income tax because the wages are not exempt from FICA tax. Thus, Elmer should have each employee sign a Form W-4 at the time employment begins. Elmer will also need to deposit federal employment taxes monthly and file an annual Form 943. However, Elmer will not be required to pay FUTA tax on the wages he pays to his workers.

Note. Chapter 9, Employment Taxes, discusses additional employment issues, some of which also apply to agricultural labor.

ENDNOTES

1 See Agriculture, Rural Development, Food and Drug Administration, and Related Agencies Appropriation Act of 2000, Pub. L. No. 106-78, Sec. 812, amending the Agricultural Market Transition Act (7 U.S.C. §7281 *et seq.*) adding Sec. 166

2 Rev. Proc. 2002-9, I.R.B. 2002-3, App. Sec. 1.01

3 IRC §1402(a)

4 *Hillman v. Commr.*, 2002-2 U.S. Tax Cas. (CCH) ¶50,700 (D. S.D. 2002)

5 Priv. Ltr. Rul. 8822064 (no tenant involved; landowner's activities under CRP did not constitute material participation)

6 Priv. Ltr. Rul. 963700; *Ray v. Commr., TC Memo 1996-436; Wuebker v. Commr.,* 205 F.3d 897 (6th Cir. 2000)

7 Notice 87-26, 1987-1 C.B. 470 (dairy termination payments); Rev. Rul. 60-32, 1960-1 C.B. 23 (soil bank payments)

8 Soc. Sec. Rul. 67-42 (cropland adjustment income; dictum)

9 Letter from Peter K. Scott, Associate Chief Counsel, Technical, March 10, 1987

10 *Ray v. Commr., TC Memo 1996-436*

11 *Commr. v. Wuebker,* 205 F.3d 897 (6th Cir. 2000)

12 *Hasbrouck v. Commr., TC Memo 1998-249*

13 S. 665

14 *Mizell v. Commr., TC Memo 1995-571*

15 TAM 9637004, May 1, 1996

16 FSA Ltr. Rul. 9917008, Dec. 10, 1998; FSA Ltr. Rul. 9917005, Dec. 10, 1998; FSA Ltr. Rul. 9917006, Dec. 10, 1998

17 *Bot v. Commr., TC Memo 1999-256; Hennen v. Commr., TC Memo 1999-306; McNamara v. Commr., TC Memo 1999-333*

18 *McNamara v. Commr.*, 236 F.3d 410 (8th Cir. 2000)

19 *Fowler Farms v. Commr.*, T.C. Docket No. 013920-01 filed Dec. 11, 2001

20 *Milton v. Commr.*, T.C. Docket No. 13594-01

21 S. 665

22 Tech. Adv. Mem o. 9652007

23 *Hansen v. Commr., TC Summary Op. 1998-91*

24 Chief Counsel Notice N(36)000-3, April 21, 1999

25 *Bot v. Commr., 118 T.C.* 138 (2002)

26 IRC §3101

27 *Stevenson v. Commr., TC Memo 1989-357*

28 *Ray v. Commr., TC Memo 1996-436*

29 Rev. Rul. 58-5, 1958-1 C.B. 322

30 *McNamara v. Commr.*, 236 F.3d 410 (8th Cir. 2000)

31 TAM 200305002, July 24, 2002

32 IRC §1031(e)

33 *Woodbury v. Commr., 49 T.C.* 180 (1967)

34 *Wylie v. United States*, 68-1 U.S.Tax. Cas. (CCH) ¶9286 (N.D. Tex. 1968)

35 *Rutherford v. Commr., TC Memo 1978-505*

36 Treas. Reg. §1.1031(a)-2(b)(1)

37 Priv. Ltr. Rul. 9448001 (May 2, 1994)

38 Treas. Reg. §1.1245-3(b)

39 Treas. Reg. §1.170A-4

40 Treas. Reg. §1.170A-1(c)(4)

41 Rev. Rul. 55-138, 1955-1, C.B. 223; Re v. Rul. 55-531, 1955-2 C.B. 520

42 *Helvering v. Horst*, 311 U.S. 112 (1940),

43 Rev. Rul. 75-11, 1975-1 C.B. 27

44 *Tatum v. Commr.*, 400 F.2d 242 (5th Cir. 1968

45 Rev. Rul. 79-207, 1979-2 C.B. 351

46 *Parmer v. Commr.*, 468 F.2d 705 (10th Cir. 1972)

