Chapter 11: Agricultural Issues and Rural Investments

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Corrections were made to this workbook through January of 2006. No subsequent modifications were made.

ISSUE 1: CONSTRUCTIVE RECEIPT

INTRODUCTION

Income that a cash-basis taxpayer has the power to control is considered income regardless of whether it is actually received. Such income is treated as accrued by an accrual-basis taxpayer.

The doctrine of constructive receipt is a basic element of federal income tax law and is frequently litigated in agriculture. From a tax accounting standpoint, income indirectly arises from the passage of value to a taxpayer representing additional wages, fees, dividends, rents, or gain on sale of an asset. This "value" is usually in some form other than cash or without a cash deposit, such as a corn sale applied to an operating note. It is easy to miss these items in a system that deals with dollars. This is particularly the case for cash-basis taxpayers who think primarily in terms of dollars received in hand.

TREASURY REGULATIONS

Treas. Reg. §1.451-2 specifies that:

Income is constructively received when it is credited to the taxpayer's account, set apart for the taxpayer, made available so the taxpayer would have drawn on it or could have drawn upon the amount if notice of intent to withdraw had been given. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions.

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Thus, when funds are credited or available to a cash-basis taxpayer without restriction, the taxpayer is deemed to have received them for income tax purposes. The test is whether the taxpayer could have had the money without substantial restrictions. The fact that some effort is necessary, such as presenting a deposit book, or detaching and mailing the coupon is not a substantial restriction.

Note. Because such items are "due" to an accrual-basis taxpayer, an accrual-basis taxpayer reports them as income.

MAJOR AREAS OF CONCERN

There are five major areas of concern:

1. Uncashed checks
2. Deferred payment contracts
3. Agricultural program payments
4. Agent sales
5. Tenants occupying a rental house rent free

1. Uncashed Checks

An uncashed check is income when received. This is an old rule. For example, in *Romine*,[1] a check for hogs sold, which a farmer could have picked up on December 30, was available income even though he did not get to town until January 2. Likewise, a retirement check was treated as received in December even though it was mailed and received in January, because it could have been picked up on the last working day.[2]

Note. A check issued and mailed on December 31, which could not possibly arrive and be in the seller's possession during that taxable year, would undoubtedly result in a tax deduction for the buyer in the year the check is mailed and income to the seller in the year of receipt. But this is not the case if the seller could have had the check earlier by merely asking for it.

The manner in which payment is made may also make a difference tax wise. For example, a check that arrived after 5:00 p.m. on December 31 was held in one case to be income on that day.[3] However, when a check was sent by certified mail, the Tax Court held that the amount was not included in income until delivered.[4]

The IRS has successfully argued that a check is income in the year received, and not two years later when the check is reissued because if it was subsequently lost.[5] But, if the payee agrees to hold a check until the payor's bank account can cover the amount of the check, the check is income when cashed.[6]

2. Deferred Payment Contracts

Many farmers make sales using deferred payment contracts. Typically, grain or livestock is sold in the fall and a contract is signed which requires the farmer to be paid early the next year. There are two basic ways to handle deferred payment contracts.

- **Installment Sale.** For individuals using the cash method, it is permissible to sell grain or livestock using the installment method. Any contract for the sale of goods, other than inventory, is an installment sale and taxable on the installment method if any part of the payment is received in a subsequent year. IRS Pub. 225, *Farmer's Tax Guide,* provides an example of a cash basis, calendar-year farmer who sells grain December 2004 under a bona fide contract that calls for payment in 2005. The sale proceeds are 2005 gross income since that is the year payment is received, unless the contract says the farmer has the right to the proceeds

1. *Romine v. Commr.,* 25 TC 859, January 26, 1957
2. Rev. Rul. 68-126, January 1, 1968. The rule is the same if an agent has the check. See *Estate of Kamm v. Commr.,* TC Memo 1963-344, December 31, 1963.
3. *Kahler v. Commr.,* 18 TC 31, April 4, 1952
4. *Davis v. Commr.,* TC Memo 1978-12, January 12, 1978
5. *Walter v. United States,* 148 F3d 1027 (8th Cir. 1998)(cash basis seller of livestock), July 8, 1998
6. *Johnston v. Commr.,* TC Memo 1964-323, December 17, 1964

any time after the grain is delivered. In this case, the sale is 2004 income. Crops and livestock are eligible for installment reporting if not required to be reported into inventory under the taxpayer's method of accounting (cash method).

- **Elect Out of Installment Reporting (or Fail to Qualify).** The consequences of not utilizing installment reporting for deferred payment or deferred pricing contracts are uncertain. The IRS issued a key revenue ruling in 1958.[7] The IRS ruled that a binding contract for sale of grain with payment to be made in the following year was effective to defer income until the year of actual receipt. A number of court cases also reached the same conclusion. However, there have always been problems with deferring the sale of livestock unless the transaction is within the Installment Sales Revision Act of 1980 (ISRA).

Note. There is a downside to the IRS ruling. The IRS has only grudgingly accepted this approach and they have been known to challenge deferred payment transactions. Indeed, in Letter Ruling 8001001 (September 4, 1979), the IRS issued a ruling that led to Congressional passage of the ISRA of 1980. The ruling involved a deferred-payment-sale arrangement entered into during mid-October with payment to occur in the following January. The IRS ruled that if on December 31 the contract is assignable or transferable, the full value of the contract must be reported as income in the year of sale.

Observation. Regardless of whether the transaction is crafted as an installment sale or structured deliberately to not come within the provisions of ISRA, the taxpayer is an unsecured creditor after delivery and before receiving payment. Deferred payment sales may not be fully covered by state bonding requirements or state indemnity funds to cover the claims of grain producers on failure of an elevator.

Price Later Contracts. Under a typical deferred payment contract, everything is pre-established. The price is settled, and the payment is deferred until a later date (often the next year). However, under a **price later contract,** the price has not yet been determined and the contract typically gives the seller a period of time in which to establish a price. The key case involving price later contracts is *Applegate*,[8] in which the U.S. Court of Appeals for the 7th Circuit upheld a Tax Court decision that ISRA eliminated the constructive receipt doctrine for installment obligations and allowed deferral for a price later contract.

Proper Construction of Contracts. Regardless of what approach is used, taxpayers must be careful in terms of not receiving or controlling the sale proceeds. The following are suggestions on crafting successful deferral contracts:

a. Use a written contract that is not assignable or transferable.

b. Ensure the contract provides that under no circumstances can the proceeds of sale be **obtained** before the payment date specified in the contract.

Note. While an immediate right to draw may be present, if the right is exercised, it must come with a price. In *Rutland*,[9] the taxpayer delivered fruit to a processor and had an immediate right to draw certain amounts from the processor. However, the taxpayer was required to pay interest at the rate of one-half of 1% above the prime interest rate if such amounts were drawn. Any amounts drawn were credited against the proceeds when they were actually received by the processor. The IRS argued that the right to draw amounted to constructive receipt of the funds. The Tax Court disagreed because the amounts were not available without restriction due to the obligation to pay interest on them.

7. Rev. Rul. 58-162, January 1, 1958

8. *Applegate v. Commr.*, 980 F2d 1125 (7th Cir. 1992), December 7, 1992

9. *Rutland v. Commr.,* TC Memo 1977-8, January 17, 1977

c. Be sure the contract bars the seller from **requesting** payment before the specified payment date.

> **Note.** Be careful of situations in which, under a purported deferral arrangement, the buyer pays an advance on the amount owed under the contract. Advances not properly characterized as bona fide loans are taxable on receipt. One indication of a bona fide interest-bearing loan is that it is made by someone regularly engaged in the business of lending money, with an expectation of repayment, and a willingness to use available remedies to collect on the loan. However, these factors are not likely to be satisfied in the context of a deferred payment contract.

d. Do not modify the written contract once entered into.

e. Do not let the buyer debit the seller's bill for the fertilizer account or the unpaid seed bill or anything similar.

f. Use a written contract and not a note. A note communicates that the transaction is complete and the seller is a creditor. That is precisely the situation that should be avoided to accomplish deferral.

Alternative Minimum Tax. The Taxpayer Relief Act of 1997 contained a provision, effective for dispositions in taxable years beginning after December 31, 1987, that eliminated an AMT complication for deferred sales of grain and livestock. Shortly after the legislation was enacted, the Tax Court held that payments made under a deferred payment contract were not included in AMT income.[10]

3. Agricultural Program Payments

Another area of possible constructive receipt of income for farmers and ranchers involves the receipt of government price-income support payments. Most government payments are included in income whether they are received as cash, materials, services, or commodity certificates. If payments are made available in a year before the time of regular payment, with the recipient having an option to accept payment currently or to defer payment to the following year, the amount made available is includable in income in the earlier of the year of actual payment or the year made available to the taxpayer.[11] Many of these payments are made electronically. Year-end transactions require review since the payment may be initiated one day, received at the recipient's bank a later day, and available for use still later. This can cause late December activity to span two months, but perhaps only one tax year. USDA commodity certificates are treated as producing taxable income when received in the same manner as cash payments.[12] Later disposition of commodity certificates may produce further gain or loss. FSA crop disaster payments received as a result of crop loss related to drought or other natural disaster are treated as crop insurance proceeds. These crop disaster payments (similar to crop insurance) are also eligible for reporting as income the year following the year of damage.

4. Agent Sales

The IRS has prevailed in numerous cases on the argument that sales to a purchaser considered an agent of the seller are ineligible for deferral of income tax liability. The major cases are:

- ***Arnwine.*** A cotton gin was determined to be acting on the seller's behalf insofar as the distribution of proceeds of crop sales was concerned.[13]
- ***Williams.*** An escrow arrangement was found to be unilateral in nature and not the product of a bona fide arm's length negotiation with the result that receipt of income by the agent was equivalent to receipt of income by the principal.[14]

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10. *Loomis v. Commr.,* TC Memo 1997-381, August 20, 1997
11. Rev. Rul. 68-44, January 1, 1968
12. Rev. Rul. 60-32, January 1, 1960
13. *Arnwine v. Commr,* 696 F2d 1102 (5th Cir. 1983), *rev'g,* 76 TC 532 (1981), January 31, 1983
14. *Williams v. Commr.,* 219 F2d 523 (5th Cir. 1955), February 11, 1955

- ***Warren.*** A cotton gin acted as the taxpayer's agent in collecting and holding proceeds of cotton sale.[15]
- ***P.R. Farms, Inc.*** A sale of fruit by the taxpayer's agent resulted in the proceeds being includable in the taxpayer's income in the year of sale even though the proceeds were not remitted to the taxpayer until a later year.[16]

In *Scherbart*,[17] the taxpayer was a member of a cooperative which was owned by corn producers for the purpose of marketing and processing their corn. Under a **uniform marketing agreement,** the taxpayer named the cooperative as the taxpayer's agent. Under the agreement, the taxpayer was obligated to deliver bushels of corn equal to the number of units of equity participation held in the cooperative. The cooperative made **value-added payments** to its members subsequent to each of the three required delivery periods for corn during the year. In addition, it made discretionary year-end value-added payments determined after the close of the cooperative's fiscal year ending September 30. The year-end payments were not mandatory and were based on the cooperative's **net proceeds.** The taxpayer attempted to defer the year-end value-added payment for 1995 to 1996, just like the taxpayer had done every year since becoming a member of the cooperative.

Based on Treas. Reg. §1.451-2(a) and the *Warren* case, the Tax Court held that the cooperative served as the taxpayer's agent for making the corn sales and receiving sales income with the only limitations placed on the taxpayer's receipt of income being self-imposed. As a result, the limitations were ineffective to achieve deferral for tax purposes with the taxpayer constructively receiving the year-end value-added payments during the taxable years at issue. Consequently, **income was not deferred.**

It may be possible to achieve deferral by establishing an irrevocable escrow account with the taxpayer having no right to the funds until the following year. In *Busby*,[18] the sale of a cotton crop on a deferred basis withstood an IRS challenge in which an irrevocable escrow account was established by a cotton gin with no right by the taxpayer to the funds until the following year. The deferred payment was the result of an arm's length agreement and was held by the court to shift the income to the next year.

> **Note.** Although there may be resistance to the time and expense involved with establishing an irrevocable escrow account, and the IRS may challenge such transactions outside the 5th Circuit, the irrevocable escrow account is a possible solution to the constructive receipt problem.

5. Tenants Occupying a Rental House Rent-Free

In the past, a question existed about whether the use of the tenant house could be income to a farm tenant. Occasionally, IRS agents still raise the issue. However, the IRS formally took the position[19] that a tenant farmer, entitled to occupy a dwelling situated on the property being farmed, does not receive income as a result of the occupancy of the dwelling.

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15. *Warren v. United States,* 613 F2d 591 (55th Cir. 1980), March 14, 1980
16. *P.R. Farms, Inc. v. Commr.,* 820 F2d 1084 (9th Cir. 1982), *aff'g*, TC Memo 1984-549, June 26, 1987
17. *Scherbart v. Commr.,* TC Memo 2004-143, June 17, 2004
18. *Busby v. United States,* 679 F2d 48 (5th Cir. 1982), June 24, 1982
19. Rev. Rul. 70-72, January 1, 1970

ISSUE 2: CONSERVATION EASEMENTS

WHAT ARE CONSERVATION EASEMENTS?

Conservation easements are voluntary perpetual restrictions on the use of land negotiated by a landowner and a private charitable conservation organization (commonly referred to as a "land trust") or government agency chosen by the landowner to "hold" the easement. "Holding a conservation easement" refers to having the right to enforce the restrictions imposed by the easement.

While the terms of conservation easements are entirely up to the landowner and the land trust to negotiate, the Code establishes requirements that must be met if the donation of an easement is to qualify for federal tax benefits. Also, many states grant tax benefits for easement donations that comply with the federal requirements.

