Chapter 12: Agricultural Issues and Rural Investments

Corrections were made to this workbook through January of 2007. No subsequent modifications were made.

ISSUE 1: QUALIFIED PRODUCTION ACTIVITIES DEDUCTION (IRC §199)

INTRODUCTION

Chapter 15 of the *2005 University of Illinois Federal Tax Workbook* provided in-depth coverage of the manufacturer's deduction. Chapter 13 of the *2006 University of Illinois Federal Tax Workbook* provides additional coverage of IRC §199 in light of final regulations issued in May 2006. The deduction also has application to agricultural businesses and producers which is addressed here.

CALCULATING THE DEDUCTION — THE WAGE LIMITATION

For purposes of the 3% of AGI limitation, taxable income and AGI are calculated without the IRC §199 deduction. The IRC §199 deduction is also disregarded for calculating the following deductions and exclusions that are based on AGI:

1. IRC §86 (social security and tier 1 railroad retirement benefits)
2. IRC §135 (interest on U.S. savings bonds used for qualified higher education expenses)
3. IRC §137 (adoption assistance)
4. IRC §219 (retirement savings)
5. IRC §221 (student loan interest)
6. IRC §222 (qualified tuition deduction)
7. IRC §469 (passive activity loss)

Note. The deduction is allowed for both regular tax and alternative minimum tax including adjusted current earnings. However, the deduction is not allowed in computing self-employment (SE) income.

The amount of the deduction allowable for any tax year may not exceed 50% of the Form W-2 wages of the employer for the year.[1]

1. IRC §199(b)(1)

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In some situations, the wage limitation does not limit the deduction.

Example 1. Robin operates her dairy and crop farming operation as a sole proprietor farmer. In 2006, she has gross receipts of $170,000 from the sale of milk, crops, and livestock. All her receipts qualify as domestic production gross receipts (DPGR) and she has no Form 4797 transactions to report. Robin has $100,000 of farm expenses, including $20,000 of qualifying Form W-2 wages for part-time labor. Her net Schedule F (Form 1040) income is $70,000. Robin's qualified production activities income (QPAI) is $70,000 ($170,000 – $100,000). Robin's AGI is $80,000. Robin's qualified production activities deduction for 2006 is $2,100 (3% of $70,000).

For many farming operations, the wage limitation may be a significant factor which limits the amount of the deduction.

Example 2. Carole operates a farm with the part-time unpaid assistance of her husband, Dennis. Carole has $150,000 of gross farm receipts that qualify as DPGR. Her farm expenses total $90,000, thus her QPAI is $60,000. For 2006, Carole paid no qualifying Form W-2 wages. Consequently, Carole does not qualify for a qualified production activities deduction for 2006.

Observation. The deduction increases to 6% for taxable years beginning in 2007, 2008, and 2009, and 9% for taxable years beginning after 2009. Practitioners should review client files to determine if present business structures should be reorganized in order to maximize the benefit of the deduction when it is fully phased in. Paying attention to the amount of wages paid in the future can help fully utilize the deduction. If a particular client's SE income exceeds the $94,200 (for 2006) base, incurring extra labor costs to qualify for the deduction may only be marginally advantageous. Most proprietors and partners tend to keep their SE income under the maximum threshold. Therefore, there should be some benefit from increasing wages to more fully utilize the deduction.

HANDLING QUALIFIED PRODUCTION ACTIVITIES INCOME (QPAI)

QPAI is domestic production gross receipts (DPGR) reduced by the cost of goods sold allocable to DPGR; other deductions, expenses, and losses directly allocable to DPGR; and indirect deductions, expenses, and losses allocable to DPGR.[2] DPGR for cash-basis farmers includes:

- Receipts reported on Form 1040, Schedule F (not reduced by the purchase price of livestock purchased for resale)[3]
- Receipts from raised draft, breeding, and dairy livestock sales on Form 4797
- (Probably) receipts from purchased draft, breeding, and dairy livestock, if the taxpayer played a significant part in raising the animal

Note. Farmers who capitalize the cost of raising the purchased draft, breeding, or dairy livestock qualify for a safe harbor if their costs of raising the livestock are at least 20% of the cost of the animals.

- Farm program payments for a producer not to produce crops or paid in lieu of production of actual crops[4]
- Gains or losses on hedges are taken into account in determining domestic production gross receipts if the hedge involves the purchase of supplies used in the business.[5]

2. IRC §199(c)(1)

3. Thus, income from the disposition of land (real property) is excluded from DPGR. IRC §199(c)(4)(B). "Real property" is defined to include buildings and inherently permanent structures other than machinery. IRC §1-199-3(m)(4).

4. Notice 2005-14, I.R.B. 2005-7, 498, Sec. 4.04(7)(a). Direct payments, counter cyclic payments, and marketing loan benefits are not "payments not to produce."

5. Treas. Reg. §1.199-3(h)(3)(i)(C)

DPGR **does not include** the following:

- Gross receipts from mineral royalties and net profits interests, other than those derived from operating mining interests[6]
- Gross receipts from property leased, licensed, or rented by the taxpayer for use by a related person[7]
- Gross receipts from the disposition of land (real property)
- Gross receipts from the sale of food and beverages prepared by the taxpayer at a retail establishment
- Gross receipts from the transmission or distribution of electricity, natural gas, or potable water
- Gross receipts from custom work

Production in the United States and Tracing the Source of Gross Receipts

DPGR, as statutorily defined, includes gross receipts derived from a lease, rental, license, sale, exchange, or other disposition of qualifying production property which was "manufactured, produced, grown, or extracted" by the taxpayer in whole or in significant part within the United States.[8]

Example 3. Slice & Dice, Inc. (S&D) operates a slaughtering plant in Montana. S&D has cattle on feed in feedlots located in the United States and in Canada that will eventually be slaughtered at its Montana facility. S&D tracks the beef it raises in each location. It must use that same method to allocate its gross receipts between the United States and Canada to calculate DPGR.

Gross Receipts Safe Harbor

A safe harbor allows a taxpayer with less than 5% of total gross receipts from items other than DPGR to treat all gross receipts as DPGR. The taxpayer is not required to allocate its gross receipts in this case.

Example 4. Anita Fixx has $200,000 of gross receipts from the sale of agricultural commodities (derived from her farming business) and $9,000 gross receipts from custom work for other farmers. Because the $9,000 from custom work is less than 5% of her total gross receipts, Anita may treat the entire $209,000 as DPGR.

Common Examples of DPGR

Example 5. Bill received $65,000 from the sale of slaughter pigs, $40,000 from the sale of wheat, and $10,000 from the sale of raised sows in 2006. He purchased the pigs for $15,000. Bill's DPGR from these sales is $115,000 ($65,000 + $40,000 + $10,000). The purchase price of the pigs does **not** reduce Bill's DPRG.

Example 6. Lorna paid $2,000 for seedling fruit trees for use in her orchard farming operation. Lorna capitalized her costs of raising the trees (which totaled $750) until the trees became productive. When Lorna sells the fruit, the sale proceeds are included in Lorna's DPGR under the safe harbor because she incurred more than 20% of the cost of raising the trees. If Lorna did not capitalize her cost of raising the trees, the safe harbor does not apply. However, if Lorna played a significant role in raising the trees (which is likely the case) she can include the sale proceeds in DPGR.

6. Treas. Reg. §1.199-3(h)(9)
7. IRC §199(c)(7)
8. IRC §199(c)(4). The Senate bill specifically provided that property would be treated as produced in significant part "by the taxpayer within the United States if more than 50% of the aggregate development and production costs were incurred by the taxpayer in the United States." The House bill, however, does not contain such specific guidance. The Conference Committee followed the House version.

> **Note.** The IRS does not require a single method of determining DPGR. Most taxpayers can use any reasonable method that accurately identifies the source of gross receipts based on information available to the taxpayer to substantiate the allocation. However, a taxpayer who uses a specific identification method for any other purpose or who has information readily available to use a specific identification method generally is required to use that method to determine DPGR.

Cost of Goods Sold

In making the determination of QPAI for the taxable year, a taxpayer must subtract from the taxpayer's DPGR the cost of goods sold which is allocable to DPGR, other expenses and deductions directly allocable to DPGR, and a ratable portion of other deductions not directly allocable to DPGR or another class of income.[9]

A taxpayer's costs must be determined using the taxpayer's method of accounting for federal income tax purposes.[10] Under the regulations, the determination of cost of goods sold that is allocable to DPGR includes costs that would have been included in ending inventory if the goods sold during the year were on hand at the end of the year.[11] If a taxpayer cannot specifically identify the cost of goods sold that is allocable to qualifying production, a reasonable method can be used to make an allocation. The same method used to allocate gross receipts to qualifying production activities must be used for determining the allocable cost of goods sold. Also, any reasonable method may be used to allocate indirect costs between DPGR and nonDPGR if the taxpayer's books do not or cannot, without undue burden or expense, identify the cost of goods sold allocable to DPGR.[12]

While the regulations provide for three possible methods of allocating and apportioning deductions, most farm clients qualify for the **small taxpayer method.** Under this method, a taxpayer may allocate both cost of goods sold and all other deductions based on the same ratio of receipts derived from qualifying production activities to total receipts from all sources. For this purpose, small taxpayers include:

1. Those with 3-year average annual gross receipts of $5 million or less, or
2. A taxpayer eligible to use the cash method of accounting.[13]

Under the small taxpayer method, the total costs are apportioned based on relative gross receipts. For pass-through entities eligible to use this method, the small taxpayer method is applied at the pass-through entity level.[14]

> **Note.** In Rev. Proc. 2006-22, the IRS provided guidance on applying the final regulations to taxable years beginning after January 1, 2005, and on or before May 17, 2006.[15]

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9. IRC §199(c)(1)
10. Treas. Reg. §1.199-4(b)(1)
11. Ibid
12. Treas. Reg. §1.199-4(b)(2)
13. Taxpayers engaged in the trade or business of farming can use this method if not required to use the accrual method of accounting under IRC §447.
14. Treas. Reg. §1.199-4(f)(1)
15. Rev. Proc. 2006-22, May 24, 2006

Example 7. In 2006, Myra Mains had the following income and expenses:

Crop sales	$100,000	83.33%	DPGR
Custom work	20,000	16.67%	NonDPGR
Schedule F receipts	120,000	100.00%	
Schedule F deductions	70,000		
Cost allocated to DPGR	58,333 (83.33% × $70,000)		
QPAI	41,667 ($100,000 − $58,333)		

Myra has $ 41,667 of QPAI for 2006.

Example 8. The small taxpayer method apparently allows Lorna from **Example 6** to allocate her cost of goods sold proportionately between her DPGR and her other gross receipts. Without that simplified method, Lorna must allocate the $2,000 cost of purchasing the fruit trees and her $750 of capitalized expenses to her DPGR from the sale of the fruit. Her cost of maintaining the trees after they become productive should be allocated to the fruit produced from the trees.

Example 9. The small taxpayer method also apparently allows Bill from **Example 5** to allocate his cost of raising his sows proportionately between his DPGR and his other gross receipts. Without that simplified method, Bill would have to allocate all of the cost of raising his sows to the DPGR from selling them.

QUALIFIED PRODUCTION PROPERTY (QPP) AND THE MANUFACTURED, PRODUCED, GROWN OR EXTRACTED (MPGE) TEST

For purposes of IRC §199, the proposed regulations (unchanged by the final regulations) state that property may be tangible personal property even though it is considered a fixture and therefore real property under state law.

> **Obervation.** Property that is in the nature of machinery is tangible personal property even if it is located outside a building.

To qualify as DPGR, the QPP must be manufactured, produced, grown, or extracted (MPGE) in whole or in significant part in the United States. Those terms include storage, handling or other processing activities (other than transportation activities) within the United States related to the sale, exchange or other disposition of agricultural products. This is dependent upon the products being consumed in connection with, or incorporated into, the MPGE of QPP whether or not by the taxpayer.

Property is treated as manufactured by the taxpayer in significant part in the United States if, based on all facts and circumstances, either of the following is true:

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1. The activity performed by the taxpayer in the United States is **substantial in nature.**
2. The labor and overhead costs incurred in the United States for manufacture, production, growth, or extraction of the property are **at least 20%** of the taxpayer's total cost for the property.

Example 10. Jack Frost buys plant seedlings from a supplier for $200 and incurs $55 in labor costs at his greenhouse in Michigan to grow decorative plants. He also incurs packaging, selling, and other costs of $4. The mature plants sell for $300 in 2006. The plants are treated as grown by Jack because his $55 labor costs are more than 20% of his $255 total cost for the plants ($200 + $55). His profit (and QPAI) on the plants is $41 [$300 – ($255 + $4)].

Jack's IRC §199 qualified production activities deduction for the plants is 3% of the $41 QPAI from the plants, or $1.23.

Example 11. Allen, Brian, and Ag Co. are unrelated taxpayers. Allen owns grain storage bins in the United States in which he stores, for a fee, Brian's wheat that was grown in the United States. Brian sells his wheat to Ag Co. and Ag Co. processes Brian's wheat into flour in the United States. The gross receipts from Allen's, Brian's, and Ag Co's activities are DPGR from the MPGE of QPP.

FORM W-2 WAGES DEFINED

As mentioned previously, for many taxpayers with farm businesses, the 50%-of-wages limitation is a significant limit on the IRC §199 deduction. Therefore, the definition of the amounts that are included in the term **wages** are important.[16] In general, the term **W-2 wages** includes amounts required to be included on statements under IRC §6051(a)(3) and (8) paid by the taxpayer for employment of employees during the calendar year ending during the tax year.[17] The term **wages** does not include amounts that are not included in a return filed with the Social Security Administration on or before the 60th day after the due date (including extensions) for the return.[18]

Wages Paid-in-Kind and "Kid Wages"

The statute defines **W-2 wages** as amounts required to be included on statements under IRC §6051(a)(3) and (8).[19] That includes wages and elective deferrals, as the term **wages** is defined in IRC §3041(a). This excludes agricultural labor unless the remuneration paid is wages as defined in IRC §3121(a).[20] This excludes remuneration paid in any medium other than cash.[21] **Employment** for purposes of this chapter excludes "service performed by a child under the age of 18 in the employ of his father or mother," which seems to define employment in IRC §3121(a).[22] That appears to exclude wages paid-in-kind to agricultural labor and wages paid to a child under age 18 in the employ of either parent. The final regulations (issued May 24, 2006) substantiate this view.

Other W-2 Wage Issues

The regulations state that payments to independent contractors and SE income, including guaranteed payments made to partners, are not included in determining W-2 wages.[23] Also, the term **employees** is defined to include only common-law employees of the taxpayer and officers of a corporate taxpayer.[24]

For tax years beginning after May 17, 2006, the wage limitation rule is modified. As originally enacted, the deduction was limited to 50% of wages deducted in arriving at QPAI. As modified, taxpayers are only able to include amounts properly allocable to domestic production gross receipts.[25] This could further reduce the amount of the deduction.

16. IRS Notice 2005-14, 2005-7 IRB 498 states that only amounts from Forms W-2, "Wage and Tax Statement," issued for employees of the taxpayer for employment by the taxpayer are included in calculating wages for purposes of the wage limitation. For purposes of this calculation, employees of the taxpayer are limited to employees as defined by IRC §3121(d)(1) and (d)(2) (that is, officers of a corporate taxpayer and employees of the taxpayer under the common law rules).

17. Treas. Reg. §1.199-2(e)

18. Treas. Reg. §1.199-2(a)(3)

19. IRC §199(b)(1)

20. IRC §3401(a)(2)

21. IRC §3121(a)(8)(A)

22. IRC §3121(b)

23. Treas. Reg. §1.199-2(a)(1)

24. Ibid

25. IRC §199(b)(2)(B)

Methods for Calculating W-2 Wages

Because no single box on Form W-2 satisfies the definition of W-2 wages under IRC §199(b)(2), Notice 2005-14 provides three alternative methods for calculating W-2 wages only for purposes of IRC §199. The regulations authorize the same three methods and make it clear that the methods are all subject to the nonduplication rule.[26] The first option is a simplified calculation, while the other two provide greater accuracy.

Unmodified Box Method. An employer may use the lesser of the total entries in box 1 or in box 5 of all Forms W-2 filed with the Social Security Administration for employees.[27]

> **Example 12.** In 2006, Scott paid $30,000 of cash wages, $20,000 of commodity wages, and $15,000 of benefits under a Health Reimbursement Arrangement (HRA) to farm employees, including his wife. The $50,000 total wages is reported in box 1 of Forms W-2 that Scott files for his employees, but only the $30,000 of cash wages is reported in box 5 of the Forms W-2 that he files. The $15,000 of HRA benefits is not subject to federal income or employment taxes. If Scott uses the unmodified box method of computing wages, his IRC §199 deduction is limited to $15,000 (50% of $30,000).

Modified Box 1 Method. An employer may modify the amounts reported in box 1 of the Forms W-2 by subtracting amounts that are not wages for federal income tax withholding purposes, as well as amounts that are treated as wages under IRC §3402(o), and adding in amounts reported in box 12 coded D, E, F, G, or S.[28] Amounts treated as wages under IRC §3402(o) include (1) supplemental unemployment compensation benefits that are includible in the employee's gross income and are paid under a plan because of the employee's involuntary separation from employment due to a reduction in workforce or other similar condition; (2) pension or annuity payments for which a withholding request is in effect; and (3) sick pay benefits that are paid under a plan to which the employer is a party, that are payments in lieu of remuneration for any period the employee is temporarily absent from work on account of sickness or personal injury, and, at the time the payment is made, a withholding request is in effect.

