# Chapter 12: Agricultural Issues and Rural Investments

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Corrections were made to this workbook through January of 2008. No subsequent modifications were made.

## ISSUE 1: FEDERAL FARM PROGRAM PAYMENT LIMITATIONS

**Caution.** This chapter discusses the 2002 Farm Bill. At the time of printing the U.S. House had passed their version of the 2007 Farm Bill, but the Senate had not yet taken action on a similar bill. The House bill would eliminate the three-entity rule and would make other changes to existing farm bill legislation.

The Bush Administration announced it disapproved of the House bill, and the Senate version appeared likely to be different. It is also possible that the 2002 Farm Bill would simply be extended.

### OVERVIEW

Tax planning is inherent in effective business planning. For farm clients that participate in the federal farm program (available for major crops such as corn, soybeans, cotton and rice), an additional concern is how the overall tax and business plan impacts eligibility for federal farm program payments. Appropriate business structures for tax as well as estate and business planning purposes may not fit well with effective payment limitation planning. Violation of the payment limitation rules can be serious, potentially resulting in civil and criminal penalties.

### PAYMENT LIMITATION RULES

Payment limitation rules are contained in Farm Bill legislation. The 2002 Farm Bill governs the 2002 through 2007 crop years for covered commodities. Under the present rules, each "person" is eligible for a maximum of $40,000 in total direct federal farm program payments for corn, grain sorghum, barley, oats, wheat, peanuts, soybeans, minor oilseeds, cotton and rice per crop year. Each "person" is also eligible for up to $65,000 in counter-cyclical payments on the same crops per crop year. The legislation also sets a $75,000 limit per person per crop year on marketing loan gains and loan deficiency payments for corn, grain sorghum, barley, oats, wheat, soybeans, minor oilseeds, cotton, rice, lentils, dry peas and small chickpeas. A separate marketing loan gain and loan deficiency payment limitation for peanuts, wool, mohair and honey has a maximum of $75,000 per "person."





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### AGI Limitation

An individual or entity is not eligible for any program benefit during a crop year if the 3-year average adjusted gross income (AGI) of the individual or entity exceeds $2,500,000, unless at least 75% of the average AGI of the individual or entity is derived from farming, ranching or forestry operations. The benefits limited by the AGI ceiling are direct payments, counter-cyclical payments, marketing loan gains and conservation payments. In addition, for benefits paid in a crop year, the amount of the benefit is commensurate with the direct and indirect ownership interest in the entity, general partnership or joint venture of each individual who has an average AGI in excess of the $2,500,000 limitation for the average of the three preceding crop years. To comply with the limitation, an individual or entity must provide the IRS with a certification by a certified public accountant "or another third party that is acceptable to the IRS" that the average AGI of the individual or entity does not exceed the limitation. The limitation applies during the 2003 through 2007 crop years.

**Note.** USDA defines "AGI" for an individual filing a separate tax return as the amount reported as AGI on the final federal income tax return for the tax year at issue. For an individual filing a joint return, "AGI" is defined as the amount reported as AGI on the final federal income tax return for the tax year unless a certified statement is provided by a CPA or attorney specifying how the income would have been reported if the individuals filed two separate returns and that the calculation is consistent with the information actually supporting the filed joint return.[1]

### When "Person" Determination is Made

A farming operation must be in existence as of April 1 of the crop year or the fiscal year, depending on the program at issue. The number of "persons" may not increase after the status date, but may decrease based on the farming operation's "status" on or before the date of the last program crop harvested.

### "Person" Defined for Payment Limitation Purposes

**Eligibility of Entities.** Individuals, corporations, LLCs, limited partnerships, trusts, estates, charitable organizations, states, and their agencies may be "persons."[2] However, a corporation that owns an entity, or a corporation in which an individual[3] owns more than 50% of the interest is not a separate person. In the event two or more individuals, limited partnerships, corporations or other entities own more than 50% of the interest in each of two or more limited partnerships or corporations engaged in farming, all the limited partnerships or corporations are considered as one person.[4]

**Note.** The percentage share of value of the interest in a corporation owned by an individual or other entity is determined as of April 1 of each year or as of another date announced by USDA.[5] In the event a shareholder acquires an interest after that date and before harvest of the last program crop in the area, the amount of that interest is included in determining the percentage share of value.

If there is only one class of stock or other unit of ownership, the value of the outstanding stock or other unit of ownership determines the percentage share of the corporation held by an individual or entity.[6] If there is more than one class of stock or unit of ownership, the percentage share is determined based on market quotations.

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1. 7 CFR §1400.601 (b)(1)-(2)
2. 7 CFR §§1400.3 and 1497.9(b)
3. An individual interest includes the interest owned by the individual's spouse, minor children, and trusts for the benefit of minor children.
4. 7 CFR §1497.9(c)
5. 7 CFR §1497.9(d)
6. 7 CFR §1497.9(e)



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In the event market quotations are lacking or are "too scarce to be recognized," percentage shares are determined on the basis "of all relevant factors affecting the fair market value of such stock or other unit of ownership, including the various rights and privileges which are attributed to each such class."

General partnerships and joint ventures (known as joint operations), as well as cooperative marketing associations, are not eligible for person status. However, their individual members may be "persons."

> **Observation.** As a rule, general partnerships and joint ventures are more advantageous for payment limitation and eligibility purposes than corporations, LLCs, and limited partnerships. While a corporation, LLC, or limited partnership will be only one person, irrespective of the number of shareholders or members of the entity, each of the partnership's or joint venture's members may be a separate "person" unless there is a combination of "persons" under the rules. Forming a partnership of single-member LLCs mitigates liability concerns with the partnership form.

