Chapter 12: Agricultural Issues

Issue 1: Inconsistency in Information Reporting of Certain Farm Subsidy Payments........................ 409

Issue 2: Self-Employment Tax Update 410

Issue 3: Hedging Versus Speculation 413

Issue 4: Claiming Deductions for Meals and Lodging 417

Issue 5: Extra-Territorial Income Exclusion 421

Issue 6: Deductibility of Soil Conditioning Expenditures 429

Issue 7: Deductible Repairs Versus Capitalization 431

Issue 8: Rolling Over Lines-of-Credit, OID Rules.. 434

Issue 9: Partitioning Property................................. 437

Issue 10: Turnover of Farm Assets to Creditors ... 439

Issue 11: Hog Ledger Contracts.............................. 442

Issue 12: Deductions Related to Purchase of Farmland.. 444

Issue 13: Saving Seed: Deductibility of GMO Liquidated Damages 446

Issue 14: Taxability of Starlink Payment 447

Issue 15: Agricultural Tax Questions and Answers.. 448

Corrections were made to this workbook through January of 2005. No subsequent modifications were made.

ISSUE 1: INCONSISTENCY IN INFORMATION REPORTING OF CERTAIN FARM SUBSIDY PAYMENTS

The *2003 University of Illinois Federal Tax Workbook* (pages 209–215) contained a detailed discussion of the proper reporting of Commodity Credit Corporation (CCC) loans, and illustrated an inconsistency in information reporting between the various methods a farmer may utilize for receiving subsidies. In summary, loan deficiency payments are reported to the IRS and the taxpayer on Form CCC-1099-G, *Certain Government Payments,* and count against the payment limitation for marketing loan gains and loan deficiency payments (LDPs) of $75,000 per person. Repayment of a marketing loan with cash at a gain is also reported to the IRS and the taxpayer on Form CCC-1099-G, and is subject to the payment limitation for combined marketing loan gains and LDPs of $75,000. However, if the marketing loan is repaid with commodity certificates, any resulting gain is not reported to the IRS or the taxpayer; this type of subsidy does not count against the payment limitation. If the commodity under loan is forfeited to the CCC, any resulting gain is reported to the IRS on Form 1099-A, *Acquisition or Abandonment of Secured Property,* but does not count against the $75,000 payment limitation.

Observation. Aside from the obvious issue of whether reporting of gain on commodity certificates is required (and there is no known authority to excuse reporting), the concerns are:

1. The behavioral impact on taxpayers who know gain from the other options is reported to the IRS via an information return; and
2. Perceptions of unfairness by taxpayers who are treated differently for essentially the same government benefit.

2004 DEVELOPMENT

On March 18, 2004, the IRS responded to the matter by restating the problem and conceding that the commodity certificate gain was taxable.[1] However, the IRS refused to require the Farm Service Agency to issue a Form 1099-G to report the gain to the IRS and the taxpayer for commodity certificate gains. The IRS states:

> *A farmer can use CCC certificates to facilitate repayment of a CCC loan. If a farmer uses cash instead of certificates, the farmer will receive a Form CCC-1099-G Information Return showing the market gain realized. However, if a farmer uses CCC certificates to facilitate repayment of a CCC loan, the farmer will not receive any information return. Regardless of whether a CCC-1099-G is received, the market gain is either reported as income or as an adjustment to the basis of the commodity, depending on whether the special election has been made.*

By acknowledging that the gain is taxable, but refusing to require information reporting, the IRS failed to improve nonreporting. The inconsistent reporting treatment may cause some producers to conclude that certificate gain is not taxable. This is because producers using commodity certificates to repay CCC loans do not receive a Form 1099, while those who repay or forfeit the CCC loan do receive the Form 1099.

Note. There is some support for the argument that taxability of the marketing loan gain can be deferred until the year the commodity is sold for those who have elected to treat CCC loans as income. Since the amount of the loan is reported as income, the commodity receives a basis. The basis is the amount of the loan. Deferral is accomplished by reducing the income tax basis for the commodity.[2] The *2003 Farmers' Tax Guide* (IRS Pub. 225) provides an example stating that if CCC loans are included as income in one year, the marketing loan gain is not recognized on redemption, but rather is used to reduce basis and any resulting gain from the sale of the crop is reported at the time of sale. That mirrors what was authorized for gain on certificates in 1987.[3]

ISSUE 2: SELF-EMPLOYMENT TAX UPDATE

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.[4] 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.

The *2003 University of Illinois Federal Tax Workbook* (pages 215–225) includes a detailed discussion of self-employment tax issues of importance to farmers. The following discussion reproduces last year's treatment of self-employment tax issues as applied to Conservation Reserve Program (CRP) payments, updates the so-called *Mizell* issue, and provides an update as to the current status of value-added payments from cooperatives.

CONSERVATION RESERVE PROGRAM (CRP) PAYMENTS

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

On June 23, 2003, the IRS released a Chief Counsel's letter ruling on the taxability of CRP payments for self-employment tax purposes. The IRS took the position, **directly contrary** to Letter Ruling 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.[5] 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.

---

[1] IR 2004-38, March 18, 2004

[2] IRC §1016(a)(8)

[3] Rev. Rul. 87-103, 1987-2 C.B. 41, revoking Rev. Rul. 87-17, 1987-1 C.B. 20

[4] IRC §1402(a)

[5] CCA Letter Ruling 200325002, May 29, 2003

Note. At this time, IRS has not changed from this position. Readers who are unfamiliar with the June 2003 announcement can find a detailed explanation in the *2003 University of Illinois Income Tax School Workbook* on pages 216–218.

RENTING LAND TO A FAMILY ENTITY: THE MIZELL PROBLEM

Most tax professionals and taxpayers who are involved in renting land to an entity in which they participate are aware of the *Mizell* problem. In *Mizell*, the Tax Court ruled that rental income is subject to self-employment tax if the owner of farm land materially participates in the farms operations. This issue is discussed in many of the *University of Illinois Income Tax School Workbooks* and most recently in the 2003 book on pages 219–221.

Note. It is also summarized in Chapter 10, Small Business Issues, Issue 4: Rentals.

2004 Developments

The Tax Court decided two cases on the *Mizell* issue on March 9, 2004. In *Solvie,* a married couple each owned half of the stock in a farming corporation. The couple leased the farmland, buildings and some personal property to the corporation. They later built an 800-head capacity hog barn on the farmland and increased the rental amount by $21 per hog per rotation of hogs passing through the barn. The Tax Court found a nexus between the hog barn and the couple's material participation in the farming operation. The court noted specifically that had the couple not performed services for the corporation, there would have been no rental on the hog barn, and concluded that the rental amount exceeded a fair market rental and was, therefore, **includible in farm rental income and subject to self-employment tax.**[6]

In *Johnson*, a married couple each owned half of the stock in a farming corporation. They leased farmland and other personal property to the corporation. The Tax Court found that the rent amount represented a fair market rent and that there was no nexus between the rent paid and the couple's material participation. As such, the **rents were not subject to self-employment tax.**[7]

Note. It is clear, based on *Solvie* and *Johnson*, that rents other than fair market rentals are likely subject to self-employment tax, and that rents dependent on the taxpayer's material participation (e.g., tied to production) are also likely to be subject to self-employment tax. Certainly, cash-rent or share-rent leases set at a premium level will be targeted by the IRS.

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, fair market rent. Also, it is important for the status as shareholder, officer, partner, employee or LLC member to be formally established and maintained.

While *Mizell* involved a partnership, a more general solution to the problem may be to own land in another type of entity such as an LLC or LP. However, the regulations on handling self-employment income from such pass-through entities are still in limbo.

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[6] *Jere J. and Paulette M. Solvie v. Commr.,* TC Memo 2004-55, March 9, 2004

[7] *Gerald E. and Dorothy Johnson v. Commr.,* TC Memo 2004-56, March 9, 2004

Outside the Eighth Circuit, the key is to make sure that the taxpayer is not on "both sides of the equation" as both lessor and lessee. In the IRS's 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) it is important 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.

Caution. There are several other income and estate tax implications to consider with this approach such as estate plans, social security issues, passive loss limitations, FSA programs, divorce issues, and so on.

DISTRIBUTIONS FROM VALUE-ADDED COOPERATIVES

Another case discussed in detail in the 2003 workbook on pages 221 and 222 was the *Bot* case.[8] This case involves payments received from a value-added cooperative and whether it constitutes self-employment income. In this case, the court ruled it was self-employment income.

Eighth Circuit Holding on Appeal. The Eighth Circuit affirmed the Tax Court, holding that the cooperative functioned as the Bots' agent and that the Bots, although retired from active farming, continued to be active in the trade or business of dealing in corn through the cooperative. The court also noted that the cooperative form of business created an agency relationship with the members. The court held that the value-added payments resulted from the business of the Bots acquiring and selling corn. The court also held that the dividends exclusion[9] or capital assets exclusion[10] did not apply to exclude the income from self-employment tax.[11]

Observation. *Bot* makes clear the need for retired farmers who are members of value-added cooperatives to watch their involvement with the cooperative if self-employment tax on value-added payments is to be avoided.

Note. Another issue to watch regarding value-added payments is that of constructive receipt, particularly for payments made late in the year. *Bot* indicates that the cooperative may be in an agency relationship with the taxpayer concerning the sale of the grain. Thus, the only limitation on the taxpayer's right to receive the year-end value-added payment is a self-imposed limitation. That is insufficient to be effective for deferral purposes.[12] However, if the cooperative negotiates a sale of the crop to a buyer with the sale proceeds placed in an irrevocable escrow account with a third party, the producer realizes income in the year the sale proceeds are actually disbursed to the producer.[13]

---

[8] *Richard J. and Phyllis Bot v. Commr.,* 353 F.3d 595 (8th Cir. 2003), aff'g, 118 TC 138 (2002), February 15, 2002

[9] IRC §1402(a)(2)

[10] IRC §1402(a)(3)

[11] *Richard J. and Phyllis Bot v. Commr.,* U.S. Court of Appeals, 8th Circuit, 2004-1 USTC ¶50,112, December 22, 2003

[12] *Keith and Janet Scherbart v. Commr.,* TC Memo. 2004-143, June 17, 2004; Bobbie and Modelle *Warren v. United States,* 613 F.2d 591 (5th Cir. 1980), March 14, 1980

[13] *James H. and Mary Busby v. United States,* 679 F.2d 48 (5th Cir. 1982), June 24, 1982; *John E. Reed v. Commr.,* 723 F.2d 138 (1st Cir. 1983), December 5, 1983

ISSUE 3: HEDGING VERSUS SPECULATION

The hedging of a commodity produces ordinary gain and ordinary losses with the futures/options gains or losses treated the same as gains and losses from the commodity involved. Similarly, gains or losses from speculative transactions generate capital gains and losses. Therefore, the key question is what distinguishes a true hedge from a speculative transaction for tax purposes? Hedging gains or losses may also impact self-employment taxes, but speculative gains or losses do not.

DEFINITIONS

Hedging transactions are defined in terms of managing price risk or interest rate fluctuations in the ordinary course of the taxpayer's business. Commodity futures/options gains and losses that do not qualify as hedges and that do not involve contracts primarily for sale in the ordinary course of business are treated as capital gains and losses. If a transaction is not entered into primarily for profit, losses may not be deductible. Speculative transactions are those that are not in the ordinary course of the taxpayer's business.

The Courts emphasize two tests in evaluating commodity futures transactions as hedges or speculative ventures.

Insurance Test

If the taxpayer uses futures trading to offset price changes in actual commodities (the "actuals"), the futures transactions are hedges. The U.S. Supreme Court held that futures trading was hedging and not speculation if the commodity transactions were engaged in as an integral part of the taxpayer's business, even if the taxpayer was not using futures trading to offset price movements in actuals.[14] Consequently, for futures purchased before the sale of a crop in an effort to guard against price increases, the transaction is a hedge. However, post-sale hedges of crops and purchases of like amounts of commodities in the futures market have been held not to be an integral part of the taxpayer's farming business. These transactions are commonly known as **store on the board** and typically involve the cash sale of the crop followed by a purchase of call options. The reasoning is that once the crop is sold, there is no remaining risk of price change in the actual commodities. Thus, the insurance test is not met, and capital gain or loss treatment results.

Direct Relation Test

The direct relation test requires a direct relation between a taxpayer's business and the commodity market transaction if the transaction is to be considered a hedge. The test is satisfied if the amount of futures trading in the particular commodity involved and the timing of purchases and sales are related to the taxpayer's position in actual commodities. Thus, where the amount of futures trading substantially exceeds what is needed to provide price protection for actual commodities, or the pattern of purchases and sales in the future is not consistent with securing price protection for the actuals, some of the transactions should be treated as speculative rather than hedges. Speculative transactions result in gains and losses being considered capital gains and losses.

Reporting Commodity Trades

Even though the insurance and direct relation tests are satisfied, commodity trades may still be speculation if the taxpayer reporting the commodity trades is not the same taxpayer who owns the hedged commodity.

In a private letter ruling, the taxpayer was a shareholder in a dairy farming business conducted by an S corporation. The taxpayer was responsible for the feeding program in the dairy operation and, in the capacity of shareholder, bought and sold commodity futures contracts to protect against price increases in the feed ingredients. The IRS ruled that the taxpayer could not attribute the corporation's business to the shareholder as the shareholder's business. The IRS concluded that in order for the shareholder to treat the gains and losses from commodity trades as hedges, the

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[14] *Corn Products Refining Co. v. Commr.,* 350 U.S. 46 (1955), June 30, 1952

shareholder must be engaged in a trade or business separate from the corporation's business and the commodity trades must be entered into as hedges in the shareholder's trade or business.[15]

It is particularly important to examine a client's futures trading plan whenever a structural change has been made in the production of the commodities, or in the ownership of the commodities.

> **Example 1.** Harley owns stock in three farming corporations and maintains a commodities account in his own name that is used as a hedge account. Harley transferred the account to the corporation that is engaged in raising crops and cattle. Harley is the majority stockholder.
>
> Harley's ownership in the other two corporations is 50% and 20%. These corporations are engaged in hog production. Harley made hog hedging transactions using hog futures contracts and incurred a loss. The losses are considered capital losses because the corporation that owns the account is not engaged in the hog business, in spite of the fact that Harley is the majority shareholder. The well-settled rule is that a corporation is an entity separate and distinct from its shareholders. Thus, the corporation's business is not attributable to its shareholders absent exceptional circumstances.[16]
>
> **Example 2.** Sam farmed for several years as a sole proprietor and engaged in commodity trading through several brokerage accounts. In 2003, Sam formed two C corporations, but retained ownership of the farmland and leased it to the farming corporations. Each of the corporations maintained its own records and separate bank accounts and filed a federal income tax return. After incorporation, Sam continued to trade crop futures through the same accounts, and did not transfer the accounts to the corporations. Any gains and losses from the futures trading are considered capital in nature.[17]

REPORTING HEDGE TRANSACTIONS

Both gains and losses from hedge transactions are reported on Schedule F, *Profit or Loss from Farming,* line 10. These gains and losses are treated as ordinary income and increase or decrease self-employment income. Only gains from closed transactions are reported.

> **Example 3.** Lisa produces corn and typically sells it at harvest time. In November 2003, she found she could contract her 2004 production for $2.52/bu. She sells 5,000 bu. of December 2004 corn futures contracts. On December 31, 2003, the corn contracts were valued at $3.00, which would result in a loss of $.48/bu. or $2,400. Since this is an open transaction and is treated as a hedge, Lisa reports no gain or loss from the transaction on her 2003 tax return. Unlike speculative transactions, hedging transactions are not marked to market as of the end of the taxpayer's year.
>
> **Example 4.** Use the same facts as **Example 3** except, Lisa feared corn would continue to increase in price. She closed the contract on January 5, 2004, when the price was $3.10. Therefore she recognizes a $.58/bu. loss or $2,900. Lisa's 2004 Form 1099-B follows, and she reports the loss on her 2004 Schedule F, line 10 as shown.