Conservation easements do not generally provide third parties, or the public, with the right to access or use the land subject to the conservation easement. However, the grantor of the easement may provide for public use.

> **Observation.** Unless the purpose of the easement is the conservation of some feature that is meaningless without public access, such as the preservation of a scenic view, no public access is required to qualify for federal tax benefits. This is likely to be an important point for many landowners.

The protection of farm and ranch land, timberland, and open space are common objectives of donors of conservation easements. This is especially true when the land is under residential or commercial development pressure and when local planning regulations identify such activities as valuable to the community. In addition, the protection of wetlands, floodplains, important wildlife habitat, scenic views, outdoor recreation uses, and historic land areas and structures are also appropriate purposes for easements.

Easements that are permanent, donated by the landowner (or conveyed under a qualified bargain sale), and that conserve publicly significant natural resource values are eligible for federal and state tax benefits. The amount of the deduction must be determined by an independent appraisal of the value of the easement by measuring the FMV of the underlying property before and after the donation.

A conservation easement typically permits the continuation of the rural uses being enjoyed by the landowner at the time the easement is donated. Importantly, land subject to a conservation easement may be freely sold, donated, given to heirs, and transferred in every normal fashion as long as it remains subject to the restrictions of the easement. Such dispositions do not negate the tax benefits of donating the easement. Likewise, it is possible for the donor to retain some rights to limited residential development and still receive the associated tax benefits, as long as the retention of such rights does not conflict with the conservation purposes of the easement.

> **Note.** The IRS recently announced it will increase its scrutiny of conservation easement transactions.[20] The Treasury Department appears skeptical of charitable deductions derived from donations when the donor retains a substantial and continuing interest in the property subject to the donation. This is particularly the case when the donor retains extensive rights to continue to use such property, as is the case with many conservation easements. In the past, the IRS has primarily limited its inquiry to the valuation of the easement itself. However, as the value of deductions for donated conservation easements increases, it is anticipated that future audits may scrutinize the terms of the easement for compliance with the requirements of the Regulations.

20. IRS Notice 2004-41, June 30, 2004

REQUIREMENTS FOR FEDERAL TAX BENEFITS

Generally, a federal tax deduction is not allowed for contributions of less than the donor's entire interest in the property donated. However, a conservation easement is an exception to the general rule.

The Regulations specify that a qualified conservation contribution is the contribution of a qualified real property interest to a qualified organization exclusively for conservation purposes in perpetuity.[21]

1. The Easement Must Convey a "Qualified Real Property Interest"

A perpetual conservation restriction is a qualified real property interest.[22] A perpetual conservation restriction is a restriction granted in perpetuity on the use which may be made of real property, including an easement or other interest in real property that under state law has attributes similar to an easement (e.g., a restrictive covenant or equitable servitude). Consequently, state law dictates the basic form of the easement.

Most states have specific enabling legislation for conservation easements. Conservation easements in these states must comply with the specifics of the enabling legislation to qualify the easement as a "perpetual conservation restriction" for federal tax purposes. In states without specific enabling legislation, other rules must be followed to ensure that the arrangement meets the federal requirements for a "qualified real property interest."

Observation. It is important to note that failing to create a conservation easement that qualifies under state law as a "qualified real property interest" may result in creation of a binding restriction on the grantor's future use of the property that fails to generate any tax benefits. This is undesirable for the grantor, and could create malpractice liability for the professional.

2. The Contribution Must Be to a "Qualified Organization"

To be deductible, a conservation easement must be conveyed to a "qualified organization." To be considered an eligible donee, an organization must:

- **Be a qualified organization.** Qualified organizations include local, state, and federal governmental agencies and charitable organizations qualified under IRC §501(c)(3). The Regulations do not require that an organization be organized or operated exclusively for one or more of the conservation purposes. Therefore, organizations whose purposes include the advancement of agriculture, ranching, or timbering practices and providing assistance to landowners engaged in those practices could qualify. Easements may be held by organizations that are not purely environmental or conservation organizations.
- **Have a commitment to protect the conservation purposes of the donation.** This requirement can be ascertained from the articles of incorporation and bylaws of a land trust. The Regulations require that the land trust be organized **and** operated **substantially** or **primarily** for one of the conservation purposes recognized by the Regulations.

Observation. A likely focus of the IRS may be on whether a land trust is being operated for the proper purposes. If the IRS finds that an organization is acting more as a tax shelter than a conservation organization, both the exempt status of the organization **and** the deductibility of the easements that it holds may be in jeopardy.

21. Treas. Reg. §1.170A-14

22. IRC §170(h)(2)(C)

- **Have the resources to enforce the restrictions.**[23] This could be a difficult test for some organizations to satisfy. Although the Regulations do not elaborate on what **resources** are required to enforce restrictions, it is likely that some relatively small organizations could fail the test.[24]

> **Observation.** While acceptance of a conservation easement does not confer a financial benefit, it does create a perpetual obligation that must be maintained. Thus, interested donors should investigate whether a potential donee has the ability to monitor and enforce the conservation easement over time.

3. The Easement Must Be "Exclusively for Conservation Purposes"

The Code defines exclusivity in terms of **qualified conservation purposes.**[25] Qualified conservation purposes include:

- **The preservation of land areas for outdoor recreation by, or for the education of the general public.** This type of easement requires public access.
- **The protection of a relatively natural habitat for fish, wildlife, or plants.** Under this type of easement, public access is not required. Also, even if the habitat has been altered by human activity, as long as wildlife continues to exist in a relatively natural state, the habitat qualifies.
- **The preservation of certain open space (including farmland and forest land).** This type of easement must advance a clearly delineated federal, state or local governmental conservation policy, or be an easement "for the scenic enjoyment of the general public."[26]
- **Preservation of a historically important land area or a certified historic structure.**

> **Observation.** In order to qualify as a **scenic easement** there must be visual access (not necessarily physical access) by the public to those features of the land considered scenic. An extensive list of criteria for scenic easements is provided in the Regulations.

> **Note.** It is useful to include a description of the conservation purpose(s) of the easement in terms that replicate the description of conservation purposes recognized by the Regulations.

The exclusivity requirement is, perhaps, the requirement most likely challenged by the IRS.[27] In *McLennan*,[28] the IRS challenged a conservation easement on the grounds that the donor had also donated the easement for purposes of obtaining a tax deduction and maintaining property values. The easement covered 169 acres, and the donors reserved the right to divide the property into eight parcels and to construct four residences and appurtenant driveways on the property. The donation fit into a pattern of land protection designed to protect a scenic area. In holding that the easement was exclusively for conservation purposes, the court did not question the substance of the conservation

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23. Treas. Reg. §1.170A-14(c)
24. The Regulations provide that "a qualified organization need not set aside funds to enforce the restrictions that are the subject of the contribution." However, it is difficult to see how an organization with a perpetual responsibility to monitor and enforce a conservation easement can effectively do so without substantial funds in the bank or an endowment.
25. IRC §170(h)(4)-(5). The Regulations provide helpful examples.
26. There have been numerous IRS private letter rulings providing guidance regarding whether a proposed conservation easement qualifies as protecting land under a "clearly delineated governmental policy." In every case, the IRS has found the requirements to be met by the proposed easements. In Letter Ruling 200418005, December 24, 2003, the IRS summarized its view of what constitutes a "clearly delineated governmental conservation policy."
27. Treas. Reg. §1.170A-14(e)(1)
28. *McLennan v. United States*, 994 F2d 839 (Fed. Cir. 1993), aff'd2, June 4, 1993; Cl. Ct. 99 (1991), January 26, 1956

achieved. Rather, it inquired into the intentions of the donor in making the donation, and verified that the technical requirements of the Regulations had been met. The court also ruled that the desire to obtain tax benefits did not negate the **donative intent** necessary for a charitable deduction.

In *Glass,*[29] the taxpayers owned a vacation home on 10 acres of shoreline on Lake Michigan, and granted a conservation easement on a portion of the property to a qualified conservation organization. The easement restricted development of the lakefront areas as part of an attempt to preserve the natural setting for wild flora and fauna and to maintain the existing shoreline. The easement did not restrict development on the portions of the property not subject to the easement. The IRS argued that the easements did not meet the exclusivity tests listed in the Regulations. The court held that the taxpayers and the conservation organization demonstrated the various conservation purposes served by the easements, including the protection of habitat for wild flora and fauna and preservation of fragile shoreline property. The court noted that the property subject to the easement is a "famous" roosting spot for bald eagles.

Donative Intent. A major question concerning the deductibility of any alleged charitable donation is whether or not the donor had the required **donative intent.** Notice 2004-41 strongly suggests that donative intent will become an increasing focus of future audits.

Note. The question of donative intent is subtle. There may be mixed motivations behind the conveyance of a conservation easement. Ultimately, the question is whether the conveyance is truly a charitable contribution or a "quid pro quo" transaction. Problems in establishing donative intent as the primary motivating factor behind the donation may arise when the conveyance of a conservation easement is in exchange for a cluster development project, or a reciprocal easement is involved (easement granted if neighbor does the same). Conservation buyer transactions (when the seller of conservation-worthy property donates an easement before selling) can also raise IRS scrutiny.

Note. The Joint Committee on Taxation prepared a report in early 2005 stating that IRC §170(h) is too broad. It proposes to specify that a qualified real property interest is not considered as contributed exclusively for a conservation purpose if the donor (or a family member of the donor) has a right to use all or a portion of the real property as a personal residence at any time after the contribution.

A donor cannot reserve uses in the easement document that are inconsistent with the conservation purposes advanced by the easement. While this does not prohibit the grantor from retaining any rights to use the property, any retained rights must be consistent with the conservation purposes of the easement.

Example 1. Mary donated a scenic easement over 900 acres of woodland, pasture and orchards on an overlook in the Missouri Ozarks. All of the property is visible from a nearby state park. Mary reserved the right to divide the property into 10 parcels with one single-family dwelling allowed on each parcel. Applicable zoning laws require a minimum 40-acre lot size.

Result. The IRS would likely deny a deduction on the basis that the reserved development potential would destroy the scenic view and would be inconsistent with the conservation purposes of the easement. However, if a portion of the 900 acres was not visible from the state park, and the conservation easement required that Mary's reserved development rights be exercised only on that portion of the property, the IRS might allow a deduction.

The Regulations also provide that a deduction is not allowed if the contribution would accomplish one of the enumerated conservation purposes, but would permit destruction of other significant conservation interests.

29. *Glass v. Commr.,* 124 TC No. 16, May 25, 2005

Example 2. Fred Farmer donated an easement on his farm to support a government flood control program, but reserved the right to farm the property. The easement did not prohibit Fred's use of pesticides.

Result. The IRS could challenge the deduction because the easement grant did not prohibit a use that could impair other significant conservation interests. This is particularly the case if there is a naturally occurring ecosystem on Fred's property.

When uses inconsistent with "other significant conservation interests" are necessary for the specific conservation purposes of the easement, the reservation of the rights to such uses in the easement does not preclude deductibility.

Example 3. Tex granted a conservation easement over his ranch to preserve the use of the land for ranching under a "clearly delineated governmental policy." If necessary, Tex could allow the destruction of some significant conservation interests, such as elimination of sage brush from grazing areas to advance the conservation purpose of ranching.

Note. It is important to include within the definition of the conservation purposes the protection of "other significant conservation interests, to the extent that it is not necessary to impair such other interests in order to advance the conservation purposes specifically described in this easement." This provides an overall limitation on reserved uses that should ensure compliance with the regulatory requirements.

When the purpose of an easement is to preserve open space, the Regulations prohibit reserved uses that would "permit a degree of intrusion or future development that would interfere with the essential scenic quality of the land or with the governmental conservation policy." Many "open space" easements reserve the right to some additional residential development of the land subject to the easement. The Regulations do not impose a blanket prohibition of such reservations, but they do provide a basis for the disallowance of a deduction if too much development is reserved. How much is too much depends upon the conservation purposes of the easement and the nature of the easement property. That is a facts and circumstances test applied on a case-by-case basis.

Observation. Occasionally, landowners want to reserve the ability to build a home on the property at a future date, with the location determined at a later date. However, unless the future location is limited to ensure that the conservation purposes and "other significant conservation interests" are not impaired; such a reservation could defeat the deductibility of the easement.

Retained residential rights in open space easements are less likely to be challenged if the conservation purpose of easement is agricultural as opposed to scenic. That is particularly the case if the rights cannot be exercised in a manner that intrudes upon highly productive soil, or with the agricultural use of the property. However, the amount of retained residential development affects the value of the conservation easement; the more development is retained, the lower the easement value and the less the tax deduction.

Note. As a condition of using retained development rights, the easement should require that future development be done in a manner "consistent with the conservation purposes" identified in the easement. This should effectively refute any argument that a reserved use is inconsistent with the conservation purposes of the easement.

In some regions where property values are extraordinarily high, the donation of conservation easements can generate very large tax deductions. Therefore, some landowners may try to maximize their tax benefits while minimizing the restrictions on the future use of their land. Again, the issue of exclusivity can be raised by the IRS as a potential bar to a deduction.

Example 4. Jack owns 100 acres. Current zoning allows 20 five-acre lots to be developed. Jack is considering a conservation easement that reduces development potential to 10 lots.

Result. The IRS could disallow the deduction on several grounds:

1. The easement is not exclusively for conservation purposes.
2. The reserved uses are inconsistent with the conservation purposes.
3. The reserved uses are inconsistent with other significant conservation values.
4. The easement does not create a significant public benefit.

If the retained development rights are restricted in such a manner that preserves the scenic qualities and to better advance the governmental conservation policy, a deduction might be allowed.

4. The Conservation Easement Must Be in Perpetuity

There are a number of factors that define perpetuity.