**Rules for Trusts. New payment limitation rules,** beginning with the 1991 crop year, change the definition of "person" for irrevocable trusts. To be a separate person under the payment limitation rules, an irrevocable trust may not:

- Allow for modification or termination of the trust by the grantor (other than a trust established prior to January 1, 1987),
- Allow the grantor to have any future, contingent or remainder interest in the corpus of the trust, or
- Provide for the transfer of the corpus of the trust to the remainder beneficiary in less than 20 years after the trust is established, except where the transfer is contingent on the beneficiary achieving at least the age of majority or on the death of the grantor or income beneficiary.[7]

**The "Separate and Distinct" Requirement.** To be eligible to receive federal farm program payments, a "person" must meet a 3-part "separate and distinct" test. The person must:

1. Have a separate and distinct interest in the land or the crop involved,
2. Exercise separate responsibility for such interest, and
3. Maintain funds or accounts separate from that of any other individual or entity for such interest.[8]

> **Observation.** The rule is designed to ensure that program participants have an independent economic investment in the farming operation. General partnerships and joint ventures may satisfy the requirements on behalf of their members. However, commingling the personal funds of a general partner with the funds of the farming general partnership results in the partner no longer being a "person." Indeed, in such a situation, the common practice of FSA is to combine all the partners into one "person."



[7] The Conference Committee report stated: "The managers intend that the Secretary carefully scrutinize all irrevocable trusts which receive payments under this act to ensure that the trusts are legitimate entities and have not been created solely for the purpose of eroding the payment limitation...."

[8] 7 CFR §1400.3.



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**Planning Points — Separate and Distinct Test.** Practitioners should take special care in situations that involve a family or other group that otherwise farms separately, but jointly buys inputs, jointly sells outputs, or exchanges equipment or services. While this is permissible under the rules, care is necessary to ensure that the farming operations remain separate and distinct. All such transactions must be at arm's-length, and appropriate documentation should show compliance with the "separate and distinct" requirements. Each farming operation should pay promptly for its share of **joint purchases.** For equipment exchanges, there should be a demonstrably equivalent exchange to avoid the appearance that one operation is assuming the responsibilities of another. In all situations, an accurate and updated set of books should avoid the commingling of funds and accounts between individuals and entities.

**Note.** In a key opinion, the 8th Circuit Court of Appeals ruled that merely having an interest in another farming operation does not negate separate person status if the individual has a separate and distinct interest in his own farmland.[9] The case involved a Minnesota farm family in which the parents had their own operation and the son operated his own farming operation on land that he owned in his own name. The son entered into contracts with his parents to jointly buy inputs and market outputs. Such an interest was insufficient to negate separate person status when the son had his own separate farming operation on land that he owned.

## THE "COMBINATION" RULES

### In General

Certain "persons" may be combined with other "persons" if they are economically interdependent. The result is to deny separate person status to "persons" who would otherwise be eligible for a separate limit.

Each corporate shareholder is a separate person from the corporation unless a shareholder holds more than a 50% interest in the corporation. In that event, the corporation is not considered a separate person.[10] The corporation then becomes subject to the same limit as the majority shareholder. **If the majority shareholder already reached the payment limit, the corporation is ineligible to receive payments**. The rule applies to corporations, LLCs and similar entities. For purposes of the 50% test, the majority owner's interest includes the interests of his spouse, minor children and trusts for the benefit of minor children of the majority shareholder.

**Example 1.** Sam owns 40% of the stock of FarmCo. Sam's wife owns 15%. Sam's brother owns 45% of FarmCo. The 50% test is triggered and FarmCo. combines with Sam for payment limitation purposes.

If the same two or more individuals or entities own more than 50% of the interest in each of two or more limited partnerships, corporations or other similar entities engaged in farming, another combination rule applies.

**Example 2.** Five persons have ownership interests in two farming corporations as follows:

| Owners | FarmCo | RanchCo |
|---|---|---|
| Annie | 30% | 10% |
| Butch | 20% | 20% |
| Chris | 15% | 25% |
| Donna | 35% | 0% |
| Edith | 0% | 45% |

9. *Mages v. Johanns,* 431 F.3d 1132 (8th Cir. 2005). The 8th Circuit Court of Appeals is comprised of Arkansas, Missouri, Iowa, Minnesota, North Dakota, South Dakota and Nebraska.

10. 7 CFR §1400.101(a)



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Annie, Butch, and Chris each have interests in the two corporations. Thus, two or more individuals have an interest in two or more entities. The combined ownership interests of Annie, Butch, and Chris are 65% in Farmco, and 55% in Ranchco. The two corporations are combined into one "person" for payment limitation purposes.

**Note.** The rule applies to corporations, LLCs, trusts, estates, spouses, minor children, governmental bodies and charitable organizations. The rules define "irrevocable trust" in such a way that not every trust that is an irrevocable trust under state law falls under the definition.[11]

### Combination of Spouses

In general, spouses are one "person."[12] However, there are two exceptions. The first exception applies to spouses who farmed separately before marriage and continue to farm separately after marriage. They maintain separate person status.

It is permissible to expand the number of payment limits by involving the spouse as a partner in the business. The spouse must satisfy the active engagement test. A common technique is to form an operating general partnership between the spouses and cash lease the land to the partnership. Another technique is to establish separate corporations for each spouse that then farm as a general partnership. With this technique, the separate corporations of husband and wife are not a controlled group of corporations limited to one set of graduated brackets below the top bracket if:

1. One spouse does not own, directly or indirectly, stock in the other spouse's corporation during the tax year;
2. One spouse does not serve as a director or employee or participate in the other spouse's corporation at any time during the tax year;
3. Not more than 50% of such corporation's gross income for the tax year is derived from royalties, rents, dividends, interest and annuity; and
4. The stock in the corporation is not, at any time during the tax year, subject to conditions which substantially restrict or limit the spouse's right to dispose of the stock and which run in favor of the individual or his children under age 21.