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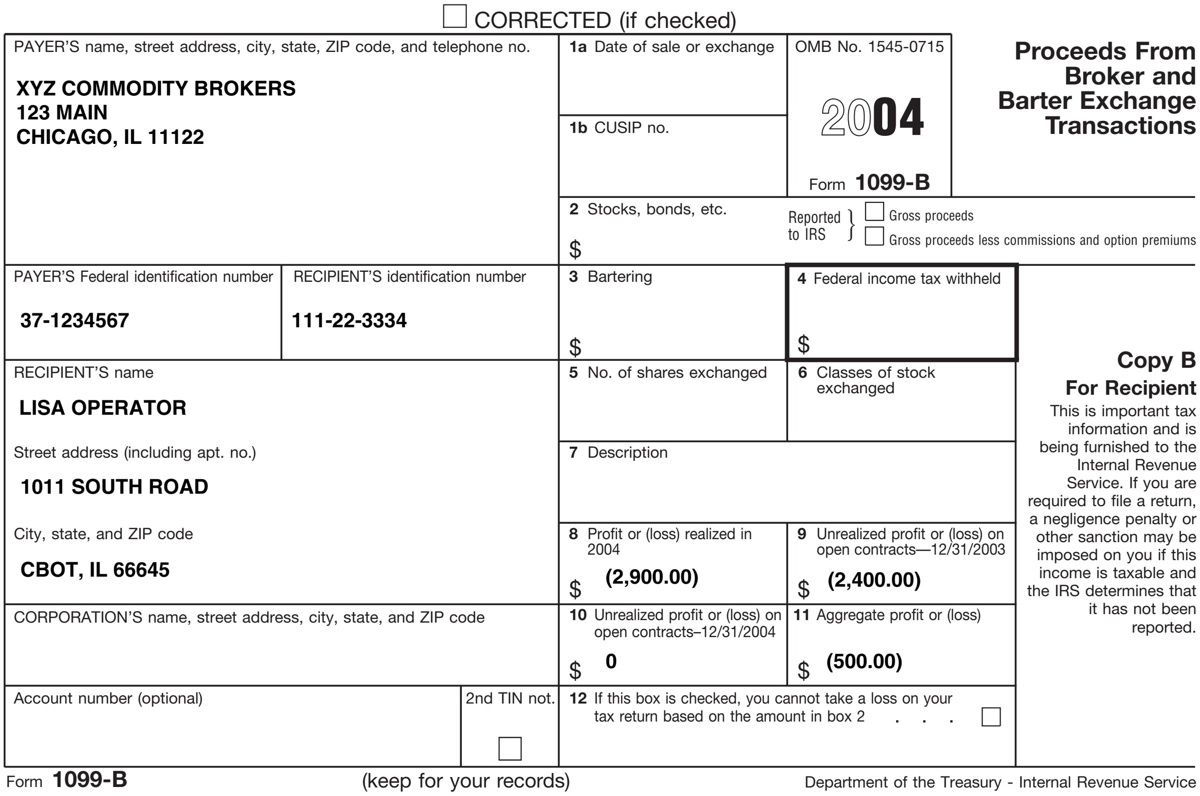
[15] Letter Ruling 9720003, January 15, 1997

[16] *Pine Creek Farms, Ltd. v. Commr.,* TC Memo 2001-176, July 17, 2001

[17] *Herman N. and Veronica Welter v. Commr.,* TC Memo 2003-299, October 29, 2003

For Example 4



☐ CORRECTED (if checked)

PAYER'S name, street address, city, state, ZIP code, and telephone no.

XYZ COMMODITY BROKERS
123 MAIN
CHICAGO, IL 11122

1a Date of sale or exchange

1b CUSIP no.

OMB No. 1545-0715

2004

Form **1099-B**

Proceeds From Broker and Barter Exchange Transactions

2 Stocks, bonds, etc. $

Reported to IRS } ☐ Gross proceeds ☐ Gross proceeds less commissions and option premiums

PAYER'S Federal identification number: **37-1234567**

RECIPIENT'S identification number: **111-22-3334**

3 Bartering $

4 Federal income tax withheld $

RECIPIENT'S name: **LISA OPERATOR**

5 No. of shares exchanged

6 Classes of stock exchanged

Street address (including apt. no.): **1011 SOUTH ROAD**

7 Description

City, state, and ZIP code: **CBOT, IL 66645**

8 Profit or (loss) realized in 2004 $ **(2,900.00)**

9 Unrealized profit or (loss) on open contracts—12/31/2003 $ **(2,400.00)**

CORPORATION'S name, street address, city, state, and ZIP code

10 Unrealized profit or (loss) on open contracts–12/31/2004 $ **0**

11 Aggregate profit or (loss) $ **(500.00)**

Copy B
For Recipient

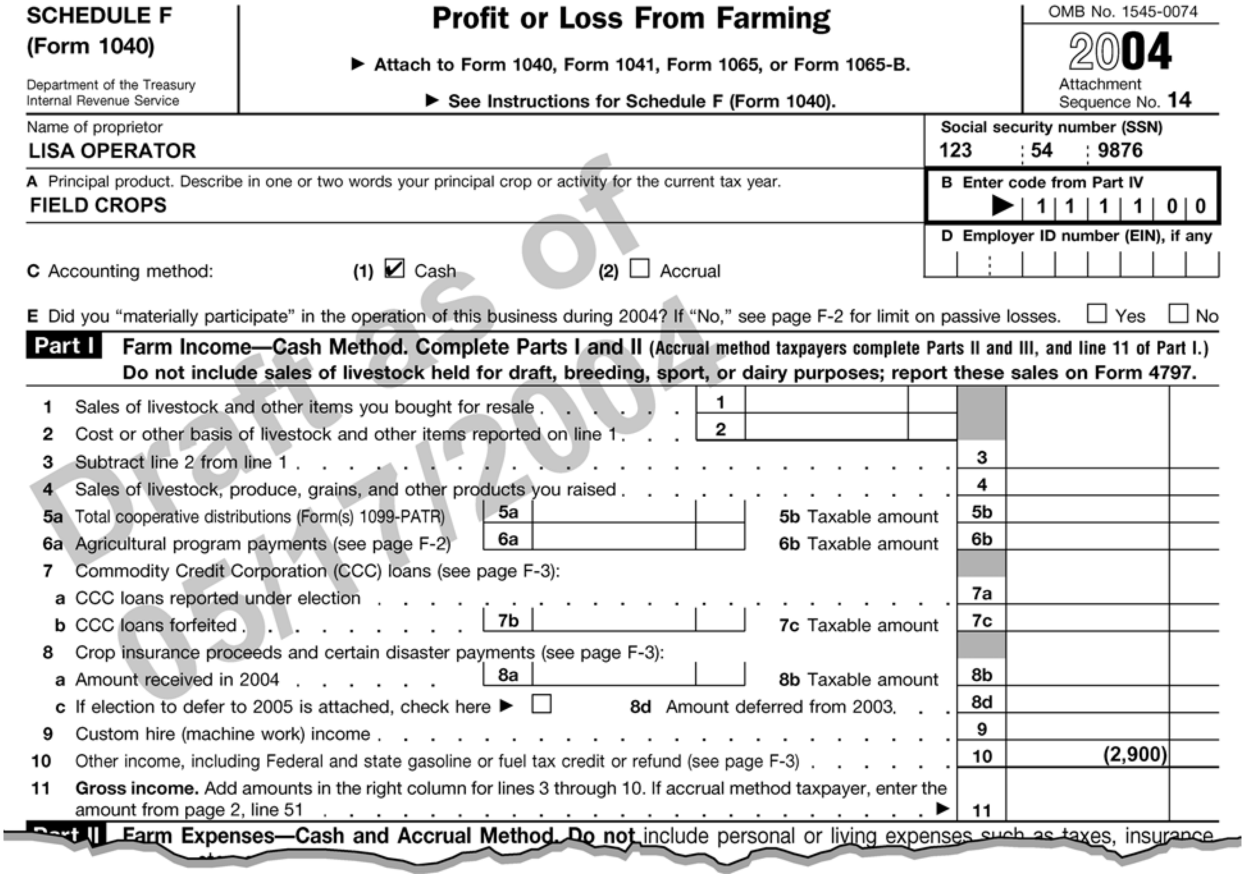
This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported.

Account number (optional)

2nd TIN not. ☐

12 If this box is checked, you cannot take a loss on your tax return based on the amount in box 2 . . . ☐

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



SCHEDULE F (Form 1040)

Department of the Treasury
Internal Revenue Service

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

2004

Attachment Sequence No. **14**

Name of proprietor: **LISA OPERATOR**

Social security number (SSN): 123 : 54 : 9876

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

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

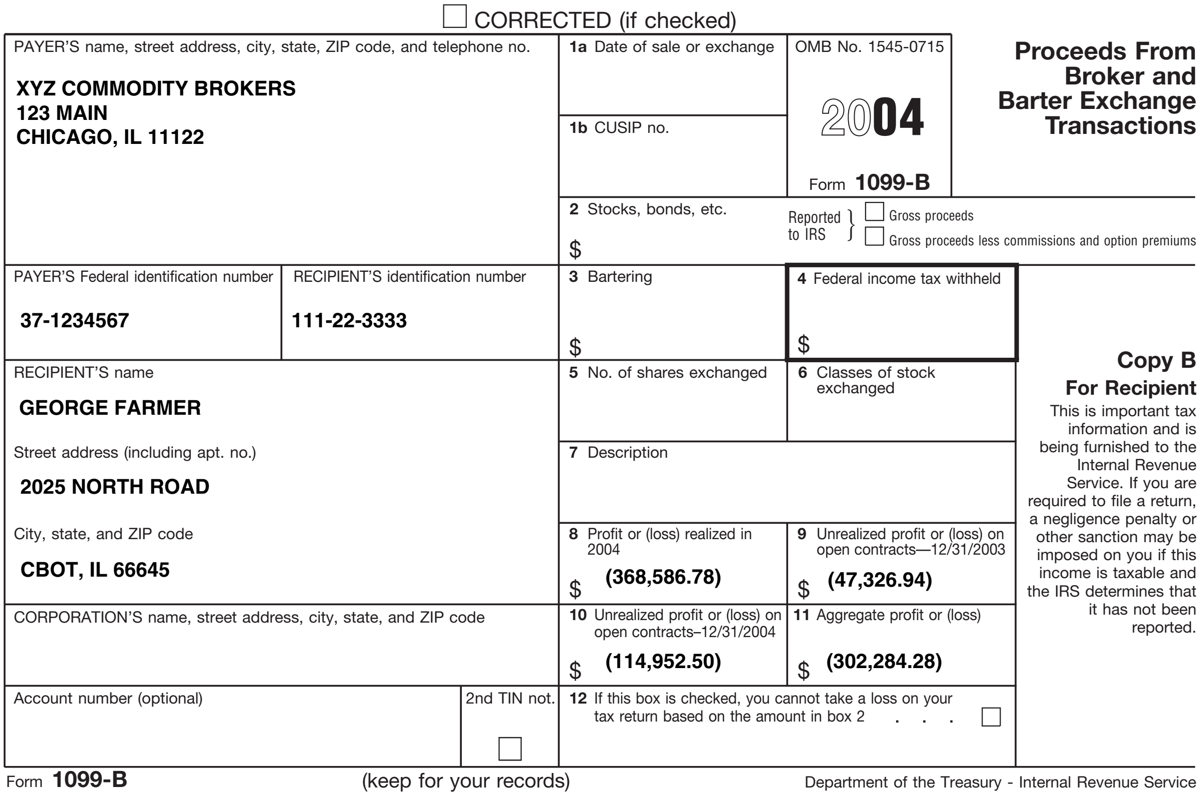
E Did you "materially participate" in the operation of this business during 2004? If "No," see page F-2 for limit on passive losses. ☐ Yes ☐ No

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

1	Sales of livestock and other items you bought for resale	1	
2	Cost or other basis of livestock and other items reported on line 1 . . .	2	
3	Subtract line 2 from line 1	3	
4	Sales of livestock, produce, grains, and other products you raised . . .	4	
5a	Total cooperative distributions (Form(s) 1099-PATR) 5a ____ 5b Taxable amount	5b	
6a	Agricultural program payments (see page F-2) 6a ____ 6b Taxable amount	6b	
7	Commodity Credit Corporation (CCC) loans (see page F-3):		
a	CCC loans reported under election	7a	
b	CCC loans forfeited . . . 7b ____ 7c Taxable amount	7c	
8	Crop insurance proceeds and certain disaster payments (see page F-3):		
a	Amount received in 2004 . . . 8a ____ 8b Taxable amount	8b	
c	If election to defer to 2005 is attached, check here ▶ ☐ 8d Amount deferred from 2003 . .	8d	
9	Custom hire (machine work) income	9	
10	Other income, including Federal and state gasoline or fuel tax credit or refund (see page F-3) . .	10	(2,900)
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

Example 5. George Farmer participates in the commodities market. He has two separate commodities accounts. One account is only used for “true” hedges of his farm production. The other account is used to speculate in the metals market. George has not had good luck in his speculative account in 2004. George uses the two accounts to meet the requirements under the regulations to clearly identify hedging transactions. A taxpayer is required to clearly identify a hedging transaction on the books and records before the end of the day the transaction was entered. His Form 1099-B, *Proceeds from Broker and Barter Exchange Transactions,* for his speculative account follows:



☐ CORRECTED (if checked)

PAYER’S name, street address, city, state, ZIP code, and telephone no.

XYZ COMMODITY BROKERS
123 MAIN
CHICAGO, IL 11122

1a Date of sale or exchange

1b CUSIP no.

OMB No. 1545-0715

2004

Form 1099-B

Proceeds From Broker and Barter Exchange Transactions

2 Stocks, bonds, etc. $

Reported to IRS ☐ Gross proceeds ☐ Gross proceeds less commissions and option premiums

PAYER’S Federal identification number: **37-1234567**

RECIPIENT’S identification number: **111-22-3333**

3 Bartering $

4 Federal income tax withheld $

Copy B
For Recipient

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.

RECIPIENT’S name

GEORGE FARMER

Street address (including apt. no.)

2025 NORTH ROAD

City, state, and ZIP code

CBOT, IL 66645

5 No. of shares exchanged

6 Classes of stock exchanged

7 Description

8 Profit or (loss) realized in 2004 $ **(368,586.78)**

9 Unrealized profit or (loss) on open contracts—12/31/2003 $ **(47,326.94)**

CORPORATION’S name, street address, city, state, and ZIP code

10 Unrealized profit or (loss) on open contracts–12/31/2004 $ **(114,952.50)**

11 Aggregate profit or (loss) $ **(302,284.28)**

Account number (optional)

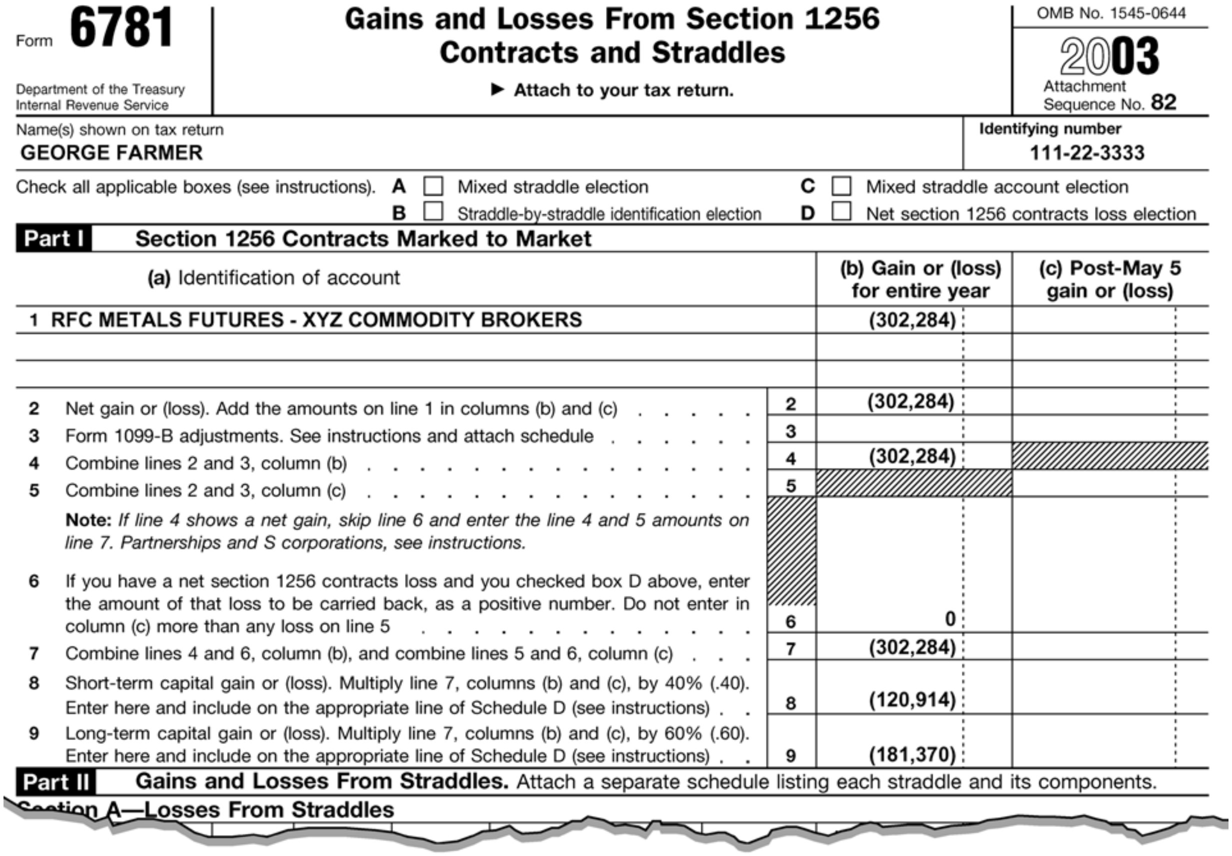
2nd TIN not. ☐

12 If this box is checked, you cannot take a loss on your tax return based on the amount in box 2 . . . ☐

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

George reports his total aggregate loss on Form 6781, *Gains and Losses from Section 1256 Contracts and Straddles,* which splits it between 40% short-term capital loss and 60% long-term capital loss. These amounts are then reported on Schedule D, *Capital Gains and Losses.* Speculative accounts must report the gains and losses on both closed and open transactions.