> **Example 13.** Under the modified box 1 method, Scott's W-2 wages for purposes of the IRC §199 deduction is the $50,000 of wages he reports in box 1 of Form W-2 reduced by the $20,000 of commodity wages (commodity wages are not subject to withholding). Therefore, Scott's IRC §199 deduction is limited to the same $15,000 [($50,000 – $20,000) × 50%)] as under the unmodified box method.

Tracking Wages Method. An employer may track the actual amount of wages subject to federal income tax withholding with modifications comparable to those in the modified box 1 method.[29]

> **Example 14.** Under the tracking wages method, Scott's W-2 wages for purposes of the IRC §199 deduction are the $30,000 of cash wages because those are the only wages subject to federal income tax withholding. Therefore, his IRC §199 deduction is limited to the same $15,000 ($30,000 × 50%) as under the unmodified box method.

CONTRACT PRODUCTION ACTIVITIES

If one taxpayer performs qualified activities for someone else (custom or contract production), only the party who has the benefits and burdens of ownership during the production process is treated as the manufacturer. As a result, only one taxpayer is entitled to the deduction for the same manufacture of tangible personal property.

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26. Treas. Reg. §1.199-1(f)(2)
27. Treas. Reg. §1.199-1(f)(2)(i)
28. Treas. Reg. §1.199-1(f)(ii)
29. Treas. Reg. §1.199-1(f)(iii)

Example 15. Amanda Lynne owns and operates a Wisconsin dairy farm. She contracts with her neighbor, Anne Tellope, to raise heifers until they are ready to be bred. The payments Anne receives from Amanda are not DPGR because Anne did not own the calves. Amanda can include the sale of cull heifers or cows that were raised by Anne in her DPGR.

Observation. If Amanda sold calves to Anne for her to raise, and then bought them back as springing heifers, Anne's sales would be included in her DPGR. Amanda could still include her sale of cull cows in her DPGR, but she must subtract her cost of calves to arrive at QPAI.

AGRICULTURAL LEASING ACTIVITIES

There is no official guidance on whether crop or livestock share-rent landlords have DPGR to qualify them for the qualified activities production deduction. Landlord eligibility appears to depend on whether the rents are from real property (not taken into account for the deduction), or from the conduct of a trade or business.

The statute specifically provides that the deduction is applied by only taking into account items which are attributable to the actual conduct of a trade or business.[30] The regulations mirror the statute, and there is no indication (either in the statute or in the regulations) where the line is drawn in terms of what is or is not a "trade or business."[31]

Without specific guidance, practitioners must closely analyze the facts of a particular client's situation to determine if a legitimate argument exists for inclusion of share-rent income in the client's DPGR. The most basic argument is that income from a crop-share or livestock-share leasing activity is clearly distinguishable from cash rental income insomuch as the landlord bears sufficient risk of production and risk of price change associated with the particular crop or livestock. The bearing of risk of price change and risk of production confirms the client is materially involved in the activity and is clearly distinguishable from a cash rent landlord collecting a fixed rent.

A "second-best" argument is that a livestock-share or crop-share landlord is considered in the "business of farming" for purposes of IRC § 175 (soil and water conservation) and IRC §1301 (farm income averaging). Consequently, they should be treated as being in the "business of farming" (producing) for purposes of IRC §199.

Perhaps a "fallback" argument is that the commodities at issue are qualified production property and that, therefore, proceeds from sale of those commodities are included in DPGR.

Observation. The key is to demonstrate that the client's income under the lease is derived from the sale of agricultural commodities produced in a trade or business (instead of being rent from real estate). That point is bolstered by the fact that income from a material participation crop-share or livestock-share is reported on Schedule F, represents income from the trade or business of farming, and is subject to social security tax. It is not merely income from the rental of real estate.

It appears that the primary argument the IRS can make for disallowing income from share-rent arrangements is that the income represents rents from real property rather than income from the conduct of a trade or business. Rents from real property are not treated as DPGR.

Practitioners should place primary emphasis on the ability to distinguish a client's leasing activity from a straightforward cash lease. Clearly drafted written leases showing the landlord's involvement in the activity should be utilized. This is the safest approach until the Treasury decides which definition of "trade or business" to utilize.

Observation. As a practical matter, it is likely that very few share-rent landowners have the requisite Form W-2 wages to claim the deduction.

30. IRC §199(d)(5)

31. Several different definitions of the term "trade or business" are utilized in the Code, with each definition requiring a varying degree of involvement in the activity for the taxpayer to be deemed to be conducting a "trade or business."

PASS-THROUGH ENTITIES

The IRC §199 deduction attributable to the qualifying production activities of a partnership or S corporation is determined at the partner or shareholder level. **As a result, each partner or shareholder must compute the deduction separately, based on all qualifying activities.**

Wage limitations are applied by allocating to the pass-through entity individual (such as a partner) the person's allocable share of W-2 wages of the partnership or S corporation. In effect, the pass-through entity allocates to each partner or shareholder a share of items of income, gain, loss, and deduction attributable to qualifying production activities, along with any other items of income, gain, loss, deduction or credit. The partner or shareholder then must aggregate the pass-through items and items attributable to any other qualified production activities to determine the deduction. These amounts are reported on Schedule K-1 on the lines for other deductions.

> **Observation.** A partner or shareholder generally cannot use the entity's Form W-2 wages to increase an IRC §199 deduction based on other sources of QPAI.

A partner or shareholder is treated as having W-2 wages for the taxable year equal to the lesser of the following:

1. Such person's allocable share of the W-2 wages of the corporation or partnership for the taxable year, or
2. Twice the applicable percentage (3% for 2006) of such person's QPAI as is attributed to items allocated.

If the partner or shareholder is not allocated positive QPAI, none of the entity's Form W-2 wages can be taken into account for purposes of computing the partner or shareholder's wage limitation for the §199 deduction.

Example 16. May Elman owns 40% of a farming S corporation. In 2006, the S corporation had $200,000 of QPAI and $50,000 of Form W-2 wages. May's allocation of QPAI is $80,000 (40% of $200,000). May's allocation of Form W-2 wages is the lesser of $20,000 (40% × $50,000) or $4,800 (2 × 3% × $80,000). May's qualified production activities deduction for 2006 is $2,400 ($80,000 QPAI × 3%). That amount is also equal to 50% of the Form W-2 wages allocated to May.

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Example 17. Bill Ding is a 50% partner in D&D Farms and also operates his own farm as a sole proprietorship. During 2006, D&D Farms had $450,000 of DPGR and $260,000 of farm expenses that were allocable to DPGR, including $40,000 of Form W-2 wages. Therefore, D&D Farms had QPAI of $190,000.

Bill also had $100,000 of DPGR and $75,000 of expenses that were allocable to DPGR from his sole proprietorship farming operation. The $75,000 of expenses include $30,000 for cost of goods sold, $40,000 of directly allocable expenses and $5,000 of indirectly allocable expenses (including $2,000 of Form W-2 wages). Bill has $10,000 of receipts that are not from DPGR.

Bill calculates his $120,000 QPAI and $130,000 AGI as shown in the following table.

DPGR from D&D Farms	$450,000 × 50%	$225,000	
DPGR from sole proprietorship		100,000	
Total DPGR		$325,000	$325,000
Expenses from D&D Farms	$260,000 × 50%	$130,000	
Expenses from sole proprietorship		75,000	
Total expenses		$205,000	(205,000)
QPAI			$120,000
Non DPGR receipts (interest income)			10,000
AGI			$130,000

Because D&D Farms has a positive QPAI, Bill can use his share of the $40,000 of Form W-2 wages of the partnership to increase the wage limit on his qualified production activities deduction. Bill's deduction is limited to the least of:

1. 3% of $120,000 QPAI = $3,600
2. 3% of $130,000 AGI = $3,900
3. Partnership share of wages ($20,000) is limited to $3,600 ($120,000 × 3% × 50%). To this amount is added 50% of Bill's proprietorship wages, which is $1,000 ($2,000 × .5). Therefore, the combined amount is $4,600.

Bill reports the DPGR income and expenses as shown on the following Form 8903, *Domestic Production Activities Deduction.*

For Example 17

Form **8903** — Department of the Treasury, Internal Revenue Service

Domestic Production Activities Deduction

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

OMB No. 1545-1984 — 2006 — Attachment Sequence No. 143

Name(s) as shown on return: **Bill Ding** — Identifying number: **111-22-3333**

1	Domestic production gross receipts (DPGR)		325,000
2	Allocable cost of goods sold. If you are using the small business simplified overall method, skip lines 2 and 3	30,000	
3	If you are using the section 861 method, enter deductions and losses definitely related to DPGR. Estates and trusts, see instructions. All others, skip line 3		
4	If you are using the section 861 method, enter your pro rata share of deductions and losses not definitely related to DPGR. All others, see instructions	175,000	
5	Add lines 2 through 4		205,000
6	Subtract line 5 from line 1		120,000
7	Qualified production activities income from pass-through entities: If you are a— Then enter the total qualified production activities income from— **a** Shareholder: Schedule K-1 (Form 1120S), box 12, code Q; **b** Partner: Schedule K-1 (Form 1065), box 13, code U; Schedule K-1 (Form 1065-B), box 9, code S2; **c** Beneficiary: Schedule K-1 (Form 1041), box 14, code C		
8	**Qualified production activities income.** Add lines 6 and 7. If zero or less, enter -0- here, skip lines 9 through 15, and enter -0- on line 16		120,000
9	Income limitation (see instructions): • Individuals, estates, and trusts. Enter your adjusted gross income figured without the domestic production activities deduction • All others. Enter your taxable income figured without the domestic production activities deduction (tax-exempt organizations, see instructions)		130,000
10	Enter the smaller of line 8 or line 9. If zero or less, enter -0- here, skip lines 11 through 15, and enter -0- on line 16		120,000
11	Enter 3% of line 10		3,600
12	Form W-2 wages (see instructions)		2,000
13	Form W-2 wages from pass-through entities: If you are a— Then enter the total Form W-2 wages from— **a** Shareholder: Schedule K-1 (Form 1120S), box 12, code R; **b** Partner: Schedule K-1 (Form 1065), box 13, code V; Schedule K-1 (Form 1065-B), box 9, code S3; **c** Beneficiary: Schedule K-1 (Form 1041), box 14, code D		7,200
14	Add lines 12 and 13		9,200
15	Form W-2 wage limitation. Enter 50% of line 14		4,600
16	Enter the smaller of line 11 or line 15		3,600
17	Domestic production activities deduction from cooperatives. Enter deduction from Form 1099-PATR, box 6		
18	Expanded affiliated group allocation (see instructions)		
19	**Domestic production activities deduction.** Combine lines 16 through 18 and enter the result here and on Form 1040, line 35; Form 1120, line 25; Form 1120-A, line 21; or the applicable line of your return		3,600

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 37712F Form **8903** (2006)

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> **Observation.** If D&D did not have positive QPAI, Bill could not use his share of the $40,000 of Form W-2 wages from the partnership to increase the wage limit on his qualified production activities deduction. In that event, Bill's wage limit would be:
>
> 50% of $2,000 wages (from sole proprietorship) = $1,000

Example 18. Shyla conducts a sole proprietorship farming operation. Shyla rents the farm ground from Acres LLC that she owns with her sister and brother. The sister and brother are not actively engaged in the farming operation. Shyla has $500,000 of DPGR and $350,000 of Schedule F (Form 1040) expenses in 2006. Form W-2 wages of $50,000 and $90,000 of rent paid to Acres LLC are included in Shyla's expenses, resulting in $150,000 of QPAI. Shyla's AGI is $180,000 for 2006.

The LLC is not entitled to a qualified production activities deduction. The rental income is not DPGR. Shyla's qualified production activities deduction for 2006 is the lesser of 3% of her $150,000 QPAI ($4,500); 50% of her W-2 wages ($25,000); or 3% of her $180,000 AGI ($5,400). Thus, her deduction is $4,500.

TRUSTS AND ESTATES

For trusts and estates, W-2 wages are apportioned among the beneficiaries and the fiduciary, and adjusted gross income is determined under IRC §67(e). The regulations specify that, for grantor trusts, a person is treated as owning all or part of the trust and reports QPAI as if the income was generated by activities performed directly by the owner.[32] For a nongrantor trust or estate, all income and expense items must be allocated among the trust or estate and its beneficiaries based on the proportion of distributable net income deemed distributed to that beneficiary for the tax year.[33] A trust or estate can claim the deduction to the extent that qualified production activity income is allocated to the trust or estate, but the deduction applies at the beneficiary level.[34]

C CORPORATION

For farming operations that are conducted by C corporations, the IRC §199 deduction is claimed at the corporate level, rather than at the individual level. Corporate income, expenses and Form W-2 payments determine the qualified production activities deduction.

Example 19. Soiltiller, Inc. is a C corporation that is engaged in farming. During 2006, Soiltiller, Inc. had $600,000 of gross farm income. The entire $600,000 of gross income qualifies as DPGR. Soiltiller's expenses total $570,000. The expenses include cash rental payments for land owned by shareholder-employees, and $100,000 of Form W-2 wages paid to the shareholder-employees. QPAI and taxable income are both $30,000. Soiltiller Inc.'s IRC§199 deduction is $1,200, calculated as the least of:

1. $900 (3% × $30,000 QPAI)
2. $50,000 (50% × $100,0000 of Form W-2 wages)
3. $900 (3% × $30,000 of taxable income)

32. Treas. Reg. §1.199-5(c)
33. Treas. Reg. §1.199-5(d)
34. Treas. Reg. §1.199-5(d)(1)

ALTERNATIVE MINIMUM TAX

The qualified production activities deduction is allowed for purposes of the AMT, except that the deduction is equal to the applicable percent of **the lesser** of the taxpayer's:

1. QPAI, determined without regard to the income tax credits, or
2. Alternative minimum taxable income (AMTI). In the case of an individual, AGI (determined without regard to IRC §199) is substituted for AMTI.

For individuals, the §199 deduction is the same for the AMT as it is for regular income tax. However, for most taxpayers who would owe AMT without the §199 deduction, the §199 deduction reduces the tentative minimum tax by more than it reduces the regular tax. Because the AMT is the difference between the tentative minimum tax and the regular tax, the AMT will be reduced by the IRC §199 deduction for most taxpayers.

Example 20. Phil Anthropy and his wife, Kara, operate a farm with the help of their four children. Phil has a $2,500 IRC §199 deduction for 2006 from his farming business. The joint income, deductions, and tax liability for Phil and his wife Kara are shown in the following table:

Item	Without §199 Deduction	With §199 Deduction	Difference
Wages	$ 80,000	$ 80,000	
Farm income	50,000	50,000	
Total income	$130,000	$130,000	
IRC §199 deduction		(2,500)	($2,500)
Other adjustments to income	(15,000)	(15,000)	
Adjusted gross income	$115,000	$112,500	($2,500)
Taxes	(20,000)	(20,000)	
Interest/charitable	(10,200)	(10,200)	
Total itemized deductions	(30,200)	(30,200)	
Exemptions deduction	(19,800)	(19,800)	
Taxable income	$ 65,000	$ 62,500	($2,500)
Regular tax	9,365	8,740	(625)
Tentative minimum tax	10,985	10,335	(650)
Alternative minimum tax	1,620	1,595	(25)
SE tax	2,579	2,579	
Total tax	$ 13,564	$ 12,914	($650)

The IRC §199 deduction reduces their regular tax liability by $625, but it decreases their tentative minimum tax (and therefore their total tax) by $650.

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PATRONS OF AGRICULTURAL AND HORTICULTURAL COOPERATIVES

Any person who receives a "qualified payment" from a "specified agricultural or horticultural cooperative" is eligible for a QPAD if the cooperative passes a portion of the QPAD to its patrons.[35] A "specified cooperative" is a cooperative to which Part I of Subchapter T applies and the cooperative has MPGE in whole or significant part within the U.S. any agricultural or horticultural product, or has marketed agricultural or horticultural products.[36]

35. Treas. Reg. §1.199-6(a). The member's deduction is allowed in the year that the payment attributable to the QPAI is received. IRC §199(d)(3)(A), as amended retroactively by the Gulf Opportunity Zone Act of 2005, §403(a)(9).

36. For this purpose, agricultural or horticultural products also include fertilizer, diesel fuel, and other supplies used in agricultural or horticultural production. Treas. Reg. §1.199-6(f).

A marketing cooperative is treated as having manufactured, produced, grown or extracted the product at issue if its patrons manufactured, produced, grew or extracted the product. This is known as the "cooperative attribution rule."

> **Note.** The cooperative attribution rule is intended to apply only to crops received from patrons who are entitled to share in patronage dividends and per-unit retain allocations from the cooperative. If a cooperative obtains a portion of the crop that it markets from others, then the cooperative attribution rule does not apply.

If a marketing cooperative has entered into a joint venture with another partnership, LLC or other type of pass-through entity, and the other pass-through entity is not engaged in qualifying activities, the cooperative attribution rule still allows the cooperative to treat its allocable share of the pass-through entity's income and expense as attributable to qualifying activities that give rise to QPAI.