The second exception became effective with the 1991 crop year. This exception applies in the case of a married couple who do not hold, directly or indirectly, a substantial beneficial interest[13] in more than one entity engaged in farm operations that also receives farm program payments as separate persons. In that event, the spouses may be considered separate persons if each spouse meets the other requirements necessary to be considered a separate person, at the option of the IRS.[14]



11. CFR §1400.3.

12. *Women Involved in Farm Economics v. USDA,* 876 F.2d 994 (D.C. Cir. 1989)(general rule of combining spouses for payment limitation purposes upheld).

13. Generally between 10% and 50%

14. The Secretary has indicated approval of this provision. See *USDA News,* Office of Public Affairs, January 7, 1991.



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> **Note.** A husband and wife cannot each have an interest in more than one entity earning payments and still be considered separate "persons" from each other.[15] However, an example in the law describes a husband and wife with a joint farming operation. The wife has a 25% interest in another farming corporation that is receiving CRP payments. While meeting all of the other tests, the example states that the couple is one "person" for payment limitation purposes because the wife also receives payments indirectly through the corporation that is a separate person from the wife.[16]

The second exception limits spouses to one payment limit each, and precludes either spouse from using the three entity rule (explained later) when each are trying to qualify for the direct receipt of payments. Thus, if spouses who farm separately or as partners want to avoid combined treatment, neither can have a "substantial" interest in a farming entity that participates in a farm program through which either of them receives payments indirectly.

> **Observation.** As stated above, because of the spousal combination rule, spouses seeking separate person status usually farm in a general partnership or a joint venture either as co-partners or in partnership with others.

## ACTIVE ENGAGEMENT TEST

Effective with the 1989 crop year, an entity must be "actively engaged" in farming in order to receive federal farm program payments.[17] Before the 1989 crop year, individuals could receive program payments merely by contributing capital to the farming operation. Sometimes taxpayers used anticipated program payments as collateral to borrow the necessary capital.

To be actively engaged in farming, three conditions must be satisfied:

1. The individual's or entity's share of profits or losses from the farming operation must be commensurate with the individual's or entity's contribution to the operation.[18]
2. The individual's or entity's contributions must be at risk.[19]

   For a contribution to be at risk, there must be the possibility of an unrecoverable loss. A contractual interest in another entity is insufficient to meet the test. In *Mages v. Johanns*,[20] a son entered into crop marketing agreements with his parents' farming operation. While the court held that the contracts were enforceable, the court also held that the son had no true economic investment in the parents' farming operation because his rights were merely contractual in nature. Thus, while he would not have met the "active engagement" test, the son avoids combination with the parents' farming operation for payment limitation purposes.
3. An individual must make a significant contribution of capital, equipment, or land, either separately or in combination (the significant input requirement); be at risk; and provide active personal labor or active personal management either separately or incombination (the significant management requirement).[21]

> **Observation.** For sole proprietorships, all requirements must be satisfied. However, use of one's own land satisfies the "significant contribution" requirement. In addition, active personal management is not required on the farm. Thus, a person can contribute "active personal management" while living away from the farm.

15. ¶253B of 1-PL (Rev. 1)
16. ¶253.5, Example 1 of 1-PL (Rev. 1), Amend. 23 (April 25, 1994)
17. 7 USC §1308-1(b)
18. 7 USC §1308-1(b)(2)(A)(ii); 7 CFR §1400.6(a)
19. 7 USC.§1308-1(b)(2)(A)(ii); 7 CFR §1400.6(b)
20. *Mages v. Johanns*, 431 F.3d 1132 (8th Cir. 2005)
21. 7 USC §1308-1(b)(2)(A)(i); 7 CFR §1497.6(b)



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**Contributions of Land, Capital or Equipment.** For contributions of land, capital or equipment, the contribution must have a value of at least 50% of the individual's or entity's commensurate share of the total value of capital or the total rental values of either the land or the equipment necessary to conduct the farming operation.

**Rules Governing Financing.** "Significant contributions" of land and equipment can include owned or leased land or equipment, and owned or borrowed capital. However, this does not include land, equipment or capital acquired through a loan made, guaranteed, or secured by an individual or entity with an "interest in the farming operation." However, such contributions may be included in the "commensurate" contribution calculation if certain requirements are satisfied.[22] A person has an interest in the farming operation of the input contributor when that person owns or rents the land; has an interest in the ag commodities produced, or is a member of a joint operation (general partnership or joint venture) that either owns or rents the land or has an interest in the ag commodities produced.

**Example 3.** Gill and Tom conduct farm operations as a general partnership. The partnership borrows all the capital it needs to finance the farming operation. The partnership also borrows all the capital it needs to fund the farming operation. If Gill and Tom guarantee the loan or secure it with their personal assets, the partnership's contributions of capital, equipment and land would not qualify as "significant contributions."

To solve this potential pitfall, the lender makes two loans to the farming operation, one which is not guaranteed by Gill and Tom. The unguaranteed loan results in a contribution of at least 50% of the capital needed by the partnership for the year's farming operation. Consequently, this contribution of capital qualifies as a "significant contribution" of capital.

**Observation.** Members of a general partnership or joint venture do not have to make individual "significant contributions" of land, capital, equipment or a combination thereof. Instead, the general partnership or joint venture may contribute for each of them. Thus, contributions made at the partnership level attribute to each partner or member in proportion to their respective shares for "commensurate contribution" purposes.

For corporations, LLCs and other entities that limit liability, the entity must make the "significant contribution" of one or more of the qualifying inputs. The same is true for trusts and estates.

### Contributions of Labor and Management

The definitions of "active personal labor" and "active personal management" exclude hired services.[23] The labor and management must be in return for contributions to the operation and must not be compensation for services rendered. However, payment of corporate shareholders, LLC and LP members for their labor and management does not exclude those services from counting as a significant contribution of active personal labor or active personal management.

**Special Rule for Partnerships.** Partners in a general partnership cannot receive a guaranteed wage or salary by the partnership for their labor or management. If they do, none of their labor or management qualifies as a "significant contribution" of "active personal labor" or "active personal management." Thus, partners must be compensated only through their partnership draws or distributive shares.