47 *Cullison v. United States*, 71-1 U.S. Tax Cas. (CCH) ¶ 9136 (E.D. Ark. 1970)(taxpayer determined to be landlord)

48 *Tompkins v. United States*, 77-1 U.S.Tax Cas. (CCH) ¶9443 (S.D. Ill. 1977) (taxpayer found to be landlord)

49 *Peterson v. United States*, 65-2, U.S. Tax Cas. (CCH) ¶9674 (E.D. Wash. 1965)(taxpayer found to be operating farmer)

50 *Davison v. United States*, 292 F.2d 937 (Ct. Cl.), cert. denied, 368 U.S. 939 (1961)

51 Rev. Rul. 64-289, 1964-2 C.B. 173

52 Treas. Reg. §1.631-2(e)(3)

53 IRC §§631(b), 1231(b)(2)

54 Treas. Reg. §1.631-2

55 Treas. Reg. §1.631-2(e)(2)

56 Rev. Rul. 57-90, 1957-1 C.B. 199

57 *Plant v. United States*, 682 F.2d 914 (11th Cir. 1982)

58 *Eck v. Commr.*, 999 F.2d 542 (9th Cir. 1993)
59 Rev. Rul. 58-579, 1958-2 C.B. 361
60 Treas. Reg. §§1.611-3, 1.631-1(d)
61 Treas. Reg. §1.611-3(h)
62 Treas. Reg. §1.611-1(c)
63 Treas. Reg. §1.631-1(d)(2)
64 *Schudel v. Commr.*, 563 F.2d 1300 (9th Cir. 1977) (sale of Christmas trees)
65 Rev. Rul. 56-434, 1956-2 C.B. 334
66 Rev. Rul. 58-135, 1958-1 C.B. 159
67 Rev. Rul. 73-489, 1973-2 C.B. 208
68 Treas. Reg. §1.631-1(c)
69 *Westvaco v. United States*, 639 F.2d 700 (Ct. Cl. 1980)
70 *Weyerhaeuser v. United States*, 92 F.3d 1148 (Fed. Cir. 1996), cert. denied, 519 U.S. 1091 (1997)
71 IRC §165(g)
72 IRC §166(a)
73 *Morton v. Commr.*, 38 B.T.A. 1270, Dec. 10,517 (non-acq)
74 *Peake v. Commr.*, 10 T.C.M. 577 (1951)
75 *Arkansas Best Corp. v. Commr.*, 485 U.S. 212 (1988)
76 Treas. Reg. §1.166-1(c)
77 Treas. Reg. §1.166-5(a)
78 Treas. Reg. §1.166-2(c)
79 *In re Steffen*, 2003-1 U.S. Tax Cas. (CCH) ¶50,454 (Bankr. M.D. Fla. 2003)
80 *Wagner v. United States*, 2003-1 U.S. Tax Cas. (CCH) ¶50,235 (M.D. Fla. 2003)
81 IRC §175
82 Treas. Reg. §1.175-3
83 Treas. Reg. §1.175-3
84 Rev. Rul. 59-12, 1959-1 C.B. 59
85 Treas. Reg. §1.175-3
86 Treas. Reg. §1.175-3
87 Treas. Reg. §1.175-2(a)
88 Treas. Reg. §1.175-4(a)
89 IRC §175 (b)
90 *Harding v. Commr., TC Memo 1970-179*
91 Treas. Reg. §1.175-6(d)
92 Treas. Reg. §1.175-6(e)
93 *Brown v. United States*, 76-1 U.S. Tax Cas. (CCH) ¶ 9338 (D. D.C. 1976)
94 IRC §1252
95 IRC §175
96 IRC §126(a)(10)
97 Section 101(a)(15)(H)(ii) of the Immigration and Nationality Act