Similarly, the terms "marketing, produced, grown or extracted" also include storage, handling or other processing activities (other than transportation activities) within the United States related to the sale, exchange or other disposition of agricultural products, provided the products are consumed in connection with, or incorporated into the marketing, production, growing or extraction of qualified production property, whether or not by the taxpayer.

Example 21. Sam, Clyde, Jayco Milling, Inc., Super Fresh Bakers and Early Morning Distributors are unrelated taxpayers and all work only in the United States. Sam is a Kansas wheat farmer who stores his wheat in grain bins owned by Clyde. At a later date, Sam sells his wheat to Jayco who produces flour which it sells to Super Fresh. Super Fresh uses the flour to produce bread which it sells to Early Morning Distributors who then wholesales the bread to various supermarkets. When Early Morning delivers the bread to the supermarkets, it picks up unsold bread and takes it to its Day Old stores.

All of the above taxpayers are considered producers and their revenue qualifies as DPGR. The exception might be the day-old bread sales which Early Morning sells in its Day Old stores. However, if the day-old sales are less than 5% of Early Morning's total revenue, they meet the de minimis exception and also qualify as DPGR.

> **Observation.** The rule applies to marketing cooperatives as well as other taxpayers and operates in conjunction with the cooperative attribution rule to determine whether a cooperative is engaged in marketing, production, growing or extraction activities.

Qualified Payment. A qualified payment is any part of a patronage dividend or per-unit retain allocation as described in IRC §§1385(a)(1) or 1385(a)(3) received by a patron from a cooperative and attributable to the portion of the cooperative's QPAI for which the cooperative is allowed a QPAD. For this purpose, patronage dividends and per-unit retain allocations include any advances on patronage or per-unit retains paid in money during the tax year.[37] Double counting is not permitted. To the extent a cooperative passes through the QPAD to a patron, a qualified payment received by the patron of the cooperative is not taken into account for purposes of IRC §199.

The deduction earned by a cooperative is computed based on the cooperative's QPAI without taking into account any deductions allowable under IRC §§1382(b) and (c).[38] As stated above, a cooperative is allowed to pass some or all of the cooperative's deduction through to patrons if it chooses. For purposes of the W-2 wage limitation, the limitation is applied at the cooperative level whether or not the cooperative chooses to pass through some or all of the QPAD. Any amount passed through by a cooperative to its patrons is not subject to the W-2 limitation a second time at the patron level.[39]

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37. Treas. Reg. §1.199-6(e)

38. IRC §199(d)(3)(B)(i) states that "any deduction allowable under IRC §§1382(b) and (c) (related to patronage dividends, per-unit retain allocations, and nonpatronage distributions)" are not taken into account for purposes of computing the deduction.

39. Treas. Reg. §1.199-6(i)

Both the cooperative and its members are engaged in activities that give rise to QPAI, and both are entitled to the deduction (provided the other requirements of §199 are met). Because a cooperative can pass some or all of the cooperative's deduction through to patrons, a question is raised as to whether patronage dividends are counted as crop receipts at the patron level and thereby enter into the computation of the patrons' QPAI, or whether they are excluded to the extent that they were taken into account in determining the cooperative's IRC §199 deduction.

The statute provides that the portion of the §199 deduction that a cooperative wishes to pass through to a patron must be "designated as such by the organization in a written notice mailed to its patrons during the payment period described in section 1382(d)."[40] The payment period for a year is the "period beginning on the first day of a year and ending with the fifteenth day of the ninth month following the close of such year."[41] The cooperative may use the same written notice, if any, that it uses to notify patrons of their respective allocations of patronage dividends, or may use a separate timely written notice to comply with the requirement. The cooperative must report the amount of patron's deduction on Form 1099-PATR issued to the patron.[42]

Observation. It is likely that many cooperatives will not know the precise amount of their §199 deduction for a year when patronage dividends are paid, especially for cooperatives that pay patronage dividends relatively soon after year end. To determine the deduction amount, a cooperative's tax return must be substantially complete. IRC §6072(d) provides cooperatives with an extended due date for their tax returns (eight and one-half months after year end).

ISSUE 2: POLLUTION CONTROL FACILITIES

By election, the cost of a certified pollution control facility can generally be amortized over a 60-month period, beginning in either the **month** after the month the facility is completed or acquired, or the tax **year** after the year the facility was completed or acquired.[43]

Note. A taxpayer can claim a special depreciation allowance on a certified pollution control facility that was qualified property, even if the election is made to amortize rather than capitalize its costs and depreciate the facility. In that event, the taxpayer is required to reduce the facility's cost (amortizable basis) by the amount of any special allowance claimed.

For otherwise qualified property that is held in life estate or remainder form, the deduction is computed as if the life tenant were the absolute owner of the property.[44]

CERTIFIED POLLUTION CONTROL FACILITY

A certified pollution control facility is a new, identifiable treatment facility used in connection with a plant or other property generally in operation before 1976 to reduce or control water, or atmospheric pollution or contamination.[45] The facility must do so by removing, changing, disposing, storing, or preventing the creation or emission of pollutants, contaminants, wastes, or heat. The facility must also be certified by state and federal authorities.[46] Examples of such facilities include septic tanks and manure control facilities.

40. IRC §199(d)(3)(A)(ii)
41. IRC §1382(d)
42. Treas. Reg. §1.199-6(g)
43. IRC §169(a)
44. IRC §169(i)
45. IRC §169(d)
46. For water pollution, the state authority is the state agency as defined in section 13(a) of the federal Clean Water Act. For air pollution, the state authority is the applicable state air pollution control agency as defined in section 302(b) of the federal Clean Air Act.

The federal certifying authority (the Secretary of the Interior in the case of water pollution; the Secretary of Health and Human Services in the case of air pollution) will not certify property to the extent it appears that the taxpayer will recover (over the property's useful life) all or part of its cost from the profit based on its operation (such as through the sale of recovered wastes). The federal certifying authority will describe the nature of the potential cost recovery. The taxpayer must then reduce the amortizable basis of the facility by the potential recovery.

New Facility for Manure Control

Example 22. In 2006, Kenny purchased a new $75,000 manure control facility for use in connection with a dairy on his farm. The farm has been in operation since 1976, and the dairy was in operation before 1976. A federal certifying authority certified that Kenny has no intention of recovering the cost of the facility through sale of the waste.

The manure control facility qualifies for amortization. Kenny can elect to amortize its cost over 60 months if the facility does not increase significantly the output or capacity of the plant or other property, extend its useful life, reduce the total operating costs, or significantly change the nature of the manufacturing or production process or facility. If Kenny does not make the election, he can capitalize the cost and depreciate the facility.

Increase in Output or Capacity

Example 23. In 2006, Tom converted his 100-sow farrow-to-finish swine operation, which began operations in 1975, to a 5,000 head finishing swine operation. Even though Tom is in a similar business after the conversion, Tom cannot amortize the cost of a new manure control facility used in connection with his swine operation because he has significantly increased its output or capacity. However, Tom can recover the cost of the facility by claiming depreciation deductions.

Facilities Placed in Service after April 11, 2005

Certain atmospheric pollution control facilities placed in service after April 11, 2005, can be amortized over 84 months. For acquired facilities, the original use must begin with the taxpayer after April 11, 2005.[47] In addition, the facility must be used in connection with an electric generation plant or other property placed in operation after December 31, 1975, that is primarily coal-fired.

If the taxpayer constructs, reconstructs or erects the facility, only the basis attributable to the construction, reconstruction, or erection completed after April 11, 2005, qualifies.

Rule for Corporations

A corporation must reduce the amortizable basis of a pollution control facility by 20% before computing the amortization deduction.

47. IRC §169(d)(5)

Tax Consequences upon Sale

If a taxpayer disposes of depreciable or amortizable property at a gain, part or all of the gain triggers ordinary income. For IRC §1245 property, gain on disposition is treated as ordinary income to the extent of depreciation allowed or allowable. IRC §1245 property includes any property that is or has been subject to an allowance for depreciation or amortization and is either:

1. Personal property (tangible or intangible),
2. Other tangible property (except buildings and their structural components) used as:
   - **a.** An integral part of manufacturing, production, extraction, or furnishing,
   - **b.** Transportation, communications, electricity, gas, water, or sewage disposal services, or
   - **c.** A research facility in any of the above activities,
3. A facility in any of the above activities for the bulk storage of fungible commodities,
4. That part of real property (not included above) with an adjusted basis reduced by certain amortization deductions (including those for certified pollution control facilities),
5. Single purpose agricultural or horticultural structures,
6. Storage facilities used in distributing petroleum or any primary product of petroleum.

STATE-LEVEL PROPERTY TAX INCENTIVES

As an incentive for livestock producers to construct waste storage structures, and other structures which prevent water pollution, some states administer a tax certification program which reduces the property tax value for many pollution control improvements. Generally, in order to recognize the tax reduction, the producer must have the improvement certified by a state agency as a pollution control facility. The states set their own definitions of a pollution control facility for livestock waste management. Generally, the following structures qualify:

- Manure pits under confined animal feed structures
- Slatted floors over manure pits
- Floors (not in feeding areas) specifically designed to collect and transport livestock wastes to liquid waste storage facilities
- Liquid livestock waste storage facilities
- Dry manure stacking structures
- Feedlot runoff sediment capture basins
- Vegetative filter systems
- Roof structures specifically intended to prevent precipitation from entering livestock waste storage facilities
- Methane digesters

ISSUE 3: VENDOR FINANCING

Farmers using cash method accounting can claim a deduction in the year inputs are purchased even if the purchase is with borrowed funds. However, if inputs are purchased with a promissory note, even though the note is secured by collateral, a deduction cannot be claimed until the note is repaid. A promissory note is only a promise to pay, and that is not enough to support an income tax deduction. To give rise to a deduction, payment must be in cash or its equivalent. Giving a promissory note is not the equivalent of cash.

PURCHASED CATTLE FEED

Example 24. Slim, a cash-basis taxpayer, had an agreement with the Pokey-Lokey feedlot to purchase feed from the feedlot. Under the agreement, Slim purchased $30,000 of feed in 2005. Slim paid $16,000 in cash in 2005 with the balance of the purchase price due and payable when the cattle are sold. The cost of the unpaid feed is deducted from the proceeds of the cattle sale before the balance of the proceeds, if any are disbursed, to Slim. Slim gave the feedlot a promissory note for $14,000 and a secured letter of credit from Usury State Bank for the same amount. The feedlot never drew on the letter of credit, and it expired on May 15, 2006. Slim, deducted $30,000 on his 2005 return, and then increased his income by $14,000 in 2006 when the letter of credit expired unused.

Result. Slim must reduce his 2006 taxable income by $14,000, and the 2005 deduction is limited to $16,000. Slim did not pay for the feed with borrowed funds. He merely promised to pay the expense and secured its payment with the letter of credit. Even though Slim pledged collateral, he did not pay money. Slim could have received a current deduction by using a certified check. That is considered a cash equivalent.

Observation. Various types of arrangements similar to secured promissory notes and letters of credit are used in the cattle feeding industry. In those situations, a feedlot customer generally is not entitled to an income tax deduction for feed until the earlier of actual payment by the customer for the feed, or application of proceeds from the sale of cattle to payment of the unpaid feed balance.

SCOPE OF THE RULE — APPLICATION TO FINANCED IMPROVEMENTS

As stated previously, cash-basis taxpayers may only deduct expenses in the year they pay cash for the expense. Improvements to property which are financed by a promissory note to the vendor or other obligations do not add to the property's income tax basis, allowing a depreciation deduction, until the note is paid. The same reasoning holds true when a taxpayer sells property. Although a taxpayer is entitled to basis for expenditures properly chargeable to capital,[48] a cash-basis taxpayer has not made an expenditure that increases basis when he only issues a secured promissory note. It is not until the note is actually paid that a cash-basis taxpayer can increase basis.

Observation. Typically, a taxpayer engaged in farming provides a promissory note to a bank lender, uses the proceeds from the bank's loan to pay operating expenses with other vendors, and thus obtains a valid business deduction for those expenses.

48. IRC §1016

ISSUE 4: LEASING ISSUES

Leasing arrangements are popular in agriculture. Leasing no longer solely involves the leasing of agricultural real estate. Leases of livestock confinement facilities and machinery are also utilized.

The two primary tax issues surrounding various types of agricultural leasing arrangements involve:

1. The treatment of such arrangements for SE tax purposes
2. The application of the passive loss rules

A third area of concern in some agricultural leasing scenarios is whether the lease represents a true lease or is, in reality, a purchase of the property.

RENTAL INCOME VERSUS SELF-EMPLOYMENT INCOME

In recent years, the IRS took the position that income from all machinery (personal property) leases, regardless of the lessor's involvement in the lease, is subject to SE tax. The IRS added instructions to Schedule E that requires taxpayers to report income and expense from the rental of personal property on Schedule C, and it has increased audit activity on the issue.

Note. IRC §1402 defines SE income as "net earnings from self-employment derived by an individual from any trade or business carried on by such individual." Specifically excluded from this definition are "rentals from real estate and from personal property leased with real estate" unless a share rental is involved with material participation (material participation may be found under the arrangement theory of *Mizell*).[49]

IRC §1402 ties the imposition of SE tax to the requirement that the individual be in a trade or business. Thus, a given level of activity by the lessor is necessary to treat lease income as income from a trade or business. The term "trade or business" has the identical meaning as under IRC §162. Courts construing the term under IRC §162 have consistently required the taxpayer's involvement in an activity to rise to the level of being regular and continuous. Therefore, if only personal property is leased and no trade or business exists, the income is not subject to SE tax and income is reported on Form 1040, line 21, and expenses on line 32. In addition, it appears that if a loss occurred, the IRS would argue that a passive loss was involved and deductibility is limited.

Observation. The safest approach is to lease farm machinery with farm real estate. Personal property leased with real estate is specifically excluded from the definition of net income from the conduct of a trade or business for SE tax purposes and should be reported on Schedule E. Incorporating or forming an LLC may also reduce the likelihood that rental income will be subject to SE tax.

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Example 25. Bill rented his farm machinery to his daughter. Under a written lease, Bonnie is required to pay fair rental value, to repair the machinery, and to provide and pay for insurance on the machinery. During or at the completion of the lease term, Bonnie may purchase one or more items at its fair market value.

Bill reports the income from the lease on Schedule E if the equipment is rented with other land and he is not involved in a trade or business. If land is **not rented** with the machinery, and Bill is **not involved** in a trade or business, the income is reported on Form 1040, line 21, and expense on line 32. Bill reports the income on Schedule C if he is involved in a trade or business. Under these facts, it appears Bill is not personally involved and that the payments are properly reported on Schedule E or Form 1040, line 21 and line 32 (although IRS may argue otherwise). Bonnie may deduct the lease payments as an expense on her Schedule F.

49. *Mizell v. Commr.*, TC Memo 1995-571, November 29, 1995

PASSIVE LOSS RULES

Under the Tax Reform Act of 1986, an activity may be considered a passive activity, and the passive loss rules of IRC §469 applied. This occurs if the activity involves a trade or business and the taxpayer does not materially participate in the activity or a rental activity "on a basis which is regular, continuous and substantial."[50] This is an important rule because losses from passive trade or business activities, to the extent they exceed income from all passive activities, may not be deducted against other income (gains from nonpassive activities). The issue arises frequently in agriculture when a farmer has multiple activities that are connected via lease, and the farmer is not directly engaged in all of the activities. Questions arise when a loss is created.

> **Observation.** Income and losses from passive activities are most commonly reported on Schedule E. If the taxpayer materially participates in the activity, the income and losses are not entered on Form 8582. Real estate activities of qualifying "real estate professionals" are not considered passive activities and are omitted from Form 8582.

WHAT IS MATERIAL PARTICIPATION?

For purposes of the passive loss rules, the meaning of "material participation" was meant to be more demanding than the meaning of "material participation" for SE tax purposes. Thus, the fact that an individual is materially participating for purposes of social security liability or special use valuation is not taken into account.[51] Furthermore, the passive loss rules do not refer to LLCs or LLPs, but do refer to limited partners in a limited partnership.[52] For example, losses attributable to limited partnerships are treated as arising from a passive activity unless a limited partner participates for more than 500 hours, materially participated in five or more of the 10 preceding years, or the activity is a personal service activity in which the limited partner materially participated for any preceding tax year.

So, why does it matter whether a particular activity is a passive activity? First, the general rule is that deductions (losses) from passive trade or business activities, to the extent the deductions exceed income from all passive activities, may not be deducted against other nonpassive activity gains. Second, a passive activity (i.e., a rental activity) cannot be combined with a business activity (i.e., an activity in which the taxpayer materially participates) unless either is insubstantial in relation to the other. Whether an item of income or loss is considered passive when allocated to a taxpayer from a pass-through entity is determined by the taxpayer's participation in that activity.

An activity is passive, and the passive loss rules apply unless an investor or other individual can meet one of two critical tests. The tests are:

1. **Material Participation Test** (the participation must be regular, continuous and substantial):
   - Participation for more than 500 hours during the year
   - Participation for less than 500 hours during the year, but the taxpayer's participation constitutes "substantially all of the participation" in the activity by all individuals during the year
   - More than 100 hours of participation during the year, and the taxpayer's participation is not less than any other individual in the activity
   - Participation in "significant participation activities" (SPAs) if the taxpayer's aggregate participation in all SPAs for the year exceeds 500 hours
   - Material participation for any five of the 10 taxable years immediately preceding the taxable year

50. With respect to rental activities, however, beginning in 1994, there is an exception for "real estate professionals."