- **Irrevocability.** To be eligible for an income tax deduction the **conservation purposes** of the easement must be irrevocably protected in perpetuity.[30] This requirement may be the most difficult one for donors to satisfy. For an easement gift to be in perpetuity, the easement deed cannot include any reversionary right in the donor, or the donor's successors in title, or any other provision that would allow the donor to unilaterally recover any or all of the rights conveyed by the easement.

> **Note.** Donors wanting to make an easement donation contingent upon obtaining favorable tax treatment will violate the perpetuity requirement.

The requirement of perpetuity means that the easement is irrevocable by the donor and the donor's successors in title. Nevertheless, conservation easements, like other contracts, may be amended if all of the parties to the easement (typically the land trust and the landowner whose property is subject to the easement) consent. Unfortunately, the Regulations do not make any provision for the amendment of a conservation easement.

- **No excess benefit transactions.** The Code and Regulations prohibit IRC §501(c)(3) organizations, such as land trusts, from entering into "excess benefit transactions."[31] The assets held by a public charity must not be used to benefit private interests. That means land trusts cannot agree to amendments that will confer a financial benefit on the owner of the land subject to the easement, or on any other private entity or individual. However, a land trust can agree to amendments that create additional conservation benefits, even if the amendment confers a private economic benefit, provided that the beneficiary offsets any economic benefit so that the transaction is economically neutral.

30. Treas. Reg. §1.170A-14(a)

31. IRC §4958

Example 5. Marcia owns land subject to a conservation easement and wants to amend the easement to allow two additional home sites on a portion of the easement property. If Marcia agrees to donate an easement over additional land, and the value of the easement equals or exceeds the value of the two additional home sites allowed by the amendment, the transaction would not be an excess benefit transaction.

- **Termination.** The Regulations address the potential for the termination of a conservation easement, and specify that the potential for termination does not defeat deductibility if certain conditions are satisfied. Under the Regulations, any resulting proceeds must be divided between the landowner and the donee organization (land trust). The division must be in proportion to the value of their respective interests, based upon the value of the easement and the unrestricted value of the property subject to the easement at the time of the donation, unless state law provides otherwise. In addition, the donee's proceeds from a subsequent sale or exchange of the property as a result of the termination must be used by the donee organization in a manner that is consistent with the conservation purposes of the original easement contribution.

Example 6. Ben Evolent donated a conservation easement on his farm to a land trust. Before the easement donation, the farm was valued at $3 million. After the donation, the farm is valued at $1.2 million. Therefore, the value of the easement is $1.8 million, which represents 60% of the unrestricted value of the farm. The "proportionate value of the perpetual conservation restriction" is 60%. If 10 acres of the easement property are condemned for a new road, and the condemnation proceeds are $300,000, the land trust must receive 60%, or $180,000.

Example 7. Ben **(Example 6),** negotiates with the state department of transportation an exchange of the 10 acres subject to condemnation for 60 acres of land in another location. No cash is paid. According to the Regulations, the land trust is entitled to 60% of the exchange property, or 36 acres.

There are **two methods of termination:**

1. **Judicial action.** In addition to amendments, conservation easements can be revised and terminated by judicial action. A court can revise or terminate a conservation easement when, due to unexpected change in conditions surrounding the property, it is impossible or impractical to continue its originally intended purpose.
2. **Exercise of eminent domain.** Conservation easements held by private organizations are also subject to the governmental exercise of the power of eminent domain to condemn the property subject to the easement. In June 2005, the U.S. Supreme Court affirmed the government's ability to exercise eminent domain to take private property for use by other private parties if there is a public benefit to the transaction, and the exercise is carried out under a developmental plan. Property that is burdened by a conservation easement has a reduced value and owners receive less compensation for property that is taken through the exercise of eminent domain.

- **Mortgages.** The perpetuity requirement also requires that there be no outstanding rights in the land subject to the easement that could defeat the conservation purposes of the easement in perpetuity, or the enforcement of its terms. Consequently, outstanding mortgages must be subordinated to the conservation easement.

Note. If a lender won't subordinate its interest on a large property, it may be possible to convince the lender to subordinate its interest such that its priority is limited to the developed portion. The easement can then be limited to the portion of the property over which the mortgage has been subordinated (or released), thereby preserving deductibility. If the donor wishes, a nondeductible easement could be placed on the balance.

- **Mineral extraction.** The requirement of perpetuity limits easement deductibility on lands where the possibility of mineral extraction exists. The Regulations pose substantial difficulties for prospective easement donors when the right to access and extract minerals has been severed from the surface.

- **Transferability conditions.** To preserve deductibility, the easement document must require that, in the event of any subsequent transfer of the conservation easement by the original holder, the subsequent holder agrees to carry out the conservation purposes of the easement. The document granting the easement must also specify that it is prohibited from transferring the conservation easement to any organization that is not a **qualified organization** within the meaning of IRC §170(h).

5. Other Requirements

Documentation. If the donor retains any rights to use the property subject to the easement (e.g., farming, limited residential use, recreational use), documentation sufficient to establish the condition of the property at the time of the gift is required. The documentation must provide the donee with a basis upon which to measure changes in the property over time. This information is essential to enforcement of the restrictions of any conservation easement. The Regulations include a list of suggested materials to include in the documentation (termed a "natural resources inventory").

The documentation must be made available to the donee before the conveyance of the easement. In addition, a statement must accompany the documentation, signed by both the donor and the donee, specifying that the documentation is an accurate representation of the protected property at the time of the donation.

Reservation of Rights. If the donor reserves rights to use the property, the reserved rights must be exercised in a manner that is consistent with the terms of the easement. Specification of the reserved rights must be set forth in the easement agreement as a prerequisite of deductibility.

INCOME TAX BENEFITS AND LIMITATIONS

How Much Is Deductible?

The value of the qualified conservation contribution may be deductible for income tax purposes. That is typically the difference in the property's value before the donation and after the donation.

> **Example 8.** Juanita donates an easement on land that is valued at $2 million before the donation. The value of the land drops to $1.5 million after the easement is donated due to the restrictions on future use imposed by the easement. The value of the easement is therefore $500,000. Juanita may deduct $500,000 on her income tax return as a charitable contribution, subject to other limitations.

The principal component of value in a conservation easement is the loss of potential developmental value due to the easement. But other factors may also be present. For example, the value of a conservation easement preserving a valuable stand of timber would likely be measured in terms of the market value of the timber as well as any development potential eliminated.

> **Observation.** Most states with an income tax provide a deduction for easement donations as well. In addition to the charitable deduction for the donation of a conservation easement, some states allow a state income tax credit for easement donations.

Annual Limitation on Charitable Deductions

Generally, the Code limits individual deductions for charitable donations to public charities such as land trusts, to 50% of the donor's **contribution base** annually.[32] The contribution base is defined as an individual's adjusted gross income (AGI) without regard to the amount of the contribution and without regard to any **net operating loss carryback.** However, a gift of **long-term capital gain** property is subject to a limitation of 30% of the donor's contribution base.

32. IRC §170(b)(1)(A)

If the easement donation consists of ordinary income property (property held for one year or less), the deduction is allowed up to 50% of the donor's contribution base limited by the donor's basis in the easement. Because a conservation easement is only a partial interest in property, the donor must allocate his basis in the property between the property as a whole and the easement.[33]

> **Note.** The holding period of property received as a gift includes the donor's holding period.[34] Property received as a bequest or devise from a decedent's estate is automatically treated as long-term capital gain property.[35]

A donation of long-term capital gain property may, by election, be treated as a donation of ordinary income property that qualifies for the 50% limitation rather than the 30% limitation. By making the election, the donor agrees to limit the amount of the deduction to the donor's basis in the donated easement.[36] As a planning strategy, the election makes sense when the value of the easement does not exceed the donor's basis in the easement. Without the election, the deduction is **30%** of AGI up to **fair market value (FMV)** of property donated. With the election, the deduction is **50%** of AGI up to **basis** of property donated.

Example 9. In 2005, Sally donates an easement worth $500,000. She has owned the property that is subject to her easement donation for five years, and would normally be subject to the 30% limitation. Sally's annual income is $100,000. Therefore, she may only deduct $30,000 of the easement gift (30% × $100,000) annually, even though the value of the easement is $500,000. However, she may carry forward the unused portion of her deduction to future tax years.

Example 10. Elee donates an easement with a basis of $100,000 within a year after he purchased the property. His annual income is $150,000. Elee may deduct $75,000 of the value of the easement (50% × $150,000), and carry the unused balance ($25,000) of the gift forward. Because this is a gift of ordinary income property, Elee's deduction may not exceed his basis in the easement.

Example 11. Jeff paid $350,000 for property that he placed under easement six months after he acquired the property. An appraiser determined that the FMV of the property before the easement was donated is $500,000, and that the value after the easement was donated is $300,000. Thus, the value of the easement is $200,000 and the easement donation percentage is 40% of the value of the property before the donation ($200,000 ÷ $500,000). Jeff multiplies his basis in the easement property ($350,000) by 40% to determine his basis in the easement. Therefore, the maximum deduction that Jeff can take for this easement donation is $140,000 ($350,000 × .40).

> **Observation.** The entire amount of a donor's charitable contributions made during a tax year is limited to 50% of the donor's contribution base. A determination must be made of the value of other gifts a prospective easement donor has made during the year in order to know the amount of the easement contribution that may be deducted that year.

Example 12. Jeff **(Example 11)** has an AGI of $125,000 and he has state income tax withholdings of $1,000. He is allowed a charitable deduction of $37,500 and he can carryover $102,500 to 2006.

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33. IRC §170(e)(2)

34. IRC §1223(2)

35. IRC §1223(11)

36. Treas. Reg. §1.170A-8(d)(2)

For Example 12

Jeff Taylor **111-22-3333**

Table 4. **Worksheet for Limit on Deductions**

Who can use this worksheet. You can use this worksheet if you made charitable contributions during the year, and one or more of the limits described in this publication under *Limits on Deductions* apply to you. You cannot use this worksheet if you have a carryover of a charitable contribution from an earlier year.

General instructions:

- The terms used in this worksheet are explained earlier in this publication.
- If your answer to any line is less than zero, enter zero.
- For contributions of property, enter the property's fair market value unless you elected (or were required) to reduce the fair market value as explained under *Giving Property That Has Increased in Value.* In that case, enter the reduced amount.

Step 1. List your charitable contributions made during the year.

1. Enter your contributions to 50% limit organizations. (Include contributions of capital gain property if you reduced the property's fair market value. Do not include contributions of capital gain property deducted at fair market value.)	1	
2. Enter your contributions to 50% limit organizations of capital gain property deducted at fair market value	2	140,000
3. Enter your contributions (other than of capital gain property) to qualified organizations that are not 50% limit organizations	3	
4. Enter your contributions "for the use of" any qualified organization. (But do not enter here any amount that must be entered on line 6.)	4	
5. Add lines 3 and 4	5	
6. Enter your contributions of capital gain property to or for the use of any qualified organization. (But do not enter here any amount entered on line 1 or 2.)	6	

Step 2. Figure your deduction for the year and your carryover to the next year.

7. Enter your adjusted gross income	7	125,000
8. Multiply line 7 by 0.5. This is your 50% limit	8	62,500

			Deduct this year	Carryover to next year
Contributions to 50% limit organizations				
9. Enter the smaller of line 1 or line 8	9			
10. Subtract line 9 from line 1	10			
11. Subtract line 9 from line 8	11	62,500		
Contributions not to 50% limit organizations				
12. Add lines 1 and 2	12	140,000		
13. Multiply line 7 by 0.3. This is your 30% limit	13	37,500		
14. Subtract line 12 from line 8	14			
15. Enter the smallest of line 5, 13, or 14	15			
16. Subtract line 15 from line 5	16			
17. Subtract line 15 from line 13	17	37,500		
Contributions of capital gain property to 50% limit organizations				
18. Enter the smallest of line 2, 11, or 13	18		37,500	
19. Subtract line 18 from line 2	19			102,500
20. Subtract line 15 from line 14	20			
21. Subtract line 18 from line 13	21			
Contributions of capital gain property not to 50% limit organizations				
22. Multiply line 7 by 0.2. This is your 20% limit	22	25,000		
23. Enter the smallest of line 6, 17, 20, 21, or 22	23			
24. Subtract line 23 from line 6	24			

Step 3. Summarize your deductions and carryovers.

25. Add lines 9, 15, 18, and 23. Enter the total here and on Schedule A (Form 1040)	25	37,500	
26. Add lines 10, 16, 19, and 24. Enter the total here. Carry it forward to Schedule A next year	26		102,500

Page 17

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For Example 12

Form 8283 (Rev. 12-2004) Page **2**

Name(s) shown on your income tax return	Identifying number
Jeff Taylor	111-22-3333

Section B—Appraisal Summary—List in this section only items (or groups of similar items) for which you claimed a deduction of more than $5,000 per item or group. **Exception.** Report contributions of certain publicly traded securities only in Section A.

Part I **Information on Donated Property—**To be completed by the taxpayer and/or appraiser.

4 Check type of property:

- ☐ Art* (contribution of $20,000 or more)
- ☐ Art* (contribution of less than $20,000)
- ☐ Collectibles**
- ☒ Qualified Conservation Contribution
- ☐ Other Real Estate
- ☐ Intellectual Property (patents, etc.)
- ☐ Computer Equipment
- ☐ Other

*Art includes paintings, sculptures, watercolors, prints, drawings, ceramics, antiques, decorative arts, textiles, carpets, silver, rare manuscripts, historical memorabilia, and other similar objects.