For Example 5



Form **6781**

Department of the Treasury
Internal Revenue Service

Gains and Losses From Section 1256 Contracts and Straddles

▶ **Attach to your tax return.**

OMB No. 1545-0644

2003

Attachment Sequence No. **82**

Name(s) shown on tax return: GEORGE FARMER

Identifying number: 111-22-3333

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

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

(a) Identification of account		**(b) Gain or (loss) for entire year**	**(c) Post-May 5 gain or (loss)**
1 RFC METALS FUTURES - XYZ COMMODITY BROKERS		(302,284)	
2 Net gain or (loss). Add the amounts on line 1 in columns (b) and (c)	2	(302,284)	
3 Form 1099-B adjustments. See instructions and attach schedule	3		
4 Combine lines 2 and 3, column (b)	4	(302,284)	▨
5 Combine lines 2 and 3, column (c)	5	▨	
Note: *If line 4 shows a net gain, skip line 6 and enter the line 4 and 5 amounts on line 7. Partnerships and S corporations, see instructions.*	▨		
6 If you have a net section 1256 contracts loss and you checked box D above, enter the amount of that loss to be carried back, as a positive number. Do not enter in column (c) more than any loss on line 5	6	0	
7 Combine lines 4 and 6, column (b), and combine lines 5 and 6, column (c)	7	(302,284)	
8 Short-term capital gain or (loss). Multiply line 7, columns (b) and (c), by 40% (.40). Enter here and include on the appropriate line of Schedule D (see instructions)	8	(120,914)	
9 Long-term capital gain or (loss). Multiply line 7, columns (b) and (c), by 60% (.60). Enter here and include on the appropriate line of Schedule D (see instructions)	9	(181,370)	

Part II **Gains and Losses From Straddles.** Attach a separate schedule listing each straddle and its components.

Section A—Losses From Straddles

ISSUE 4: CLAIMING DEDUCTIONS FOR MEALS AND LODGING

GENERAL RULE

Meals and lodging furnished to an employee for the convenience of the employer do not constitute taxable income to the recipient.[18] The IRS ruled that no deduction is allowed for meals and lodging for a sole proprietor.[19] To meet the employer's convenience rule, meals must be provided for one of the following reasons:

1. To make employees available for emergency calls during the meal period.
2. Meal periods must be short (30–45 minutes) because of the nature of the employer's business and the employee does not have time to eat elsewhere.
3. There is a lack of eating facilities near the business.
4. Meals are furnished to food service employees during work hours.
5. Meals are furnished immediately after working hours that would have been provided during business hours, but because of work duties were not eaten during work hours.

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[18] IRC §119

[19] FSA Letter Ruling 200031003, March 16, 2000

BASIC REQUIREMENTS

Certain requirements must be satisfied for meals and lodging furnished to an employee to be excluded from the employee's income:

1. For meals, they must be furnished **on the employer's business premises.** In various rulings, the courts have ruled on what constitutes a "business premise." The same is true for lodging. For lodging, there must generally be a direct and substantial relationship between the provision of lodging and the interests of the employer.
   - Living quarters that constitute an integral part of the business property or premises on which the employer conducts some of its business activities meet the substantial relationship test.
   - The exclusion was disallowed where employee houses were located approximately one mile from the place of employment.
   - A residence "two short blocks" from a motel managed by the taxpayer for the employer failed to meet the substantial relationship test.
   - A residence on the employer's premises met the substantial relationship test.
   - An apartment supplied by the employer and occupied by the taxpayer that was not located at the place of employment failed the substantial relationship test.
   - The value of discounted lodging was not excludible, and the use of a telephone on the business premises was not sufficient to meet the substantial relationship test.
   - Government ownership of a home was insufficient to prove that the home was "on the business premises."
   - The rental value of living quarters on the grounds of a VA hospital were excludible from the taxpayer-physician's gross income.
2. In order for the lodging's value to be excluded, the employee must be required to accept lodging on the premises as a condition of employment. Significant other points include the following:
   - "Lodging" includes such items as heat, electricity, gas, water, and sewer service, unless the employee contracts for the utilities directly from the supplier.
   - If the employee pays for the utilities without reimbursement from the employer, the utilities are not furnished by the employer and are not excludible from income.
   - The lodging must be provided "in-kind."
   - The value of lodging that is provided merely for the personal use of an employee is not excludible from income.

THE NEED TO ESTABLISH EMPLOYEE STATUS

IRC §119 treatment is available only for meals and lodging furnished to employees, not tenants as concluded in *Weeldreyer.*[20]

> **Example 6.** Seth formed a farming corporation and conveyed all of his farmland (including the farmhouse) to the corporation. The corporation assumed the mortgage on the property. Seth and his wife, Juanita, owned all of the corporate stock. The corporation adopted a medical reimbursement plan and paid the premiums on a health insurance policy covering Seth, Juanita, and their children.
>
> The corporation adopted a resolution requiring all officers and employees "to live at the worksite of the corporation to ensure security for the corporation property and operation [and] to supervise the care and feeding

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[20] *Ronald D. and Suzanne Weeldreyer v. Commr.,* TC Memo 2003-324, November 25, 2003

of the livestock of the corporation." The corporation leased the land to Seth and Juanita under a crop-share arrangement and paid for food consumed, utilities, repairs, and maintenance on the farmstead as well as the cost of telephone service. The corporation paid Seth a small amount annually as a corporate officer/employee.

Result. The medical expenses are deductible to the corporation and excludible from the employees' income. However, the food and lodging fail the §119 test because Seth farmed the land in question as a tenant and not as a corporate employee. Also, expenses incurred for repair and maintenance of the farmhouse and deductions for utilities and telephone expense are likely disallowed and are taxable to Seth. A deduction for depreciation on the farmhouse is available. The portion of the rent attributable to the farmhouse is included in Seth's income.

Three cases involving similar facts to *Weeldreyer* were decided by the Tax Court in late 2003. In one case, the taxpayer agreed to pay $6,000 annually for the use of the building site and improvements.[21] The corporation leased the farmland to the taxpayer and received all of the crop proceeds and government payments. This outcome was the same as in *Weeldreyer.*

Note. The *Schmidt* case is covered in detail in the Rulings and Cases section.

In another case, the taxpayer and the taxpayer's mother owned all of the common stock of a newly formed corporation.[22] The taxpayer conveyed land to the corporation that was leased back for 30% of the calf crop and 40% of the crop produced. The taxpayer's compensation from the corporation was $400 in the first year, $1,000 in the second year and $2,000 in year three. Again, the outcome was the same as in *Weeldreyer.*

In the third case, the individual taxpayers owned all of the stock of a newly formed corporation with the corporation leasing the farmland back to the taxpayers on a crop-share basis. Again, the outcome was the same.[23]

Observation. Deductions based on employee status are not claimable if paid to a farm tenant for services even though the same person may be a corporate officer. Careful structuring of relationships is necessary to ensure employee status.

OTHER ISSUES

A significant issue is whether an employee must be on the premises at all times for livestock observation and periodic chores. Again, the answer to the question rests on whether the employee is required to reside on the premises as a condition of employment for the convenience of the employer. The key seems to be whether requiring the employee to reside on the premises is indispensable to the proper discharge of the employee's job.

Example 7. Lloyd is the president of a poultry breeding corporation and lives in the corporate-provided house adjacent to the corporation's poultry farm. Lloyd provides supervisory duties for the poultry farm.

Result. The IRS may be successful in arguing that there is no need for Lloyd to live adjacent to the poultry farm because his duties are only supervisory and could be performed adequately while living in a nearby town.[24] If Lloyd's duties were to be more than supervisory in nature, a better argument could be presented as to the necessity of Lloyd living on the premises.

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[21] *Ricky and Suzetta Schmidt v. Commr.,* TC Memo 2003-325, November 25, 2003

[22] *Robert W. Tschetter v. Commr,* TC Memo 2003-326, November 25, 2003

[23] *Waterfall Farms, Inc. v. Commr.,* TC Memo 2003-327, November 25, 2003

[24] *Lloyd E. and Lorrayne Peterson v. Commr,* TC Memo 1966-196

In one court case, the taxpayer met the burden of proving that furnished lodging was indispensable to proper discharge of employment. In another, the taxpayer proved the value of lodging and cost of utilities excludible from manager's income and his residence on the farm was necessary and a condition of employment in swine raising and grain drying operation.[25]

The IRS maintains that groceries are not included under the definition of "meals."[26] But the courts are split on the issue, with the U.S. Court of Appeals for the Third Circuit holding that groceries count as meals, and the U.S. Court of Appeals for the Ninth Circuit holding that groceries do not count as meals (although the case did not involve IRC §119). The U.S. Tax Court agrees with the IRS position. In one additional case, the court included nonfoodstuffs such as napkins, toilet tissue, and soap as groceries.[27]

Observation. The IRS is bound by the Ninth Circuit's opinion in those states that are part of the Ninth Circuit: AK, AZ, CA, HI, ID, MT, NV, OR, and WA. Elsewhere, the IRS follows its position staked out in the 1991 Private Letter Ruling[28] and the position of the Tax Court.

Note. In a 2000 case, payments for groceries were considered payment of personal living expense where meals were not provided on the business premises and the taxpayers received a cash reimbursement for meals, not meals in kind.[29]

Under legislation enacted in 1998, if more than one-half of the employees to whom meals are provided on an employer's premises are provided for the convenience of the employer, then all of the meals are treated as furnished for the convenience of the employer.[30] If that test is met, the value of all meals is excludable from the employee's income and is 100% deductible by the employer.

The value of meals and lodging furnished for the employer's convenience is not wages for FICA and FUTA purposes. However, the amount is subject to FICA and FUTA taxes if it is not for the convenience of the employer.

If the value of meals furnished is included in the employee's wage, the employer may claim a 100% deduction (not limited to 50%).

RESIDENCES OWNED BY ENTITIES

If the residence is owned by a C corporation shareholder, rented to the corporation and occupied by the shareholder-owner as an employee, a question is raised concerning the ability to claim deductibility of depreciation on the residence.

A deduction to an individual or S corporation (but not a C corporation) is barred for a dwelling used by the taxpayer as a residence (other than for regular and exclusive use for business purposes) except where residency is for the employer's convenience under IRC §119(a).[31] The Tax Court denied depreciation and other deductions for a shareholder-owned residence rented to an S corporation.[32] But in the case, neither party raised the IRC §119 issue. The IRS ruled that an individual who rents a portion of a dwelling to the employer and uses the dwelling in performing services as an employee may deduct home mortgage interest, real property taxes, and personal casualty losses, but not casualty losses, under IRC §165(c)(1).[33]

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[25] *J. Grant Farms, Inc. v. Commr.,* TC Memo 1985-174, April 8, 1985

[26] Letter Ruling 9126063, March 29, 1991

[27] *Jacob v. Commr.,* 3d Cir. 1974, March 27, 1974

[28] Letter Ruling 9126063, March 29, 1991

[29] *Bernardus A.P. and Klazina W. Dobbe v. Commr.,* TC Memo 2000-330, October 25, 2000

[30] IRC §119(b)(4)

[31] IRC §280A

[32] *Leslie A. and Betsy M. Roy v. Commr.,* TC Memo 1998-125, March 31, 1998

[33] CCA Letter Ruling 200121070, March 19, 2001

ISSUE 5: EXTRA-TERRITORIAL INCOME EXCLUSION

OVERVIEW

Under legislation enacted in 1984, the Code authorized the establishment of foreign sales corporations (FSCs), being corporate entities in foreign jurisdictions through which U.S. manufacturing companies could channel exports and have 15% of the revenue exempted from the corporate tax. At a corporate tax rate of 35%, that amounted to an overall 5.25% tax break. A good number of qualifying companies utilized the provision through tax-exempt companies in the U.S. Virgin Islands, the Bahamas, Barbados, and Bermuda. However, the World Trade Organization (WTO) ruled in early 2000 that the legislation amounted to an illegal trading subsidy. As a result, Congress passed the Extra-Territorial Income Exclusion Act of 2000 (ETI) as replacement legislation.

The ETI Act, effective September 30, 2000, repealed the rules regarding FSCs[34] and provides an exclusion from income for a certain portion of extra-territorial income.[35] The ETI Act extends to any type of entity with qualifying foreign sales. Also, foreign companies that are U.S. taxpayers can also utilize the provision.

> **Observation**. The amount of tax savings for entities utilizing the ETI Act is the same as under previous law, but the total amount of revenue forgone by the Treasury is more because a broader range of companies can utilize the provision.

On January 14, 2002, the WTO ruled that the ETI Act was "inconsistent with international trade agreements." The European Union then prepared a list of U.S. products on which it proposed to apply sanctions in the form of countervailing duties and obtained the WTO's permission for such action, which it put into effect in March 2004. The counter tariffs began at a rate of 5% and rise in 1% increments every month until the European Union is satisfied that the Congress has taken appropriate action to remedy the problem. The United States faces possible sanctions if the ETI Act is not repealed by the end of 2004.

HOW THE STATUTE WORKS

Extra-territorial income is the taxpayer's gross income attributable to foreign trading gross receipts and is excludible to the extent it is "qualifying foreign trade income."[36] "Qualifying foreign trade income" is the amount of gross income which, if excluded, would result in a reduction of taxable income by the greater of 15% of foreign trade income, 1.2% of foreign trading gross receipts or 30% of foreign sale and lease income. "Foreign trade income" is taxable income attributable to foreign trade gross receipts.[37]

Foreign Trading Gross Receipts

The threshold for determining whether gross receipts are treated as foreign trading gross receipts is whether the gross receipts are derived from a transaction involving "qualified foreign trade property." **Foreign trading gross receipts** are derived from activities in connection with qualifying foreign trade property. This includes the sale, exchange, or other disposition of qualifying foreign trade property and the lease or rental of qualifying trade property for the lessee's use outside the United States. This also includes services related to the sale or lease, of engineering or architectural services outside the United States, or for the performance of managerial services supporting the production of foreign trading gross receipts.[38]

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[34] IRC §§ 921-927

[35] Pub. L. No. 106-519, 114 Stat. 2423 (2000)

[36] IRC §114(e)

[37] IRC §941(b)(1)

[38] IRC §942(a)(1)

Observation. "Foreign trading gross receipts" do not include receipts of a taxpayer arising from a transaction if the property or services are for ultimate use in the United States or the transaction is accomplished by a subsidy granted by the government of a country in which the property is manufactured, grown, or extracted.[39]

Note. Because U.S. income tax principles generally deny deductions for expenses related to exempt income, deductible expenses that are allocated to qualifying foreign trade income generally are disallowed. The instructions to IRS Form 8873, *Extra-territorial Income Exclusion,* require that the cost of goods sold allocated to foreign trading gross receipts be calculated. The deductions, other than those included in figuring cost of goods sold, must also be calculated. This appears to include Schedule F deductions.