51. Temp. Treas. Reg. §1.469-5T(b)(2)(i)

52. Temp. Treas. Reg. §1.469-5T(e)

- Material participation for any three taxable years preceding the taxable year in question for participation in personal service activities
- At least 100 hours of participation and facts and circumstances compel the material participation conclusion.

An investor who reviews financial statements, prepares summaries of finances or operations for his own use, or monitors the finances in a nonmanagerial capacity cannot include this time in the material participation computation unless the investor is directly involved in the day-to-day management of the activity.[53]

Participation of both spouses may be combined to meet material participation requirements.

Note. A special rule for farmers allows them to qualify as materially participating if they participated in an activity for five or more years in the 8-year period before retirement or death.[54]

2. **Active Participation Test.** A taxpayer may deduct $25,000 of passive activity losses annually and the deduction equivalent of passive activity credits attributable to rental real estate activities in which the taxpayer actively participates.[55]

   The test applies in both the year of loss and the year of allowance of the loss. An annual maximum of one $25,000 offset is allowed for all of a taxpayer's rental activities. The $25,000 limitation does not apply to a taxpayer who is a real estate professional. To qualify, more than 50% of the personal services performed in trades or businesses by the taxpayer for the tax year are performed in real property trades or businesses in which the taxpayer materially participates, and the taxpayer performs more than 750 hours of services during the tax year in real property trades or businesses in which the taxpayer materially participates.

   A limited partner cannot meet the active participation test.

   The allowance phases out ratably as the taxpayer's AGI (determined without regard to passive activity losses) increases from $100,000 to $150,000.

Note. The IRS deems crop share leases reported on Form 4835 to be joint ventures and not rental real estate activities. However, the Form 4835 instructions suggest that the passive loss deduction under the active participation test is available for a nonmaterial participation share lease.

GROUPING ACTIVITIES

General Rule. Some taxpayers may have multiple activities that can be grouped together as a single economic unit for passive loss purposes. By grouping activities, it may be possible to avoid application of the passive loss rules. Grouping activities is permitted if the activities constitute "an appropriate economic unit." A taxpayer may use any reasonable method for making the grouping determination, but certain factors are given the greatest weight in determining whether activities should be grouped or kept separate. These factors are:

1. Similarities or differences in types of businesses
2. Extent of common control
3. Extent of common ownership
4. Geographical location
5. Business interdependencies

53. Temp. Treas. Reg. 1.469-5T(f)(2)(ii)
54. IRC §469(h)(3)
55. IRC §469(i)

Example 26. Jack raised hogs for many years as part of his sole proprietorship farming operation. His practice was to purchase feeder pigs, and then sell them when they reached market weight. Last year, Jack joined with two other local farmers in creating a limited liability company (LLC) to engage in hog breeding. The LLC hog breeding operation produces the piglets that Jack (and the other farmers) purchase for use in their sole proprietorship farming operations. The farmers created the LLC to provide them with a steady supply of feeder pigs. Jack does not materially participate in the LLC.

Result. Even though Jack does not materially participate in the LLC, he can elect to aggregate his hog finishing activity with his interest in the LLC. Aggregation as a single entity allows Jack's material participation in his sole proprietorship hog finishing operation to count as material participation in the LLC. The result is that Jack's share of any losses from the LLC (from Schedule K-1) is not subject to passive loss limits.

Example 27. Friendly Co-op added onto its facility by building a "condominium storage" grain bin. The bin was built on property that the cooperative leases from an LLC that was formed for the creation of the condominium storage units. Friendly Co-op is the LLC's manager-member, and a service agreement between the cooperative and the LLC governs most of the LLC's activity. The service agreement specifies an annual service fee for the first three crop years, and it specifies a formula for determining adjustments to the fees after the first three years. The Co-op is required to pay all operating expenses.

John is a local farmer who buys membership units in the LLC. As designed by virtue of the service agreement, the LLC is expected to have no revenue or expenses during the first 20 years of its operation, or until structural repairs on the bins are necessary. Accordingly, depreciation of the bins is the only material tax aspect of owning a membership unit.

John does not recognize any income from his investment in the LLC. He may depreciate his membership unit over seven years, and can deduct any service fee he is charged. Because John does not materially participate, the activity is passive, and the passive loss rules apply. But, John could elect to aggregate his condominium storage activity with his farming activity. That would allow his material participation in his farming operation to count as material participation in the LLC. Thus, John's share of any losses from the LLC (from Schedule K-1) is not subject to passive loss limits when his accountant completes John's Form 1040.

Grouping Rental and Business Activities. A rental activity cannot be combined with a business activity unless either is insubstantial in relation to the other.[56] Unfortunately, the final regulations do not define the term "insubstantial." Under the temporary regulations, "insubstantial" meant a rental activity's gross receipts had to be less than 20% of the gross receipts of the other activity, or vice versa. In addition, the rule remains that the two activities (the rental activity and the nonrental activity) must also be "an appropriate economic unit."

While there hasn't been a large number of court opinions construing the "insubstantial" language of the regulation, there are some:

1. *Glick v. United States*[57] — The court decided that the reasonableness of grouping the rental activity and the business activity was determined by measuring the gross income of each activity, the fair market value of the assets used in each activity, and then adding a qualitative test as to whether the two activities represented an appropriate economic unit. Based on the interdependence between the activities, the incidental relationship under the gross income, and market value of asset measurement tests, the result was that the taxpayer could combine the two activities.

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56. Treas. Reg. §1.469-4(d)(1)

57. *Glick v. United States*, 96 F. Supp. 2d 850 (S.D. Ind. 2000)

2. *Schumacher v. Commr.*[58] — The lease of airplanes and aircraft-related equipment to an S corporation in which the taxpayer was a majority shareholder satisfied the "insubstantial" exception, and the two activities could be combined. The court seemed to focus on the fact that the taxpayer created and operated the leasing activity for the benefit of the related corporation.

Lease of Unimproved Farmland. As mentioned previously, losses from passive trade or business activities, to the extent they exceed income from all passive activities, may not be deducted against other income (gains from nonpassive activities). So, there is a natural incentive to create income from passive activities. As a result, the IRS published regulations in the mid-1980s that recharacterize (or have the potential to recharacterize) passive income as nonpassive income. There are several areas of recharacterization that are important to agriculture.

Beginning in 1988, temporary regulations went into effect designed to prevent taxpayers from creating passive rental income through either (1) the leasing of unimproved farmland; or (2) self-rental arrangements. The rule aimed at farmland leases specifies that net income from rental property is considered not from a passive activity if less than 30% of the unadjusted basis of the property is depreciable.[59]

Observation. The rule applies only if there is net income from the rental activity. If a loss is incurred, the loss is passive.

Example 28. Polly Anna owned several tax shelter limited partnerships with suspended passive losses. In an attempt to use the deferred losses, Polly bought unimproved farmland from her brother for $200,000. Of the original cost, $20,000 is attributable to depreciable property such as fences, culverts, and tile. Polly leases the farmland to another brother under a written cash-rent lease.

Polly's income under the lease is recharacterized as nonpassive because less than 30% of the unadjusted basis of the land is attributable to depreciable property. Consequently, Polly's rental income cannot be used to offset the suspended limited partnership passive losses.

Observation. If Polly had realized a net loss under the lease, the loss would be passive.

Self-Rental Rule. While the general rule is that any rental activity is passive,[60] the self-rental regulations[61] prohibit using net income from self-rentals to offset other passive losses if the rented property is used in a trade or business in which the taxpayer materially participates.[62]

Observation. If self-rental leasing results in net income, not only is the net income **not** passive, but the net income may also be subject to SE tax.

An individual that leases assets to a partnership, S corporation, or C corporation in which the individual materially participates is subject to the self-rental rule with the result that the rental income is treated as nonpassive under the passive loss rules. The only exception from the self-rental rule is if the rental income is attributable to a written binding contract entered into before February 19, 1988.

58. *Schumacher v. Commr.*, TC Summary Opinion 2003-96, July 23, 2003

59. Temp. Treas. Reg. §1.469-2T(f)(3)

60. IRC §469(c)(2)

61. Treas. Reg. §1.469-2(f)(6)

62. Again, the rule only applies is the rental arrangement generates net income. If a loss results, the loss is passive.

Example 29. Kevin incorporated his farming operation a few years ago. Kevin is the only shareholder of the corporation, and is also the only employee. Kevin individually owns several livestock buildings, a machine shed, several other farm buildings, and some farmland. He leases all of the property that he owns personally to his corporation. Kevin reports the rental income on the Form 1040, Schedule E. He cannot carry the rental income to the Form 8582, *Passive Activity Loss limitations.* The rental income is treated as nonpassive.

The self-rental rule also applies to situations where one spouse owns a building and leases the building to a business in which the other spouse materially participates.[63] The passive loss rules treat the material participation of one spouse as attributable to the other spouse.[64]

The Tax Court held that a grouping election does not overcome the self-rental regulation.[65] While taxpayers can group multiple rentals as a single activity for purposes of the passive loss rules if the rentals represent an appropriate economic unit, the self-rental regulation recharacterizes net rental income from “an item of property” rather than net income from an entire passive activity.

Example 30. Jack and Jill file a joint return. They operate their farming business as an S corporation. They own two farms that they lease to the S corporation. Jack and Jill also own all the stock of the S corporation, and they materially participate in the farming business. In 2006, one of the farms generated $125,000 of net rental income. The other farm produced a $25,000 net rental loss. On their Schedule E, Jack and Jill grouped the two farms together as a single activity and reported rental income of $100,000.

Under the self-rental regulation, the IRS has the authority to separate the rents from the two farms. Therefore, the net rental income will be recharacterized as nonpassive. The net rental loss remains passive. So, the net rental income of $125,000 cannot be used to offset the net rental loss of $25,000. The $25,000 loss is a suspended activity loss on Jack and Jill’s Form 8582.

Note. In the IRS’s view, Schedule E rental activities with few expenses and significant net income could be indicative of a self-rental situation. If the income is reflected on Form 8582, line 1, the IRS is likely to inquire as to the identity of the lessee and if the taxpayer renders material participation in the entity.

LEASE VERSUS INSTALLMENT SALE

IRC §1245 requires the recapture of all depreciation deductions taken in the year of sale as ordinary income. As a result, the installment sale of farm machinery can generate large tax liabilities in the same year that only a fraction of the sales proceeds are received. In addition, leasing (as opposed to a conditional sales agreement) may increase the current deductions to the lessee. Thus, it is generally more desirable to lease property than to sell it, so the receipts can be reported over a period of years. If the arrangement is a lease, payments are ordinary income to the lessor and are fully deductible by the lessee. The lessor’s rental proceeds may be subject to SE tax. If the arrangement is treated as a sale, a portion of each payment is treated as imputed interest. The seller reports the §1245 recapture in the year of the sale and interest income each year. The buyer (lessee) has imputed interest expense under IRC §483 to report and must depreciate the purchase price. Depending on the participation of the buyer (lessee) and the assets purchased (leased), the buyer (lessee) may also take IRC §179 expense and MACRS depreciation.

63. See, e.g., *Connor v. Commr.,* 218 F3d 753 (7th Cir. 2000), *aff’g,* TC Memo 1999-185, June 7, 1999

64. IRC §469(h)(5)

65. *Carlos v. Commr.,* 123 TC No. 16, September 20, 2004

FACTORS DISTINGUISHING A LEASE FROM AN INSTALLMENT SALE

IRS Pub. 225, *Farmers Tax Guide*, provides that the intent of the parties determines whether an agreement is a lease or an installment sale. In the absence of other persuasive factors, an agreement is treated as a sale rather than a lease if any of the following are true:

1. The agreement applies part of each payment toward an equity interest.
2. The lessee receives title to the property after paying a stated amount of required payments.
3. The lessee must, over a short period of time, pay an amount that represents an unusually large part of the price a buyer would pay to buy the property.
4. The lessee pays rent that is much more than the current fair rental value of the property.
5. The lessee has an option to buy the property at a reduced price compared to the value of the property at the time the lessee can exercise the option. Determining the value at the time of entering into the original agreement also indicates a sale.
6. The lessee has an option to buy the property at a reduced price, compared to the total amount paid under the lease.
7. The lease designates some part of the payments as interest, or part of the payments is easy to recognize as interest.

Important factors to consider are:

- The parties' intention
- Whether the owner/lessor pays insurance and taxes
- Whether the lease runs over the estimated life of the machinery, such as five to seven years.

An appraisal is also important. Interest should not be charged. If an option to purchase is involved at any time, the option to purchase should be at fair market value at the time of purchase. Automatically receiving title at the end of the lease period has the appearance of a sale and should be avoided. The lease payment should be comparable to what used property would lease for. The primary issue is the business reality and economic substance of the transaction.

Tractor Lease

Example 31. Marcia owns a tractor that she purchased in 1995 at a cost of $25,000. In 2006, Marcia leased a new tractor under a true lease for the sum of $12,500 per year and transfers her old tractor to the lessor for the first payment.

Tax Result. Marcia has ordinary income as a result of IRC §1245 recapture in the amount of $12,500, and a lease expense on her Schedule F in the amount of $12,500.

Machine Shed Lease

Example 32. David needs a machine shed for his equipment. David signs a lease containing the following terms:

1. The $30,000 cost of the machine shed is paid by the leasing company.
2. The lease term is for six years, began in 2000, and is payable as follows:

Date Payment Due	Amount of Payment
3-1-2001	$7,500
3-1-2002	7,000
3-1-2003	6,500
3-1-2004	6,000
3-1-2005	6,000
3-1-2006	6,000

David is responsible for paying all real estate taxes, insurance, utilities, and repairs on the machine shed during the lease period. At the end of the lease period, David may purchase the building from the leasing company for $1,000. If the purchase option is not exercised, the leasing company reserves the right to remove the building.

Tax Result. This lease is merely a financing arrangement, and should be treated as a purchase. David has all the responsibilities of ownership of the machine shed and the "buyout" amount of $1,000 does not approximate the fair market value of the shed. David should depreciate the cost of the shed over 20 years and deduct the imputed interest.

Real Estate Lease

Example 33. Chloe executes a lease granting the lessee a right of access to her real estate. She receives $4,000 per year for seven years as rental payments, and pays all real estate taxes, insurance, and repairs. The lease may be renewed at the end of seven years at fair market value. The building may be purchased at fair market value at the end of the lease or the lease may be terminated.

The lease should be treated as a true lease, since the lessor provided all of the original equity and no bargain purchase was included.

Vehicle Leases

The question of leasing a vehicle as opposed to purchasing the vehicle must be decided on a case-by-case basis. Although one generally looks at the least cost approach, other tax and nontax considerations may be involved. The leasing of an automobile or pick-up truck with a gross vehicle weight of less than 6,000 pounds, which is used in a trade or business, may result in the inclusion of an amount in the taxpayer's income. Likewise, this type of vehicle would be subject to MACRS rules and IRC §280(f) depreciation limits. If a vehicle was purchased, the owner would be entitled to deduct the business portion of the lease and nonrefundable security deposit subject to the lease value inclusion amounts. If the FMV of such a vehicle is greater than $15,300 for leases beginning in 2002, the inclusion amount must be computed under Rev. Proc. 2002-14. The inclusion amount is prorated based on the number of days leased during the year and the percentage of business and investment use. The income is reported on the same schedule as the leasing expense deduction.

ISSUE 5: FARM TILE TAX ISSUES

Drainage of agricultural land is a very important issue for both farm tenants and landlords. Among other things, drainage impacts the underlying value of the land, enhances productivity, can provide significant tax deductions and may increase the rental value. In addition, the use of global positioning systems by farmers makes it much easier to target wet spots in fields that could benefit the most from appropriate drainage.

Economics of Tiling

Based on research by Iowa State University (ISU) Extension, corn and soybean yields decrease with inadequate tile. Yield loss due to inadequate drainage ranged from 10 to 45 bushels per acre for corn, and four to 15 bushels per acre for soybeans. That is a big problem, particularly in light of the current structure of federal farm programs, and no set-aside acres. This results in poorly tiled acres being cropped. When yield from these acres is added to an entire farm, average overall yields decline. These reduced yields translate into reduced income per acre. The ISU research indicates that for corn ground, the per acre reduction due to inadequate drainage ranges from $20 to $90 and from $20 to $75 for soybeans. These potential losses make poorly or less than completely drained acres less productive. Consequently the land is less desirable to rent. These values also indicate that poorly-drained fields rent for less than well-drained areas because of the inability to produce maximum yields and income.

LANDLORD/TENANT PAYMENT OPTIONS WHEN ADDING TILE

Most research and cash flow data shows that on average, tiling pays for itself in three to five years, although it can take as long as seven to 10 years. Questions arise about who pays for the tiling, and how the rental contract reflects the change. Base rent may be either the fair value for cash rent or a standard crop share arrangement.

Tenant and Landlord Split Cost of Tiling

Example 34. When a tenant and landlord split the cost of tiling, one pays for tile and the other pays for or provides installation. They enter into a long-term rental contract — seven to 10 years. Base rent is established at an amount less than what well-tiled land rents for. Over the lease period, the rent is gradually increased. The tenant and landlord utilize tax depreciation for the amount of cost each incurred. Repairs on the tile are completed by the tenant until the initial agreement is complete. If the land is sold prior to the end of the initial rental contract, the landlord pays the tenant any undepreciated tile amount remaining.