**Collectibles include coins, stamps, books, gems, jewelry, sports memorabilia, dolls, etc., but not art.

Note: *If your total art contribution deduction was $20,000 or more, you must attach a complete copy of the signed appraisal. See instructions.*

5	(a) Description of donated property (if you need more space, attach a separate statement)	(b) If tangible property was donated, give a brief summary of the overall physical condition at the time of the gift	(c) Appraised fair market value
A	Conservation easement	Excellent	200,000
B			
C			
D			

	(d) Date acquired by donor (mo., yr.)	(e) How acquired by donor	(f) Donor's cost or adjusted basis	(g) For bargain sales, enter amount received	See instructions: (h) Amount claimed as a deduction	See instructions: (i) Average trading price of securities
A	June 2004	Purchase	140,000			
B						
C						
D						

Part II **Taxpayer (Donor) Statement—**List each item included in Part I above that the appraisal identifies as having a value of $500 or less. See instructions.

I declare that the following item(s) included in Part I above has to the best of my knowledge and belief an appraised value of not more than $500 (per item). Enter identifying letter from Part I and describe the specific item. See instructions. ▶ ____________

Signature of taxpayer (donor) ▶ Date ▶

Part III **Declaration of Appraiser**

I declare that I am not the donor, the donee, a party to the transaction in which the donor acquired the property, employed by, or related to any of the foregoing persons, or married to any person who is related to any of the foregoing persons. And, if regularly used by the donor, donee, or party to the transaction, I performed the majority of my appraisals during my tax year for other persons.

Also, I declare that I hold myself out to the public as an appraiser or perform appraisals on a regular basis; and that because of my qualifications as described in the appraisal, I am qualified to make appraisals of the type of property being valued. I certify that the appraisal fees were not based on a percentage of the appraised property value. Furthermore, I understand that a false or fraudulent overstatement of the property value as described in the qualified appraisal or this appraisal summary may subject me to the penalty under section 6701(a) (aiding and abetting the understatement of tax liability). I affirm that I have not been barred from presenting evidence or testimony by the Director of Practice.

Sign Here Signature ▶ Tony Appraiser Title ▶ Certified appraiser Date of appraisal ▶ 12/01/2005

Business address (including room or suite no.)	Identifying number
125 South Street	

City or town, state, and ZIP code
Anytown, IL 55555

Part IV **Donee Acknowledgment—**To be completed by the charitable organization.

This charitable organization acknowledges that it is a qualified organization under section 170(c) and that it received the donated property as described in Section B, Part I, above on ▶ 12/08/2005 (Date)

Furthermore, this organization affirms that in the event it sells, exchanges, or otherwise disposes of the property described in Section B, Part I (or any portion thereof) within 2 years after the date of receipt, it will file **Form 8282,** Donee Information Return, with the IRS and give the donor a copy of that form. This acknowledgment does not represent agreement with the claimed fair market value.

Does the organization intend to use the property for an unrelated use? . . . . ▶ ☐ Yes ☒ No

Name of charitable organization (donee)	Employer identification number	
Lincoln Park Trust	11-2222222	
Address (number, street, and room or suite no.)	**City or town, state, and ZIP code**	
100 Main Street	Anytown, IL 55555	
Authorized signature	**Title**	**Date**
Ima Trustee	Trustee	03/01/2006

Printed on recycled paper

For Example 12

SCHEDULES A&B (Form 1040)

Department of the Treasury Internal Revenue Service (99)

Schedule A—Itemized Deductions

(Schedule B is on back)

▶ Attach to Form 1040. ▶ See Instructions for Schedules A and B (Form 1040).

OMB No. 1545-0074

2005

Attachment Sequence No. 07

Name(s) shown on Form 1040: Jeff Taylor

Your social security number: 222 11 3333

Medical and Dental Expenses		**Caution.** Do not include expenses reimbursed or paid by others.				
	1	Medical and dental expenses (see page A-2)	1			
	2	Enter amount from Form 1040, line 38 [2]				
	3	Multiply line 2 by 7.5% (.075)	3			
	4	Subtract line 3 from line 1. If line 3 is more than line 1, enter -0-			4	0
Taxes You Paid (See page A-2.)	5	State and local **(check only one box)**: a ☐ Income taxes, **or** b ☐ General sales taxes (see page A-2)	5	1,000		
	6	Real estate taxes (see page A-3)	6	140,000		
	7	Personal property taxes	7			
	8	Other taxes. List type and amount ▶	8			
	9	Add lines 5 through 8			9	1,000
Interest You Paid (See page A-3.)	10	Home mortgage interest and points reported to you on Form 1098	10			
	11	Home mortgage interest not reported to you on Form 1098. If paid to the person from whom you bought the home, see page A-4 and show that person's name, identifying no., and address ▶	11			
Note. Personal interest is not deductible.	12	Points not reported to you on Form 1098. See page A-4 for special rules	12			
	13	Investment interest. Attach Form 4952 if required. (See page A-4.)	13			
	14	Add lines 10 through 13			14	0
Gifts to Charity	15	Gifts by cash or check. If you made any gift of $250 or more, see page A-4	15			
If you made a gift and got a benefit for it, see page A-4.	16	Other than by cash or check. If any gift of $250 or more, see page A-4. You **must** attach Form 8283 if over $500	16	140,000		
	17	Carryover from prior year	17			
	18	Add lines 15 through 17 Excess contributions		(102,500)	18	37,500
Casualty and Theft Losses	19	Casualty or theft loss(es). Attach Form 4684. (See page A-5.)			19	0
Job Expenses and Most Other Miscellaneous Deductions	20	Unreimbursed employee expenses—job travel, union dues, job education, etc. Attach Form 2106 or 2106-EZ if required. (See page A-6.) ▶	20			
	21	Tax preparation fees	21			
(See page A-5.)	22	Other expenses—investment, safe deposit box, etc. List type and amount ▶	22			
	23	Add lines 20 through 22	23			
	24	Enter amount from Form 1040, line 38 [24]				
	25	Multiply line 24 by 2% (.02)	25			
	26	Subtract line 25 from line 23. If line 25 is more than line 23, enter -0-			26	0
Other Miscellaneous Deductions	27	Other—from list on page A-6. List type and amount ▶			27	0
Total Itemized Deductions	28	Is Form 1040, line 38, over $145,950 (over $72,975 if married filing separately)? ☐ **No.** Your deduction is not limited. Add the amounts in the far right column for lines 4 through 27. Also, enter this amount on Form 1040, line 40. ☐ **Yes.** Your deduction may be limited. See page A-6 for the amount to enter. ▶			28	38,500
	29	If you elect to itemize deductions even though they are less than your standard deduction, check here ▶ ☐				

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 11330X **Schedule A (Form 1040) 2005**

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Observation. The amount of the deductible contribution may also vary based on the type of organization receiving the easement. See the *2004 University of Illinois Federal Tax Workbook,* Chapter 6, "Charitable Giving" for more information.

Carrying Deductions Forward

Any unused portion of a charitable deduction may only be **carried forward** for five years **after** the year of the donation, or until the full amount of the deduction has been used, whichever occurs first. The deduction carried forward has the same characteristics as the original deduction. That means that if the deduction is attributable to a gift of ordinary income property (i.e., held one year or less), the amount of the deduction carried forward continues to be subject to the 50% limitation. If the deduction carried forward is for a gift of long-term capital gain property (i.e., held for more than one year), it is subject to the 30% limitation.

Example 13. Sally **(Example 9)** was only able to use $30,000 of her $500,000 easement deduction in the year of the donation due to the 30% annual limitation (30% × $100,000 AGI). Sally can carry the unused balance of $470,000 forward to 2006, 2007, 2008, 2009, and 2010 as shown below:

Year	Projected AGI	Projected 30% Deduction
2005	$100,000	$ 30,000
2006	160,000	48,000
2007	160,000	48,000
2008	180,000	54,000
2009	210,000	63,000
2010	210,000	63,000
Total six-year deductions:		$306,000

"Phasing" Easement Donations. As illustrated in **Example 13,** the deduction percentage limitations prevent some easement donors from deducting the full value of the easement. One approach to addressing this problem may be to have the donor phase the easement donation over time. This technique may work best when a landowner is considering donating a large tract of land and has insufficient income to be able to claim the entire charitable deduction.

Example 14. Sam donates a 1,000-acre conservation easement over his farm. The value of the easement is $1 million. Sam's average annual income is $200,000. The maximum deduction that Sam can use, assuming he is subject to the 30% annual limitation, is $360,000 (30% × $200,000 × 6 years). However, Sam could increase the amount of the deduction he can use by donating two separate easements at different times. For example, the first easement could cover 500 acres of the farm, with the value of that easement at $360,000.

Result. Over a six-year period, Sam can fully deduct this gift. Once this gift is fully deducted, Sam could donate a second 500 acres easement from his farm. If the second easement is worth $640,000 (reflecting both enhancement from the first donation, and appreciation due to market forces), and Sam's average annual income increases to $360,000, Sam will be able to deduct the second easement donation over six years because the six-year limitation on the deduction is now $648,000 (30% × $360,000 × 6 years).

Alternative Minimum Tax (AMT) and the 2% Floor on Itemized Deductions

AMT does not apply to conservation easement donations. Charitable contributions of conservation easements are **not** considered **tax preference items.** The provision treating gifts of appreciated property as tax preference items was repealed for gifts of appreciated property effective December 23, 1992. Furthermore, the limitation on certain itemized deductions to allow only those in excess of 2% of the taxpayer's AGI does not apply to charitable contributions.[37]

Easement Valuation

One of the most important issues involving the donation of conservation easements is the valuation of the easement. It is also the issue that is examined most closely by the IRS. There are three areas that the IRS primarily looks at.

Valuation Methods. There are two types of valuation methods.

1. **"Before and After" Valuation Method.** When data concerning donated conservation easements comparable to the taxpayer's conservation easement is unavailable, the "before and after" valuation method may be utilized. Under this approach, the easement property is valued before the easement is in place and is again valued after the property becomes subject to the easement. The difference represents the value of the easement donation for deduction purposes.

> **Observation.** An experienced appraiser can estimate the value of a potential donation by knowing the terms of the proposed easement and assuming it is in place.

2. **"Comparable Sales" Method.** In the IRS's view, the preferred method of valuing a conservation easement is comparable sales. This approach utilizes actual easements as comparables. However, the Regulations recognize that in many cases there will not be a "substantial record" of comparable easement sales. Therefore, the IRS accepts valuations based upon the before and after method.[38]

Requirements for Substantiating Easement Values. Any deduction for the donation of property exceeding $5,000 in value must be supported by a **qualified appraisal** conducted by a **qualified appraiser.** The appraisal must generally be conducted within the 60-day period before the conveyance of the easement, but must be completed no later than the due date, including extensions, for the tax return on which the deduction is first claimed. Regardless of the date upon which the appraisal was conducted, the valuation must be of the easement's value on the date that it was donated, which is the date that it was officially recorded. The cost of the appraisals does not qualify for a charitable contribution.

> **Note.** Form 8283, *Noncash Charitable Contributions,* is a summary of the appraisal and must accompany any return claiming an easement deduction. The form must be signed by the donee receiving the easement. By signing the form, the recipient is not verifying the valuation of the donation, only the receipt of the donation. The taxpayer does not file the actual appraisal with the return claiming the deduction, only Form 8283.[39] In addition to signing Form 8283, the recipient must separately acknowledge receipt of the gift in writing. In this acknowledgement, the recipient must state whether the donor has received any goods or services in exchange for the gift.

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37. IRC §67(b)(4)

38. Treas. Reg. §1.170A-14(h)(3)(i)

39. IRC §170(f)(11)(D)

Overvaluation Penalties. The Code imposes substantial penalties for overvaluation of a charitable contribution, including the contribution of a conservation easement.[40] A **substantial valuation misstatement** (200% over actual value) can result in a penalty of 20% of the amount of the underpayment of tax. A **gross valuation misstatement** (400% over actual value) can result in a penalty of 40% of the amount of the underpayment of tax. In both penalty situations, the taxpayer must have underpaid the tax liability by more than $5,000 due to the overvaluation. These penalties are imposed on the taxpayer. In addition, a penalty in the amount of $1,000 may be imposed on anyone "aiding and abetting" in the overvaluation. This includes **return preparers and appraisers** providing valuations of conservation easements for tax purposes.

> **Observation.** In Notice 2004-41,[41] the IRS expressed criticism of aggressive easement valuation practices. The notice stated that the IRS plans to closely scrutinize easement values in the future. Commentators have also criticized easement valuation practices.[42] The valuations that appear targeted by these criticisms are ones in which conservation easements are valued far in excess of what the donors paid for the property within a year or so of the donation. It appears that aggressive values often are the result of appraisals that value individual lots into which the land being appraised could be developed under existing zoning regulations. Each potential lot into which the parcel could be divided is valued independently and the total value of all lots is then discounted to reflect development and selling costs, and for estimated "market absorption time."

Accounting for Enhancement of Non-Eased Property Value. The Regulations require that enhancement to the value of property not subject to the easement be taken into account in valuing the easement if an easement donor, or member of the donor's family, owns such property. This is the case whether or not the property is contiguous to the easement.

Example 15. Martha owns a 100-acre tract that overlooks another tract on which she donated a conservation easement. The easement reduces the value on the property subject to the easement by $150,000, but the 100 acres increases in value by $50,000 because the view from this property is permanently protected by the easement. This $50,000 "enhancement" must be subtracted from the $150,000 value of the easement. Therefore, Martha's deduction will be reduced to $100,000.

The Need to Offset Other Benefits. The amount of a conservation easement must be reduced by any cash payment or other economic benefit received, or reasonably expected, by the donor or donor's family member, as a result of the easement's donation. This limitation relates to cash payments, governmental approvals granted in exchange for the donation of conservation easements, reciprocal easement donations, bargain sales of conservation easements, and certain conservation buyer transactions.