**Note.** In a Director Review of a USDA National Appeals Division (NAD) hearing officer's determination, the Director held that amended tax returns were admissible evidence to show that partnership members were taking draws from their capital accounts for their contributions of labor and management.[24]

22. CFR §1400.3

23. 7 CFR §1400.3

24. In case No. 200tE000012 (February 17, 2005)



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**Other Rules for Contributions of Management and Labor.** Determing if a contribution is significant depends upon whether the contribution is in the form of management or labor or in the form of land, capital or equipment.[25] Under the regulations, "active personal labor" is defined as **the lesser of** 1,000 hours per calendar year or 50% of the total hours required to conduct a farming operation comparable in size to the individual's or entity's commensurate share in the farming operation.[26] "Active personal management" requires that activities be engaged in which are critical to the farming operation's profitability when considering the individual's or entity's commensurate share in the farming operation.

**Note.** USDA regulations define "active personal management" to include the "marketing and promotion" of agricultural commodities produced by the farming operation.[27] This raises a question of whether "active personal management" can be present through a crop marketing agreement with another farming operation. However, USDA regulations exempt a "cooperative association of producers that markets commodities for producers" from being considered a person with respect to the commodities so marketed for producers"[28]

Several factors determine if the entity is actively contributing a significant amount of active personal labor or active personal management:

- Types of crops produced by the farming operation;
- Normal and customary farming practices of the area; and
- Total amount of labor and management that is necessary for such a farming operation in the area.[29]

## SPECIAL RULES FOR ACTIVE ENGAGEMENT TEST

**Relaxed Rule for Family Operations.** The "actively engaged in farming" rules are relaxed for farm operations in which a majority of the "persons" are individuals who are family members. The term "family member" includes lineal ancestors, descendants, and siblings, as well as spouses of those individuals who do not make a "significant contribution" to the farming operation.

**Rules for Tenants.** A person owning an interest in land that receives rent or income for the use of the land based on the land's production, or the farming operation's operating results is "actively engaged in farming."[30] The use of custom farming services may also qualify a person as a "landowner." However, cash rent property owners are not "actively engaged in farming."[31] A tenant that operates under a cash-rent lease, a crop share lease guaranteed for the amount of the commodity paid in rent, or who rents land free must meet certain tests to be "actively engaged in farming." Those tests specify that the tenant must make a significant contribution of either:

1. Land, capital or equipment and active personal labor; or
2. Equipment and active personal management.

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25. 7 CFR §1497.3
26. Ibid.
27. 7 CFR §1400.3
28. Ibid.
29. 7 CFR §1497.6(c)
30. 7 CFR §1400.207
31. 7 CFR.§1400.211



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To qualify under #2, tenants who lease equipment from the property owner must pay the equipment's fair rental value. If the tenant **provides labor** to the farming operation, the equipment lease and labor fees must be at FMV, and the tenant must exercise complete control over a significant amount of the equipment during the crop year.[32] If the tenant **hires labor,** the equipment lease must not give the equipment owner the right to use the equipment on demand.

**Observation.** Cash leasing is common, particularly among larger operations. If the operation is organized as a general partnership, each member of the partnership must satisfy the cash rent tenant rule.

**Note.** For farming partnerships that **hire labor,** no individual partner is likely to make a "significant contribution" of "active personal labor." Consequently, for each partner to satisfy the cash rent tenant rule for the cash rented land, either each partner must make a "significant contribution" of equipment, or the partnership must make a "significant contribution" of equipment on behalf of its members. In addition, the partners must each make a "significant contribution" of "active personal management." Careful planning can ensure that equipment acquisitions do not violate the "financing rules."

**Rules for Corporations and Limited Partnerships.** A corporation or limited partnership is actively engaged in farming if:

- The entity separately makes a significant contribution to the farming operation of capital, equipment or land, or a combination thereof; **and**
- The interest holders collectively make a significant contribution of compensated or uncompensated "active personal labor," or "active personal management" to the farming operation or a combination thereof.[33]

The combined beneficial interests of all shareholders or partners providing "active personal labor" or "active personal management" or a combination must equal at least 50%.

**Note.** A similar rule applies for trusts related to the income beneficiaries. For estates, either the personal representative or the heirs must collectively "activate" the estate by contributing the requisite labor and/or management.

**Production Contract Growers.** The rules are not clear about how to apply the "actively engaged in farming" rule to farmers that grow covered commodities under a production contract.

## BUSINESS PLANNING IMPLICATIONS

The "person" and "actively engaged in farming" rules encourage farming by multiple-member general partnerships. Farming through a general partnership is the most effective way for multiple "persons" to receive payments from a single farming operation. In addition, the rules permit an individual to receive payments from up to three "entities." From a policy standpoint, critics argue that the dollar limits and the "person" and "actively engaged in farming" rules promote the aggregation of land into large farming operations and permit some individuals to receive more payments than they deserve.



32. 7 CFR §1400.401(a)

33. 7 CFR §§1497.7; 1497.9(a)(2); 7 USC §1308-1(b)(2)(B)(ii); 7 CFR §1497.9(a)(9)



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### The "Three-Entity" Rule

Under the "three-entity" rule, separate "persons" must have a "separate and distinct" economic investment in the farming operation. In general, a corporation, LLC, limited partnership or similar entity may receive farm program payments. In turn, the entity can distribute the payments to its shareholders or members. Before the 1989 crop year, the payment limitation rules did not limit the number of entities through which an individual could receive program payments. From the 1989 crop year forward, the "three-entity rule" has limited the number of entities through which an individual can receive program payments. Under the rule, an individual who receives payments as an individual cannot receive program payments from more than two entities. An individual who does not receive payments as an individual may receive program payments from up to three entities.

This rule may allow an individual to receive twice as much payment as individuals who are not involved in other entities.