Note. Due to potential accelerated depreciation deductions related to the §179 expense election or, in prior years, the special depreciation allowance, an economic or book depreciation schedule may better determine any buyout value.

Tenant Pays for Tiling

Example 35. Tenant pays for all initial tiling costs. Tenant and landlord enter into a long term contract — seven to 10 years. Tenant pays a base rent similar to amounts for nontiled land. After the contract expires, rent is determined by the amount paid on comparable land with similar tiling. If the land is sold during the period covered by the contract, the landlord repays the tenant for the remaining tiling cost. Following the completion of the contract, the landlord owes nothing on the tile if the land is sold. The tenant receives all tax depreciation from the improvement.

Landlord Pays Tiling Costs

Example 36. The landlord pays for all tiling costs. Base cash rent is established at a level comparable with tiled land. All tax depreciation goes to the landlord.

Observation. The decision regarding who pays for the tile and how subsequent rent is determined varies considerably by locale. The above should not be used as the standard for all farms around the country.

OTHER TAX AND LEGAL ISSUES REGARDING TILE

1. Tile can be depreciated over 15 years.
2. Tenant can use §179 expense election and depreciate the remainder over 15 years.
3. Basis for land increases, and then declines as the tile is depreciated, if the tiling is paid for by the landlord.
4. Landlord cannot use §179 expense election unless the tile is used in the course of business such as **share rent.**
5. For the tenant to own the tile for the length of the contract, and therefore take advantage of tax depreciation, it must be so stated in the lease.
6. If the tenant pays for all tiling costs and the lease is terminated early or the tiled land is sold, the lease must include a landlord repayment clause. The landlord's repayment should be based upon the lease period, not the tax period.
7. If the tile is paid for by the tenant and is depreciated over the term of the lease, and the lease is terminated, the tenant may be subject to depreciation recapture.
8. If the tile is paid for by the tenant and not completely depreciated by the end of the contract, the tenant could incur a loss.
9. When the lease is terminated or completed, the landlord generally owns the tile.
10. A lease longer than a specified amount of time could be recorded in the county recorder's office.
11. Although not applicable in some states, real estate taxes may increase as determined by the county assessor.
12. Tiling could have been depreciated with special depreciation allowances in prior years by either a cash rent or crop share landlord.
13. The value of field tile included with a land purchase can generate depreciation deductions for the buyer.

ISSUE 6: CHAPTER 12 BANKRUPTCY TAX ISSUES

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA)[66] is the most far-reaching revision of bankruptcy law since 1978. For agriculture, the changes are principally in two areas:

1. Amendments to the eligibility requirements for Chapter 12 filing, and
2. Modification of the income tax treatment of gains on property liquidated in connection with a Chapter 12 bankruptcy reorganization.

Also, effective July 1, 2005, BAPCPA makes Chapter 12 a permanent part of the bankruptcy code.

> **Note.** A discussion of the new bankruptcy act can be found in Chapter 8, "Special Taxpayers."

66. S. 256, Pub. L. No. 109-31, signed into law on April 20, 2005.

CHANGES IN ELIGIBILITY REQUIREMENTS

Only debtors who are "family farmers" are eligible for Chapter 12. Under BAPCPA, "family farmer" is defined as an individual or individual and spouse who earned more than 50% of their gross income from farming either for the taxable year preceding the year of filing or during the second and third tax years preceding filing, and whose aggregate debts do not exceed $3,237,000 (prior law was $1,500,000).

> **Note.** The farm income test is applied at the time of bankruptcy filing. "Gross income from farming" includes government program payments, proceeds of the sale of farm equipment, and income from rental of farm equipment where the lessor has some risk in the farm operation. But, income from the sale of farmland and income from custom farming, even if performed for the debtor's farm operation, is not included in gross income from farming.

In addition, at least 50% (prior law was 80%) of the debtor's aggregate, noncontingent, liquidated debts on the date the case is filed, must have arisen out of a farming operation owned or operated by the debtor, or the debtor and his spouse. This excludes debt for the individual's principal residence, or the individual and spouse unless such debt arises out of the farming operation. To meet the test of arising out of a farming operation, the debt must be directly related to the farming operation.[67]

Closely-held corporations, business trusts (but not other trusts), cooperatives, and partnerships in which more than 50% of the stock or equity is held by one family, or by one family and its relatives, can be "family farmers" if:

- The family or relatives conduct the farming operation,
- More than 80% of the value of its assets are related to the farming operation,
- Its aggregate debts do not exceed $3,237,000 and not less than 50% of its "aggregate noncontingent liquidated debts on the date the case is filed, arose out of the farming operation owned or operated by such corporation or such partnership. This excludes a debt for one dwelling which is owned by such corporation or partnership, and which a shareholder or partner maintains as a principal residence, unless such debt arises out of a farming operation, and
- Issued stock if not publicly traded.

Importantly, BAPCPA does not impose the 50% gross income test on otherwise eligible partnerships and corporations for family farmers. This was the original rule as Chapter 12 was enacted, and was not changed by BAPCPA.

> **Note.** The new eligibility requirements for Chapter 12 debtors became effective on October 17, 2005. The tax provisions became effective upon enactment, April 20, 2005. Chapter 12 became a permanent part of the bankruptcy code effective July 1, 2005.

INCOME TAX CONSEQUENCES OF DEBT RESOLUTION

An important part of debt resolution is the income tax consequences to the debtor. There are actually two major categories of income tax consequences:

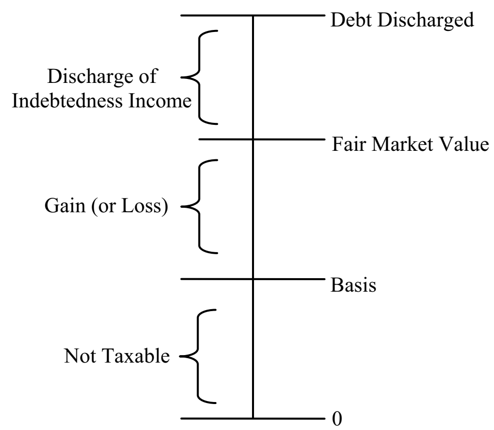
1. Gain or loss, if property is transferred to the lender in satisfaction of indebtedness, and
2. Possible discharge of indebtedness income to the extent debt discharged exceeds the fair market value of property given up by the debtor.

67. For a "family fisherman," aggregate debts cannot exceed $1,500,000 and not less than 80% of the aggregate, noncontingent liquidated debt must arise out of a commercial fishing operation. Also, for a "family fisherman," the 50% gross income test must be met during the taxable year preceding filing.

NATURE OF THE DEBT — RECOURSE OR NONRECOURSE

The handling of discharge of indebtedness depends upon whether the debt was recourse or nonrecourse. With recourse debt, the collateral acts as security on the loan. If the collateral is insufficient, the debtor is personally liable on the obligation and the debtor's nonexempt assets may be used to satisfy any deficiency.[68]

Here is how the bankruptcy consequence looks graphically:



Recourse Debt

For recourse debt, if property is given up by the debtor, the income tax consequences involve a 2-step process. In essence, it is as if the property is sold to the creditor, and the sale proceeds are applied on the debt. First, there is no gain or loss (and no other income tax consequence) up to the income tax basis on the property. The difference between FMV and the income tax basis is a gain or loss. **There is no relief from gain, even if the taxpayer is insolvent.**[69]

> **Example 37.** I.M. Poor transferred an asset with an FMV of $60,000 to a creditor who then discharged $75,000 of indebtedness for which I.M. is personally liable. I.M.'s income tax basis in the asset is $40,000.
>
> The $40,000 return of basis does not create taxable gain. The difference between basis ($40,000) and FMV ($60,000) of the property ($20,000) is taxed as if the property were sold and may produce ordinary income or capital gain depending on the nature of the asset involved (depreciation recapture may also be triggered).
>
> I.M. has income from discharge of indebtedness of $15,000. This is the difference between the FMV ($60,000) of the asset and the amount of indebtedness discharged ($75,000).

68. The bulk of farm debt is recourse debt.

69. See, e.g., *Gehl v. Commr.*, 102 TC 784, *aff'd*, 50 F3d 12 (8th Cir. 1995), *cert. den.*, 116 S. Ct. 257 (1995)

Nonrecourse Debt

For nonrecourse debt, the collateral acts as security on the obligation. But, if the collateral is worth less than the balance of the debt, the debtor does not bear personal liability on the obligation. Therefore, the creditor must look solely to the collateral in the event of default.[70] Handling nonrecourse debt involves a simpler one-step process.[71] Fair market value is ignored, and the entire difference between the income tax basis of any property involved (and transferred to the creditor) and the amount of debt discharged is gain (or loss). There is no discharge of indebtedness income.

> **Example 38.** Cybil purchased an unimproved farm on contract in 1981 for $200,000 to use in her farm business. In 1987, Cybil forfeited the contract to the seller. At that time, the balance due on the contract was $140,000 and the farm's FMV was $100,000. Cybil was solvent at the time.
>
> Cybil has a $60,000 IRC §1231 loss. The FMV of the property is not relevant. The gain or loss is computed by examining the difference between Cybil's income tax basis (purchase price), and the amount of the liability discharged.

> **Note.** The IRS prescribed special rules for handling Farmers Home Administration loans. (FmHA was redesignated as the Farm Service Agency in 1994.)

HANDLING DISCHARGE OF INDEBTEDNESS INCOME

Bankruptcy

Debtors in bankruptcy need not report discharge of indebtedness income as income on their tax return. However, debtors in bankruptcy must reduce their tax attributes (including operating losses and investment tax credits carried forward), and reduce their property's income tax basis. Losses are reduced dollar for dollar and credits are reduced $1 for $3 ($1 of credit offsets $3 of discharge of indebtedness income). To preserve net operating losses and tax credit carryovers, a debtor may elect to reduce the basis of depreciable property before reducing other tax attributes.

Insolvent Debtors

Debtors who are insolvent but not in bankruptcy also do not have income to report from discharge of indebtedness. However, they must reduce tax attributes and reduce the income tax basis of property. The amount of income from discharge of indebtedness that can be excluded from income is limited to the extent of the debtor's insolvency. If the amount of debt discharged exceeds the amount of insolvency, income is triggered on the excess. Thus, for the rule of insolvent taxpayers to apply, the taxpayer must be insolvent both before and after the transfer of property and the indebtedness.

> **Note.** The determination of the taxpayer's solvency is made immediately before the discharge of indebtedness. "Insolvency" is defined as the excess of liabilities over the FMV of the debtor's assets. Both tangible and intangible assets are included in the insolvency calculation, but contingent liabilities are not. The separate assets of the debtor's spouse are not included in determining the extent of the taxpayer's insolvency. In 1999, the IRS ruled that property exempt from creditors under state law is included in the insolvency calculation,[72] and the Tax Court agreed in 2001.[73]

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70. As a practical matter, very little farm debt is nonrecourse, except perhaps for some installment land contracts and commodity loans from the Commodity Credit Corporation to the extent that the debtor may pay off the loan with a sufficient amount of an eligible commodity having a price support value equal to the outstanding value of the loan (or less than the value of the loan in the case of "marketing assistance loan").

71. The U.S. Supreme Court decision in *Commr. v. Tufts*, 461 U.S. 300 (1983), seems to mandate the one-step approach for nonrecourse debt. The case involved nonrecourse debt, but the court did not limit the holding to nonrecourse debt.

72. Ltr. Rul. 9932013, May 4, 1999, *revoking*, Ltr. Rul. 9125010, March 19, 1991; Tech. Adv. Memo. 9935002. May 3, 1999

73. *Carlson v. Commr.,* 116 TC No. 9, February 23, 2001

REAL PROPERTY BUSINESS DEBT

Taxpayers, other than C corporations, can elect to exclude from gross income amounts realized from the discharge of "qualified real property business indebtedness." But, the income tax basis of the property is reduced.

> **Note.** The real property business debt provision does not apply to farm indebtedness.

Solvent Farmers

For all debtors other than farmers, there is income from discharge of indebtedness once solvency is reached. For solvent farm debtors, the discharge of indebtedness arising from an agreement between a person engaged in the trade or business of farming and a "qualified person" to discharge "qualified farm indebtedness" is eligible for special treatment. A special procedure for reducing tax attributes and reducing the property's basis is available to the debtor.

A "qualified person" is someone who is "actively and regularly engaged in the business of lending money and who is not related to or connected with the debtor." "Qualified farm indebtedness" means indebtedness incurred by the taxpayer directly in connection with the operation of the trade or business of farming. And in the aggregate, 50% or more of the average annual gross receipts of the taxpayer for the three preceding taxable years must be attributable to the trade or business of farming. Off-farm income and cash rent income can present problems in meeting the 50% test if significant enough in amount.[74]

If the requirements are met, a solvent farm debtor reduces tax attributes in the following order:

1. Net operating losses of the taxable year, and any carryover losses to that year
2. General business credits, including investment tax credits carried over to that year
3. Minimum tax credit
4. Capital losses for the year and capital losses carried over to that year
5. Passive activity loss and credit carryovers
6. Foreign tax credits

> **Note.** Losses reduce discharge of indebtedness income dollar for dollar. But, $1 of credit reduces $3 of discharge of indebtedness income.

After the reduction of tax attributes, solvent farm debtors reduce the income tax basis of property used in the trade or business, or held for the production of income in the following order:

1. Depreciable property
2. Land used or held for use in the trade or business of farming
3. Other qualified property

An election can be made to reduce the basis of depreciable property first, before reducing the tax attributes, which may help preserve the tax attributes for later use. If discharge of indebtedness remains after tax attributes and property basis is reduced, the remainder is income.

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74. See, e.g., *Lawinger v. Commr.,* 103 TC 428, Sep. 1, 1994 (cash rent landlord not engaged in trade or business of farming with result that discharge of indebtedness not qualified discharge of indebtedness)

Special Treatment for Purchase Price Adjustment

For solvent taxpayers who are not in bankruptcy, any negotiated reduction in the asset's selling price does not have to be reported as discharge of indebtedness income. To be eligible, the debt reduction must involve the original buyer and the original seller.

Example 39. Boyd purchased 320 acres of land from Adam in 1990 for $300,000. In 2006, Boyd is unable to make any of the principal payments. Boyd convinces Adam to reduce the selling price to $200,000. The $100,000 reduction would usually be discharge of indebtedness income, except for this special provision. Boyd must reduce the basis by $100,000. This can pose a problem for fully depreciated assets, or assets already depreciated to a low level.

Sometimes a question arises concerning whether the seller has adverse tax consequences from the forgiveness.

Example 40. George and his wife, Martha, agreed to sell the family farm to their three children under an installment land contract. The contract calls for an annual payment of $36,000 ($12,000 from each child), with payment due on December 25. Every year, George and Martha forgive each child's $12,000 liability. No gift tax is generated because of the current annual exclusion.

Result. IRC §453B makes it clear that cancellation or forgiveness of payments must be treated as though received by the seller. However, the IRS ruled in 1987 that forgiveness of payments to help a financially troubled debtor does not result in income to the seller.[75]

SUMMARY

The taxation issues associated with troubled farm debtors can usually be broken down into six steps:

1. Determining whether the particular indebtedness involved is recourse or nonrecourse debt
2. Determining the FMV of the property transferred to creditors, and the debtor's income tax basis in the property
3. For recourse debt, computing the gain or loss on sale, or other turnover of the assets to creditors, and computing discharge of indebtedness income
4. For nonrecourse debt, computing gain or loss on sale
5. For any resulting discharge of indebtedness income, determining whether an exception to the general rule of income recognition applies
6. Making the appropriate reduction of tax attributes

INCOME TAX ISSUES FOR DEBTORS IN CHAPTER 12 BANKRUPTCY

There is no exception to the rule of income recognition for gain or loss triggered on sale or other turnover of assets to creditors. This can cause problems for a farm debtor that has filed Chapter 12 bankruptcy and is proposing to downsize the farming operation as a means of reorganizing debts, paying off creditors, and continuing the farming operation.

75. Ltr. Rul. 8739045, June 30, 1987

Confirmation of the Chapter 12 Plan — The Issue of Feasibility

Tax liability can play a significant role in getting a debtor's Chapter 12 plan confirmed. Unless the time limit is extended by the court, the confirmation hearing must be concluded not later than 45 days after the plan is filed. The court is required to confirm a plan if all the following apply:

1. The plan conforms to all bankruptcy provisions.
2. All required fees have been paid.
3. The plan proposal was made in good faith without violating any law.
4. Unsecured creditors receive not less than the amount the unsecured creditors would receive in a Chapter 7 liquidation.
5. Each secured creditor either accepts the plan, retains the lien securing the claim,[76] or the creditor receives the property securing the claim.
6. The debtor will be able to make all payments under the plan and to comply with the plan.

If the court determines that the debtor is unable to make all payments as required by the plan, the court may require the debtor to modify the plan, convert the case to a Chapter 7, or request the court to dismiss the case.

As noted above, one of the requirements for confirmation is that the debtor "be able to make all payments under the plan and to comply with the plan." This feasibility standard requires the bankruptcy court to determine whether the plan offers a reasonable prospect of success and is workable. The debtor bears the burden of proof in meeting the feasibility requirement. The court considers the farm's earning power, capital structure, economic conditions, managerial efficiency and whether the same management will continue operations. In addition, the debtor's income and expense projections may be considered in conjunction with their actual past performance to determine feasibility of the proposed plan.