Example 16. Al Truistic strikes an agreement with a land trust that he will donate an easement over his land in return for the land trust's acquisition and protection of a parcel of land adjoining Al's land. The land trust does as Al wishes and the acquisition enhances the value of Al's land by $150,000. The value of Al's easement is $400,000. However, the land trust must notify Al that, in exchange for his easement donation, he received $150,000 in "goods and services" from the land trust, thereby reducing the amount of Al's deduction to $250,000 ($400,000 – $150,000).

Effect of Easement Donations on Basis

Upon donation of a conservation easement, the donor must reduce basis in the easement property to reflect the proportion of the unrestricted FMV of the land at the date of the donation represented by the value of the easement. This has the effect of limiting the tax benefit of the original donation. However, because the gain on sale is taxed at long-term capital gain rates, and the income sheltered by the deduction is taxed at ordinary income rates, the basis adjustment should not be a significant disincentive to most easement donations.

40. IRC §6662

41. Notice 2004-41, July 12, 2004

42. McLaughlin, Nancy A., "Questionable Conservation Easement Donations," *Probate and Property,* September/October 2004

Example 17. Hap E. Donor donates a conservation easement on his land. Before the easement, the land was valued at $1 million. After the easement, the land was valued at $700,000. Therefore, the value of the easement donation is $300,000 ($1,000,000 – $700,000). Hap's basis in his land before the donation was $100,000. The easement represents 30% of the unrestricted value of the land when the donation was made ($300,000 ÷ $1,000,000). Therefore, Hap's adjusted basis after the easement donation is $70,000 ($100,000 – (30% × $100,000)).

Example 18. Ralph Rancher donates a conservation easement over 500 acres of his 2,500-acre ranch. Ralph's basis in the entire ranch is $1,000 per acre. The land has a current FMV of $2,000 per acre. The easement is worth $700,000, reducing the value of the 500 acres to $300,000. The easement also enhances the value of the unrestricted portion of the ranch by 10%, from $4 million to $4.4 million.

Therefore, the net deduction that Ralph is entitled to is $300,000 ($700,000 – $400,000). Only that portion of the ranch that is subject to the conservation easement is required to receive an adjusted basis. The adjustment does not take into account the enhancement to the unrestricted part of the ranch, even though that enhancement reduced Ralph's deduction. It did not reduce the value of the easement; it merely offset that value for deduction purposes. The percentage of the unrestricted value of the 500 acres represented by the easement was 70% (($1,000,000 – $300,000) ÷ $1,000,000). Therefore, the adjusted basis for the portion of the ranch subject to the easement is $300 per acre ($1,000 – (70% × $1,000)).

Ralph can use the entire $300,000 deduction. The income sheltered by this deduction would have been taxed at 35%. Therefore, the initial tax benefit is $105,000 (35% × $300,000). The additional gain on that portion of the ranch subject to the easement when Ralph sells the ranch is $700 greater per acre because of the basis adjustment required to reflect the easement donation ($1,000 – $300). Thus, Ralph pays long-term capital gains tax on an additional $350,000 ($700 × 500 acres) of value, or $52,500 ($350,000 × 15%). This increased capital gains tax must be subtracted from the initial benefit derived from the easement donation to determine Ralph's net tax benefit ($105,000 – $52,500), for a net tax benefit of $52,500.

Donations by Real Estate Dealers and Landowners Who Subdivide

The Regulations provide that ordinary income property includes property "held by the donor primarily for sale to customers in the ordinary course of his trade or business." This has particular relevance for gifts of conservation easements made by "real estate dealers." Because lots held by dealers for sale to customers are considered ordinary income property, any deduction for the donation of a conservation easement over such property is limited to the dealer's basis in the easement over lots, significantly limiting the tax benefits derived from such a donation.

Real estate dealer status is not limited to commercial developers, but may include any landowner who subdivides his property. If a landowner subdivides property into more than five lots or parcels and sells or exchanges the lots or parcels, or if the landowner sells fewer than five lots or parcels but fails to meet the three conditions provided in IRC §1237(a), other lots or parcels retained by the landowner as part of the subdivision may be considered property held primarily for sale to customers in the ordinary course of business. That means that any deduction for an easement over such lots or parcels is limited to the landowner's basis in the easement.

The three IRC §1237(a) conditions[43] deal with:

1. Not having previously held the property for sale to customers in the ordinary course of business,
2. Not making any substantial improvements on the property (in terms of value), and
3. Holding the property for five years (except if the property is acquired by bequest or devise).

Not all of a dealer's property is ordinary income property. In addition, property that is ordinary income property may become "long-term capital gain property" when circumstances change. The deduction for donating an easement related to long-term capital gain property is not limited to the dealer's basis in the easement.

43. IRC §1237(a)

Whether property is ordinary income property or long-term capital gain property is a factual question determined on a case-by-case basis. For example, property designated as "open space" on a subdivision plat that has never been offered for sale, and that has been carried on the developer's books as a capital asset rather than as inventory, is likely treated as long-term capital gain property. Similarly, property once held as inventory that a developer ceases to hold for sale, and that is recharacterized on the books as a capital asset, will, in time, likely qualify as long-term capital gain property.

Furthermore, even when a landowner subdivides his property, it does **not** make him a **dealer.**

Example 19. Jason is a real estate developer. He developed 50 lots for sale, but identified 100 acres of the development property for "open space" protection. The tract was never offered for sale. On his books, Jason carries the 50 lots as inventory and the 100 acres as a capital asset. Five years later, after having sold 40 lots, Jason decides to start a new project and wrap up this one. He agrees with a local land trust to donate a conservation easement on the remaining 10 lots, plus the 100 acres. His basis in the 10 lots, including development costs, is $10,000 each. The FMV of each lot is $100,000, and the easement reduces the value to $5,000 each. Therefore, the easement on each lot is valued at $95,000, which is 95% of the FMV. Accordingly, Jason's basis in the easement on each lot is $9,500 ($10,000 × 95%). The maximum deduction that Jason can take for each lot easement is $9,500. His basis in the 100 acres is $100,000, his original cost (he made no improvements). The easement on the 100 acres is valued at $5 million.

Result. Jason can deduct $95,000 for the donation of the easement on the lots (10 × $9,500) due to the limitation to basis for gifts of ordinary income property. He can deduct the full $5 million (subject to other limitations such as the income limitation) on the 100 acres because this property was clearly not held for "sale to customers in the ordinary course of his trade or business" and is treated as long-term capital gain property.

Contributions by Trusts

The IRS ruled that complex trusts (trusts that do not require distribution all of their income currently) may not deduct charitable contributions of conservation easements.[44] This is because a conservation easement donation is considered a distribution of corpus, not income. Although the IRS only addressed deductions by complex trusts, the principle involved appears applicable to all trusts.

The IRS ruling does not pertain to grantor trusts. A grantor trust is a trust that is considered owned by the grantor due to the reservation by the grantor of certain interests in or powers over the trust. All of the income and deductions pertaining to a grantor trust are passed through to the owners of the trust.

However, if a grantor trust does not authorize the trustee to make a charitable contribution of a conservation easement the conveyance may be subject to challenge by a trust beneficiary and possibly by the beneficiary's successors in title to the trust property as well. This raises important issues as to whether the easement has been donated in perpetuity.

If title to a home is transferred to a qualified personal residence trust, the Regulations prohibit the distribution of any trust corpus, directly or indirectly, to or for the benefit of a beneficiary or the grantor, during the term of the trust. However, because a land trust is not a qualified beneficiary or grantor of a qualified personal residence trust (QPRT), the donation of a conservation easement to such an entity does not appear to violate the requirements. Because QPRTs cannot hold real property other than the grantor's personal residence, they typically do not hold large acreages and, therefore QPRT assets are unlikely to figure significantly in major easement donations.

The existence of a conservation easement over a taxpayer's personal residence does not disqualify that property from being included in a QPRT.[45]

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44. Rev. Rul. 2003-123, January 1, 2003

45. Letter Ruling 200039031, June 30, 2000

ISSUE 3: TAXATION OF TOBACCO PROGRAM BUYOUT PAYMENTS

OVERVIEW

The American Jobs Creation Act of 2004 (AJCA) terminates the tobacco marketing quota program and the tobacco price support program.[46] To compensate **tobacco quota holders** (owners) for the elimination of these programs, AJCA also creates a buyout program,[47] which is administered by the U.S. Department of Agriculture (USDA). Eligible owners may receive a total of $7 per pound of quota. The buyout is paid in 10 equal annual installments from 2005 through 2014. AJCA does not provide for stated interest on payments due under the contracts.

The buyout payments raise a number of tax-related questions. For federal income tax purposes, owner payments are the proceeds from a sale of the owner's tobacco quota as of the effective date applicable to the owner. The effective date applicable to an owner is the earlier of:

- June 30, 2005, for flue-cured tobacco and September 30, 2005, for all other types of tobacco, or
- The date on which an owner and the USDA enter into a contract for owner payments for the quota.

To assist in answering the numerous tax questions, the IRS issued Notice 2005-51.[48] The following discussion is based on the IRS ruling.

INCOME TAX TREATMENT OF OWNER PAYMENTS

Taxation of "Owner Payments"

Owner payments are subject to federal income tax. If the amounts received by the owner are more than the owner's adjusted basis in the quota, the owner has a taxable gain. Conversely, if the owner receives less than the owner's adjusted basis, the owner has a loss that may be deductible for tax purposes if the requirements for deduction under §165 are satisfied. In determining an owner's gain or loss, the amount received for the quota does not include any amount treated as interest for federal tax purposes.

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46. AJCA §611 and 612
47. AJCA §622
48. Notice 2005-51, July 11, 2005

Determining Basis

The adjusted basis of a quota is determined differently depending upon how the owner acquired the quota.

- An owner who holds a quota that is derived from an original grant by the federal government has a zero basis in the quota.
- The basis of a purchased quota is the price the owner paid for it.
- Generally, an owner who received a quota as a gift takes a basis equal to the basis of the donor.

> **Note.** An owner who received a quota by gift may have his basis increased by an amount related to the amount of gift tax paid. If the basis is greater than the quota's FMV at the time of the gift, the basis for determining loss is that FMV.

- The basis of a quota that an owner inherited generally is the FMV of the quota at the time of the decedent's death.

The basis of a tobacco quota is not subject to adjustment through amortization, depletion, or depreciation. However, if an owner deducted any amount for these purposes, the owner must reduce basis by the amount deducted when determining gain or loss. A similar basis reduction must be made for any amount previously deducted as a loss because of a reduction in the number of pounds of tobacco allowable under the quota. If an owner purchased a quota and deducted the entire cost in the year of purchase, then the owner's basis in the quota is zero.

Reporting Gain

The installment method may be used to report gain if an owner receives at least one payment after the close of the owner's taxable year that includes the owner's applicable effective date. The amount of gain is the excess of the total amount of owner payments received, reduced by any amount treated as interest, over the owner's adjusted basis in the quota. Under the installment method, a proportionate amount of the gain is taken into account in each year in which an owner payment is received.

If the installment method is not utilized, the owner must report the entire gain on the return for the taxable year that includes the effective date applicable to the owner.

Nature of the Gain and Reporting Rules

For quotas used in the trade or business of farming with a holding period of more than one year, the transaction is reported on Form 4797. If an owner has no other §1231 transactions reportable on Form 4797, any gain is treated as long-term capital gain and any loss is treated as ordinary loss. Even if an owner has other reportable §1231 transactions, the net result of all §1231 transactions reported is either long-term capital gain or ordinary loss.

If an owner held a quota for investment purposes, or for the production of income, but did not use the quota in a trade or business, any gain or loss is capital gain or loss.

Under certain circumstances, some or all of the gain may be recharacterized and reported as ordinary income. If an owner previously deducted either the cost of acquiring a quota, amounts for amortization, depletion, depreciation, or amounts to reflect a reduction in the quota pounds, any gain is taxed as ordinary income up to the amount previously deducted. Such amounts are reportable on the owner's return for the taxable year that includes the effective date applicable to the owner, even if the owner uses the installment method to report the remainder of the gain.

Example 20. Samuel Owner purchased a 400 pound tobacco quota on January 7, 2000, for $1,000. As part of the government program, this quota was reduced to 250 pounds in 2002. However, the basis in the quota did not change. Samuel entered into a contract for $7 per pound for the 250 pound quota on July 5, 2005, for a total of $1,750. In 2005, he received $175, the first of the 10 payments received under the contract. He elects to include the entire quota proceeds as 2005 income and reports the sale on Form 4797, Part I, as shown:

Form **4797** — **Sales of Business Property**
(Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2))
▶Attach to your tax return. ▶See separate instructions.
Department of the Treasury Internal Revenue Service (99)
OMB No. 1545-0184 — **2005** — Attachment Sequence No. **27**

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

1 Enter the gross proceeds from sales or exchanges reported to you for 2005 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20 (see instructions). 1

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

	(a) Description of property	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Gross sales price	(e) Depreciation allowed or allowable since acquisition	(f) Cost or other basis, plus improvements and expense of sale	(g) Gain or (loss) Subtract (f) from the sum of (d) and (e)
2	400# quota	01/07/2000	07/05/2005	1,750		1,000	750

3	Gain, if any, from Form 4684, line 39	3	
4	Section 1231 gain from installment sales from Form 6252, line 26 or 37	4	
5	Section 1231 gain or (loss) from like-kind exchanges from Form 8824	5	
6	Gain, if any, from line 32, from other than casualty or theft	6	
7	Combine lines 2 through 6. Enter the gain or (loss) here and on the appropriate line as follows:	7	750

Partnerships (except electing large partnerships) and S corporations. Report the gain or (loss) following the instructions for Form 1065, Schedule K, line 10, or Form 1120S, Schedule K, line 9. Skip lines 8, 9, 11, and 12 below.