**Example 4.** Joe farms as a sole proprietor. Joe also holds a 50% interest in two LLCs. Each of the LLCs has a farming operation that is separate from the other LLC and from Joe's sole proprietorship. In 2006, Joe received the full $180,000 of payments. In addition, each of the LLCs also receives $180,000 of payments. In accordance with Joe's ownership interest in the LLCs, he will receive $90,000 from each LLC. The total amount of payments Joe receives in 2006 is $360,000. The same result would occur if Joe farmed as a general partnership with himself, and the two LLCs as partners.

The rule allows the capture of a payment amount somewhere between the single limit amount and the double limit amount.

**Example 5.** Joe is a partner in a farming general partnership. The partnership consists of Joe and an LLC equally owned by Joe and Jim. Joe and Jim are each eligible for one and one-half payment limits.

**Observation.** The rule does not limit the number of "persons" in a farming operation who are eligible to receive payments. However, as the number of persons rise, practical difficulties arise with respect to tax, as well as estate and business planning.

The "three-entity rule" requires individuals having an interest in more than the number of "permitted" entities to provide notification of the entities through which they expect to receive payments.[34]

### The Substantive Change Rule

When the number of "persons" in a farming operation increases from the preceding crop year, the "substantive change" rule applies. The rule provides that the increase in "persons" occurs only if there was a "bona fide and substantive" change in the farming operation. In general, any structural business change of the farming or ranching business that increases the number of payment limits must be bona fide and substantive and not a "scheme or device" to evade the payment limitation rules.[35]

**Note.** The change must occur by April 1 of the applicable program or fiscal year.[36] Otherwise, the increase in "persons" occurs the subsequent year.

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34. 7 CFR §1308-1(a)

35. 7 USC §1308-2. See, e.g., *Val Farms v. Espy,* 29 F.3d 1570 (10th Cir. 1994) (reorganization of general partnership that increased number of "persons" not bona fide and substantive; no change in farming operations other than to increase number of general partners).

36. 7 CFR §1400.100(b)



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The regulations provide a list of bona fide and substantive changes.[37] Examples of violations include concealing information, submitting false or erroneous information, or creating fictitious entities for the purpose of concealing the interest of a person in a farming operation.

**Note.** Persons affiliated with wetland violations are ineligible for some or all farm program benefits.[38] If the wetlands violator is a corporation, only shareholders holding more than 20% of the corporate shares are "affiliated persons" of a wetland violator.[39] The mere fact that an individual enters a valid and enforceable contract with a corporation does not give the individual an interest in the corporation nor make the corporation such person's alter ego.[40] Most of the substantive change rules are found in the FSA 1-PL (Rev. 1, ¶¶ 93-97).

### "Scheme or Device" Rule

The regulations expand the "scheme or device" prohibition by proscribing "schemes or devices" having the purpose of evading the payment limitation rules.[41] This appears to make unintentional oversights subject to the "scheme or device" rule. However, because the penalties are only quasi-criminal in nature, the USDA must find that a person intended to defraud the government before he engaged in a "scheme or device."

**Note.** A person who adopts or participates in a prohibited "scheme or device" is ineligible for payments in that year and the following year.

False statements made in seeking farm program benefits can also lead to civil or criminal penalties under the False Claims Act[42] and a criminal prosecution for mail fraud[43] and other offenses.

## ISSUE 2: HEALTH INSURANCE/MEDICAL REIMBURSEMENT PLANS

**Note.** More information on health insurance and medical reimbursement plans can be found in Chapter 9, "Small Business Issues," in Issue 1, "Fringe Benefits."

### OVERVIEW

IRC §105(b) excludes from gross income employee reimbursements for expenses incurred for medical care of the employee, his spouse, and dependents. IRC §105(g) states the term "employee" does not include the self-employed.

Medical reimbursement plans do not generally work for sole proprietors, but the IRS issued a revenue ruling in 1971[44] providing an opportunity for sole proprietors to use medical reimbursement plans when the spouse of the sole proprietor works for the business.



37. 7 CFR §1400.109
38. 7 CFR §12.8
39. 7 CFR §12.8(c)
40. *Mages v. Johanns,* 431 F.3d 1132 (8th Cir. 2005)
41. 7 CFR §1400.5
42. 31 USC §§3729-31 (civil); 18 USC §§286-87 (criminal)
43. 18 USC §1341
44. Rev. Rul. 71-588, 1971-2 CB 91



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In 1999, the IRS issued two coordinated issue papers[45] detailing the requirements for successful spousal reimbursement plans. In the papers, the IRS made the following points:

- The employee-spouse must be a bona fide employee of the business and provide services to the business for which the compensation and fringe benefits represent reasonable compensation. Issuing a Form W-2, withholding taxes, and providing regular payments bolster a bona fide employment arrangement.

**Note.** Careful documentation is evidence that the employee-spouse is actually an employee of the business, as opposed to a co-owner or partner. The IRS views co-ownership of assets as barring the use of spousal reimbursement plans.

- The employer-spouse should deduct all the fringe benefits as a business expense.

**Note.** The spouse of a more than 2% shareholder of an S corporation cannot have fringe benefits.

- The employer-spouse may have medical benefits as a member of the employee's family.
- Retroactive coverage is not permitted (i.e., reimbursements of medical expenses incurred before the adoption of the plan).
- Part-time employment can still warrant employee status, but service performed must have economic substance.
- The medical insurance policy should be in the name of the employee-spouse.

**Note.** The IRS position that the policy should be in the name of the employee-spouse is arguably incorrect. There appears to be no tax reason why ownership of the policy by the employer-spouse precludes deductibility. In some situations, it may not be possible to change ownership of the policy from the employer-spouse to the employee-spouse (such as for health reasons or cost reasons, etc.).

- A partnership or LLC can sponsor a written health insurance and/or medical reimbursement plan and provide benefits to employees, including employees who are also spouses of partners (LLC members), as long as the spouses themselves are not also partners (members).