Pre-BAPCPA Chapter 12 Tax Provision

The deed-back of collateral to a secured creditor and asset sales conducted in an attempt to downsize a farming operation could negatively impact the feasibility of the debtor's reorganization plan, because of the associated income tax consequences to the debtor. These taxes were a priority claim in the bankruptcy estate and have to be paid in full on a deferred basis.[77] As part of a proposed reorganization plan, the debtor may propose to downsize the farming operation by selling assets or turning them back over to secured creditors. However, the tax liability triggered by such sales and other transfers often significantly affects the feasibility of the debtor's plan if the debtor does not have the means to pay the taxes (which is likely). The likely result is that the debtor's reorganization plan would not be confirmed.[78]

Example 41. Ron and Nancy filed their Chapter 12 petition on September 24, 2004. They proposed to fund their reorganization plan with income from farming and from off-farm employment. They also proposed to deed 80 acres to FSA to satisfy its secured claim. FSA objects to confirmation of the plan because the debtors' plan did not acknowledge potential liability for capital gains tax from the transfer of the 80 acres to FSA. The debtors' basis in the land is $54,000 and the FMV is $207,000.

Result. The $153,000 difference between basis and FMV is taxable income to the debtors. The tax is a priority claim in the bankruptcy estate, and must be paid in full on a deferred basis. The debtors' failure to acknowledge this income and related taxes in the plan may undermine the plan's feasibility. In the absence of other factors in their favor, the court may deny confirmation of the reorganization plan.

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76. With the value of the property to be distributed for the allowed amount of the claim, as of the effective date of the plan, to equal not less than the allowed amount of the claim.

77. Under 11 U.S.C. §507(a) the taxes are priority taxes. Under the pre-BAPCPA version of 11 U.S.C. §1222(a)(2), these priority taxes had to be paid in full on a deferred basis.

78. See, e.g., *In re Specht*, No. 96-21022KD (Bankr. N.D. Iowa Apr. 9, 1997)(Chapter 12 plan denied confirmation, at least in part, because of significant capital gains taxes triggered by proposed deed-back of collateral to secured creditor)

> **Note.** Assets other than land may be disposed of as part of the reorganization plan. As a result, it is possible that in addition to capital gains, recapture of depreciation can also be triggered. Before amendment by BAPCPA, that tax obligation was also a priority claim in the bankruptcy estate that must be paid in full.

BAPCPA Chapter 12 Tax Provision

Under BAPCPA, a Chapter 12 debtor can treat claims arising out of "claims owed to a governmental unit" as a result of "sale, transfer, exchange, or other disposition of any farm asset used in the debtor's farming operation" as an unsecured claim that is **not entitled to priority** under Section 507(a) of the Bankruptcy Code, provided the debtor receives a discharge.[79] The provision became effective upon enactment on April 20, 2005. The amended statutory language specifies that a Chapter 12 plan must:

2. provide for the full payment, in deferred cash payments, of all claims entitled to priority under section 507, unless—

a. the claim is a claim owed to a governmental unit that arises as a result of the sale, transfer, exchange, or other disposition of any farm asset used in the debtor's farming operation, in which case the claim shall be treated as an unsecured claim that is not entitled to priority under section 507, but the debt shall be treated in such manner only if the debtor receives a discharge; or

b. the holder of a particular claim agrees to a different treatment of that claim…[80]

> **Observation.** From a policy standpoint, Congress has chosen to recognize the uncollectability of the majority of the income taxes occasioned by the sale of a farm debtor's assets used in the farming operation. The impact of the revision is to provide financially-strapped family farmers the opportunity to downsize and restructure their farming operations without the necessity of paying the taxes in full. **It is also important to note that the provision only applies to farm assets and does not apply to assets used in a commercial fishing operation.**

COMPREHENSIVE EXAMPLE[81]

To illustrate the myriad of questions surrounding the BAPCPA's Chapter 12 tax provision, use the following factual scenario:

Facts. Austin and Amy Farmer have been farming since 1983. They utilize the cash method of accounting. They own 160 acres with two large hog finishing setups. In the past, Austin and Amy operated a farrow-to-finish operation. Presently, they operate their hog operation under a contract with Oinkers, Inc. Under the contract, Oinkers, Inc. pays Austin and Amy $14,000 per month. When hogs are in the buildings, Austin and Amy care for the hogs according to Oinkers' protocol. Oinkers, Inc. provides the feed, veterinary care, and marketing for its pigs.

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Austin and Amy also have a crop business operated in conjunction with Austin's father and brother. They share machinery and labor for the crop operation. Austin and Amy grow corn and soybeans on the portion of their property not occupied by hog buildings. They also rent two additional farms consisting of approximately 300 acres for crop production.

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79. BPACPA, §1003, *amending* 11 U.S.C. §1222(a)(2) by the addition of subsection (A)

80. Ibid

81. This comprehensive example is from seminar materials prepared by Joseph A. Peiffer and Roger A. McEowen, and presented at the Thirty-Fifth Annual Bankruptcy Seminar, Cedar Rapids, IA, August 19, 2005, sponsored by Bankruptcy Seminars, Inc.

Austin and Amy's balance sheet is as follows:

Assets		Liabilities	
Parcel 1: 120 acres	$ 480,000	Friendly Bank[a]	$ 852,519
Parcel 2: 40-acre homestead[b]	529,000	Friendly Bank[c]	45,194
Parcel 3: remainder interest[d]	150,000	Happy Mills[e]	42,027
Machinery	46,000	Central State Coop[f]	39,747
Growing crops	64,947	Landlords	8,750
Motor vehicles	15,000	Friendly Bank[g]	9,000
Oinkers, Inc. receivable	14,000	2004 federal and state taxes[h]	56,700
Government program payments[i]	Unknown	Credit cards	101,000
Stock and patronage dividends	29,000	Ruthless Co-Op	70,000
Household goods	3,800		
Cash and accounts	540		
Total assets	$1,332,287	Total liabilities	$1,224,937
		Equity	$ 107,350

[a]Friendly Bank has first, second, and fourth mortgage liens on the debtors' 160 acre farmstead that was split into parcels 1 and 2. In addition, Friendly Bank has a blanket security interest in the debtors' farm machinery, equipment, crops, growing crops and livestock, as well as on contract receivables and the debtor's vehicles.

[b]All of the debtors' hog facilities are on the homestead.

[c]Friendly Bank has a first mortgage lien on the debtors' remainder interest in parcel 3.

[d]The life tenant is Austin's father, age 69, who lives with an artificial heart valve and has high blood pressure. The valuation was arrived at by taking the FMV of the property times the percentage set forth under state law, which shows that the remainder is worth 58.118% of the FMV of the property without discounts for owning only a portion of the remainder interest.

[e]Happy Mills has a third mortgage on parcels 1 and 2 to secure this indebtedness.

[f]Central State Coop has a fifth mortgage lien on parcels 1 and 2 to secure its indebtedness.

[g]Friendly Bank has a purchase money lien of $9,000 on one of the debtors' vehicles having a value of $12,500.

[h]Listed as unsecured claims given provisions of 11 U.S.C. §1222(a)(2) as the taxes are for sales of farm assets used in the farming operation.

[i]Claimed as exempt under state law (may not be exempt in every state).

2003–2004 Change in Operations:

In the late 1990s, the Farmers' hog herd suffered from significant outbreaks of disease, and Austin was injured in a farm accident that immobilized him for several months. The bank started pushing the Farmers to cease operations. Over the years, the Farmers had amassed significant debt with their feed suppliers and were able to restructure most of that indebtedness with the creditors.

Austin and Amy made a fundamental change in their farming operation beginning in 2003. They determined that it was in their best interests to locate a swine integrator. This integrator would provide pigs for their nursery buildings and pigs for their finishing houses to care for on a custom basis.

Therefore, they sold their sows, discontinued farrowing, and sold all their fat hogs. This wind-down of the farrow-to-finish operation began in late 2003 and was completed in September of 2004. In 2004, Austin and Amy sold $339,487 worth of fat hogs.

During 2004, Austin and Amy sold their breeding stock and liquidated their hog herd. They also sold some equipment so they could begin the contract feeding arrangement with Oinkers, Inc. The contractual arrangement began in May of 2004 in the nursery buildings, and went into full swing in the finishing buildings in July of 2004. The change of operations resulted in significant income as shown on the Farmers' 2004 income tax return.

For Comprehensive Example

Form **1040** Department of the Treasury—Internal Revenue Service
U.S. Individual Income Tax Return 2004 (99) IRS Use Only—Do not write or staple in this space.

For the year Jan. 1–Dec. 31, 2004, or other tax year beginning , 2004, ending , 20 OMB No. 1545-0074

Label (See instructions on page 16.) **Use the IRS label.** Otherwise, please print or type.

LABEL HERE

Your first name and initial: **Austin**	Last name: **Farmer**	**Your social security number**: 123 45 6789
If a joint return, spouse's first name and initial: **Amy**	Last name: **Farmer**	**Spouse's social security number**: 987 65 4321
Home address (number and street). If you have a P.O. box, see page 16.: **911 Rural Road**	Apt. no.	**▲ Important! ▲** You **must** enter your SSN(s) above.
City, town or post office, state, and ZIP code. If you have a foreign address, see page 16.: **Anytown IA 55111**		

Presidential Election Campaign (See page 16.)
Note. Checking "Yes" will not change your tax or reduce your refund.
Do you, or your spouse if filing a joint return, want $3 to go to this fund? ▶ You: ☐ Yes ☑ No Spouse: ☐ Yes ☑ No

Filing Status Check only one box.

1 ☐ Single
2 ☑ Married filing jointly (even if only one had income)
3 ☐ Married filing separately. Enter spouse's SSN above and full name here. ▶
4 ☐ Head of household (with qualifying person). (See page 17.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶
5 ☐ Qualifying widow(er) with dependent child (see page 17)

Exemptions

6a ☐ **Yourself.** If someone can claim you as a dependent, **do not** check box 6a
b ☐ **Spouse**
Boxes checked on 6a and 6b: 2

c **Dependents:**

(1) First name Last name	(2) Dependent's social security number	(3) Dependent's relationship to you	(4) ✓ if qualifying child for child tax credit (see page 18)
Jean Farmer	444 44 4444	Daughter	☐
Mike Farmer	333 33 3333	Son	☑
Mary Farmer	222 22 2222	Daughter	☑
Ann Farmer	111 11 1111	Daughter	☑

If more than four dependents, see page 18.

No. of children on 6c who:
• lived with you: 4
• did not live with you due to divorce or separation (see page 18)
Dependents on 6c not entered above
Add numbers on lines above ▶ 6

d Total number of exemptions claimed

Income

Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld.

If you did not get a W-2, see page 19.

Enclose, but do not attach, any payment. Also, please use **Form 1040-V.**

7	Wages, salaries, tips, etc. Attach Form(s) W-2	7	9,803
8a	**Taxable** interest. Attach Schedule B if required	8a	
b	**Tax-exempt** interest. **Do not** include on line 8a (8b)		
9a	Ordinary dividends. Attach Schedule B if required	9a	608
b	Qualified dividends (see page 20) (9b)		
10	Taxable refunds, credits, or offsets of state and local income taxes (see page 20)	10	
11	Alimony received	11	
12	Business income or (loss). Attach Schedule C or C-EZ	12	
13	Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ ☐	13	34,077
14	Other gains or (losses). Attach Form 4797	14	21,659
15a	IRA distributions (15a) b Taxable amount (see page 22)	15b	
16a	Pensions and annuities (16a) b Taxable amount (see page 22)	16b	
17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E	17	
18	Farm income or (loss). Attach Schedule F	18	159,686
19	Unemployment compensation	19	
20a	Social security benefits (20a) b Taxable amount (see page 24)	20b	
21	Other income. List type and amount (see page 24)	21	
22	Add the amounts in the far right column for lines 7 through 21. This is your **total income** ▶	22	225,833

Adjusted Gross Income

23	Educator expenses (see page 26)	23			
24	Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ	24			
25	IRA deduction (see page 26)	25			
26	Student loan interest deduction (see page 28)	26			
27	Tuition and fees deduction (see page 29)	27			
28	Health savings account deduction. Attach Form 8889	28			
29	Moving expenses. Attach Form 3903	29			
30	One-half of self-employment tax. Attach Schedule SE	30	7,588		
31	Self-employed health insurance deduction (see page 30)	31	6,780		
32	Self-employed SEP, SIMPLE, and qualified plans	32			
33	Penalty on early withdrawal of savings	33			
34a	Alimony paid b Recipient's SSN ▶	34a			
35	Add lines 23 through 34a			35	14,368
36	Subtract line 35 from line 22. This is your **adjusted gross income** ▶			36	211,465

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see page 75. Cat. No. 11320B Form **1040** (2004)

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For Comprehensive Example

Form 1040 (2004) Page **2**

Tax and Credits	37	Amount from line 36 (adjusted gross income)		37	211,465
	38a	Check if: { ☐ **You** were born before January 2, 1940, ☐ Blind. / ☐ **Spouse** was born before January 2, 1940, ☐ Blind. } **Total boxes checked ▶ 38a** ☐			
	b	If your spouse itemizes on a separate return or you were a dual-status alien, see page 31 and check here ▶ 38b ☐			
Standard Deduction for— • People who checked any box on line 38a or 38b **or** who can be claimed as a dependent, see page 31. • All others: Single or Married filing separately, $4,850 Married filing jointly or Qualifying widow(er), $9,700 Head of household, $7,150	39	**Itemized deductions** (from Schedule A) **or** your **standard deduction** (see left margin)		39	9,700
	40	Subtract line 39 from line 37		40	201,765
	41	If line 37 is $107,025 or less, multiply $3,100 by the total number of exemptions claimed on line 6d. If line 37 is over $107,025, see the worksheet on page 33		41	18,600
	42	**Taxable income.** Subtract line 41 from line 40. If line 41 is more than line 40, enter -0-		42	183,165
	43	**Tax** (see page 33). Check if any tax is from: **a** ☐ Form(s) 8814 **b** ☐ Form 4972		43	10,271
	44	**Alternative minimum tax** (see page 35). Attach Form 6251		44	30,392
	45	Add lines 43 and 44 ▶		45	40,663
	46	Foreign tax credit. Attach Form 1116 if required	46		
	47	Credit for child and dependent care expenses. Attach Form 2441	47		
	48	Credit for the elderly or the disabled. Attach Schedule R	48		
	49	Education credits. Attach Form 8863	49		
	50	Retirement savings contributions credit. Attach Form 8880	50		
	51	Child tax credit (see page 37)	51		
	52	Adoption credit. Attach Form 8839	52		
	53	Credits from: **a** ☐ Form 8396 **b** ☐ Form 8859	53		
	54	Other credits. Check applicable box(es): **a** ☐ Form 3800 **b** ☐ Form 8801 **c** ☐ Specify ______	54		
	55	Add lines 46 through 54. These are your **total credits**		55	
	56	Subtract line 55 from line 45. If line 55 is more than line 45, enter -0- ▶		56	40,663
Other Taxes	57	Self-employment tax. Attach Schedule SE		57	15,176
	58	Social security and Medicare tax on tip income not reported to employer. Attach Form 4137		58	
	59	Additional tax on IRAs, other qualified retirement plans, etc. Attach Form 5329 if required		59	
	60	Advance earned income credit payments from Form(s) W-2		60	
	61	Household employment taxes. Attach Schedule H		61	
	62	Add lines 56 through 61. This is your **total tax** ▶		62	55,839
Payments	63	Federal income tax withheld from Forms W-2 and 1099	63: 282		
	64	2004 estimated tax payments and amount applied from 2003 return	64		
If you have a qualifying child, attach Schedule EIC.	65a	**Earned income credit (EIC)**	65a		
	b	Nontaxable combat pay election ▶ 65b			
	66	Excess social security and tier 1 RRTA tax withheld (see page 54)	66		
	67	Additional child tax credit. Attach Form 8812	67		
	68	Amount paid with request for extension to file (see page 54)	68		
	69	Other payments from: **a** ☐ Form 2439 **b** ☑ Form 4136 **c** ☐ Form 8885	69: 238		
	70	Add lines 63, 64, 65a, and 66 through 69. These are your **total payments** ▶		70	520
Refund	71	If line 70 is more than line 62, subtract line 62 from line 70. This is the amount you **overpaid**		71	
Direct deposit? See page 54 and fill in 72b, 72c, and 72d.	72a	Amount of line 71 you want **refunded to you** ▶		72a	
	b	Routing number ▶ **c** Type: ☐ Checking ☐ Savings			
	d	Account number			
	73	Amount of line 71 you want **applied to your 2005 estimated tax** ▶	73		
Amount You Owe	74	**Amount you owe.** Subtract line 70 from line 62. For details on how to pay, see page 55 ▶		74	55,319
	75	Estimated tax penalty (see page 55)	75		

Third Party Designee Do you want to allow another person to discuss this return with the IRS (see page 56)? ☐ **Yes.** Complete the following. ☐ **No**

Designee's name ▶ Phone no. ▶ ( ) Personal identification number (PIN) ▶

Sign Here Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Joint return? See page 17. Keep a copy for your records.