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

8	Nonrecaptured net section 1231 losses from prior years (see instructions)	8	
9	Subtract line 8 from line 7. If zero or less, enter -0-. If line 9 is zero, enter the gain from line 7 on line 12 below. If line 9 is more than zero, enter the amount from line 8 on line 12 below and enter the gain from line 9 as a long-term capital gain on the Schedule D filed with your return (see instructions).	9	750

Ordinary Gains and Losses (see instructions)

Self-Employment Tax Treatment of Owner Payments

In the notice, the IRS states that owner payments are not subject to self-employment taxation.

Treatment of Owner Payments as Interest

If the total amount paid under the contract equals or exceeds $3,000, some of the payment may be treated as interest. It may be necessary to reduce the total quota buyout program payment by the interest portion before calculating the gain or loss.

> **Note.** IRC §483 generally applies to a contract if the total amount paid under the contract does not exceed $250,000, or if a cash method election is made under §1274A and Treas. Reg. §1.1274A-1(c) (available if total amount paid under the contract is not more than $3,202,100 for 2005).

Applicability of Farm Income Averaging

In the notice, the IRS stated that gain or loss attributable to owner payments is ineligible for farm income averaging. The rationale is that a tobacco quota is considered to be an interest in land. As such, farm income averaging is unavailable.

Information Reporting

Because a tobacco quota is considered to be an interest in land, the total amount received under a contract by an owner in a taxable year generally is reported by the USDA on Form 1099-S, *Proceeds From Real Estate Transactions,* if the amount is $600 or more. If the sale is reported on Form 4797, the amount from Form 1099S should be listed on line 1. In addition, any portion of an owner payment treated as interest for federal tax purposes is generally reported by the USDA on Form 1099-INT, *Interest Income,* if the total amount of interest received in a taxable year is $600 or more.

Involuntary Conversion and Like-Kind Exchange Treatment

The termination of a tobacco quota under AJCA is not an involuntary conversion of the quota. However, an owner can enter into a like-kind exchange of a quota to postpone the reporting of gain or loss from the termination of a quota. For purposes of the like-kind exchange rules,[49] the date on which an owner is deemed to relinquish a quota is the effective date applicable to the owner.

SUBSEQUENT GUIDANCE

Tobacco producers (growers) are also eligible for buyout payments.[50] Growers may receive up to $3 per pound of quota in exchange for the termination of tobacco marketing quotas and related price support. The buyout will be paid in 10 equal annual installments from 2005 through 2014. The amount of quota eligible for buyout is calculated based on the total amount of quota that the grower “produced under” during the 2002, 2003, and 2004 tobacco marketing years, prorated over the three years. The federal tax treatment of grower payments is expected to be addressed in subsequent guidance.

ISSUE 4: WEATHER-RELATED SALES OF LIVESTOCK

OVERVIEW

Weather-related problems are a significant risk for agricultural production. Consequently, Congress recognized the impact of weather on the livestock industry and the difficulty producers have in protecting themselves from this risk by enacting special tax rules. Due to prolonged drought in certain areas in recent years, Congress made important amendments to the weather-related livestock sale rules in 2004.

SALE AND REINVESTMENT PROVISION

Drought, floods, and other weather-related conditions can force a farmer to sell livestock that otherwise would not have been sold. Forced sales of livestock (other than poultry) held for draft, dairy or breeding purposes may qualify to be treated as **involuntary conversions**. Only those sales during the abnormal weather conditions that are **in excess of the amount normally sold** during that time period qualify for this treatment.[51]

> **Note.** Although it is not necessary for the livestock to have been held in the area, the sale must have been solely due to weather-related conditions, the existence of which affected the water, grazing, or other requirements of the livestock necessitating the sale.[52]

The number of animals that may qualify for involuntary conversion treatment is limited to the excess over the number that would have been sold or exchanged under usual business practices.

49. IRC §1031

50. AJCA §623

51. IRC §1033(e)

52. Treas. Reg. §1.1033(e)-1(b)

Replacement Property

Under the long-standing rule, livestock sold or exchanged because of the weather-related condition must be replaced within the replacement period with livestock similar or related in service or use. The new livestock must be held for the same purpose as the disposed animals. However, an amendment to IRC §1033(f) made by AJCA provides that if it is not feasible for the taxpayer to reinvest the proceeds from compulsorily or involuntarily converted livestock in livestock similar or related in use, other property (except real estate) used for farming purposes can be treated as property similar or related in service or use to the livestock so converted. Property acquired by gift or inheritance does not qualify as replacement property.

Replacement Period

Through 2002, the replacement period is two years after the year in which the proceeds were received. However, AJCA extended the two-year period to four years, effective for taxable years with the due date (without regard to extensions) for the return after December 31, 2002. The provision, however, is only applicable for weather-related conditions that result in the area being designated for assistance by the federal government. In addition, the Treasury Secretary is given authority to extend, on a regional basis, the period for replacement if the weather-related conditions continue for more than three years.

> **Note.** Although the legislation is not entirely clear, it appears that the requirement of federal designation only applies to reinvestment beyond the two-year period.
>
> It is also important to note that if livestock is replaced with dissimilar property (in accordance with the 2004 amendment), the replacement period is two years (and not four).

Holding Period

The holding period for the animals sold or exchanged can be added to the holding period of the acquired animals if the basis is determined by reference to the basis of the animals sold or exchanged.[53]

ONE-YEAR DEFERRAL RULE

Farm and ranch taxpayers using the cash method of accounting who are forced because of drought (for sales and exchanges after December 31, 1996) or other weather-related conditions to dispose of livestock (including poultry) are able to defer reporting the gain until the following taxable year.[54] Deferral of income is limited to sales in excess of "usual business practices."

Eligibility Requirement

To Be Eligible for Deferral, the Taxpayer's Principal Business Must Be Farming. On this point, there is a very helpful IRS ruling.[55] Under the facts of the ruling, a rancher grossing an average of $121,000 per year and earning $65,000 per year from a full-time off-farm job was determined to have farming as his principal business. The rancher devoted 750 to 1,000 hours per year to the ranch and the rancher's spouse contributed about 300 hours.

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> **Note.** The livestock need not be raised or sold in a drought or weather-related area. However, the sale must occur solely as a result of conditions in the designated area which affected the water, grazing, or other requirements of the livestock so as to necessitate the sale.[56] Also, the livestock may be sold before the disaster designation if they are sold because of the disaster. Any designation of assistance by a federal agency is acceptable for this purpose including the Farm Service Agency or the Small Business Administration.

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53. IRC §1223(1)(A)

54. IRC §451(e)(1)

55. Letter Ruling 8928050, April 18, 1989

56. IRS Notice 89-55, May 15, 1989

The taxpayer must establish that under the taxpayer's usual business practice, the sale or exchange would not have occurred but for the weather conditions; and the conditions must have resulted in the area being designated for assistance by the federal government.[57]

Making the Election to Postpone Gain

The election to postpone gain is made by attaching a statement to the income tax return or on an amended return that is filed during the replacement period for livestock under IRC §1033(e). This is only done if §1033(e) applies to a sale or exchange of the livestock. This means the election can be made within the four-year period (if applicable) or the two-year period.

> **Note.** This is a change in the law made by AJCA of 2004. The provision is applicable to any tax year in which the due date (without regard to extensions) for the return is after December 31, 2002. Prior to the amendment (or if the amendment does not otherwise apply), the election had to be made within the time for filing the return including extensions. Thus, the election could not be made on a late-filed return.

The election must contain the following:

- A declaration that the election is being made
- Evidence of the existence of weather-related conditions which forced the early sale or exchange of the livestock and the date, if known, on which the area was designated as eligible for federal assistance as a result of the conditions[58]
- A statement explaining the relationship of the area to the taxpayer's early sale or exchange of the livestock
- The total number of animals sold in each of the three preceding years
- The number of animals which would have been sold in the taxable year had the taxpayer followed its normal business practice
- The total number of animals sold and the number sold as a result of weather-related conditions during the taxable year
- A computation of the amount of deferred income

> **Note.** To arrive at the amount of deferred income, the total amount of income from the sale or exchange of livestock in a classification during the taxable year is divided by the total number of all livestock sold in that classification.[59] The result is then multiplied by the excess number of livestock sold as a result of weather in that classification.

A taxpayer who has made an election to defer the taxation of gain from the sale of livestock because of weather-related conditions is allowed to later revoke the election and make an election with the consent of the Commissioner to defer income by reinvestment under IRC §1033(e).

To revoke, it may be necessary to file a letter ruling request or request a determination letter from the district director.

> **Observation.** The IRS national office does not issue letter rulings on the replacement of involuntarily converted property, whether or not property has been replaced, if the taxpayer has already filed a return for the tax year in which the property was converted.[60] The district director may issue a determination letter in such a situation.

57. Treas. Reg. §1.451-7(a)-(h)
58. Remember, the sale can occur **before** the designation. IRS Notice 89-55, May 15, 1989
59. Treas. Reg. §1.451-7(e)(1)
60. Rev. Proc. 93-1, January 4, 1993

OTHER FILING RULES

Another statement must be attached to the tax return for the year in which replacement property is acquired. The statement should contain detailed information on the replacement property and a computation of tax basis allocation. If part of the replacement property is acquired in one year and part in another year, a statement must be attached to each year's return.

If replacement property is not acquired within the replacement period, Form 1040X must be filed for the tax year when the transaction occurred in order to report it and pay any additional tax. Further, if replacement property is acquired, but at a cost less than the amount received from the involuntary conversion, that portion (the difference) of the postponed gain must be reported as taxable gain on a Form 1040X and additional tax paid.

ISSUE 5: AGRICULTURAL PROGRAM PAYMENTS

GENERAL RULE

In general, all agricultural program payments are included in income. Agricultural program payments are reported on line 6a of the 2005 Schedule F.

> **Note.** Cropshare landowners may also receive agricultural payments. For these taxpayers who are not materially participating in the farming operation, the program payments are reported on Form 4835, *Farm Rental Income and Expenses.*

TIMING: WHEN ARE PAYMENTS INCLUDED IN INCOME?

In general, the time at which the funds are made available or received is the time the payments are included in income.

> **Note.** Rev. Rul. 65-98[61] specifies that funds are "made available" to the farmer in the calendar year in which the program requirements are met, regardless of whether the farmer has signed the application to receive final payment.

For cash-basis farmers, advance payments should be included in income in the earlier year even though deferred at the request of the taxpayer to the following year. The only exception is if a specific statutory exception applies that ties reporting to the tax year of actual receipt.

Gross amounts of agricultural program payments are reportable on line 6a even if:

- A government check is returned for cancellation,
- Payments received are refundable to the government, or
- The amounts are repaid to the government in some other manner.

The amounts refunded or returned are deductible on Schedule F, Part II, in the year of repayment or reduction. Schedule F instructions indicate only the taxable amount is reported on line 6b.

Agricultural program payments based on improvements, such as a pollution control facility, are includable in income. The full cost is capitalized, and cost is recoverable by depreciation or amortization.

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61. Rev. Rul. 65-98, January 1, 1965

Market loss assistance payments to dairy producers under the 1999 Omnibus spending bill were taxed in the year of receipt and not eligible for deferred tax treatment to the following year. The Farm Security and Rural Investment Act of 2002 created two new types of payments, direct and counter-cyclical payments. These payments are not subject to the constructive receipt rules and are included in income in the year of receipt.

TAXATION OF COMMODITY CERTIFICATES

Commodity certificates received from the Commodity Credit Corporation (CCC) are transferred for value and are included in income upon receipt. The face value of the certificates is reported in Schedule F, Part I, line 7. The certificates acquire an income tax basis equal to the amount reported in income.

Disposition of Certificates

In general, the current use of certificates for corn and soybean producers is a simultaneous acquisition and disposition used primarily when the producer exceeds payment limits for purposes of participating in loan deficiency programs. But there are several other situations when commodity certificates are authorized to be used. For example, commodity certificates can be used when the payment limit has not been reached. They can also be used in situations not involving loan deficiency payments, such as when marketing loans are used and the payment limitation is reached. Sometimes they can be used when the payment limit is not reached.

When commodity certificates are sold, the gain on the sale (the difference between the selling price and the income tax basis in the certificate) should be reported in Schedule F, Part I, line 1, as from property purchased for resale. The gain is ordinary income.

If commodity certificates are used to pay down the taxpayer's outstanding CCC loans on commodities in storage, an FMV determination must be made. The amount by which a certificate can be used to pay down a CCC loan is indicative of the FMV of the certificate and is calculated based upon the **posted price** for the commodity. The gain involved (the difference between the amount paid down the CCC loan and the income tax basis in the certificate) should be reported in Schedule F, Part I, lines 1 and 2, as property purchased for resale. The gain is ordinary income.

Observation. The amount paid on the CCC loan is not, in itself, taxable. The pay-down on the loan was accomplished with commodity certificates with an income tax basis equal to its FMV. Thus, the pay-down on the loan is handled as though it were done with money.

If the commodity is then sold, the entire selling price is ordinary income to a cash-basis farmer that treats CCC loans as loans. The amount is reported in Schedule F, Part I, line 14. If the taxpayer treats CCC loans as income, the taxpayer has an income tax basis in the commodity equal to the amount of the loan previously reported into income. The difference between the amount previously reported into income and the selling price should be reported as ordinary income or loss in Schedule F, Part I, line 4.