## 2007 DEVELOPMENT

It is clear that the spouse must be a bona fide employee of the business and receive **reasonable** compensation (including the medical reimbursement) for the services **actually** performed. In a 2006 case, the taxpayer prevailed against an IRS challenge to the medical reimbursement plan she adopted to cover her spouse/employee. The Tax Court ruled that the spouse was truly an employee of the enterprise and that a proper plan existed. The court was impressed with the quality of the records the taxpayers retained on the work the husband performed, which was key to the case.[46]

However, in 2007, the IRS prevailed in two cases due largely to lack of substantiation.

45. UIL 162.35-02, March 29, 1999

46. *Peter F. and Maureen L. Speltz v. Comm'r,* T.C. Summ. Op. 2006-25, February 14, 2006



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In the one case,[47] the taxpayer adopted a plan that provided reimbursement of all health insurance premiums and up to $3,000 in other medical expenses to eligible employees for themselves and their immediate family. Mrs. Snorek executed an employment agreement with her husband late in 2000 in which she agreed to pay him $480 in annual wages and make him an eligible employee under the plan. During the tax year at issue, the husband was paid $480 in wages and received $10,355 of benefits under the plan. Of this amount, $3,906 represented health insurance premiums for the taxpayer. The IRS took the position that the taxpayer failed to show that the husband actually paid the premiums. The taxpayer did not produce cancelled checks, receipts, or premium statements showing the husband actually paid or had the obligation to pay the premium. The IRS took the position that the premiums were deductible to the extent of 60% — the amount allowed for self-employed persons in 2000. The deduction was an "above-the-line" deduction and did not count as a deduction against self-employment tax. The court agreed with the IRS. If the taxpayer had provided cancelled checks, receipts or premium statements, the premiums would have been fully deductible.

**Observation.** The court's opinion demonstrates that the form of the transaction must be correct, not just the substance. The wife's business was permitted to reimburse the husband for the premium payment. However, the taxpayer tried to short-circuit the process and lost some of the tax benefit as a result.

In another 2007 case,[48] the husband was a sole proprietor farmer who had been in business for 40 years. His wife helped him by doing chores and other miscellaneous odd jobs around the farm without compensation. The husband adopted a medical reimbursement plan in 1991 that paid health insurance costs for eligible employees, and provided additional reimbursement up to $8,000 for other medical expenses.

In 1997, the wife signed an employment agreement. She kept the farm's books, ran errands for the farm, and answered telephone calls. Her annual salary was $2,004, and she participated in the medical reimbursement plan. Unfortunately, her employment agreement did not set forth the number of hours of work or establish the days or times she would be available to work.

In the year at issue (2001), the wife performed services for the farm, but there was no documentation of hours worked or a description of what work she performed. She received $9,502 of reimbursements, including payment of $5,571 on a joint health insurance policy and Medicare supplement for the husband. Therefore, her total compensation for 2001 was $11,506. The husband deducted the entire medical reimbursement amount on Schedule F.

The IRS denied the $9,502 deduction for reimbursed medical expenses and the court agreed. While the court was troubled as to whether there was proof of a bona fide employment relationship, that was not determinative of the outcome. Instead, the court held that the couple failed to establish whether any compensation paid to the wife in excess of the $1,988 actually paid was reasonable insomuch as the couple failed to document any hours or times the wife may have performed services for the farm. Therefore, a full deduction would have been available if the couple had kept records (the IRS conceded that the $1,988 was deductible).[49]



**Observation.** It is important for self-employed persons using "boilerplate" medical reimbursement plans to pay attention to the details. There is more involved than simply adopting a plan and forgetting about it. Tax practitioners should advise their clients to maintain good records.

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47. *Snorek v. Comm'r,* TC Memo 2007-34, February 8, 2007

48. *Francis v. Comm'r,* TC Memo 2007-33, February 8, 2007

49. See also *Albers v. Comm'r,* TC Memo 2007-144, June 7, 2007. Taxpayers failed to establish that husband paid wife, either directly or indirectly under the medical reimbursement plan, the amount claimed for health insurance premiums, or medical and dental expenses that the wife incurred; taxpayers also failed to establish that any portion of the claimed premiums and expenses was an ordinary and necessary business expense.



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## ISSUE 3: SE TAX TREATMENT OF CRP PAYMENTS

**Caution.** The following discussion clearly explains the IRS's position, as well as rulings and court case decisions. In light of IRS Notice 2007-54 issued June 11, 2007, practitioners should, in consultation with the client, determine whether appropriate disclosures should be included on the tax return.

### OVERVIEW

On December 5, 2006, the IRS issued a notice of proposed revenue ruling[50] concerning the self-employment (SE) tax treatment of conservation reserve program (CRP) payments. The primary purpose of the notice is to address the question of whether CRP payments are subject to SE tax if the taxpayer is retired or not otherwise actively engaged in agriculture. The notice concludes that participation in the CRP, absent the taxpayer's participation in a farming operation, constitutes a trade or business. This is because the CRP itself meets the criteria to be a trade or business based on the activities required directly under the program. Activities include seeding a cover crop and maintaining weed control. **Thus, CRP rental payments are subject to SE tax regardless of whether the recipient is engaged in a farming business on nonCRP land**. However, the notice states that any amounts received as a cost-share payment for participation in the CRP that are excludible from income under IRC §126 are not subject to SE tax.