Qualifying Foreign Trade Property

Property is considered to be qualifying foreign trade property if **three requirements** are met:

1. The property must be manufactured, produced, grown or extracted within the United States (or outside the United States if certain conditions are met);
2. The property must be held for sale, lease, or rent in the ordinary course of a trade or business for direct use, consumption or disposition outside the United States; and
3. No more than 50% of the property's FMV may be attributable to articles manufactured, produced, grown or extracted outside the United States, and direct costs for labor performed outside the United States.

Nonqualifying Foreign Trade Property

Some property cannot qualify as foreign trade property. The types of property that do not fit the definition include:

1. Property leased or rented for use by a related party;
2. Patents, inventions, certain copyrights, goodwill, trademarks, trade brands, franchises, or like property;
3. Oil and gas property;
4. Any unprocessed timber which is a softwood; and
5. Any property that has been designated as in short supply by executive order, so long as the executive order remains in effect.

Foreign Sale and Lease Income

Foreign sale and lease income is foreign trade income that is allocable to transactions in which a person (or person acting under contract with the taxpayer) has participated outside the United States. The transaction involves the solicitation, negotiation, or making of the contract relating to the transaction or activities that include advertising and sales promotions, processing of customer orders, or arranging for delivery. It also includes transportation outside the United States in connection with delivery to a customer, the determination or final transmittal of a final invoice or statement of account, or the receipt of payment and the assumption of credit risk.[40] However, these requirements are considered met if the foreign trading gross receipts for the taxpayer for the year do not exceed $5 million.[41]

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[39] IRC §942(a)(2)(A-B)

[40] IRC §942(b)(3)

[41] IRC §942(c)(1)

HOW THE EXCLUSION WORKS

For transactions after September 30, 2000, the exclusion provides a tax benefit by excluding from gross income a portion of income from qualified foreign sales.

> **Note.** The exclusion does not involve any transactions involving an FSC, and no foreign tax credit is allowed for transactions that utilize the exclusion. However, the exclusion does apply for AMT purposes.

For a foreign sale to qualify as foreign trade property, the property must be held for sale in the ordinary course of business for direct use, consumption, or disposition outside of the United States. This is for businesses with foreign trading gross receipts of less than $5 million. Also, no more than 50% of the FMV of the property can be attributable to materials and labor provided from outside the United States.

> **Observation.** A major issue for farmers is whether commodities that are sold to a buyer must have actually been exported, or whether the proportion of the buyer's commodities that are exported can be attributed to the farmer. The statutory limitation on claiming the exclusion if the "ultimate use [is] in the United States" suggests that the farmer's commodities must have been actually exported, not merely sold, to a purchaser that exports.[42] However, the issue is not entirely clear.
>
> The Senate Finance Committee Report on the ETI Act states that "a taxpayer may determine the amount of qualifying foreign trade income either on a transaction-by-transaction basis or on an aggregate basis for groups of transactions, so long as the groups are based on product lines or recognized industry or trade usage."[43] Neither the IRS nor the Treasury has provided guidance as to the meaning of that statement.

For businesses with more than $5 million in foreign trading receipts, **two economic process tests must also be met:**

1. The foreign sales transactions must have either solicitation of the contract, negotiation of the contract or the making of the contract outside the United States, and
2. 50% or more of total direct costs must be foreign direct costs, or 85% or more of two categories of direct costs must be foreign direct costs. The categories of direct costs for the 85% test include advertising, processing and delivery of orders, transportation outside the United States for delivery to customers, determination and transmittal of a final invoice or statement of account or receipt of payment, and assumption of credit risk.

Calculating the Exclusion

There are **three methods** for calculating the exclusion. As a general rule, the method that provides the largest exclusion for the client should be utilized.

> **Note.** The taxpayer reports all extra-territorial income on the tax return with the exclusion, then calculates from income for the portion eligible to be excluded.

Method 1

The exclusion equals 1.2% of gross receipts from sales, exchange, or other disposition of qualifying foreign trade property. It may also include the lease or rental of qualifying foreign trade property, services related to the sale of lease of qualifying property, engineering or architectural services for construction projects outside the United States, and managerial services associated with the production of foreign trading gross receipts.

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[42] IRC §942(a)(2)(A)

[43] S. Rep. No. 104-416, Pub. L. No. 106-519, 106th Cong., 2d Sess. (2000)

Note. In computing the exclusion under this approach, the exclusion is limited to 200% of the amount of the exclusion provided by Method 2 (described below).

Method 2

The exclusion equals 15% of the taxable income attributable to foreign trading gross receipts.

Method 3

Businesses that lease or sell leased property outside the United States may use this method. Under this method, the exclusion equals 30% of eligible profits from income derived from the lease, rental, or sale of qualifying foreign trade property.

Observation. For many businesses, the exclusion may be beneficial. Many businesses with less than $5 million in foreign trading gross receipts can qualify for the exclusion. However, a major drawback to the exclusion is tracking the costs associated with foreign sales transactions. Additional bookkeeping or advanced software may be necessary.

APPLICATION TO COOPERATIVES

When computing taxable income for cooperatives that are engaged in the marketing of agricultural or horticultural products, deductions allowed for patronage dividends, per-unit retain allocations, and nonpatronage distributions are not taken into account. For agricultural or horticultural cooperatives, patronage dividends or per-unit retain allocations allocable to qualifying foreign trade income in a written notice mailed to patrons are treated as qualifying foreign trade income for the year.[44]

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[44] IRC §943(g)

CALCULATING AND REPORTING THE EXCLUSION

Form 8873 is used to calculate and report the exclusion. The completed Form 8873 should be attached to the business' income tax return for the tax year. The instructions to Form 8873 are useful for completing the form.

Example 8. Minny raises white corn and soybeans for export. She sells all of her production to Grain Exporters, Inc., who then puts it into containers to ship to Japan. She also raises yellow corn, but it is not sold on the export market. Minny extracted the following information from her farm records.

Minny 123-45-6789
Form 8873 Computation
Extra-Territorial Income Exclusion

	Crop			
	White Corn	Soybeans	Form 8873 Line	Total Net Foreign Trade
Export percentage	100.00%	100.00%		
Total sales	$169,958	$ 85,343		
Foreign sales	$169,958	$ 85,343	6	$255,301
Expenses				
Cost of labor	11,367	9,275		
Foreign cost of labor	$ 11,367	$ 9,275	17c	(20,642)
Other costs (production)				
Chemicals	18,757	5,800		
Fertilizer	21,603	0		
Seed	14,486	5,800		
Total other costs	$ 54,846	$ 11,600		
Total foreign other costs	$ 54,846	$ 11,600	17e	(66,446)
Other costs (nonproduction)				
Machine hire	$ 2,694	$ 1,931		
Drying	3,799	0		
Machine repair	8,088	5,797		
Fuel	6,972	4,997		
Utilities	111	79		
Building repair	352	252		
Insurance	2,029	1,454		
Real estate taxes	1,222	876		
Rent	29,180	20,913		
Interest	13,747	9,853		
Machinery depreciation	18,540	13,287		
Total other costs	$ 86,734	$ 59,439		
Total foreign other costs	$ 86,734	$ 59,439	19	(146,173)
Net foreign trade income				$ 22,040

Note. These expense items are directly attributable to the sale of the crop which was exported. While the crop was produced and sold in 2003, part of the expenses were deducted on Minny's 2002 cash basis Schedule F. Therefore, Minny has completed the above expenses on the accrual basis.

Minny completes the following Form 8873 and attaches it to her federal income tax return.

For Example 8

Form **8873**

Department of the Treasury
Internal Revenue Service

Extraterritorial Income Exclusion

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

OMB No. 1545-1722

2003

Attachment Sequence No. **126**

Name(s) as shown on return: Minny

Identifying number: 123-45-6789

Part I Elections and Other Information

1 Check the box if you are electing under section 942(a)(3) to exclude a portion of your gross receipts from foreign trading gross receipts on line 15. Attach a schedule indicating which receipts are being excluded . . . . ▶ ☐

2 Check the box if you are electing to apply the extraterritorial income exclusion provisions to certain transactions involving a FSC (see instructions). Attach a schedule listing the affected transactions . . . . ▶ ☐

3 Check the box if the taxpayer is a foreign corporation electing to be treated as a domestic corporation (see instructions) . . ▶ ☐

4a Are you excepted from the foreign economic process requirements because your foreign trading gross receipts are $5 million or less? . . . . ▶ ☑ Yes ☐ No

b If “No,” check the applicable box to indicate how you met the foreign economic process requirements:
(1) ☐ You met the 50% foreign direct cost test (see instructions).
(2) ☐ You met the alternative 85% foreign direct cost test (see instructions).

5 See page 3 of the instructions before completing lines 5a through 5c. **Note:** *For transactions for which the exclusion is determined using the foreign sale and leasing income method (i.e., line 44 equals line 45), complete only lines 5a and 5c(1).*

a Business activity code 111100 **b** Product or product line Field Crops

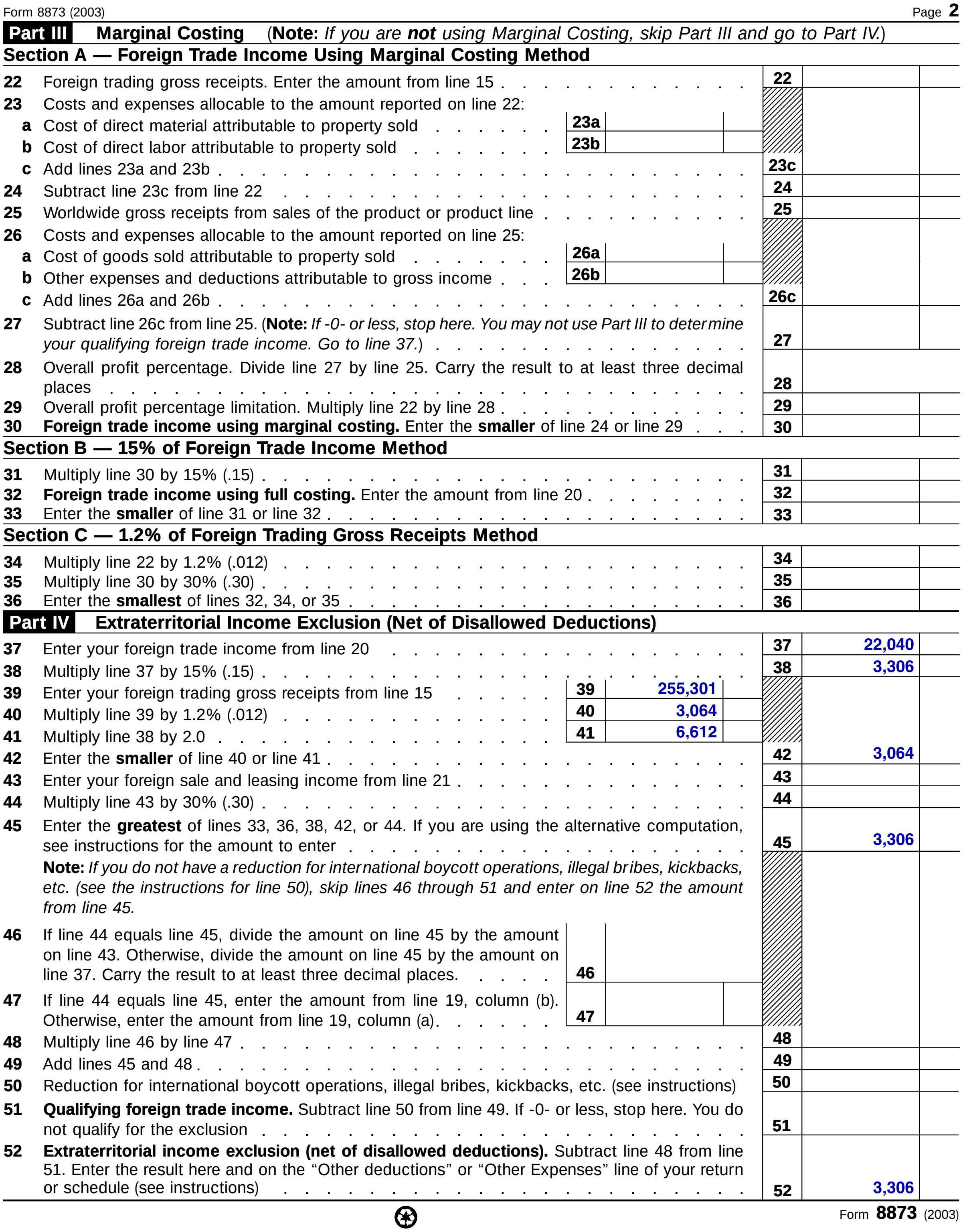
c Check the applicable box to indicate the basis of your reporting:
(1) Transaction-by-transaction:
(a) ☐ Aggregate on Form 8873 **(b)** ☑ Aggregate on tabular schedule **(c)** ☐ Tabular schedule of transactions
(2) ☐ Group of transactions

Part II Foreign Trade Income and Foreign Sale and Leasing Income

			(a) Foreign Trade Income	(b) Foreign Sale and Leasing Income
	Caution: *If a related person is also eligible for an extraterritorial income exclusion, see* ***Excluded property*** *on page 2 of the instructions.*			
6	Sale, exchange, or other disposition of qualifying foreign trade property	6	255,301	
7	Enter the amount from line 6, column (a), attributable to the sale of property formerly leased or rented for use by the lessee outside the United States	7		
8	Lease or rental of qualifying foreign trade property for use by the lessee outside the United States. Enter the same amount in both columns . .	8		
9	Services related and subsidiary to the sale, exchange, or other disposition of qualifying foreign trade property	9		
10	Enter the amount from line 9, column (a), attributable to the sale of property formerly leased or rented for use by the lessee outside the United States	10		
11	Services related and subsidiary to the lease of qualifying foreign trade property for use by the lessee outside the United States. Enter the same amount in both columns .	11		
12	Engineering or architectural services for construction projects outside the United States	12		
13	Managerial services provided to unrelated persons (see instructions) .	13		
14	Enter the sum of the amounts from lines 6, 9, 12, and 13 of column (a) attributable to foreign economic processes. **Do not** include any amounts already included on lines 7, 8, 10, or 11 in column (b)	14		
15	**Foreign trading gross receipts.** Add lines 6 through 13 in column (a) .	15	255,301	
16	Add lines 7 through 14 in column (b)	16		
17	**Cost of goods sold:**			
a	Inventory at beginning of year	17a		
b	Purchases	17b		
c	Cost of labor	17c	20,642	
d	Additional section 263A costs (attach schedule)	17d		
e	Other costs (attach schedule)	17e	66,446	
f	Total. Add lines 17a through 17e	17f	87,088	
g	Inventory at end of year	17g		
h	Subtract line 17g from line 17f	17h	87,088	
18	In column (a), subtract line 17h from line 15. In column (b), subtract line 17h from line 16	18	168,213	
19	Other expenses and deductions (see instructions) (attach schedule) .	19	146,173	
20	**Foreign trade income.** In column (a), subtract line 19 from line 18. If -0- or less, stop here. You do not qualify for the exclusion	20	22,040	
21	**Foreign sale and leasing income.** In column (b), subtract line 19 from line 18	21		

For Paperwork Reduction Act Notice, see page 4 of the instructions. Cat. No. 30732F Form **8873** (2003)

For Example 8



Form 8873 (2003) Page **2**

Part III **Marginal Costing** (**Note:** *If you are **not** using Marginal Costing, skip Part III and go to Part IV.*)

Section A — Foreign Trade Income Using Marginal Costing Method

22	Foreign trading gross receipts. Enter the amount from line 15			**22**	
23	Costs and expenses allocable to the amount reported on line 22:				
a	Cost of direct material attributable to property sold	**23a**			
b	Cost of direct labor attributable to property sold	**23b**			
c	Add lines 23a and 23b			**23c**	
24	Subtract line 23c from line 22			**24**	
25	Worldwide gross receipts from sales of the product or product line			**25**	
26	Costs and expenses allocable to the amount reported on line 25:				
a	Cost of goods sold attributable to property sold	**26a**			
b	Other expenses and deductions attributable to gross income	**26b**			
c	Add lines 26a and 26b			**26c**	
27	Subtract line 26c from line 25. (**Note:** *If -0- or less, stop here. You may not use Part III to determine your qualifying foreign trade income. Go to line 37.*)			**27**	
28	Overall profit percentage. Divide line 27 by line 25. Carry the result to at least three decimal places			**28**	
29	Overall profit percentage limitation. Multiply line 22 by line 28			**29**	
30	**Foreign trade income using marginal costing.** Enter the **smaller** of line 24 or line 29			**30**	