Note. A taxpayer may elect to report CCC loans as income in the taxable year in which the loan is received under IRC §77. Under the long-standing rule, the election, once made, applies to all subsequent taxable years unless the taxpayer changes back to treating loans as loans. However, effective for tax years ending on or after December 31, 2001, the IRS ruled[62] that a taxpayer reporting CCC loans as income can automatically switch to treating CCC loans as loans by filing Form 3115, *Application for Change in Accounting Method,* with the return for the year of the change. There is no user fee. However, the automatic consent procedure is inapplicable if the taxpayer:

- Is under examination by the IRS or has an issue before an IRS appeals office,
- Is affected by an IRS examination or an appeal before an IRS appeals office,
- Has made the same change in method of accounting or applied for a change in the same method of accounting within the last five years, or
- Is required to take the entire adjustment resulting from the change in method of accounting in the year of change because it is the final year of the taxpayer's business.

REVENUE RULING 87-103[63]

Under Rev. Rul. 87-103, farmers who treated CCC loans as loans were required to report the gain from the 1983 payment-in-kind (PIK) program that year, but gain on the commodity under loan could be deferred until later sale or disposition of the commodity. For farmers treating CCC loans as income, gain from PIK was handled as a reduction in basis in the commodity previously under CCC loan. The gain was the difference between the farmer's income tax basis in the certificate and the amount of the CCC loan reduction.

The following examples are provided to further detail the taxation of agricultural program payments. The analysis should be viewed in light of the fact that the IRS has **not** specifically ruled on the points raised by the examples.[64]

Example 21. Melanie, a cash-method farmer, received a generic commodity certificate in 2004 with a face value of $10,000. Melanie has 5,000 bushels of 2003 crop corn under a CCC loan taken out in 2003 in the amount of $10,750. The 2003 loan rate was $2.15 per bushel. The county posted price is $1.85 per bushel. The CCC loan was redeemed in 2004 using a commodity certificate. In 2005, the corn was sold for $11,500. Melanie has not made an IRC §77(a) election and therefore reports CCC loans as loans.

Result. The IRS's view is that Melanie has $10,000 of income on receipt of the commodity certificate in 2004.

Because Melanie is able to pay off the CCC loan of $10,750 in 2004, she has $750 of additional income when the $10,750 loan is paid off using a certificate with a tax basis of $10,000. The corn continues to have a zero basis. Thus, when the corn is sold in 2005 for $11,500, Melanie has $11,500 of income in 2005.

Income in 2003	$ 0
Income in 2004	10,750
Income in 2005	11,500
Total income	$22,250

62. Rev. Proc. 2002-9, Appendix Section 1.01 (for the year of change, all loans reported as loans), January 7, 2002. See also Rev. Proc. 2004-23, (procedures for automatic change of accounting; for first tax year after December 31, 2003), March 24, 2004.

63. Rev. Rul. 87-103, October 26, 1987

64. The examples are adapted from Harl, *Agricultural Law*, Vol. 4, Sec. 27.03[4] (2005).

If Melanie had sold the corn crop in 2004 instead of 2005, the result in the IRS's view would be:

Income in 2003	$ 0
Income in 2004	22,250
Income in 2005	0
Total income	$22,250

If Melanie elected to report CCC loans as income rather than as loans, the result would be:

- $10,750 of income in 2003 when the loan is taken out. The corn has an income tax basis of $10,750.
- $10,000 of income in 2004 upon receipt of the commodity certificate.

Because the corn has an income tax basis of $10,750 less the amount of gain when the loan is paid off ($750), Melanie's basis in the corn is $10,000. When the corn is sold in 2005 for $11,500, Melanie has additional income of $1,500.

Income in 2003	$10,750
Income in 2004	10,000
Income in 2005	1,500
Total income	$22,250

If Melanie had sold the corn in 2004 rather than 2005, the result in the IRS's view is:

Income in 2003	$10,750
Income in 2004	11,500
Income in 2005	0
Total income	$22,250

Observation. Example 21 currently applies to only a small number of commodities.

Example 22. The original facts of **Example 21** apply, except Melanie **purchased** the commodity certificate (face value of $10,000) for $10,500. In the IRS's view, the $10,500 purchase price of the certificate established Melanie's basis in the certificate and she cannot claim any deduction for the purchased commodity certificate.

Melanie is able to pay off the CCC loan of $10,750 in 2004 with the certificate bearing a face value of $10,000. Therefore, Melanie has $250 of additional income when the $10,750 loan is paid off using a certificate with an tax basis of $10,500.

The corn continues to have a zero basis. That means that when the corn is sold in 2005 for $11,500, Melanie has $11,500 of income at that time.

Income in 2003	$ 0
Income in 2004	250
Income in 2005	11,500
Total income	$11,750

If Melanie sold the corn crop in 2004 rather than in 2005, the result in the IRS's view would be:

Income in 2003	$ 0
Income in 2004	11,750
Income in 2005	0
Total income	$11,750

If Melanie sells her crop in 2005 and treats loans as income, the result is:

- Melanie has $10,750 of income when the CCC loan is taken out in 2003 and the corn has a tax basis of $10,750.
- The $10,500 purchase price for the certificate is Melanie's basis in the certificate (no deduction for the purchased certificate).
- The corn continues to have a tax basis of $2.15 per bushel ($10,750 in total) less the $250 gain from redeeming a $10,750 loan with a certificate having a basis of $10,500. The resulting basis in the corn is $10,500.

Note. Arguably, the gain of $250 from redeeming the CCC loan should be reportable in the year of the loan redemption, but Rev. Rul. 87-103 does not require that result.

When the corn is sold in 2005 for $11,500, Melanie has $1,000 of additional income.

Income in 2003	$10,750
Income in 2004	0
Income in 2005	1,000
Total income	$11,750

If Melanie sold the corn crop in 2004 rather than in 2005 and treated loans as income, the result would be:

Income in 2003	$10,750
Income in 2004	1,000
Income in 2005	0
Total income	$11,750

Example 23. Mark is a cash-basis farmer. In 2003, he purchases a commodity certificate with a face value of $10,000 for $10,500. Mark has 5,000 bushels of 2003 crop corn under a CCC loan taken out in 2003 in the amount of $10,750. The 2003 loan rate was $2.15 per bushel. The county posted price is $1.85 per bushel. The CCC loan was redeemed in 2004 using a commodity certificate. Mark fed the corn to livestock in 2004. He did not made an IRC §77(a) election. Therefore, he reports CCC loans as loans.

The purchase price for the certificate of $10,500 is Mark's tax basis in the certificate. No deduction is available for a purchased commodity certificate.

In 2004, Mark paid off the CCC loan of $10,750 with the commodity certificate having a tax basis of $10,500 (face value). Consequently, he has $250 of additional income in 2004.

The corn continues to have a zero basis. Therefore, when he feeds the corn to livestock in 2004, he does not receive a deduction.

Income in 2003	$ 0
Income in 2004	250
Income in 2005	0
Total income	$250

If Mark treats CCC loans as income and not as loans, the result is:

- The purchase price of the certificate of $10,500 is his income tax basis in the certificate (no deduction for the purchased commodity certificate).
- Mark has $10,750 of income in 2003 when the loan was taken out. Thus, his tax basis in the corn is $10,750.
- The corn continues to have a tax basis of $2.15 per bushel ($10,750 in total) less the $250 gain when the $10,750 loan is paid off with a certificate having a basis of $10,500. Thus, the resulting basis in the corn is $10,500.
- Mark receives a deduction for **feed purchased** in 2004 of $10,500.

Income in 2003	$10,750
Income in 2004	(10,500)
Income in 2005	0
Total income	$ 250

Note. If a taxpayer is merely speculating in buying and selling commodity certificates, the purchase gives rise to a tax basis in the certificate (but not a deduction), which would offset the selling price received on the sale with the gain reported on Schedule D. If the taxpayer is not speculating, but is using certificates to acquire grain for livestock feed, the purchase gives rise to a tax basis (but not a deduction). When the certificate is used to acquire grain for feed, the amount of the tax basis in the certificate gives rise to a tax deduction for feed if the amount bears a reasonable relationship to the feed needs of the taxpayer's livestock enterprise. The deduction would be claimed on Schedule F, Part II, line 18.

CCC LOANS AND ACCRUAL BASIS TAXPAYERS

Some tax professionals have expressed uncertainty regarding the completion of Schedule F for transactions involving CCC loans for accrual basis taxpayers. The following example discusses how one taxpayer filed his self-prepared return **incorrectly.** The correct reporting on Schedule F is also shown.

Example 24. Farmer John maintains his records primarily on the cash basis, but adjusts his income for beginning and ending inventories on his Schedule F, Part III. John made an election to report CCC loans as income. He claims the check for the repurchase of grain as an expense, and reports the sale of the grain when it is deposited. John typically has very little in accounts payable or accounts receivable, and always tries to clear up any matters before year end so there is no carryover. John reflects the inventory for sealed grain at the difference between the sealed price and FMV as of the end of the year. He reflects any unsealed grain at FMV at year end. John makes no other adjustments to book income or expenses to arrive at the amounts reflected on the return.

In 2004:

- John has 100,000 bushels of corn sealed at $2.00/bushel.
- John reports $200,000 on his Schedule F, Part III, line 41(a), as a CCC loan reported as income under the §77 election.
- If the FMV of the grain at the end of the year is $2.25/bushel, John shows an ending inventory of $25,000 (100,000 bushels at $.25/bushel) on Schedule F, Part III, line 49.

Consequently, John reports gross income in the amount of $225,000. In 2005, when the loan is redeemed:

- John claims the checks written to the CCC as "other expense" on his Schedule F, Part II, line 34.
- He reports the full amount of the sale proceeds from the grain as income on Schedule F, Part III, line 38.

Question 24A. Is the transaction reported properly, including the valuation of the ending inventory?

Answer 24A. It appears that John is not using cash accounting even though he maintains records on the cash basis and reports income and expense in the same manner as a cash basis taxpayer. However, he is probably not an accrual basis taxpayer either because of the way income and expenses are handled. Instead, it appears that John is utilizing a type of **hybrid accounting.** The IRS could object to this method, unless John has continued the practice for some time. There is authority for the continuation of a hybrid method of accounting, and the accounting practices are subject to the uncertain rules if changed.

John's electing to report CCC loans as income gives the commodity a basis derived from the amount reported into gross income. If John reports the FMV at year end in inventory, that gives the commodity a new basis (up or down from the amount reported as income under §77) which means additional income or a negative adjustment to income measured by the difference between the inventory value and the amount of income reported in accordance with the §77 election. Reporting the commodity's basis in inventory at the closing value would not create that result, but that would be a departure from how John has been treating these transactions and would constitute a change in accounting method.

In any event, John has income from redemption of the commodity from the CCC loan, apart from the gain on the commodity.

John should report the CCC transaction as shown on the 2004 and 2005 Schedule F.

For Example 24

Schedule F (Form 1040) 2004 Page **2**

Part III **Farm Income—Accrual Method** (see page F-6)
Do not include sales of livestock held for draft, breeding, sport, or dairy purposes; report these sales on Form 4797 and do not include this livestock on line 46 below.

38	Sales of livestock, produce, grains, and other products during the year		38	
39a	Total cooperative distributions (Form(s) 1099-PATR) 39a	39b Taxable amount	39b	
40a	Agricultural program payments 40a	40b Taxable amount	40b	
41	Commodity Credit Corporation (CCC) loans:			
a	CCC loans reported under election		41a	200,000
b	CCC loans forfeited 41b	41c Taxable amount	41c	
42	Crop insurance proceeds		42	
43	Custom hire (machine work) income		43	
44	Other income, including Federal and state gasoline or fuel tax credit or refund		44	
45	Add amounts in the right column for lines 38 through 44		45	
46	Inventory of livestock, produce, grains, and other products at beginning of the year	46		
47	Cost of livestock, produce, grains, and other products purchased during the year	47		
48	Add lines 46 and 47	48		
49	Inventory of livestock, produce, grains, and other products at end of year	49 25,000		
50	Cost of livestock, produce, grains, and other products sold. Subtract line 49 from line 48*		50	(25,000)
51	**Gross income.** Subtract line 50 from line 45. Enter the result here and on page 1, line 11 ▶		51	225,000

*If you use the unit-livestock-price method or the farm-price method of valuing inventory and the amount on line 49 is larger than the amount on line 48, subtract line 48 from line 49. Enter the result on line 50. Add lines 45 and 50. Enter the total on line 51.

Part IV **Principal Agricultural Activity Codes**

CAUTION File **Schedule C** (Form 1040), Profit or Loss From Business, or **Schedule C-EZ** (Form 1040), Net Profit From Business, instead of Schedule F if:

- Your principal source of income is from providing agricultural services such as soil preparation, veterinary, farm labor, horticultural, or management for a fee or on a contract basis or
- You are engaged in the business of breeding, raising, and caring for dogs, cats, or other pet animals.

These codes for the Principal Agricultural Activity classify farms by the type of activity they are engaged in to facilitate the administration of the Internal Revenue Code. These six-digit codes are based on the North American Industry Classification System (NAICS).

Select one of the following codes and enter the six-digit number on page 1, line B.

Crop Production

111100 Oilseed and grain farming
111210 Vegetable and melon farming
111300 Fruit and tree nut farming
111400 Greenhouse, nursery, and floriculture production
111900 Other crop farming

Animal Production

112111 Beef cattle ranching and farming
112112 Cattle feedlots
112120 Dairy cattle and milk production
112210 Hog and pig farming
112300 Poultry and egg production
112400 Sheep and goat farming
112510 Animal aquaculture
112900 Other animal production

Forestry and Logging

113000 Forestry and logging (including forest nurseries and timber tracts)

Schedule F (Form 1040) 2004

For Example 24

Schedule F (Form 1040) 2005 — Page **2**

Part III **Farm Income—Accrual Method** (see page F-6).
Do not include sales of livestock held for draft, breeding, sport, or dairy purposes; report these sales on Form 4797 and do not include this livestock on line 46 below.