### PRIMARY BASIS FOR THE IRS'S POSITION

The primary authority for the IRS's position is Announcement 83-43,[51] which pre-dates the existence of the CRP. In the announcement, the IRS took the position that participation in the payment-in-kind (PIK) program (or any other land diversion program) does not cause the enrolled land to cease to be treated as land used in the active conduct of a farming business for purposes of IRC §2032A[52] and IRC §6166.[53] The IRS stated that this is also the result if a taxpayer's entire farm was devoted to conservation use under the program. The impact of the ruling is that a decedent's estate containing PIK-enrolled land remained eligible for special use valuation because the decedent still met the qualified use test for the enrolled land, and the estate was also eligible to pay any resulting estate tax in installments. Likewise, if an heir enrolled land in the PIK, no recapture or acceleration of federal estate tax would be triggered. On the other hand, the announcement states that the cash rental amount received by a **farmer** for participation in the PIK is subject to SE tax. The announcement, however, is silent on the question of whether PIK payments received by a nonfarmer (investor) or retired farmer are subject to SE tax.

### SUBSEQUENT IRS RULINGS

The IRS has applied the principles of Announcement 83-43 in several rulings.

In a 1987 letter ruling, the IRS ruled that the CRP is similar to the PIK program. In that regard, a qualified heir's participation in the CRP does not trigger recapture of estate tax under IRC §2032A if the elected land is not used as a farm for farming purposes. To elect special-use valuation in a decedent's estate, the decedent must have used the land for farming purposes for a specified period before death, and the qualified heir(s) must continue the farm use for 10 years after the decedent's death. The ruling provides no guidance on whether a taxpayer that is either retired from farming or has never been a farmer receives farmer status by virtue of enrollment of land into the CRP.[54]

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50. Notice 2006-108, 2006-51 IRB 1118
51. Announcement 83-43, 1983-10, I.R.B. 29
52. Special-use valuation
53. Installment payment of federal estate tax
54. Letter Ruling 8729037 (April 21, 1987)



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In a similar letter ruling, the IRS ruled that a qualified heir's participation in the CRP does not trigger recapture of federal estate tax under IRC §2032A for failure to use the land as a farm for farming purposes.[55]

In a letter ruling more squarely on point, the IRS ruled that CRP payments are considered receipts from farming operations rather than rents from real estate, which are excluded from SE tax by virtue of IRC §1402(a)(1). However, the IRS noted in the ruling that the taxpayer, who was 71-years old and had been farming the land personally during the year immediately prior to enrolling the land in the CRP, was retired from farming. As such, the IRS ruled that the CRP payments were not subject to SE tax.[56] The IRS referenced Rev. Rul. 68-44,[57] Rev. Rul 65-149,[58] and Rev. Rul. 60-32[59] to bolster its position. In those rulings, the IRS stated that annual payments under farm programs comparable to the CRP are in the nature of farm receipts from farm operations and are not rental payments. However, the IRS stated in the rulings that such payments are **not** subject to SE tax if the taxpayer was not materially participating in farming operations (either personally or via a lease) on land not in the government land diversion program.

Tech. Adv. Memo. 9212001,[60] involved facts about a taxpayer who was engaged in the active trade or business of farming who purchased land previously enrolled in the CRP. The taxpayer subsequently died while engaged in the trade or business of farming on the nonCRP land. The question was whether the CRP land constituted a closely-held business interest for purposes of an IRC §6166 election to pay federal estate tax on installment. The IRS ruled that the CRP land constitutes an interest in a closely-held business for purposes of IRC §6166 because it was part of the taxpayer's trade or business of farming in addition to the other property used by the taxpayer (before death) in the trade or business of farming. The ruling is silent as to whether such CRP land would constitute an interest in the trade or business of farming if the taxpayer was not engaged in the trade or business of farming by virtue of being retired or as a passive investor in farmland.

### COURT RULINGS

The courts consistently uphold the IRS's position in ruling that rental payments (either within the context of the CRP or not) are subject to SE tax in the hands of a taxpayer **engaged in a trade or business when the rental payments relate to that business.** Conversely, the courts have ruled that if the taxpayer is not engaged in a trade or business, then rental payments, by themselves, are insufficient to constitute a trade or business which would result in the payments being subject to SE tax.

IRC §1402(a)(1) excludes "rents from real estate" from the definition of "net earnings from self-employment." In a letter ruling, the IRS ruled that CRP rental payments are receipts from farming operations rather than rents from real estate. Thus, they are not excluded from SE tax by virtue of the statutory exception under IRC §1402(a)(1).[61]

The 6th Circuit supported this position in *Wuebker v. Comm'r.*[62] The court held that the services required under the CRP contract were substantial enough to classify the payments as "services rendered to the occupant" within the meaning of Treas. Reg. §1.1402(a)-4(c)(2). Thus, the CRP payments are included in SE tax by virtue of being "rental payments." Because the taxpayers in *Wuebker* conducted farming operations on nonCRP land, the court, consistent with prior IRS rulings, held that the CRP payments were subject to SE tax due to the "nexus" with the taxpayer's existing farming operation. The court's opinion followed the rationale of *Ray v. Comm'r*[63] in which the court ruled that the SE tax treatment of CRP payments was dependent on a "direct nexus" to an existing farming operation the taxpayer conducted. The court in *Wuebker* did **not** state that CRP payments are subject to SE tax in the hands of a retired farmer or an investor in CRP land.



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55. Letter Ruling 8745016 (August 7, 1987)
56. Letter Ruling 8822064 (March 7, 1988)
57. Rev. Rul. 68-44, 1968-1 C.B. 191
58. Rev. Rul 65-149, 1965-1 C.B. 434
59. Rev. Rul. 60-32, 1960-1 C.B. 23
60. Tech. Adv. Memo. 9212001 (June 20, 1991)
61. Letter Ruling 8822064 (March 7, 1988)
62. *Wuebker v. Comm'r*, 205 F.3d 897 (6th Cir. 2000)
63. *Ray v. Comm'r*, TC Memo 1996-436, September 25, 1996



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In the agricultural context, other courts have similarly required a taxpayer to materially participate in a farming trade or business (personally, via an agent, or through a lease) for other income to be subject to SE tax. The same outcome occurred in *Henderson v. Flemming,*[64] *McNamara v. Comm'r,*[65] and *Bot v. Comm'r.*[66] Conversely, in *Dugan v. Comm'r,*[67] a taxpayer was not liable for SE tax on income from share-farming operations conducted with a friend when the taxpayer did not materially participate in farming operations and permitted the friend (as tenant) to make all the decisions concerning the farming activity. Importantly, the contract (lease agreement) between the property owner and the tenant was insufficient, by itself, for the lease payments to be subject to SE tax in the property owner's hands. Instead, an examination of the facts was necessary to determine whether the taxpayer was engaged in a trade or business that resulted in the payments being subject to SE tax.