Your signature	Date	Your occupation	Daytime phone number
		Farmer	( )
Spouse's signature. If a joint return, **both** must sign.	Date	Spouse's occupation	
		Housewife	

Paid Preparer's Use Only

Preparer's signature ▶	Date	Check if self-employed ☐	Preparer's SSN or PTIN
Firm's name (or yours if self-employed), address, and ZIP code ▶		EIN	
		Phone no.	( )

Form **1040** (2004)

For Comprehensive Example

SCHEDULE D (Form 1040)
Department of the Treasury Internal Revenue Service (99)

Capital Gains and Losses

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

OMB No. 1545-0074
2004
Attachment Sequence No. 12

Name(s) shown on Form 1040: Austin H & Amy J Farmer
Your social security number: 123 45 6789

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

	(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see page D-6 of the instructions)	(e) Cost or other basis (see page D-6 of the instructions)	(f) Gain or (loss) Subtract (e) from (d)
1						
2	Enter your short-term totals, if any, from Schedule D-1, line 2		2			
3	**Total short-term sales price amounts.** Add lines 1 and 2 in column (d)		3			

4	Short-term gain from Form 6252 and short-term gain or (loss) from Forms 4684, 6781, and 8824	4	
5	Net short-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1	5	
6	Short-term capital loss carryover. Enter the amount, if any, from line 8 of your **Capital Loss Carryover Worksheet** on page D-6 of the instructions	6	( )
7	**Net short-term capital gain or (loss).** Combine lines 1 through 6 in column (f)	7	

Part II Long-Term Capital Gains and Losses—Assets Held More Than One Year

	(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see page D-6 of the instructions)	(e) Cost or other basis (see page D-6 of the instructions)	(f) Gain or (loss) Subtract (e) from (d)
8	500 SH IA Prem	04/02/01	12/20/04		500	-500
9	Enter your long-term totals, if any, from Schedule D-1, line 9		9			
10	**Total long-term sales price amounts.** Add lines 8 and 9 in column (d)		10			

11	Gain from Form 4797, Part I; long-term gain from Forms 2439 and 6252; and long-term gain or (loss) from Forms 4684, 6781, and 8824	11	34,577
12	Net long-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1	12	
13	Capital gain distributions. See page D-1 of the instructions	13	
14	Long-term capital loss carryover. Enter the amount, if any, from line 13 of your **Capital Loss Carryover Worksheet** on page D-6 of the instructions	14	( )
15	**Net long-term capital gain or (loss).** Combine lines 8 through 14 in column (f). Then go to Part III on the back	15	34,077

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 11338H **Schedule D (Form 1040) 2004**

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For Comprehensive Example

SCHEDULE F (Form 1040)
Department of the Treasury Internal Revenue Service (99)

Profit or Loss From Farming

▶ Attach to Form 1040, Form 1041, Form 1065, or Form 1065-B.
▶ See Instructions for Schedule F (Form 1040).

OMB No. 1545-0074
2004
Attachment Sequence No. 14

Name of proprietor: **Austin H Farmer**
Social security number (SSN): 123 : 45 : 6789

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

B Enter code from Part IV ▶ 1 1 1 9 0 0

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

D Employer ID number (EIN), if any

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

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

1	Sales of livestock and other items you bought for resale	1			
2	Cost or other basis of livestock and other items reported on line 1	2			
3	Subtract line 2 from line 1			3	
4	Sales of livestock, produce, grains, and other products you raised			4	525,384
5a	Total cooperative distributions (Form(s) 1099-PATR) / 5b Taxable amount	5a	2,762	5b	2,762
6a	Agricultural program payments (see page F-2) / 6b Taxable amount	6a	25,935	6b	25,935
7	Commodity Credit Corporation (CCC) loans (see page F-3):				
a	CCC loans reported under election			7a	
b	CCC loans forfeited / 7c Taxable amount	7b		7c	
8	Crop insurance proceeds and certain disaster payments (see page F-3):				
a	Amount received in 2004 / 8b Taxable amount	8a		8b	
c	If election to defer to 2005 is attached, check here ▶ ☐ / 8d Amount deferred from 2003			8d	
9	Custom hire (machine work) income			9	
10	Other income, including Federal and state gasoline or fuel tax credit or refund (see page F-3)			10	102,008
11	**Gross income.** Add amounts in the right column for lines 3 through 10. If accrual method taxpayer, enter the amount from page 2, line 51 ▶			11	656,089

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

12	Car and truck expenses (see page F-4—also attach **Form 4562**)		25	Pension and profit-sharing plans	
13	Chemicals	19,183	26	Rent or lease (see page F-5):	
14	Conservation expenses (see page F-4)		26a	Vehicles, machinery, and equipment	500
15	Custom hire (machine work)	5,250	26b	Other (land, animals, etc.)	46,698
16	Depreciation and section 179 expense deduction not claimed elsewhere (see page F-4)	36,921	27	Repairs and maintenance	30,963
			28	Seeds and plants purchased	58,440
			29	Storage and warehousing	
17	Employee benefit programs other than on line 25	1,638	30	Supplies purchased	17,531
			31	Taxes	7,173
18	Feed purchased	120,643	32	Utilities	12,820
19	Fertilizers and lime	36,215	33	Veterinary, breeding, and medicine	
20	Freight and trucking	6,666	34	Other expenses (specify):	
21	Gasoline, fuel, and oil	6,128	34a	Employee WH	3,913
22	Insurance (other than health)	9,489	34b	Professional Fees	1,262
23	Interest:		34c	LO Gas	28,248
23a	Mortgage (paid to banks, etc.)	6,830	34d	FSA Repayment	2,589
23b	Other	5,843	34e	Pickup Exp 75%	1,740
24	Labor hired (less employment credits)	8,883	34f	Other	20,837

35	**Total expenses.** Add lines 12 through 34f ▶	35	496,403
36	**Net farm profit or (loss).** Subtract line 35 from line 11. If a profit, enter on **Form 1040, line 18,** and **also** on **Schedule SE, line 1.** If a loss, you **must** go on to line 37 (estates, trusts, and partnerships, see page F-6)	36	159,686

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

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

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 11346H **Schedule F (Form 1040) 2004**

For Comprehensive Example

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. | OMB No. 1545-0184 **2004** Attachment Sequence No. **27**

Department of the Treasury
Internal Revenue Service (99)

Name(s) shown on return	Identifying number
Austin H & Amy J Farmer	123-45-6789

1	Enter the gross proceeds from sales or exchanges reported to you for 2004 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 Raised sows	03/01/98	03/25/04	34,577		0	34,577

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	0
7	Combine lines 2 through 6. Enter the gain or (loss) here and on the appropriate line as follows:	7	34,577
	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. **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 Schedule D 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 Schedule D (see instructions)	9	

Part II **Ordinary Gains and Losses**

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

11	Loss, if any, from line 7	11	( )
12	Gain, if any, from line 7 or amount from line 8, if applicable	12	
13	Gain, if any, from line 31	13	21,659
14	Net gain or (loss) from Form 4684, lines 31 and 38a	14	
15	Ordinary gain from installment sales from Form 6252, line 25 or 36	15	
16	Ordinary gain or (loss) from like-kind exchanges from Form 8824	16	
17	Combine lines 10 through 16	17	21,659
18	For all except individual returns, enter the amount from line 17 on the appropriate line of your return and skip lines a and b below. For individual returns, complete lines a and b below:		
a	If the loss on line 11 includes a loss from Form 4684, line 35, column (b)(ii), enter that part of the loss here. Enter the part of the loss from income-producing property on Schedule A (Form 1040), line 27, and the part of the loss from property used as an employee on Schedule A (Form 1040), line 22. Identify as from "Form 4797, line 18a." See instructions	18a	
b	Redetermine the gain or (loss) on line 17 excluding the loss, if any, on line 18a. Enter here and on Form 1040, line 14	18b	21,659

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For Comprehensive Example

Form 4797 (2004) Page **2**

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

19 (a) Description of section 1245, 1250, 1252, 1254, or 1255 property:	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)
A Livestock trailer	03/01/1996	08/21/2004
B Farrowing equipment	08/20/1992	04/01/2004
C		
D		

These columns relate to the properties on lines 19A through 19D. ▶		Property A	Property B	Property C	Property D
20 Gross sales price (**Note:** *See line 1 before completing.*)	20	7,500	14,160		
21 Cost or other basis plus expense of sale	21	10,555	20,000		
22 Depreciation (or depletion) allowed or allowable	22	10,554	20,000		
23 Adjusted basis. Subtract line 22 from line 21	23	1	0		
24 Total gain. Subtract line 23 from line 20	24	7,499	14,160		
25 **If section 1245 property:**					
a Depreciation allowed or allowable from line 22	25a	10,554	20,000		
b Enter the **smaller** of line 24 or 25a	25b	7,499	14,160		
26 **If section 1250 property:** If straight line depreciation was used, enter -0- on line 26g, except for a corporation subject to section 291.					
a Additional depreciation after 1975 (see instructions)	26a				
b Applicable percentage multiplied by the **smaller** of line 24 or line 26a (see instructions)	26b				
c Subtract line 26a from line 24. If residential rental property **or** line 24 is not more than line 26a, skip lines 26d and 26e	26c				
d Additional depreciation after 1969 and before 1976	26d				
e Enter the **smaller** of line 26c or 26d	26e				
f Section 291 amount (corporations only)	26f				
g Add lines 26b, 26e, and 26f	26g				
27 **If section 1252 property:** Skip this section if you did not dispose of farmland or if this form is being completed for a partnership (other than an electing large partnership).					
a Soil, water, and land clearing expenses	27a				
b Line 27a multiplied by applicable percentage (see instructions)	27b				
c Enter the **smaller** of line 24 or 27b	27c				
28 **If section 1254 property:**					
a Intangible drilling and development costs, expenditures for development of mines and other natural deposits, and mining exploration costs (see instructions)	28a				
b Enter the **smaller** of line 24 or 28a	28b				
29 **If section 1255 property:**					
a Applicable percentage of payments excluded from income under section 126 (see instructions)	29a				
b Enter the **smaller** of line 24 or 29a (see instructions)	29b				

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

30 Total gains for all properties. Add property columns A through D, line 24	30	21,659
31 Add property columns A through D, lines 25b, 26g, 27c, 28b, and 29b. Enter here and on line 13	31	21,659
32 Subtract line 31 from line 30. Enter the portion from casualty or theft on Form 4684, line 33. Enter the portion from other than casualty or theft on Form 4797, line 6	32	00

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

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

Form **4797** (2004)

> **Observation.** For the typical farmer, the year of liquidation of an enterprise customarily results in dramatically higher income taxes. This is certainly true for Austin and Amy. The 2004 asset sales were coupled with lower deductible expenses. In 2004, their feed purchases were lower, their semen purchases and other supply purchases were lower, and many other expenses were lower than they would have been in a traditional year when they were feeding sows, breeding the sows, and preparing for additional farrowing and finishing throughout the year.

With fewer expenses in 2004, the tax liability for Austin and Amy increased $55,280 from 2003 to 2004.

Chapter 12 Bankruptcy Is Filed

Ruthless Co-op was unwilling to renegotiate a slow repayment of the $70,000 obligation secured by a mortgage on the Farmers' real estate, and began litigation against the Farmers. Given their balance sheet and the pending lawsuit against them by Ruthless Co-op (scheduled to go to trial in early July), Austin and Amy Farmer filed Chapter 12 bankruptcy on July 1, 2005. Their attorney informed them of the provisions of 11 U.S.C. §1222(a)(2) that allow the taxes owed to governmental units arising from the sale of farm assets used in the farm operation to be treated as unsecured claims provided they receive a Chapter 12 discharge.

Analyses of the Farmers' Income Tax Returns

The primary issue is how much of the Farmers' tax liability can be treated as an unsecured claim under 11 U.S.C. §1222(a)(2). The following scenarios illustrate the possibilities:

Scenario One
All Income from the Sale of Farm Assets Qualifies for §1222(a)(2) Treatment

Schedule	Line	Farm Assets Sold	Type of Income	Amount
D[a]	11	Raised sows	LTCG	$ 34,577
4797	25b	Livestock trailer (Prop. A)	§1245 recapture	7,499
4797	25b	Farrowing equipment (Prop. B)	§1245 recapture	14,160
F	36 adj[b]	Raised livestock and grain	Ordinary income	127,874
Scenario one total income from the sale of farm assets in 2004				$184,110

[a] Refers to long-term capital gain reported in Part I of Schedule 4797

[b] The net income shown on Schedule F is $159,686. The gross income reported on Line 11 is $656,089. The sales of raised livestock and grains total $525,384, which is 80.01% of the gross income. Therefore, 80.01% of the net income shown on Schedule F, Line 36 is included in this example: $159,686 × 80.01% = $127,874.

Scenario Two
Income from the Sale of Raised Grain Is Excluded from §1222(a)(2) Treatment

Schedule	Line	Farm Assets Sold	Type of Income	Amount
D[a]	11	Raised sows	LTCG	$ 34,577
4797	25b	Livestock trailer (Prop. A)	§1245 recapture	7,499
4797	25b	Farrowing equipment (Prop. B)	§1245 recapture	14,160
F	36 adj[b]	Raised livestock and grain	Ordinary income	88,152
Scenario two total income from the sale of farm assets in 2004				$144,388

[a]Refers to long-term capital gain reported in Part I of Schedule 4797

[b]The net income shown on Schedule F is $159,686. The gross income reported on Line 11 is $656,089. The sales of raised livestock is $525,384 less corn and soybean sales of $163,200 = $362,184, which is 55.20% of the gross income. Therefore, 55.20% of the net income shown on Schedule F, Line 36 is included in this example: $159,686 × 55.20% = $88,152.

Scenario Three
Income from the Sale of Grain Raised for Sale Is Excluded from §1222(a)(2) Treatment

Schedule	Line	Farm Assets Sold	Type of Income	Amount
D[a]	11	Raised sows	LTCG	$ 34,577
4797	25b	Livestock trailer (Prop. A)	§1245 recapture	7,499
4797	25b	Farrowing equipment (Prop. B)	§1245 recapture	14,160
F	36 adj[b]	Raised livestock and grain	Ordinary income	114,925
Scenario three total income from the sale of farm assets in 2004				$171,161

[a]Refers to long-term capital gain reported in Part I of Schedule 4797

[b]The net income shown on Schedule F is $159,686. The gross income reported on Line 11 is $656,089. Prior to the change in operations, Austin and Amy fed all of the corn they raised to their hogs and sold all of their soybean production. The Sales of raised livestock is $525,384 less soybean sales of $53,200 = $472,184, which is 72.00% of the gross income. Therefore, 72.00% of the net income shown on Schedule F, Line 36 is included in this example: $159,686 × 72.00% = $114,925.

Scenario Four
All Income from the Sale of Raised Livestock and Grain Is Excluded from §1222(a)(2) Treatment[a]

Schedule	Line	Farm Assets Sold	Type of Income	Amount
D[b]	11	Raised sows	LTCG	$34,577
4797	25b	Livestock trailer (Prop. A)	§1245 recapture	7,499
4797	25b	Farrowing equipment (Prop. B)	§1245 recapture	14,160
Scenario four total income from the sale of farm assets in 2004				$56,236

[a]Under this scenario, Austin and Amy Farmer are assumed to sell all of their corn and soybean production in the year of production.

[b]Refers to long-term capital gain reported in Part I of Schedule 4797

Questions for Discussion

Which sales can be treated under §1222(a)(2)?

1. Raised sows
2. Livestock trailer
3. Farrowing equipment
4. Soybeans
5. Traditionally fed corn
6. Not traditionally fed corn

IRS Position. The IRS has taken the position in litigation that only the sale of capital assets qualifies for treatment under 11 U.S.C. §1222(a)(2)(A). Consequently, asset sales reported on Schedule F do **not qualify**. In addition, the IRS position is that the prepetition sale of farm assets used in a debtor's farming operation remains collectible after the entry of the Order of Discharge in the Chapter 12 proceeding. The rationale is that taxes that arise from a debtor's prepetition sale of farm assets used in the farming operation are priority taxes. Thus, if any portion of the priority tax is not paid, it is fully collectible together with penalty and interest when the Chapter 12 discharge is entered. It is the IRS's position that the provision's benefit to farm debtors is to merely delay payment of an otherwise priority tax that debtors would have had to pay in the plan under the prior version of Chapter 12. Therefore, debtors might be able to make a lower payment and make an otherwise unconfirmable plan confirmable.

Observation. The IRS position appears to be contrary to Congressional intent, overly limiting, and would render the statute a nullity. The legislative history behind the statutory provision illustrates that the Congress contemplated the scaling down of a farming operation to make the operation viable and not have the tax liability impact the feasibility of the debtor's reorganization plan. In addition, the statute does not specifically limit governmental claims to only those taxes resulting from the sale of capital assets.

Additional Questions

1. Does AMT affect this analysis?
2. How does income averaging affect §1222(a)(2)?
3. Does it make a difference if Austin and Amy Farmer operate as an S corporation known as Farmer, Inc. since the taxation occurs at the shareholder level and not at the corporate level?

PLAN TREATMENT #1 — SALE OF 120 ACRES

Within the plan, Austin and Amy anticipate selling 120 acres and concentrating their efforts on the contract feeding arrangement with Oinkers, Inc. This should dramatically reduce their debt to Friendly Bank and increase their probability of long-term success. The income tax basis of the 120 acres is $1,000 per acre. They anticipate a sale price of $4,000 per acre. Thus, $3,000 per acre or $360,000 will be a long-term capital gain.