Section B — 15% of Foreign Trade Income Method

31	Multiply line 30 by 15% (.15)	**31**	
32	**Foreign trade income using full costing.** Enter the amount from line 20	**32**	
33	Enter the **smaller** of line 31 or line 32	**33**	

Section C — 1.2% of Foreign Trading Gross Receipts Method

34	Multiply line 22 by 1.2% (.012)	**34**	
35	Multiply line 30 by 30% (.30)	**35**	
36	Enter the **smallest** of lines 32, 34, or 35	**36**	

Part IV **Extraterritorial Income Exclusion (Net of Disallowed Deductions)**

37	Enter your foreign trade income from line 20			**37**	22,040
38	Multiply line 37 by 15% (.15)			**38**	3,306
39	Enter your foreign trading gross receipts from line 15	**39**	255,301		
40	Multiply line 39 by 1.2% (.012)	**40**	3,064		
41	Multiply line 38 by 2.0	**41**	6,612		
42	Enter the **smaller** of line 40 or line 41			**42**	3,064
43	Enter your foreign sale and leasing income from line 21			**43**	
44	Multiply line 43 by 30% (.30)			**44**	
45	Enter the **greatest** of lines 33, 36, 38, 42, or 44. If you are using the alternative computation, see instructions for the amount to enter			**45**	3,306
	Note: *If you do not have a reduction for international boycott operations, illegal bribes, kickbacks, etc. (see the instructions for line 50), skip lines 46 through 51 and enter on line 52 the amount from line 45.*				
46	If line 44 equals line 45, divide the amount on line 45 by the amount on line 43. Otherwise, divide the amount on line 45 by the amount on line 37. Carry the result to at least three decimal places.	**46**			
47	If line 44 equals line 45, enter the amount from line 19, column (b). Otherwise, enter the amount from line 19, column (a).	**47**			
48	Multiply line 46 by line 47			**48**	
49	Add lines 45 and 48			**49**	
50	Reduction for international boycott operations, illegal bribes, kickbacks, etc. (see instructions)			**50**	
51	**Qualifying foreign trade income.** Subtract line 50 from line 49. If -0- or less, stop here. You do not qualify for the exclusion			**51**	
52	**Extraterritorial income exclusion (net of disallowed deductions).** Subtract line 48 from line 51. Enter the result here and on the "Other deductions" or "Other Expenses" line of your return or schedule (see instructions)			**52**	3,306

Form **8873** (2003)

Minny's 2003 Schedule F is prepared as follows:

For Example 8

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: Minny
Social security number (SSN) 123 45 6789

A Principal product. Describe in one or two words your principal crop or activity for the current tax year.: Field Crops
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	1,322,253
5a	Total cooperative distributions (Form(s) 1099-PATR)	5a		5b Taxable amount 5b	
6a	Agricultural program payments (see page F-2)	6a	25,786	6b Taxable amount 6b	25,786
7	Commodity Credit Corporation (CCC) loans (see page F-3):				
a	CCC loans reported under election			7a	
b	CCC loans forfeited	7b		7c Taxable amount 7c	
8	Crop insurance proceeds and certain disaster payments (see page F-3):				
a	Amount received in 2003	8a		8b Taxable amount 8b	
c	If election to defer to 2004 is attached, check here ▶ ☐			8d Amount deferred from 2002 8d	
9	Custom hire (machine work) income			9	
10	Other income, including Federal and state gasoline or fuel tax credit or refund (see page F-3)			10	
11	**Gross income.** Add amounts in the right column for lines 3 through 10. If accrual method taxpayer, enter the amount from page 2, line 51 ▶			11	1,348,039

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

12	Car and truck expenses (see page F-4—also attach **Form 4562**)	12		25	Pension and profit-sharing plans	25	
13	Chemicals	13	148,991	26	Rent or lease (see page F-5):		
14	Conservation expenses (see page F-4)	14		a	Vehicles, machinery, and equipment	26a	
15	Custom hire (machine work)	15	22,498	b	Other (land, animals, etc.)	26b	243,672
16	Depreciation and section 179 expense deduction not claimed elsewhere (see page F-4)	16	154,820	27	Repairs and maintenance	27	70,477
				28	Seeds and plants purchased	28	116,385
				29	Storage and warehousing	29	29,000
17	Employee benefit programs other than on line 25	17		30	Supplies purchased	30	
				31	Taxes	31	10,207
18	Feed purchased	18		32	Utilities	32	926
19	Fertilizers and lime	19	164,914	33	Veterinary, breeding, and medicine	33	
20	Freight and trucking	20		34	Other expenses (specify):		
21	Gasoline, fuel, and oil	21	58,219	a	Extraterritorial income	34a	
22	Insurance (other than health)	22	16,946	b	exclusion	34b	3,306
23	Interest:			c		34c	
a	Mortgage (paid to banks, etc.)	23a		d		34d	
b	Other	23b	114,800	e		34e	
24	Labor hired (less employment credits)	24	96,048	f		34f	

35	**Total expenses.** Add lines 12 through 34f ▶	35	1,251,209
36	**Net farm profit or (loss).** Subtract line 35 from line 11. If a profit, enter on **Form 1040, line 18,** and **also** on **Schedule SE, line 1.** If a loss, you **must** go on to line 37 (estates, trusts, and partnerships, see page F-6)	36	96,830

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

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

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 11346H **Schedule F (Form 1040) 2003**

RECENT LEGISLATIVE DEVELOPMENTS

Legislation initially proposed in 2003 would repeal the ETI Act and replace it with a corporate rate reduction for domestic manufacturers. Under the proposal, firms with 100% of their production based in the United States would be subject to a 31.5% tax rate, down from the 35% corporate tax rate on export-generated profits, and a sliding-scale would be utilized depending on the firm's ratio of domestic to international production. In 2004, the Senate passed S.1637 as its version of a repeal bill. Later, the House passed similar legislation.[45] Under the proposals, the ETI Act would be repealed on a phased-out basis beginning in 2005. This has no impact on transactions entered into in the ordinary course of business if the transactions are the result of a binding contract between the taxpayer and an unrelated person. The contract must have been in effect on January 14, 2002, and continue to remain in effect.

The Senate bill creates a tax deduction for qualified domestic production activities (manufacturers, producers and farmers) income. The provision applies to all types of business entities and provides that the percentage amount of the deduction shall be nine percent of domestic production activities for taxable years beginning in 2009. The deduction is limited to 50% of the W-2 wages of an employer for a taxable year. The deduction would also be allowed for purposes of computing AMT liability. The House bill creates a phased-in reduction in the corporate tax rate from 35% to 32% between 2004 and 2009 for domestic production activities. The provision is limited to those companies with taxable income over $75,000 and under $1 million, but with the top end of the bracket increasing to $20 million by 2013.

Note. Both the Senate and House bills contain numerous other tax provisions with the details of a final bill to be hammered out in conference committee. At the time of this writing, House and Senate conferees were expected to meet in September to begin working on a final bill. The details of any final bill will be included in supplemental material to the 2004 Workbook.

ISSUE 6: DEDUCTIBILITY OF SOIL CONDITIONING EXPENDITURES

OVERVIEW

Before enactment of the statutory provision, the IRS routinely took the position that the cost of fertilizer and lime applied to land was a capital expenditure that had to be deducted over a period of years rather than deducting all expenses in the year applied. Audit conflict on the issue over a number of years resulted in the 1960 enactment of IRC §180. Under that provision, an election is available to currently deduct expenditures paid or incurred during the taxable year for the "purchase or acquisition of fertilizer, lime, ground limestone, marl, or other materials to enrich, neutralize or condition land used in farming." If the election is not made, the expenditures must be capitalized over the period soil fertility is affected.

Note. The election is made by entering it as a deduction on the return with a notation in the margin that the taxpayer is electing to deduct fertilizer and lime cost currently.

Note. In 1989, the IRS took the position that the cost of fertilizer applied to an existing timber stand may not be deducted immediately and must be amortized.[46] However, the IRS later withdrew the GCM "pending further consideration of the issue."[47]

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[45] H.R. 4520, the American Jobs Creation Act

[46] GCM 39791, June 9, 1989

[47] GCM 39844, April 16, 1991

Land Must Be Used in Farming

To be currently deductible, expenditures must be paid or incurred during the tax year for the "purchase or acquisition of fertilizer, lime, ground limestone, marl, or other materials to enrich, neutralize or condition land used in farming."[48] The term **land used in farming** is defined as land used by the taxpayer or tenant for the production of crops, fruits or other agricultural products or for the sustenance of livestock.[49]

Taxpayer Must Be Engaged in Farming

In order to deduct costs associated with fertilizer and lime, the taxpayer must be engaged in the trade or business of farming which requires either that the taxpayer be an operator or a landlord under a crop or livestock share lease, or materially participate in the operation or the management of the farm (in the case of a cash rent lease). The same definition of "business of farming" is used as for the soil and water expense deduction under IRC §175.

Note. A nursery engaged in the raising of ornamental plants is considered to be in the business of farming for purposes of the election.[50]

Residual Fertilizer Supply in Farmland

One of the more recent conflicts with the IRS concerning the current deductibility of soil conditioners is whether premium fertilizer levels or the residual fertilizer supply are deductible as "fertilizer" by virtue of the election. A "residual fertilizer supply" may occur on the purchase of farmland where the prior owner had applied fertilizer to the point that an increased level of fertilizer in the soil results. As noted above, for soil conditioning expenses to be deductible currently, the taxpayer must be engaged in the business of farming and the land involved must have been used for the production of crops, fruits, or other agricultural products or for the sustenance of livestock "before or simultaneously with the expenditures."[51] The regulations state that "expenditures for the initial preparation of land never previously used for farming by the taxpayer or his tenant" are not eligible for the election.[52]

Note. There is confusion on this point. The regulations specify that for land used by the immediately preceding owner for farming purposes, the taxpayer is considered to be using the land in farming when the 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 predecessor or any of the other permissible uses. However, the regulations also imply that land not used previously by the taxpayer or tenant in farming is not eligible for the election.[53]

Example 9. Jack is a farmer. He purchased a farm. His corporation (Jack owned a majority interest) purchased the "residual fertilizer supply" in the land that was purchased.

Jack leased the land to his corporation under a one-year lease. The prior owner of the farm had applied sufficient levels of fertilizer resulting in a residual fertilizer supply. Jack's corporation claimed an amortization deduction over a 7-year period for the residual fertilizer supply.

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[48] IRC §180(a)

[49] IRC §180(b)

[50] Rev. Rul. 59-12, 1959-1 C.B. 59

[51] IRC §180(b)

[52] Treas. Reg. §1.180-1(b)

[53] Treas. Regs. §§1.180-1(b) and 1.175-4

Result. In a 1991 ruling involving these facts, the IRS denied the deduction for the residual fertilizer supply.[54] While the IRS agreed that capitalized farm fertilization costs could be amortized, the IRS noted that the taxpayer must be the beneficial owner of the fertilizer. In the example, Jack, rather than the corporation, purchased the land.

Note. Under the 1991 ruling, the IRS denied a deduction for the residual fertilizer supply on the basis that the corporation failed to establish the presence and extent of the fertilizer (did not measure or provide data to indicate the level of soil fertility applied to the land by the previous owner). The IRS also noted that, in order to amortize the cost of the fertilizer supply over time, the corporation (as the taxpayer) must be actually exhausting the fertilizer in the soil. However, the soil test results involved in the facts of the ruling showed that the level of fertility in the majority of the parcels was not declining.

IRS Pub. 225 states that taxpayers can deduct in the year paid or incurred the cost of fertilizer, lime and other materials applied to farmland and the cost of application. If the benefits last substantially more than one year, the costs must be capitalized and deducted each year the benefits last unless the taxpayer chooses to deduct these expenses in the year paid or incurred. Farmland, for these purposes, is land used for producing crops, fruits, or other agricultural products or for sustaining livestock. It does not include land never previously used for producing crops or sustaining livestock.

ISSUE 7: DEDUCTIBLE REPAIRS VERSUS CAPITALIZATION

OVERVIEW

The rules as to what is considered a "repair" and therefore deductible, and what must be capitalized and depreciated have never provided a bright line for determining how an expense should be handled. In general, any expense associated with the business with a useful life of less than one year is deductible against gross income. Expenses are deductible as repairs if the cost involves "incidental repairs which neither materially add to the value of the property nor appreciably prolong its life, but keep it in an ordinary efficient operating condition."[55] The courts have not always provided consistent rulings. Clearly, the facts and circumstances of each particular situation determine the outcome of any dispute.

Observation. Given the increased IRC §179 expense election amounts and special depreciation allowances of recent years, taxpayers may reduce any dispute by placing more items on a depreciation schedule and utilizing these expanded depreciation deductions in lieu of trying to support deductions for repairs.

APPLICABLE CODE AND REGULATIONS

Trade or Business Expenses

A taxpayer may deduct ordinary and necessary business expenses paid or incurred during the taxable year.[56] The regulations to IRC §162 state,

> *The cost of incidental repairs which neither materially add to the value of the property nor appreciably prolong its life, but keep it in an ordinary efficient operating condition, may be deducted as an expense.*[57]

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[54] Letter Ruling 9211007, December 3, 1991

[55] Treas. Reg. §1.162-4

[56] IRC §162

[57] Treas. Reg. §1.162-4

Capital Expenditures

IRC §263 disallows a deduction for *"any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate."*[58]

Exceptions to the disallowance rule are provided for:

1. Developmental expenditures associated with natural deposits;
2. Research and experimental expenses;
3. Soil and water conservation expenses;
4. Expenses for soil conditioners;
5. Expenses incurred for removal of architectural and transportation barriers to the handicapped and elderly that are elected to be deducted;
6. Any expenses for which an expense method depreciation deduction is allowed; or
7. An amount expended in restoring property or in making good its exhaustion for which an allowance is or has been made.

The regulation governing capitalization states that expenses are capital expenditures and are to be depreciated if the expenses:

(1) add to the value, or substantially prolong the useful life of property owned by the taxpayer, or (2) adapt property to a new or different use.[59]

Capital improvements are generally viewed as an expenditure that will:

- Last for more than one year,
- Do more than restore the property to its previous condition,
- Change the use of the property, or
- Substantially increase the value of the property.

The regulation also provides that "amounts paid or incurred for incidental repairs and maintenance of property are not capital expenditures."[60]

> **Example 10.** Helen owns two properties that she uses in her farming and breeding business. The properties are located across the road from one another. Helen produces hay and straw, sells goats and pigs, and raises poodles and quarter horses which she sells.
>
> Property 1 consists of 20 acres, a house, a granary, a large barn, two chicken coops and a bee cellar. The barn is in fair condition and has a solid foundation, but the roof leaks, the doors are wind damaged, and the back wall had been bowed out for almost 10 years. The remainder of Property 1 is in terrible shape, with weeds and brush everywhere and fences in disrepair. The chicken coop, bee cellar, and house were in such bad shape that Helen demolished them in 2004. During 2004, Helen incurred expenses for repairing the barn roof, painting the sides of the barn, removing debris from inside the barn, repairing the granary roof, and painting the sides of the granary.

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[58] IRC §263

[59] Treas. Reg. §1.263(a)-1(b)

[60] Id.

Property 2 consists of 40 acres and includes a large farmhouse, a small house that Helen uses as an office, a chicken coop, a garage, a pump shed and a barn in which Helen stores hay and stabled horses. In 2004, Helen resealed and painted the wood on the barn, installed new windows, fixed the doors and roof, divided a horse stall into two foaling stalls and demolished the chicken coop. On her 2004 return, Helen wants to deduct amounts expended for repairing the barn roof and painting the barn.

Question. What amounts may Helen deduct on her 2004 return?

Answer. The expenditures that Helen incurred to keep the particular asset in efficient operating condition are deductible currently. These include expenditures that restored the barns to their previous condition without adding to the value of the barns or prolonging their life. Expenses Helen incurs for such things as prepping, treating, and painting wood, replacing roofing material, sealing nail holes, and painting roofs that are already in operating condition are deductible on Helen's 2003 return. However, expenditures associated with dividing the horse stall into two foaling stalls and the demolition costs are not currently deductible.