38	Sales of livestock, produce, grains, and other products			38	225,000
39a	Cooperative distributions (Form(s) 1099-PATR)	39a	39b Taxable amount	39b	
40a	Agricultural program payments	40a	40b Taxable amount	40b	
41	Commodity Credit Corporation (CCC) loans:				
a	CCC loans reported under election			41a	
b	CCC loans forfeited	41b	41c Taxable amount	41c	
42	Crop insurance proceeds			42	
43	Custom hire (machine work) income			43	
44	Other income, including Federal and state gasoline or fuel tax credit or refund			44	
45	Add amounts in the right column for lines 38 through 44			45	
46	Inventory of livestock, produce, grains, and other products at beginning of the year	46	25,000		
47	Cost of livestock, produce, grains, and other products purchased during the year	47	200,000		
48	Add lines 46 and 47	48	225,000		
49	Inventory of livestock, produce, grains, and other products at end of year	49	0		
50	Cost of livestock, produce, grains, and other products sold. Subtract line 49 from line 48*			50	225,000
51	**Gross income.** Subtract line 50 from line 45. Enter the result here and on Part I, line 11 ▶			51	0

*If you use the unit-livestock-price method or the farm-price method of valuing inventory and the amount on line 49 is larger than the amount on line 48, subtract line 48 from line 49. Enter the result on line 50. Add lines 45 and 50. Enter the total on line 51 and on Part I, line 11.

If John sells the corn for more or less than his $225,000 basis he will have an additional gain or loss the report in the year of sale.

John should not deduct the amount paid to the CCC. That amount is a nondeductible loan repayment.

EXCEPTION TO RULE OF INCLUSION: COST SHARING BENEFITS

Under the Revenue Act of 1978, Congress permitted some cost-sharing amounts received under state and federal programs to be excluded from income.

Eligible Amounts

Eligible amounts include those paid under the following programs:

- Rural Clean Water Program
- Rural Abandoned Mine Program
- Water Bank Program
- Emergency Conservation Measures Program

- Agricultural Conservation Program
- Great Plains Conservation Program
- Resource Conservation and Development Program
- Forest Land Enhancement Program (replaced the Forestry Incentives Program repealed in 2002)
- Any small watershed program administered by the Secretary of Agriculture that is determined by the Treasury Secretary to be substantially similar to the types of programs made in connection with small watersheds under the Stewardship Incentive Program
- Wetlands Reserve Program
- Environmental Quality Incentives Program
- Wildlife Habitat Incentives Program
- Soil and Water Conservation Assistance Act
- Conservation Reserve Program
- Agricultural Management Assistance Program
- Texas Forest Service Oak Wilt Suppression Program
- Wisconsin Department of Natural Resources Forest Landowner Program
- Any state program for which payments are made for the purpose of conserving soil, protecting the environment, improving forests, or providing a habitat for wildlife

Requirements for Excludability

For amounts paid under eligible programs to be excludible, **three requirements** must be satisfied:

1. The Secretary of Agriculture must determine that the payments are made "primarily for the purpose of conserving soil and water resources, protecting or restoring the environment, improving forests, or providing a habitat for wildlife."[65]
2. The Treasury Secretary must determine the expenditures made under the program are not "increasing substantially" the annual income from the property.[66]

> **Note.** An increase in annual income is not substantial unless it exceeds the greater of $2.50 per acre or 10% of the average annual income derived from the property prior to the improvement.[67] Practitioners that have clients receiving these payments should consult Temp. Treas. Reg. §16A.126-1 for an example and the relevant formulas.

3. No part of a payment can be excluded if it is for an expense that is allowed to be deducted in the current tax year, such as rent for the property, or for services of the recipient.

65. IRC §126(b)(1)(A)
66. IRC §126(b)(1)(B)
67. Temp. Treas. Reg. §16A.126-1

Example 25. Mindy owns a 640-acre farm in Indiana. She received a gross income of $64,000 from crop production over each of the last three years. In 2005, Mindy had a grass waterway installed to comply with a soil and water conservation plan for the farm. The waterway (a nondepreciable land improvement) cost $48,000, and increased the value of her farm by $27,000. Mindy received a $24,000 cost-share payment from the local FSA office, which she reported as a government payment. Mindy meets all of the tests for excludability. How much of the $24,000 cost-sharing payment can she exclude from income?

Computation of the 10%/$2.50-per-acre limit:

$$10\% = \$6{,}400$$

$$\$2.50 \times 640 = \$1{,}600$$

Therefore, 10% of the rent ($6,400) is greater than $2.50 times 640 acres ($1,600). Part or all of the $24,000 cost-share amount is excludible if the annual income does not increase more than $6,400 because of the waterway.

Computation of the excludible amount, based on the formula described in Temp. Treas. Reg. §16A.126-1(g):

1. Determine the value of the improvement.

$$\text{Improvement FMV} \times \frac{\text{§126 Cost}}{\text{Cost of the improvement}}$$

$$\$27{,}000 \times \frac{\$48{,}000}{\$48{,}000} = \$27{,}000$$

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

$$\frac{\$6{,}400}{.025 \text{ (assumed PFMV discount factor)}} = \$256{,}000$$

3. Determine Mindy's cost associated with the improvement.

$$\$24{,}000$$

4. Add the results of Steps 2 and 3.

$$\$48{,}000 + \$256{,}000 = \$280{,}000$$

5. If the result of Step 4 exceeds the value of the improvement, the entire amount of cost-share payment can be excluded from income if annual income does not increase more than $6,400.

Note. If Mindy did not made an election to exclude the cost-share amount, she would include in gross income the excess value of the improvement ($27,000) over her contribution ($24,000), or $3,000.

11

Effects of the Exclusion. When figuring the basis of property acquired or improved using cost-sharing payments excluded from income, subtract the excluded payments from the capital costs. Any payment excluded from income reduces basis.

Eligibility of Lessors for the Exclusion

In 1990, the IRS ruled that the exclusion is available to lessors of property.[68] However, the ruling made no mention of the type of lease. Therefore, the type of lease is apparently not relevant, and all lessors are eligible to claim the exclusion.

Recapture

If property acquired, improved, or otherwise modified by the application of payments excluded from gross income is disposed of within 20 years, part or all of the excluded payments are taxed as ordinary income on Form 4797.[69] The amount taxable as ordinary income is the lesser of the gain realized on sale of the property, or the applicable percentage of the amount of payment that had been excluded from income. The applicable percentage for the first 10 years after the date the payments are received and excluded is 100%. Thereafter, the applicable percentage is reduced annually by 10%. After the 19th year, there is no recapture.

Note. The exclusion and recapture rules do not apply to government cost-share payments to the extent a deduction is allowed in the year paid or incurred. If the exclusion is claimed, expenditures may not be used to generate deductions or credits and may not be added to the tax basis of the acquired property.

Election Not to Have Exclusion Apply

A taxpayer may elect not to have the exclusion rules apply to all or part of an improvement.[70] Taxpayers who prefer to avoid the 20-year recapture provision and who can cover their cost sharing amounts with deductions and credits may want to make the election. This choice must be made by the due date, including extensions, for filing the tax return; provisions also exist for a late election.

68. Letter Ruling 9014041, January 5, 1990

69. IRC §1255

70. IRC §126(c)

The form for making the election should take the following general format:

SAMPLE ELECTION TO HAVE EXCLUSION FOR COST-SHARING PAYMENTS NOT APPLY UNDER IRC §126(c)

John Conservation

Rural Route #7

Flowering Hill, Iowa 12345

Internal Revenue Service

RE: Form 1040, Calendar Year 2005

Dear Sir or Madam:

I hereby elect to have the statutory exclusion for cost-sharing payments under Internal Revenue Code Section 126(c) not apply to my taxable year that began January 1, 2005, and ended December 31, 2005, and in support of such election, I hereby submit the following information:

I am a sole proprietor and operate a general farming operation in Multiflora Rose County, Iowa.

I have constructed terraces on 200 acres of farmland. The value of the improvement is $35,000.

I have applied for reimbursement from the United States Department of Agriculture within the provisions of the Watershed Protection and Flood Prevention Act.

The United States Department of Agriculture has reimbursed me in the amount of $17,500 under that program in the 2005 taxable year.

The Secretary of Agriculture has certified that 100% of the reimbursement is primarily for conservation purposes.

The excludable portion of the reimbursement in accordance with Temp. Treas. Reg. §16A.126-1(b)(5) is $7,500, which, by this election, will not be excluded from income.

____

John Conservation

ISSUE 6: FARM LABOR TAX ISSUES

LABOR HIRED

A sole proprietor farmer enters expenses incurred in carrying out the farming business on Schedule F. A farmer may deduct all ordinary and necessary expenses incurred in the farming business.[71] On line 24, the amount paid for farm labor is entered as a deduction.

Note. Wages paid to farm workers or to independent contractors for farm labor performed are deductible. For independent contractors, the contract price paid for services rendered is fully deductible.[72]

71. IRC §162

72. Treas. Reg. §1.162-5

Payments in Kind

As a general rule, when property is transferred as payment for services, the FMV of the asset is deductible. However, an exception exists if the asset has an adjusted basis lower than the FMV of the asset that is transferred. In that event, the transfer is an exchange that triggers taxable income to the farmer in an amount representing the difference between basis and FMV of the asset. The character of the gain depends on the type of property transferred.

> **Example 26.** Jethro works as a hired hand for his uncle Jed in Jed's farming operation. Jethro is paid in the form of a dairy cow that Jed owned for the past three years. Jed's basis in the cow at the time of the transfer was $400 and the cow had an FMV of $650.
>
> **Result.** Jed deducts $650 from ordinary income as a labor expense (line 24) and includes the $250 gain in income. The dairy cow qualifies as property used in the trade or business, so the gain to Jed is capital in nature.

Restricted Property Rule

When property is transferred for personal services that are subject to a substantial risk of forfeiture, the taxpayer need not include the value of the property in income until the risk abates or the property becomes freely transferable.[73] By election, the wage earner may include the property in gross income. In that event, the employer may claim a deduction in the year the employee includes the compensation in income.[74]

Room and Board

If reasonable, the cost of room and board provided to employees as compensation is deductible. **Lodging** includes all expenses associated with lodging (including repairs, utilities, and insurance). The full cost of board is also deductible.

> **Observation.** Court cases reveal that the key to deducting compensation paid in the form of room and board is documentation and reasonableness.

Wages Paid to Family Members

Cases abound on the issue of whether compensation is reasonable when a family business incorporates and the officers (family members) attempt to drain all the corporate profits in the form of deductible salaries. Setting salaries too high gives the IRS opportunity to argue that the salaries, at least in part, are nondeductible dividends. The same issue can arise in the context of room, board, and lodging. A current focus of S corporation transactions is a low salary paid to family members to minimize social security and Medicare tax liabilities.

Wages Paid to Children. Under Rev. Rul. 72-23,[75] reasonable wages paid by a parent to an unemancipated minor child for personal services (actually rendered), as a bona fide employee in the conduct of a trade or business, are deductible by the parent/employer. In addition, income earned by the children is not attributed to the parents.[76] Obviously, the key is to establish that an employment relationship exists, and that the payments were actually made.

> **Note.** If the child is treated as an employee (due to a written employment agreement, proof of payment, receipt of funds, and proof that the work was performed), the employer-parent may be responsible for withholding income tax. After the children reach age 18, they are considered employed for purposes of social security tax. Also, the IRS draws a line at providing compensation in the form of meals and lodging. Parents are legally responsible for the support and maintenance of minor children. The cost of providing meals and lodging to them is deemed a personal expense, even if an employer/employee relationship is established.[77]

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73. IRC §83(a)

74. IRC §83(h)

75. Rev. Rul. 72-23, January 1, 1972

76. IRC §73

77. Rev. Rul. 73-393, January 1, 1973

Payments to the Spouse. Deductibility of wage payments to the spouse hinges on the establishment of a true employer-employee relationship and the rendering of substantial services from the employee-spouse. Establishing an employment relationship with a spouse should be evaluated with other legal and tax implications (estate plans, social security benefits).

ISSUE 7: RECENTLY ENACTED AGRICULTURAL TAX LEGISLATION

AMERICAN JOBS CREATION ACT OF 2004[78]

Farm Income Averaging

In computing AMT, the regular tax liability for farmers and fishermen is determined without regard to income averaging. Consequently, a farmer receives the full benefit of income averaging.[79] The provision is effective for taxable years beginning after December 31, 2003.

Capital Gain Treatment for Timber

In the case of a sale of timber by the owner of the land from which the timber is cut, the requirement that a taxpayer retain an economic interest in the timber in order to treat gains as capital gains under IRC §631(b) does not apply. Outright sales of timber by the landowner qualifies for capital gains treatment in the same manner as sales with a retained economic interest, except that the usual tax rules relating to the income from the sale of the timber will apply.[80] The provision is effective for sales after December 31, 2004.

Expensing of Reforestation Expenditures

Up to $10,000 of qualified reforestation expenditures can be deducted in the year paid or incurred. Qualified expenditures above $10,000 are amortized over 84 months.[81] The reforestation credit is also repealed. The amendments apply to expenditures paid or incurred after the date of enactment.

Start-Up Costs

Up to $5,000 of business start-up costs paid or incurred after date of enactment can be deducted with the remaining amount amortized over 180 months.

§179 Elections

Section 179 deduction elections can be made or revoked by filing an amended return. This is applicable to property placed in service after 2002 and before 2008.

Increase to FUTA Tax Deposit Threshold

The Treasury Department increased the accumulated FUTA tax deposit threshold from $100 to $500 for periods beginning after December 31, 2004.

78. H.R. 4520; signed into law on October 22, 2004

79. Act, Sec. 314(a), *amending* IRC §55(c)

80. Act. Sec. 315(a), *amending* IRC §631(b)

81. Act, Sec. 322(a), *amending* IRC §194(b)