Questions Arising from the Anticipated Sale of Farmland

1. Will the tax generated by sale of the 120 acres post filing and as part of the plan qualify for §1222(a)(2) treatment?
2. Does the timing of the sale, prepetition versus postpetition, matter for §1222(a)(2) treatment?
3. Does the timing of the sale in the tax year before filing or during the tax year of filing affect §1222(a)(2) treatment?
4. What if the Farmers get their plan confirmed, and two years later sell the 120 acres? Would/should the sale qualify for §1222(a)(2) treatment provided that the governmental bodies received at least as much as they would have received in a chapter liquidation?

IRS Position. The position of the IRS is that postpetition taxes are not subjected to treatment under 11 U.S.C. §1222(a)(2)(A), i.e., income taxes that result from the postpetition sale of assets are not a priority claim. Thus, a debtor remains liable for the full amount of tax triggered by a sale or other disposition of farm assets utilized in the debtor's farming operation after filing.

Observation. The statute states that it applies to **all** priority claims under Sec. 507. That should include postpetition sales that are an administrative expense under Sec. 507(a)(2). Chapter 12 does not create a separate taxable estate. Can a postpetition sale qualify as an administrative expense if the tax burden belongs to the individual debtor and not the bankruptcy estate?

PLAN TREATMENT #2 — SALE OF REMAINDER

Austin and Amy carefully reviewed their options and determined that they must sell Austin's remainder interest in real estate to ensure that they pay the unsecured creditors at least as much as they would be entitled to receive under a Chapter 7 liquidation. Austin's income tax basis in the remainder is $43,250. If it sells for $150,000, the long-term capital gain is $106,750. The net available to pay unsecured creditors without regard to the payment of income taxes is $104,106. This is computed by deducting the sum owed to Friendly Bank, $45,894, from the FMV of the remainder $150,000.

Additional Questions

1. Will the taxes generated by the sale of the remainder interest qualify for §1222(a)(2) treatment, or is it treated as a traditional long-term capital gain with income taxes due in the year the sale is reported?
2. Is the sale of the remainder interest the sale of a "farm asset" used in the debtor's farming operation?
3. Does the timing of the sale make any difference to the analysis?

Observation. It is unclear at the present time what the IRS's position is.

Summary of IRS Position

The following reflects the present litigating position of the IRS:

Issue	IRS Position
Does 11 U.S.C. §1222(a)(2)(A) apply to prepetition taxes?	Yes
Does 11 U.S.C. §1222(a)(2)(A) apply to the sale of the Farmers' farrowing equipment and livestock trailer?	Yes
Does 11 U.S.C. §1222(a)(2)(A) apply to the sale of the Farmers' fat hog inventory sold to facilitate a change in the farmers' farming operation?	No
Assuming the Farmers receive a discharge through Chapter 12, is the tax treated under 11 U.S.C. §1222(a)(2)(A) discharged and noncollectible?	No
Does 11 U.S.C. §1222(a)(2)(A) apply to postpetition taxes such as the sale of the Farmers' machinery and 120 acres?	No
What is the proper way to calculate the amount of tax subject to 11 U.S.C. §1222(a)(2)(A) treatment?	Proration of total tax when compared to percentage of total income treated under 11 U.S.C. §1222(a)(2)(A)
Does treatment under 11 U.S.C. §1222(a)(2)(A) only relate to the timing of payment of tax, thereby subjecting the Farmers to payment of interest after the Chapter 12 discharge?	Yes
Does treatment afforded under 11 U.S.C. §1222(a)(2)(A) result in classification, treatment, and discharge of a claim of a governmental unit when the Chapter 12 discharge is entered?	No

The Timing Issue

Under BAPCPA, Chapter 12 filers are given flexibility in making decisions regarding downsizing the farming operation both before and after filing the Chapter 12 petition. Nothing in the legislation limits the timing of the farm debtor's decision as to when the assets used in the farming operation should be disposed, whether prepetition, postpetition or postconfirmation. What is certain is that, irrespective of the timing of the sale of the assets used in the farming operation, the taxing bodies must receive as large a dividend as they would have received if the tax claims arising from the disposition of the assets used in the farming operation were treated as prepetition unsecured claims.

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PLANNING POINTS — THE CORRECT APPROACH UNDER BAPCPA

Preconfirmation Decisions About Asset Sales

Sometimes the debtor liquidates assets used in the farming operation within the tax year of filing. If depreciation recapture and capital gains taxes are incurred, the plan should provide that there will be no payments to unsecured creditors until the amount of the tax owed to governmental bodies for the sale of assets used in the farming operation is ascertained. This is also true if he decides to liquidate assets used in the farming operation after the filing as a part of the Chapter 12 plan. Next, the 11 U.S.C. §1222(a)(2) claims are added to the prepetition unsecured claims to determine the percentage distribution to be made to the prepetition unsecured claims as well as the claims of the governmental units that are being treated as unsecured creditors not entitled to priority. Thus, all claims that are required to be treated the same[82] are treated equitably.

82. These claims include the 11 U.S.C. §1222(a)(2) tax claims as well as the unsecured claims without priority.

Postconfirmation Decisions about Asset Sales

If the debtor determines postconfirmation that in order to ensure financial viability, assets used in the farming operation must be liquidated, the Chapter 12 plan could be modified to allow the sale of the assets. This is acceptable as long as the modified plan makes provision to pay the taxing bodies an amount that includes the appropriate dividend. Next, upon entry of the Chapter 12 discharge, the governmental taxing body's postpetition claim for taxes on the sale of assets used in the debtor's farming operation is also discharged.

Example 42. Karl and Kathryn Korncob filed a Chapter 12 petition and had their reorganization plan confirmed on September 15, 2005. The plan provided for a dividend of 5% for unsecured creditors' totaling $200,000. No disposition of assets used in their farming operation was contemplated at the time the plan was confirmed.

In 2007, the Korncob's determined that their farming operation would be economically viable if they sold a farm having an adjusted tax basis of $500,000 for an anticipated sale price of $1 million. The federal tax resulting from depreciation recapture and long-term capital gains from the sale of the farm was $75,000, and the state tax was $25,000. At the time of the sale, the Korncobs had paid two-thirds of the anticipated dividend to unsecured creditors ($6,667).

Result. When the additional $100,000 of tax claims is added to the pool of unsecured creditors, the original dividend of 5% decreases to 3.33%. Since distribution to the other unsecured creditors occurred under this three year plan, the modified plan could propose that further dividends be suspended to the prepetition creditors. The dividends would remain suspended until the payments to the governmental bodies on their post modification tax claims[83] equals the percentage of claims that were made to the other unsecured creditors after which point, distributions could be made to all unsecured creditors and to the 11 U.S.C. §1222(a)(2) priority claimants on a pro rata basis. The treatment of post-petition taxes on the sale of assets used in the farming operation should also qualify for the favorable treatment afforded pre-petition taxes on the sale of these assets.

Example 43. Use the same facts as in **Example 41,** except the amount of the unsecured claims treated in the plan was $100,000 with a projected dividend of 10%. Payment of two-thirds of the projected payments of disposable income means that the unsecured creditors received 6.67% of their unsecured claims. The addition of $100,000 in claims from governmental bodies decreases the projected payment to unsecured creditors to 5%. If the plan were modified after payment of 6.67% to unsecured creditors, the remaining distribution of $3,333 of disposable income would not allow the governmental bodies to receive 5% of their claims. Therefore, merely suspending payments to the other unsecured creditors and making payment to the 11 U.S.C. §1222(a)(2) claimants of the remaining projected disposable income of $3,333 would only allow the 11 U.S.C. §1222(a)(2) claimants to receive 3.33% of their claims while the unsecured creditors receive 6.67% of their claims.

Result. For the modified plan to be confirmed, it must make provision for the debtor to make an additional payment to the trustee for the benefit of the 11 U.S.C. §1222(a)(2) claimants in an amount that allows these claimants to receive at least as much as the unsecured creditors are paid (i.e., $3,334). The trustee should suspend the remaining distribution to unsecured creditors making payments only to the 11 U.S.C. §1222(a)(2) claimants through the modified plan in an amount that allows the unsecured creditors and the 11 U.S.C. §1222(a)(2) creditors to be equitably treated for distributions of disposable income.

83. These are claims that resulted from the sale of assets used in the Korncobs' farming operation.

> **Observation.** In order to fund the additional payment to the trustee for the 11 U.S.C. §1222(a)(2) claimants, the debtors could sell additional assets or lengthen their plan. Thus, a payment to the trustee on behalf of the taxing bodies in excess of the anticipated disposable income payment to be made under the original plan should be required in the modified plan as a condition of confirmation so that the taxing bodies are compensated appropriately. Then, upon payment to the governmental taxing bodies of the same percentage payment made to other unsecured creditors, the postpetition depreciation recapture and capital gains taxes referred to in 11 U.S.C. §1222(a)(2) would be discharged.

CALCULATION OF TAX TO BE TREATED UNDER 11 U.S.C. §1222(a)(2)(A)

Procedure Believed to be Correct Under BAPCPA:

1. Use a pro forma tax return that excludes income from the sale of the debtor's farm assets used in the debtor's farming operation.
2. Subtract the tax resulting from Step 1 from the income tax due as shown on the debtors' actual return.

IRS Approach

The IRS approach (taken in pending litigation) is to prorate the income tax between the ordinary income and the gain triggered by asset sales. This approach guarantees that some of the resulting income tax obligation is taxed at each rate attributable to the debtor.

> **Observation.** Merely prorating the taxes in proportion to the portions of the income that qualify for 11 U.S.C. §1222(a)(2)(A) treatment against the income that does not qualify, does not appear to give effect to the plain meaning of the statute. It is only by eliminating the income from the sale of the farm assets used in the debtor's farming operation via completion of a pro forma tax return that the true amount of tax that is a direct result of the sale of the farming assets can actually be calculated.

Conclusion

New Chapter 12 provides numerous opportunities for family farmers to downsize and right size their operations without worrying about the tax effects of the sale of farm assets. There are many unanswered questions, which the bankruptcy courts will face as they seek to determine Congress's intent in writing the legislation.

ISSUE 7: SELECTED ETHANOL COOPERATIVE TAX ISSUES

The American Jobs Creation Act of 2004 and the Energy Policy Act of 2005 contain several provisions of importance to ethanol cooperatives and ethanol production in general.

Volumetric Ethanol Excise Tax Credit

The volumetric ethanol excise tax credit replaced the existing ethanol tax incentive. Any taxpayer eligible for the former alcohol fuels tax credit is eligible for the new credit. Taxpayers can file for a refund for every gallon of ethanol used in the marketplace without regard to the taxpayer's income, or whether the ethanol is used in a taxed fuel or tax-exempt fuel.

The act also modifies the "dividend allocation rule" to allow cooperatives to more easily raise equity from nontraditional sources. The act allows cooperatives to bypass the rule under an agreement of its membership. If that action is taken, the cooperative can more easily create a class of preferred stock or other proprietary capital interest on which dividends can be paid without giving up any control of the cooperative by the farmers who patronize the cooperative.

Small Ethanol Producer Tax Credit (SEPTC)

IRC §40 provides for a small ethanol producer tax credit through December 31, 2010. The provision allows an eligible small ethanol producer a nonrefundable federal income tax credit (on an annual basis) equal to 10¢ per gallon produced for the first 15 million gallons. A "small producer" is defined as an ethanol production facility that has a productive capacity of less than 60 million gallons. Investors can invest in more than one ethanol plant, but the productive capacity for each investor is limited to 60 million gallons. Similarly, if an investor has in interest in multiple plants where the total productive capacity is less than 60 million gallons, and the income tax credit for which the investor is eligible is greater than $1,500,000, then the investor would also be limited to the $1,500,000, which would equate to 15 million gallons of production.

The production capacity limit applies at both the entity-producer level and the entity-owner level.

> **Note.** The capacity limitation includes denaturant and is measured by the greater of boilerplate capacity **or** actual production in any given year.

Example 44. Measurement of Productive Capacity. Mary owns 5% of a 50 million gallon plant and a 10% interest in a 100 million gallon plant. She calculates 5% times 50 million (2,500,000) plus 10% times 100 million (10,000,000) for a total productive capacity of 12,500,000 gallons.

Producer entities that make an investment in other producing plants must add the allocated production gallons that pertain to their ownership. Investors are subject to the controlled group and attribution rules of IRC §267. Ownership of over 50% requires that entities be considered as a single controlled group for production limitation purposes.

SEPTC, AMT, and Sec. 87 Income Add-Back. For tax years beginning after December 31, 2004, the credit offsets AMT.[84] The tax benefit of the SEPTC is reduced by the IRC §87 requirement to add the amount of the tax credit into taxable income. But, the IRC §87 income add-back is excluded in computing the AMT, and does not result in any additional assets for the company, and does not increase a partner's or member's capital account. The add-back amount must be included in regular taxable income and will likely increase the tax basis of the partner's or member's interest. Thus, the add-back amount increases the company's federal taxable income by $1,500,000 if the ethanol plant claims the entire credit. In states that compute state taxable income by starting with federal taxable income, the state must have a specific subtraction for the SEPTC to negate the impact of this phantom state income. Some states have enacted corrective legislation. However, the IRC §87 income add-back provision does not apply to credits allocated to the taxpayer as a shareholder, partner, beneficiary, or patron per the instructions for Form 6478, line 4.

Carryforward and Carryback Rules

The SEPTC is an annual election that is claimed at the entity level by recognizing the tax credit on the ethanol production company's federal tax return. The credit can be claimed or revoked within the 3-year statute of limitations by filing an amended return. The proper amended returns must be filed by the owners of a pass-through entity as well. Unused credits can be carried back one year and forward for a maximum of three years beyond the statutory expiration date of the credit. Any amount of unused credit becomes an income tax deduction after the carryforward period has expired.

The SEPTC election can be used if neither the plant nor the investor has much tax liability. The ethanol plant would be required to add the $1,500,000 back into taxable income subject to the IRC §87 add-back. If the ethanol plant is a pass-through entity or a cooperative, the credit passes to the owners and can be utilized on their individual tax returns. To the extent the ethanol plant and the investors have no tax liability to offset, the credit can be carried back one year and forward three years beyond the statutory termination date (December 31, 2013).

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84. The provision, however, remains limited by IRC §38(c)(4) which prohibits the SEPTC from reducing regular income tax below 25% of the amount by which the taxpayer's regular income tax exceeds $25,000.

Allocation of the SEPTC

If an ethanol plant has different classes of partner-investors, the SEPTC cannot be allocated to one class of investors and the profits to a different class of investors. The SEPTC is generated from the production and sale of ethanol. Because the credit is related to an item of partnership income (the sale of ethanol), the credit must be allocated to each partner in the same proportion as profits from the sale of ethanol are allocated. The instructions to Form 6478 provide that a partnership should allocate the SEPTC to each partner "in the same way that income and loss are divided."

Cooperatives are not considered pass-through entities. Instead, the IRS considers cooperatives to be corporations that receive a special dividend deduction when operating on a cooperative basis. The SEPTC is allocated in a manner that is proportionate to the income that is allocated to patron members of the cooperative. The cooperative must make an election to utilize the SEPTC and then make an additional election to pass the credit through to its patron members. The cooperative must also notify the members in writing that they have been allocated their proportionate share of the SEPTC. A cooperative must make the notification within 8½ months after the close of the fiscal year (after the election was made). Typically, the notification is included on the written notice of allocation of patronage earnings. The election to allocate the SEPTC to patron members cannot be revoked. The allocation is reported on 2006 Form 1099-PATR, box 10, *Other Credits and Deductions.*

Passive Income Issues

Most investors in ethanol production companies are considered passive investors. As noted earlier in the chapter, passive activities generally include activities conducted by pass-through entities in which the investor does not materially participate. The SEPTC retains the character of the income that generated the credit. The SEPTC is limited to the extent that the credit amount exceeds the taxpayer's regular tax liability allocable to all passive activities for the year.[85] Interest and dividend income are not considered passive income. They are considered portfolio income.

> **Observation.** Individual investors looking for tax credits to offset passive income gains will have added benefits to becoming new investors in small ethanol plants.

Small Agri-Biodiesel Producer Tax Credit

Under the 2005 legislation, a small agri-biodiesel producer tax credit was created.[86] The provision is a nonrefundable federal income tax credit for producers of agri-biodiesel. The credit is 10¢ per gallon for the first 15 million gallons of agri-biodiesel produced by small producers. Agri-biodiesel is defined as biodiesel derived solely from virgin oils. The credit became effective upon enactment (August 8, 2005) and is scheduled to expire on December 31, 2008. The credit is subject to the same definitions as the small ethanol producer tax credit (which means that it is generally limited to offset tax generated by passive activities, and is subject to the taxable income add-back provision of IRC §87).

Multi-State Income

Ethanol plants may derive income from states outside the taxpayer's state of residence, or perhaps from multiple states. This may require the taxpayer to file state income tax returns in more than one state.

Unique Tax Reporting Requirements

Some ethanol plant businesses have reorganized their business structure from one entity to another (such as farmer cooperative to LLC). This can require reporting the sale of corporate stock or a sale of individual assets. These firms may also pay cash and noncash patronage dividends, stock dividends, member distributions, liquidating distributions, arbitrage payments, and other types of payments that may affect tax liability.

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85. IRC §469(d)(2)

86. IRC §40(a)(3)