Note. In situations where some expenditures are capital in nature and others are repairs, the IRS may argue that all expenses were part of an overall plan of rehabilitation of the property and therefore, must be capitalized. The case law reveals, however, that the rehabilitation doctrine is imposed in situations involving substantial capital improvements and repairs to the same specific asset, usually a structure in a state of disrepair.

EXPENSES FOR ENGINE AND TRANSMISSION OVERHAUL

Recent cases provide useful authority for the position that major engine or transmission overhauls are currently deductible as repairs. Under these court opinions, engines and transmissions are generally treated as part of the larger machine. This means that the economic life of the engine or transmission is treated as coextensive with the economic life of the larger machine (e.g., a tractor or combine). Because the larger machine cannot function without an engine or transmission, overhaul of the engine or transmission while affixed to the machine can give rise to a current deduction.

A 2003 case involved the deductibility of expenses incurred for aircraft maintenance. The court reasoned that whether an expense was a repair or a cost that had to be capitalized depended on the unit of property involved.[61] Consequently, the court had to determine whether the larger unit of property or the smaller unit of property was the appropriate unit for purposes of determining deductibility of the maintenance expenses. The court cited the *Ingram Industries* and *Smith* cases for authority in establishing four factors for consideration in identifying the appropriate unit of property for applying the factors in the repair regulations:[62]

1. Whether the taxpayer and the industry treat the component part as part of the larger unit of property for regulatory, market, management, or accounting purposes;
2. Whether the economic useful life of the component part is coextensive with the economic useful life of the larger unit of property;
3. Whether the larger unit of property and the smaller unit of property can function without each other; and
4. Whether the component part can be and is maintained while affixed to the larger unit of property

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[61] *FedEx Corp. & Subs. v. United States*, 2003-2 USTC ¶50,697 (W.D. Tenn. 2003), August 27, 2003

[62] *Ingram Industries, Inc. & Subs. v. Commr.,* TC Memo. 2000-323,October 18, 2000; *Richard L. Smith v. Commr.,* 300 F.3d 1023 (9th Cir. 2002), August 12, 2002

> **Note.** The four factors can be applied to engines and transmissions for tractors and combines. In general, engines and transmissions are treated as part of the larger machine. The economic life of the engine or transmission is typically considered as coextensive with the economic life of the tractor or combine. A tractor cannot function without an engine or transmission. The engine or transmission can be and generally is maintained while affixed to the tractor or combine.

The court concluded that the four factors favored the entire aircraft as the separate unit of property, not the engines, and then examined whether the repairs (involving engine scheduled visits) were "incidental repairs" as specified by the repair regulations. The court found no support in case law for treating "incidental" as a separate capitalization requirement under the repair regulations. The court then considered whether the expenditure returned the property to its state prior to the situation prompting the expenditure, was an expenditure intended to correct a situation, or whether the expenditure was a more permanent increment in the longevity, utility or worth of the property. The court determined that the appropriate test to apply was the corrective test, and that the expenditure returned the property to its state prior to the situation prompting the expenditure. Thus, the expenditures were all allowable as repairs.

> **Observation.** The court's reasoning in *FedEx* and *Ingram Industries* is most helpful in determining whether a major repair on a combine or tractor engine or transmission should be considered a repair or whether the expenditure must be capitalized. The cases support the position that even major engine or transmission overhauls should be deductible as repairs.

ISSUE 8: ROLLING OVER LINES OF CREDIT, OID RULES

Difficult times in the agricultural sector inevitably lead to unpaid lines of credit at year-end with credit line balances often rolled over into the following year's line of credit. Following are several important questions:

- How is the rollover treated for income tax purposes?
- How is the interest income reported from the lender's perspective?
- How is the interest paid deducted from the borrower's perspective?

Original interest discount (OID) is interest. Normally, interest is earned on money loaned to a debtor. That interest is generated over the life of the loan. Each year the lender earns interest on the loan that must be included in income. Sometimes, however, a lender will loan money under an agreement with the debtor that the debtor pay a fixed amount a number of years later as full satisfaction for the loan, with the amount including a payback of principal and accrued interest. The accrued interest is called **original issue discount** because it arises **when the obligation is originally issued** by the debtor. It is discount because it is computed by **discounting the fixed amount payable at the end of the loan** back to its present value in the year of the loan. The difference between the total amount that must be repaid at the end of the term of the loan and the amount of the loan is OID.

Example 11. Farmers' Bank lends Sid $1,615 at a 20% interest rate in 2003 in exchange for Sid's promise to pay $10,000 in year 2013. How much OID does the transaction generate? How much interest must the bank report as interest income during each year of the loan? How much interest deduction can Sid claim each year during the life of the loan?

Answer. The OID is the difference between the total amount that must be repaid ($10,000), and the amount of the loan ($1,615), or $8,385. The bank must report as interest income and Sid can claim as a deduction the following amounts each year over the life of the loan:

Year	OID
1	$ 323.00
2	387.60
3	465.47
4	558.14
5	669.78
6	803.72
7	964.48
8	1,157.36
9	1,388.85
10	1,666.60

Observation. For interest earned from a bank in the typical savings deposit, the interest is taxed annually. The question is whether a loan creating OID should be taxed any differently. Obviously, the answer should be "No" if the tax law is to remain neutral between different kinds of investments. The tax law forces the lender to accrue OID annually, whether or not the lender is a cash method taxpayer.[63]

GENERAL RULE

The general rule, for loans coming within the exception (for loans with fixed interest payable in one year or less) to the OID rules, is that an interest deduction will be denied in a rollover of a remaining line of credit into the following year. The same outcome can be expected if the taxpayer borrows funds from the same lender for the purpose of satisfying the interest obligation to that lender. Therefore, a taxpayer should avoid borrowing funds for interest payments from the same lender that furnished the original loan even if unrestricted control is maintained over the loan proceeds.

Observation. In an era of financial and economic trauma, it is often unrealistic for a financially troubled borrower to be able to establish a line of credit elsewhere.

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[63] IRC §§1272(a)(1) and 1273(a)

LOAN ROLLOVERS: OID COMPLICATION

A rollover of an old loan into the following year's line of credit may cause the OID rules to apply if the old loan does not become payable until more than one year after the original loan was obtained. The result is that the interest amount is spread over the term of the loan with a portion deductible in the year the loan is rolled.

Example 12. Myra borrowed $100,000 from a bank on May 1, 2003, at 10% simple interest with interest and principal due six months later on November 1, 2003. Because of low prices, Myra and the bank agreed on November 1 to defer payments on the loan until November 1, 2004, with the interest continuing to accrue at a 10% rate. Because no payment is due until after May 1, 2004, under the renegotiated terms of the loan, the OID rules apply. Under the new terms, the issue price is $100,000 and the stated redemption price at maturity is the $100,000 as of November 1, 2003, plus the half-year of interest to that date ($5,000) plus the interest expected to November 1, 2004, for a total of $115,500. Since the $115,500 due November 1, 2004 exceeds the $100,000 issue price, there is OID of $15,500. That means Myra can deduct in 2003 (including interest on the $5,000 of interest not paid) the $5,000 of interest as OID through November 1, 2003, plus two months of OID for November and December of 2003 (one-sixth of $10,500) or $1,750 for a total deduction of $6,750 for 2003. The remaining $8,750 of OID is deductible in 2004.

Thus, the total of interest for the two years ($15,500) is deductible to the extent of $6,750 in 2003 and $8,750 in 2004. Whether that is an advantage (compared to obtaining the full deduction in 2003 when actually paid) depends upon the value to Myra of the $6,750 deduction in 2003. If the deduction results in a larger net operating loss (and possibly a tax refund) or a smaller 2003 tax bill, the outcome could be advantageous.

Original loan	$100,000
Interest 5-1-03 to 11-1-03	5,000
Total due 11-1-03	$105,000
Interest 11-1-03 to 11-1-04	10,500
Total due 11-1-03	$115,500
Original loan	(100,000)
OID	$ 15,500
2003 deduction	
OID through 11-1-03	5,000
OID Nov and Dec 2003	1,750
Total 2003 deduction	$ 6,750
2004 Deduction	$ 8,750

Note. The example simplifies the OID statute. Interest compounding occurs semi-annually.[64]

HOW ARE PAYMENTS APPLIED?

An important issue is how payments are allocated, for federal income tax purposes, between principal and interest. The OID rules require that payments first be allocated to OID, to the extent of the OID that has accrued as of the date the payment is due, and then to payment of principal. Thus, paying down on principal and leaving the interest amount to be rolled over does not avoid the OID characterization.

Note. Negotiations with a lender over a line of credit rarely leave room for a discussion of the finer points of income tax treatment of the interest. However, it may be in the best interest of the borrower to carefully plan the rollover of unpaid balances with an eye to interest deductibility. Often loan agreements or policies require interest to be paid currently prior to any rollover of principal, renewal, or refinancing. Banking regulators prefer not to roll over interest.

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[64] IRC §1272)(a)(5)

ISSUE 9: PARTITIONING PROPERTY

PARTITION AND SALE OF LAND

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

Coverage in *2002 University of Illinois Farm Income Tax School Workbook*

Chapter 4, pages 233 – 236, addresses several tax issues associated with partition and sale of land. Here is a summary of the issues addressed by that discussion:

1. A partition of property involving related parties comes within the exception to the "related party" rule under the like-kind exchange provision. This occurs in situations where the IRS is satisfied that avoidance of federal income tax is not a principal purpose of the transaction. Therefore, transactions involving an exchange of undivided interests in different properties that result in each taxpayer holding either the entire interest in a single property or a larger undivided interest in any of the properties come within the exception to the related party rule. This is true where avoidance of federal income tax is not a principal purpose of the transaction.
2. As for the income tax consequences on the sale of property in a partition proceeding to one of two co-owners, such a sale does not trigger gain for the purchasing co-owner as to that co-owner's interest in the property.

New Issue: Is a Partition an Exchange?

Related to the issues addressed in the 2002 book is the question of whether a partition is an exchange and whether property can be partitioned without recognition of gain or loss. This is important because if the transaction is not an exchange, the transaction does not need to be reported to the IRS, and the related party rules are not involved. Items of significance include debt, realizable or recognized gain, contiguous tracts, and whether properties differ in kind or extent.

Governing Regulation

The regulations provide that gain or loss is realized (and recognized) from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or extent, is treated as income or loss sustained.[65]

IRS Position

The IRS ruled that the conversion of a joint tenancy in capital stock of a corporation into tenancy in common ownership (to eliminate the survivorship feature) was a non-taxable transaction for federal income tax purposes.[66]

Note. It can be argued this ruling addressed a transaction distinguishable from a partition of property insomuch as the taxpayers in the ruling owned an undivided interest in the stock before conversion to tenancy in common and owned the same undivided interest after conversion.

Observation. In a partition, the transaction, by parties of jointly owned property, is not a sale or exchange or other disposition. Severance of joint ownership is all that results.

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[65] Treas. Reg. §1.1001-1(a)

[66] Rev. Rul. 56-437, 1956-2 C.B. 301

Example 13. Brothers John, James, and Jesse each hold an undivided interest as tenants-in-common in three separate tracts of land. If they agree to partition the ownership interests, what is the tax consequence?

Answer. Any gain or loss realized on the partition is not recognized and is, therefore, not includible in gross income.[67] However, in a 2002 Letter Ruling, the IRS stated that the 1973 Revenue Ruling on this set of facts held that gain or loss is "realized" on a partition. It did not address explicitly the question of whether the gain or loss was "recognized" although the conclusion was that the gain was not reportable as income.[68]

Observation. A partition with undivided interests that are transformed into the same degree of ownership in a different parcel appears to be distinguishable from an ordinary partition of jointly owned property. However, in one IRS ruling, the taxpayers proposed to divide real property into two parcels by partition, and the IRS ruled that gain or loss would not be recognized.[69] Likewise, in another ruling,[70] a partition of contiguous properties was not considered to be a sale or exchange. The tracts were treated as one parcel.

Example 14. Edith and Ethel, unrelated widows, each own an undivided one-half interest in two separate tracts of farmland. They transfer their interests. Each now becomes the sole owner of a separate parcel. Ethel's tract is subject to a mortgage. Ethel received a promissory note from Edith of one-half the amount of the outstanding mortgage. What is the tax consequence of the transaction?

Answer. Ethel must recognize gain to the extent of the FMV of the note she received in the transaction because the note is considered unlike property. [71]

Based on the rulings, while they are not entirely consistent, gain or loss on a partition is not recognized (although it may be realized) unless a debt security is received or property is received that **differs materially in kind or extent** from the partitioned property. The key issue in partition actions then is a factual one. Does the property received in the partition differ "materially in kind or extent" from the partitioned property? Also, it may be important whether the partition involves a single contiguous tract of land or multiple contiguous tracts of land.

However, in two other rulings the taxpayer owned a one-third interest in a single parcel of property with two siblings as tenants-in-common.[72] The parties agreed to partition the property into three separate, equal-valued parcels with each person owning one parcel in fee. The property was not subject to any indebtedness. The IRS ruled that the partition of common interests in a single property into fee interests in separate portions of the property did not cause realization of taxable gain or deductible loss.[73]

Note. If the partition is not an exchange, it is not subject to the related party rules and need not be reported to the IRS. However, further clarification of the matter from the IRS would be helpful.

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[67] Rev. Rul. 73-476, 1973-2 C.B. 301

[68] Letter Ruling 200303023, October 1, 2002

[69] Letter Ruling 9327069, February 12, 1993

[70] Letter Ruling 9633028, May 20, 1996

[71] Rev. Rul. 79-44, 1979-2 C.B. 265

[72] Letter Ruling 200411022, Dec. 10, 2003 and 200411023, December 10, 2003

[73] Rev. Rul. 56-437, 1956-2 C.B. 507

ISSUE 10: TURNOVER OF FARM ASSETS TO CREDITORS

DISTINCTION WITH REPOSSESSIONS

If land is sold on an installment basis and is later repossessed, the statutory provisions of IRC §1038 governing the calculation and reporting of gain on repossession of real property must be followed. These provisions govern the calculation of gain on repossession of real property, as well as the character of the gain. However, the provisions of IRC §1038 do not apply if the disposition constitutes an exchange of the property, or if the indebtedness was not secured by real property. Reconveyance of property by the obligor under a private annuity to the annuitant is not subject to the rules of IRC §1038.

Note. The IRS ruled that reacquisition of oil and gas leases is eligible for repossession treatment under IRC §1038.[74]

Note. For acquisitions of real property by a taxpayer after October 19, 1980, the estate or beneficiary of a deceased seller is entitled to the same nonrecognition treatment upon the acquisition of real property in partial or full satisfaction of secured purchase money debt as the deceased seller would have been.

Repossessions of personal property are governed by the general rules for repossessions, not those for real property. Therefore, if a seller repossesses personal property originally sold under the installment method, the seller realizes gain or loss in the year of repossession as though the note or other obligation had been sold.

A crucial point, however, is that the tax consequence of turnover of property to a seller is the same for both real property and personal property.

Gain Relief Provisions Unavailable

Not only is the tax consequence of turnover of property to a seller the same for both real and personal property, there is no relief to the buyer from gain triggered in conjunction with a turnover of personal property to a seller. For recourse debt, the return of property to the lender is essentially treated as a sale of the asset by the debtor to the lender.

Observation. Relief from discharge of indebtedness income is available for taxpayers in bankruptcy, insolvent taxpayers, situations involving qualified farm indebtedness, situations involving qualified real property indebtedness, and purchase price indebtedness and purchase price adjustments. For a discussion of these provisions see Chapter 11 of the *2002 Illinois Farm Income Tax Workbook.*

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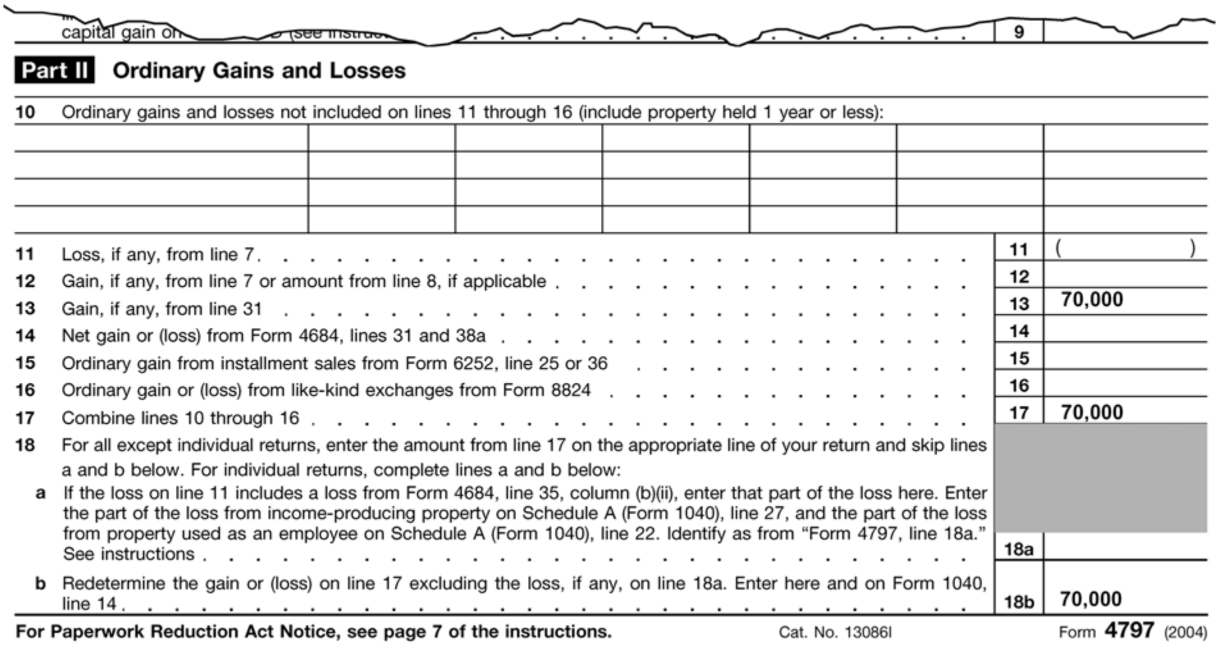
[74] Letter Ruling 9833005, May 12, 1998

Example 15. Clay experienced financial trouble in 2004. As part of his plan to work himself out of his situation, he agreed to a voluntary repossession of his combine by Usury State Bank, in return for the bank's promise to cancel the debt on the combine. Clay had fully depreciated the combine (aided, in part, by the increased §179 expense amount in recent years and bonus first-year depreciation). The bank sold the combine at public auction for $70,000 (the combine's FMV). At the time of the turnover of the combine to the bank, Clay owed the bank $100,000 on the combine. What is the tax consequence to Clay of the turnover of the combine to the bank?

Answer. Clay must recognize gain of $70,000 (FMV less basis) on the combine. The difference between the $70,000 FMV and the $100,000 indebtedness ($30,000) is discharge of indebtedness at the time the indebtedness is cancelled since the obligation is a recourse loan. If the obligation was nonrecourse the entire difference between income tax basis and the debt would be gain or loss and there would be no discharge of indebtedness income.

Clay's Form 4797, *Sale of Business Property,* Parts II and III follow:



capital gain o (see instru 9

Part II **Ordinary Gains and Losses**

10 Ordinary gains and losses not included on lines 11 through 16 (include property held 1 year or less):

11 Loss, if any, from line 7	11	( )
12 Gain, if any, from line 7 or amount from line 8, if applicable	12	
13 Gain, if any, from line 31	13	70,000
14 Net gain or (loss) from Form 4684, lines 31 and 38a	14	
15 Ordinary gain from installment sales from Form 6252, line 25 or 36	15	
16 Ordinary gain or (loss) from like-kind exchanges from Form 8824	16	
17 Combine lines 10 through 16	17	70,000
18 For all except individual returns, enter the amount from line 17 on the appropriate line of your return and skip lines a and b below. For individual returns, complete lines a and b below:		
a If the loss on line 11 includes a loss from Form 4684, line 35, column (b)(ii), enter that part of the loss here. Enter the part of the loss from income-producing property on Schedule A (Form 1040), line 27, and the part of the loss from property used as an employee on Schedule A (Form 1040), line 22. Identify as from "Form 4797, line 18a." See instructions	18a	
b Redetermine the gain or (loss) on line 17 excluding the loss, if any, on line 18a. Enter here and on Form 1040, line 14	18b	70,000

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Note. If the debt obligation remains effective, there is no discharge of indebtedness income until collection on the debt is barred by the applicable statute of limitations or one creditor forgives the debt. In the event indebtedness is discharged or cancelled, there is relief for the discharge of indebtedness involved. In any event, however, the relief from discharge of indebtedness income does not apply to the FMV less basis gain realized on turnover of property to the creditor.

Clay reports $70,000 gain from the repossession of the combine on Form 4797 and $30,000 discharge of indebtedness income on line 21 of Form 1040.

For Example 15

Form 4797 (2004) Page **2**

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

		(b) Date acquired (mo., day, yr.)	**(c)** Date sold (mo., day, yr.)
19	**(a)** Description of section 1245, 1250, 1252, 1254, or 1255 property:		
A	COMBINE	7-30-2002	5-1-2004
B			
C			
D			

	These columns relate to the properties on lines 19A through 19D. ▶		**Property A**	**Property B**	**Property C**	**Property D**
20	Gross sales price (**Note:** *See line 1 before completing.*)	20	70,000			
21	Cost or other basis plus expense of sale	21	100,000			
22	Depreciation (or depletion) allowed or allowable	22	100,000			
23	Adjusted basis. Subtract line 22 from line 21	23	0			
24	Total gain. Subtract line 23 from line 20	24	70,000			
25	**If section 1245 property:**					
a	Depreciation allowed or allowable from line 22	25a	100,000			
b	Enter the **smaller** of line 24 or 25a	25b	70,000			
26	**If section 1250 property:** If straight line depreciation was used, enter -0- on line 26g, except for a corporation subject to section 291.					
a	Additional depreciation after 1975 (see instructions)	26a				
b	Applicable percentage multiplied by the **smaller** of line 24 or line 26a (see instructions)	26b				
c	Subtract line 26a from line 24. If residential rental property **or** line 24 is not more than line 26a, skip lines 26d and 26e	26c				
d	Additional depreciation after 1969 and before 1976	26d				
e	Enter the **smaller** of line 26c or 26d	26e				
f	Section 291 amount (corporations only)	26f				
g	Add lines 26b, 26e, and 26f	26g				
27	**If section 1252 property:** Skip this section if you did not dispose of farmland or if this form is being completed for a partnership (other than an electing large partnership).					
a	Soil, water, and land clearing expenses	27a				
b	Line 27a multiplied by applicable percentage (see instructions)	27b				
c	Enter the **smaller** of line 24 or 27b	27c				
28	**If section 1254 property:**					
a	Intangible drilling and development costs, expenditures for development of mines and other natural deposits, and mining exploration costs (see instructions)	28a				
b	Enter the **smaller** of line 24 or 28a	28b				
29	**If section 1255 property:**					
a	Applicable percentage of payments excluded from income under section 126 (see instructions)	29a				
b	Enter the **smaller** of line 24 or 29a (see instructions)	29b				

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

30	Total gains for all properties. Add property columns A through D, line 24	30	70,000
31	Add property columns A through D, lines 25b, 26g, 27c, 28b, and 29b. Enter here and on line 13	31	70,000
32	Subtract line 31 from line 30. Enter the portion from casualty or theft on Form 4684, line 33. Enter the portion from other than casualty or theft on Form 4797, line 6	32	0

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

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

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Form **4797** (2004)

TAX TREATMENT OF DISCHARGE OF INDEBTEDNESS INCOME

The general rule is that discharge of indebtedness income is taxed as ordinary income under IRC §61(a)(12). In addition, the discharge of indebtedness amount is subject to self-employment tax if it is related to the operation of a trade or business or a trade or business investment in which the taxpayer materially participates. The IRS took this position in a situation involving the cancellation of part of an FmHA emergency loan.[75]

Since the debt was incurred to purchase a capital asset, some practitioners might argue that the discharge of indebtedness income should be reported on Form 4797 Part II and not subject to self employment tax.

SITUATIONS INVOLVING INVOLUNTARY REPOSSESSIONS

In an involuntary repossession where the remaining debt is not cancelled, the secured party may obtain a deficiency judgment for the balance. The issue of discharge of indebtedness is delayed until the deficiency judgment issue is resolved. If a deficiency judgment is satisfied out of the debtor's other property, the debtor has effectively conveyed additional amounts to the lender. In the event the deficiency judgment remains unsatisfied, the indebtedness involved remains uncancelled and undischarged until the deficiency judgment becomes uncollectible.

For nonrecourse debt, where the value of the property is less than the unpaid balance of the debt, the amount realized on the asset portion of the transaction must be calculated by reference to the unpaid balance of the debt, rather than by reference to the FMV of the property. FMV is ignored, and there is no discharge of indebtedness income.

> **Note.** The IRS takes the position that a debtor in bankruptcy may encounter nonrecourse debt treatment (even though the obligation was originally recourse) where property subject to the debt is abandoned to the debtor with the secured creditor able to acquire the abandoned property to satisfy the debt. The result is that the entire difference between the income tax basis of the property and the debt involved is taxed as gain.[76]

ISSUE 11: HOG LEDGER CONTRACTS

More than 50% of hog production in the United States is sold under a long-term marketing agreement (typically three to 10 years) between the producer and the packer. Certain types of these contracts (known as hog ledger contracts) establish a minimum price that the producer receives for the hogs. If the market price rises above the floor, the producer receives the floor price and the extra amount is credited to a "ledger" account with the packer. If the market price is beneath the floor, the producer receives the floor price and the difference is subtracted from the ledger balance. Several important tax issues arise from the use of these contracts.

REPORTING CONTRACT PAYMENTS

Amounts actually paid to a producer are reported as income upon receipt.[77]

> **Example 16.** Paul entered into a hog ledger contract with a packer that sets the contract price at $.40 per pound. In 2003, Paul delivered 100 hogs weighing a total of 25,000 pounds at a time when the market price for hogs was $.45 per pound. Paul is paid $10,000 ($.40/pound × 25,000 pounds) for the hogs, and his ledger account with the packer is credited in the amount of $1,250 [($.45/lb. × 25,000 lbs.) – ($.40/lb × 25,000 lbs)].

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[75] Rev. Rul. 76-500, 1976-2 C.B. 254

[76] Letter Ruling 8918016, January 31, 1989

[77] IRC §61(a)

Note. Payments in excess of the market price are not treated as loans (amount not reportable in income) unless it can be established that the amounts are bona fide loans. This is particularly difficult to establish when the contract does not characterize the amounts as loans (the usual case). In recent decades, court cases concerning the taxation of advances on commodity sales sold with deferred payment provide useful guidance on when a payment is a bona fide loan.[78]

If the market price for hogs at the time of delivery under the contract is less than the contract price, the producer is still paid the contract price, but the difference between the contract price and the market price is subtracted from the producer's ledger account.

Example 17. Use the same facts as **Example 16** except, in 2004 Paul delivers 100 hogs weighing a total of 25,000 pounds at a time when the market price for hogs was $.35 per pound. Paul is still paid $10,000 ($.40/lb contract price × 25,000 lbs.), and $1,250 is subtracted from Paul's ledger account with the packer ([$.40 × 25,000] – [$.35 × 25,000]).

From the examples above, Paul reports $10,000 of income from sale of hogs on his 2003 Schedule F (Form 1040). Paul reports another $10,000 of income from the sale of hogs on his 2004 return.

Observation. Paul reports the current payments for the sale of his hogs as income irrespective of the method of accounting that he utilizes.

REPORTING LEDGER BALANCES

Over time, fluctuations in the hog market can be expected to roughly balance out such that there will not be large positive or negative account balances in a producer's hog ledger contract. However, the extended downturn in live hog prices in 1998 and 1999 produced large, sustained negative ledger account balances. Hog ledger contracts typically require the packer to pay any resulting positive balances to the producer at the end of the contract term. Likewise, a producer is responsible for paying the packer the amount of any negative balances existing at the end of the contract term.

Because producers that deliver hogs under a hog ledger contract do not have the right to collect a positive balance in the ledger account, or have a duty to pay a negative balance in the account until the end of the contract, the producer is neither required nor allowed to report the ledger account balances until the contract expires.

TREATMENT OF POSITIVE LEDGER ACCOUNT BALANCES

Any positive account balances existing at the end of the contract that are paid to a producer must be reported by the producer as ordinary income on Schedule F. The payment is treated as ordinary income and is subject to self-employment tax if the producer is engaged in the trade or business of producing hogs. The payment is properly reported as gain from a marketing arrangement (Schedule F, line 10) rather than gain from a sale of produce (Schedule F, line 4) in the current tax year.

TREATMENT OF NEGATIVE ACCOUNT BALANCES

Negative ledger account balances that are repaid at the end of the contract term are reported as a negative amount on Schedule F, line 10 for the year of repayment. The payment will reduce ordinary income for income tax purposes and will reduce self-employment income.

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[78] *F. Devere Fleming v. Commr.,* TC Memo 1966-251; *Herbert and Ruth Rutland v. Commr.,* TC Memo 1977-8; Rev. Rul. 69-358, 1969-1 C.B. 139; Rev. Rul. 69-359, 1969-1 C.B. 140

FINANCIAL DISTRESS AT CONTRACT TERMINATION?

If a producer is unable to pay a negative account balance at the end of the contract term and the packer forgives the indebtedness, the producer does not recognize income. Because the producer would have been able to deduct any payment had it been made, IRC §108(e)(2) excludes discharged debt from income if payment of the debt would have allowed the producer to claim a deduction.

ISSUE 12: DEDUCTIONS RELATED TO PURCHASE OF FARMLAND

Numerous deduction items may be present upon purchase of farmland. When agricultural land is purchased, it is not uncommon for items associated with the land to be part of the transaction. These items may include fences, tile lines, farm buildings, residential rental property, soil conditioners and irrigation equipment. The following is intended as a brief checklist of the common deduction items associated with purchase of farmland, and the associated tax rules for claiming deductions.

RESIDUAL FERTILIZER SUPPLY

As discussed in Issue 6 of this Chapter, a "residual fertilizer supply" may occur on purchase of farmland where the prior owner had applied fertilizer to the point that an increased level of fertilizer in the soil results. As noted in Issue 6, a deduction for "residual fertilizer supply" by a purchaser of farmland may not be available.

TILE LINES

Under the Modified Accelerated Cost Recovery System (MACRS), the 15-year classification includes property with an ADR mid-point life of 20 years or more and less than 25 years. Land improvements fall into this class including tile lines and any other land improvements not specifically mentioned elsewhere, such as sidewalks. The cost of these items may be recovered using the 150% declining balance method switching to straight-line over a 15-year period.

LANDSCAPING AND LAND IMPROVEMENTS

The courts are divided on whether landscaping costs are depreciable. The general rule is that landscaping costs are depreciable if the landscaping would be destroyed if buildings were replaced. In one federal case,[79] the court refused to allow a depreciation deduction for trees and bushes that had been planted as a windbreak and to reduce moisture evaporation and soil erosion. The court, while it noted that trees held for the production of income were depreciable, ruled that the trees and bushes at issue in the case were part of the land and not depreciable. Arguably, the windbreak would be depreciable (as would landscaping costs in general) 15-year property as a land improvement. Also, the court noted that the trees were not depreciable because the expense of planting the trees would have been deductible as a soil and water conservation expense in the year incurred.

Observation. The court's reasoning appears somewhat flawed. Not all expenses associated with assets that qualify as deductible as soil and water conservation expenses are precluded from being depreciated by a subsequent purchaser of the real estate on which qualifying property has been placed. In *Rudolph Investment Corp.,*[80] the taxpayer was allowed to depreciate earthen dams and earthen water storage tanks located on ranchland even though the structures qualified for a current deduction as a soil and water conservation expense under IRC §175.

An irrigation system is likely to be categorized as a depreciable land improvement. However, the IRS ruled that depreciation on an irrigation system for the period before the time an orchard or grove reaches the income-producing stage is not deductible and must be capitalized and recovered over the useful life of the trees.[81]

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[79] *Gary and Mary Everson v. United States,* 95-1 USTC ¶50,150 (D. Mont. 1995), February 21, 1995

[80] *Rudolph Investment Corp. v. Commr.,* TC Memo 1972-129, June 12, 1972

[81] Rev. Rul. 83-67, 1983-1 C.B. 74

FENCES

Under MACRS, fences are classified as 7-year property. Consequently, if the fences are used in the farming business, they are depreciable under the 150% declining balance method switching to straight-line. Non-farm fences are classified as 15-year property.

FARM BUILDINGS

Under MACRS, farm buildings have a 25-year midpoint life and are classified as 20-year MACRS property. They are depreciable under the 150% declining balance method over 20 years, switching to straight-line. Commodity storage structures that are "buildings" are also 20-year property. The term "building" is not defined in the statute. However, the term was defined for investment tax credit purposes as "any structure or edifice enclosing a space within its walls, and usually covered by a roof, the purpose of which is, for example, to provide shelter or housing, or to provide working, office, packing, display, or sales space." For investment tax credit purposes, various types of facilities were not considered to be "buildings." These included refrigerated storage areas for apples, potato storage facilities, peanut houses, refrigerated fruit storage shelters, citrus processors compartments, cooling and holding rooms for fruit and freezer storage facilities.

RESIDENTIAL RENTAL PROPERTY

Depreciable residential rental property is depreciable over 27½ years using the straight-line depreciation method. The term "residential rental property" is defined as "a building or structure…for any taxable year only if 80% or more of the gross rental income from such building or structure for such year is rental income from dwelling units." In addition, if any portion of a building or structure is occupied by the taxpayer, the gross rental income from the property includes the rental value of the portion occupied.[82] Therefore, unless business use is more than 20% of the structure, the business use portion should be 27½-year property. The term "dwelling units" is defined as "a house or an apartment used to provide living accommodations in a building or structure, but does not include a unit in a hotel, motel, inn or other establishment more than one-half of the units in which are used on a transient basis."

FARM HOUSE

For farm and ranch houses, a question exists as to whether they are 20-year property as a farm building or 27½-year property as residential real estate. A strong argument can be made that if the farmhouse is used as an integral part of a farming or ranching operation (i.e., the tenant lives there) and the tenant is running the farming operation, it should be classified as a farm building. On the other hand, if the residence has been carved out and occupied by someone working away from the farm or ranch, it is undoubtedly 27½-year property depreciated over 27½ years under the straight-line method. The question is further complicated by the fact that if the structure is not occupied by the owner, and no rental is charged, it is not a "dwelling unit." In this case, the structure seems to be either 20-year property (a farm building) or 39-year property (nonresidential real property). As of yet, the IRS has not issued guidance on the matter.

Caution. There is no specific classification for farm houses. Treating them as 20-year property could invite IRS scrutiny. However, the default classification of 7-year property for property that is not otherwise classified also seems unlikely.

SINGLE-PURPOSE AGRICULTURAL STRUCTURES

Single-purpose agricultural and horticultural structures and trees and vines that produce nuts and fruits are classified under MACRS as 10-year property. Trees and vines are limited to straight-line depreciation.

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[82] IRC §167(j)(2)(B)

ISSUE 13: SAVING SEED: DEDUCTIBILITY OF GMO LIQUIDATED DAMAGES

ISSUE

Can farmers who violate a Technology Agreement and pay liquidated damages, deduct these payments as an ordinary operating expense on their tax return?

Farmers who purchase genetically modified (GM) seeds are required to pay, directly or indirectly, a technology fee to the company which developed the GM seed. For example, the fee for soybeans might be $6.50 for every unit of beans purchased. Typically, at the time the seed is purchased, the farmer must agree to the certain conditions contained in a Technology Agreement, such as:

1. The seed will only be used to plant a commercial crop for a single season.
2. The seed will not be supplied to any other person or entity for planting, and he will not save any crop produced from the seed for replanting, or supply saved seed to anyone else for planting.
3. The seed will not be used for crop breeding, research or generation of herbicide registration data or seed production or furnished to any other person or entity for these purposes.

The Technology Agreement may also contain a clause specifying the amount of damages in the event of a breach of the above conditions by the farmer. Because the herbicide resistant gene is passed from the seed to the crop produced, farmers who save seed for planting the following year receive the benefit of the gene without paying a fee to the gene developer. Furthermore, the gene is passed to all subsequent generations of the seed.

This makes it very difficult to determine the amount of financial damages to the developers, a fact often noted in the Technology Agreement. The agreement typically states: The grower agrees the developer will suffer damages for breach of contract, the measure of which is difficult to determine, and as a result the developer has a right to liquidated damages to recover losses as just compensation and not as a penalty. The amount of damages might be equal to the gross revenue from the seed or grain produced from infringing use of the seed. The agreement usually describes how the liquidated damages will be calculated.

DEDUCTIBILITY

Fines and penalties are not deductible if paid to the state or federal government, the government of a foreign country or an entity serving as an agent for either of the above.[83] This is based on the concept that penalties and fines are meant to punish the violator. However, amounts paid for actual damages are deductible.[84]

This applies to liquidated damages if they are compensatory in nature and not punitive. The Technology Agreement typically states the damages are not meant to be a penalty and should be deductible as an ordinary and necessary business expense of the farmer.

> **Caution.** Even though a court award is called "liquidated damages," it does not necessarily make it deductible. Taxpayers must look at all of the facts and circumstances connected to the award.

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[83] Treas. Reg. §1.162-21(a)

[84] Treas. Reg. §1.162-21(b)(2)

PLANNING ISSUE

Because the damages specified in the Technology Agreement equal the gross receipts produced from the GM seed, the amount can be substantial depending on the amount of seed planted. For some farmers who pay the entire amount of the damages in one year, this can create a net operating loss (NOL). Consideration should be given regarding whether to make this payment over a number of years, or whether carrying the NOL back to prior years is more beneficial.

> **Example 18.** In 2003, Karim plants 300 acres of GM soybeans saved from his 2002 harvest. Following an investigation by the seed developer holding the patent, the seed developer demands payment of the liquidated damages described in the Technology Agreement. Based on the calculation in the Technology Agreement, Karim owes liquidated damages of more than $72,000. Karim has the option of paying this in 2004 or making payments over three years. It is important that Karim analyze the tax impact before making this decision.

Note. Karim should seek legal advice from his attorney regarding his payment obligations and settlement possibilities as well as considering the tax ramifications.

ISSUE 14: TAXABILITY OF STARLINK PAYMENT

ISSUE

Is the debit card a farmer receives for his share of the StarLink litigation taxable income?

Some farmers planted StarLink corn seed in 2000. StarLink was a GM seed designed to be herbicide and insect resistant. While the Food and Drug Administration approved the GM corn for livestock feed, it was not approved for human consumption. Unfortunately, some of the corn produced from the StarLink seed got into the human food supply and showed up in taco shells. The resulting publicity caused the selling price for all corn to decline.

A class-action lawsuit was filed to help nonStarLink producers recover some of their loss. On April 7, 2003, a district judge approved the $110 million settlement for the StarLink litigation. In the Fall of 2004, farmers who did not plant Starlink corn and who submitted an approved claim will receive their share of the settlement. This is estimated to be $3.00/acre of nonStarLink corn planted in 2000.

As an enhancement to the payment, it was agreed that the farmer will receive a Visa debit card. Their share of the settlement will be encoded on the card, which can then be used for purchases from any merchant who accepts Visa. The card can also be converted to cash by using it in an ATM machine. An agreement was reached with Tractor Supply Company to give the farmer a 10% discount for any purchases made using the debit card.

QUESTIONS

The StarLink payment creates a number of questions:

Question 1. Is the settlement a taxable payment, and if so, how is it reported?

Answer 1. **Yes**. The purpose of the award is to reimburse farmers for loss of revenue. It will be reported on the same form where farmers report their normal grain sales.

Question 2. If the farmer does not use the debit card until Janaury 2005, can he defer the income recognition until 2005?

Answer 2. **No**. Since the money is available to the farmer in 2004, under the doctrine of constructive receipt, it is taxable in 2004.

Question 3. If the farmer uses the debit card to make farm purchases, must she report the income?

Answer 3. Yes. The farmer must report the income, but she is also entitled to take a deduction for the purchases provided they qualify as ordinary and necessary expenses under IRC §162.

Question 4. The farm tenant receives payment for all corn acres in 2000. His lease with the landlord calls for the landlord to receive 50% of the corn crop. Must the StarLink award be shared with the landlord?

Answer 4. Since only farm operators could apply for payment, the tenant should pay the landlord for his share. This is required by the court approved settlement agreement.

Question 5. How does the tenant report this payment?

Answer 5. The tenant reports 100% of the award on his tax return. He then takes a deduction on the same form for the portion paid to the landlord. The landlord should report the portion received in the same way income from the sale of landlord's crops is reported.

Question 6. Must the increased value of the debit card, due to the 10% Tractor Supply discount be reported as income?

Answer 6. No. However, the farmer will only be able to deduct the actual price of his purchases after receiving the discount.

ISSUE 15: AGRICULTURAL TAX QUESTIONS AND ANSWERS

Question 1. Tom, a farmer, wants to trade land with another person and have the trade qualify as a tax-free exchange. He identified the land he wants to trade, but the owner is presently purchasing it under a multiyear contract for deed. If Tom trades for this property, will the transaction qualify under the like-kind exchange rules? What will be the tax effects of this trade?

Answer 1. The mere fact that identified replacement property is subject to a contract for deed does not disqualify the property for like-kind exchange treatment. However, if an exchange relieves the taxpayer of indebtedness, there is a taxable amount to the extent of the liability. So, if the taxpayer assumes the liability or takes the property subject to the contract for deed, the amount involved is treated as money received by the transferring party and could create taxable gain.

Question 2. Mia owns land near a location where an ethanol plant is going to be built. She owns water rights on the land and the ethanol plant would like to buy her water rights. Mia is concerned about the tax she would incur with an outright sale of the land and is wondering if she could set up a tax-free exchange of her water rights for an interest in other land. Is this a possibility?

Answer 2. The IRS ruled in 1955 that an exchange of water rights for a fee simple interest in land is like-kind if the water right is considered real property under state law. However, an Arizona federal court in 2002 held that the exchange is not like-kind if the water rights are limited in quantity, duration and priority.[85] In *Wiechens*, the water rights were limited to 50 years. In a 2003 letter ruling, the IRS ruled that the water rights at issue were sufficiently like-kind to a fee interest in land to qualify as like-kind property where the water rights were not limited in time, but were only limited as to annual use.[86]

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[85] *Donald, Gary, and Deborah Wiechens v. United States,* 2002-2 USTC ¶50, 708, 228 F. Supp. 2d 1080 (D. Ariz. 2002), September 11, 2002

[86] Letter Ruling 200404044, Oct. 23, 2003

Question 3. What is the tax treatment of Farm Services Administration (FSA) Grassland Reserve Program Payments? Can a recipient of payments reduce their basis in the land to offset the payments?

Answer 3. Payments received will first be used to reduce the basis of the affected land. Payments in excess of basis should result in capital gain treatment. The IRS says the payments are subject to self-employment tax, irrespective of whether the recipient is an active farmer or not. But the IRS may be reconsidering that position. Cost-share payments to restore the function and value of the grasslands are includible in income unless the payment is a reimbursement under IRC §126. Expenses could be deductible as a trade or business expense or deductible as soil and water conservation expense under IRC §175.

Question 4. Can a taxpayer claim an off-highway fuel credit for the fuel used in the combines of his custom harvesting business?

Answer 4. A credit is allowed against federal income tax equal to the sum of the amounts payable to the taxpayer for gasoline used on a farm for farming purposes.[87] The "ultimate purchaser" of the gasoline is entitled to a credit determined by multiplying the number of gallons used by the rate of tax applied to the gasoline on the date of purchase.[88] Except as provided in IRC §6420(c)(4), gasoline is considered to have been used for farming purposes only if used by the owner, tenant, or operator of a farm for various farming purposes. The owner, tenant or operator of a farm is generally treated as the user and ultimate purchaser of gasoline used for the farming purposes. However, "an aerial or other applicator of fertilizers or other substances" who is the ultimate purchaser of the gasoline is treated as having used the gasoline on a farm for farming purposes if the owner, tenant or operator of the farm "waives his right to be treated as the user and ultimate purchaser of the gasoline." [89]

Therefore, a taxpayer may claim the credit, but only if he complies with the waiver requirement and obtains formal waivers of the fuel tax credits from your customers.[90] Filing Form 4136, *Credit for Federal Tax Paid on Fuels,* without the waivers, is not sufficient to claim the credit.

Question 5. Greg's farmland is subject to an oil and gas lease, and the company that is doing the drilling would like to spread oil and gas by-products on his land. The by-products contain minerals that would be beneficial for his land. An agronomist and crop scientist confirmed this. What is the tax impact of the payments the company would make to him to dispose of their by-product on his land? Will the payments be subject to income tax?

Answer 5. Unless Greg can make the case that the application of by-products enhances the overall long-term value of his land, the payments must be reported as income with an offsetting deduction of the same amount. Greg must report the payments on Schedule F and elect to not capitalize fertilizer costs to create offsetting amounts. That is the case whether or not the drilling company issues a Form 1099.

Question 6. Can a buyer of farmland allocate a portion of the land's purchase price to a windbreak and claim depreciation on the windbreak. Are windbreaks depreciable?

Answer 6. While an argument can be made that the trees are depreciable 15-year property as land improvements, the IRS will likely argue that the trees are not depreciable because they are part of the nondepreciable land. The IRS won a case on this issue in the federal district court for Montana in 1995. That case involved a 3,700-acre ranch for a total purchase price of $1.2 million. The ranch contained about 250,000 bushes and trees that were planted years before as a windbreak. The buyer allocated $250,000 to the trees and bushes and claimed depreciation on them. The IRS challenged the depreciation deduction and prevailed in court. The court noted that there is a specific depreciation category for trees and vines that produce nuts and fruits, but that the trees involved in this case did not directly produce income. As such, the court reasoned that the trees were part of the land and were not depreciable. To be depreciable, property must have a determinable useful life.

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[87] IRC §34(a)(1)

[88] IRC §6420(a)

[89] IRC §6420(c)(4)

[90] *Crop Care Applicators, Inc. v. Commr.,* TC Summary Opinion 2001-21, March 6, 2001

Note. An argument can be made that if the windbreak is used in the taxpayer's trade or business (e.g., for production of livestock, or for shrubbery or landscaping) it should be deductible as 15-year MACRS property.

Question 7. Kim received an advance countercyclical payment in February this year. Since prices have increased, she may have to refund part or all of her countercyclical payment later this year. The information she received from FSA explained that she had two options for refunding the unearned payments. She can have her expected direct and countercyclical payments reduced by the amount to be repaid, or she can issue a check to Commodity Credit Corporation for the unearned amount. Is there any difference in the tax treatment of the two options?

Answer 7. If the direct and countercyclical payments were already reported as income, as would have happened if Kim received the payments in an earlier year, and she refunded the amount in a later year, the refund is treated as a deduction. If the payments were not yet reported as income, a refund merely subtracts from the taxable amount of the payment. This repayment may not be required until late 2004 or early 2005, depending upon the payment schedule selected by the taxpayer for Advance 2005 Direct Payments.

Question 8. Brett is an investor in an LLC that operates a hog sow unit. He does not participate in any of the management of the LLC. Brett is a farmer and his farming activity primarily involves finishing hogs at his home farm location. The LLC incurred substantial losses in recent years. Is there a way that Brett can combine his finishing activity at his home farm with the activity conducted by the LLC so that his share of the LLC loss is fully deductible?

Answer 8. Under the passive activity loss rules, an activity is considered passive (and subject to the passive loss rules of IRC §469) if the activity involves a trade or business and the taxpayer does not materially participate in the activity or a rental activity "on a basis which is regular, continuous and substantial." In general, losses from passive trade or business activities, to the extent the deductions exceed income from all passive activities may not be deducted against gross income. There are seven tests for material participation.[91]

For tax years ending after May 10, 1992, the definition of "activity" depends upon a single facts and circumstances test allowing taxpayers to use any reasonable method of trade or business activities as a single activity if they represent "an appropriate economic unit." Factors that are given the greatest weight in determining whether activities should be grouped or kept separate include the similarities or differences in the types of businesses, the extent of common control, the extent of common ownership, geographical location and business interdependencies.

The election to group activities is made by filing a statement with the taxpayer's original income tax return for the taxable year. However, passive activities can only be grouped with other passive activities. Passive activities are not permitted to be grouped with "active" activities. Therefore, Brett cannot combine his LLC losses with his farming profits.

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[91] Temp. Treas. Regs. §§1.469-5T(a)(1)-(7)