**Note.** The approach requiring an examination of all of the facts of a particular situation is consistent with the U.S. Supreme Court's opinion in *Groetzinger v. Comm'r,*[68] in which the court noted that whether a taxpayer is engaged in a trade or business requires a factual determination in every case. There is no reported court opinion that supports the notion that the mere signing of a CRP contract (or any contract or lease) is sufficient, by itself, to cause the taxpayer to be engaged in a trade or business. Examining the terms of the contract (or lease) and determining whether the taxpayer is an active farmer answers that question.

In addition, *Hasbrouck v. Comm'r*[69] involved a situation where the taxpayers purchased CRP land but were never engaged in the trade or business of farming. The taxpayers signed a CRP contract to continue enrollment of the land in the CRP, and the USDA determined that the taxpayers were actively engaged in farming. Based on that determination, the taxpayers filed a Schedule F showing net losses after reporting the CRP income and deducting farming expenses. The IRS disallowed the loss on the basis that the taxpayers were **not** actively engaged in the trade or business of farming during the tax year in issue. Again, consistent with prior IRS rulings and court opinions, the IRS took the position that the CRP contract, by itself, was insufficient to deem the taxpayer as being in the trade or business of farming. As expected, the court upheld the IRS's position as being substantially justified.

### THE 2003 IRS RULING AND THE 2006 NOTICE

In a CCA letter ruling,[70] the Chief Counsel's office took the position for the first time that CRP payments (and all USDA land diversion and conservation program payments) are subject to SE tax regardless of whether the taxpayer is actively conducting a farming operation on nonCRP land. The IRS took this position without the support of any court cases. As illustrated above, the courts and the IRS have always determined whether a taxpayer is engaged in a trade or business based on the facts of each particular situation presented. That approach is consistent with long-standing precedence, including the U.S. Supreme Court's opinion in *Groetzinger.* The notice essentially restates the position of the Chief Counsel's office as stated in the 2003 ruling.

**Observation.** There remains no support for the proposition that the mere signing of a CRP contract is sufficient to constitute a trade or business such that the payments are subject to SE tax. While CRP payments may indeed not constitute "rents from real estate" such that they are exempt from SE tax under the exception of IRC §1402(a)(1), that determination has no bearing on the issue of whether the taxpayer is engaged in a trade or business as required by IRC §1402(a). Examining the facts pertinent to a particular taxpayer answers that. Mere signing of a CRP contract by a taxpayer is insufficient to answer that question.

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64. *Henderson v. Flemming,* 283 F.2d 882 (5th Cir. 1960)
65. *McNamara v. Comm'r,* 236 F.3d 410 (8th Cir. 2003)
66. *Bot v. Comm'r,* 353 F.3d 595 (8th Cir. 2003)
67. *Dugan v. Comm'r,* TC Memo 1994-578, November 28, 1994
68. *Groetzinger v. Comm'r,* 480 U.S. 23 (1987)
69. *Hasbrouck v. Comm'r,* TC Memo 1998-249, July 7, 1998, *aff'd* 189 F.3d 473 (9th Cir. 1999)
70. Letter Ruling 200325002 (May 29, 2003)



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> **Note.** The IRS received numerous comments on its proposal, none of which favored the IRS position. In addition, legislation has again been introduced in the Congress to amend IRC §1402 to specify that CRP payments are not subject to SE tax.[71]

## ISSUE 4: ADDITIONAL FORM 1099 FILING REQUIREMENT

In late July, the IRS issued a notice[72] stating that information reporting will be required for marketing loans repaid on or after January 1, 2007. The information reporting requirement now applies to all four methods of paying marketing loan benefits (loan deficiency payments, Commodity Credit Corporation (CCC) loans repaid with cash, CCC loans repaid with generic commodity certificates and forfeiture of commodities to CCC under nonrecourse loans) under the federal commodity subsidy program. Previously, the IRS had not required the repayment of CCC loans with generic commodity certificates to trigger the issuance of Form 1099 to the IRS or to the taxpayer. The other three methods of receiving the benefits — loan deficiency payments, CCC loans repaid with the cash and forfeiture of commodities to CCC — have always been subject to information reporting on Form 1099-G. The IRS also stated that taxpayers that elect to treat CCC loans as income must account for the market gain in the year of CCC loan repayment. Adjusting the basis of the commodity that secures the loan accomplishes this accounting. The taxpayer's basis in the commodity before the repayment of the loan is equal to the amount of the loan previously reported as income.

Any market gain associated with the repayment of the loan reduces the basis by the same amount.

> **Note.** See pages 421–433 in the 2005 *University of Illinois Federal Tax Workbook* for a thorough discussion of agricultural payments taxation.

## ISSUE 5: FARM INCOME AVERAGING

### OVERVIEW

Higher commodity prices in recent months may heighten interest in income averaging for farmers. The provision is available for farmers and fishermen and allows averaging of current farm income over three prior base years. The provision is available by election (by filing Schedule J) and provides the benefit of applying lower income tax rates from the prior base years.

> **Observation.** Farm clients should consider the election when farm income for the current year is high and taxable income from one or more of the three prior years was low. The election may also be valuable even though it provides no current year tax benefit. This allows the taxpayer to move current year income to a prior year providing lower bracket amounts.



[71] HR 2659 and S 1155

[72] IRS Notice 2007-63, I.R.B. 2007-33.



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For purposes of income averaging, a farming business is a trade or business involving the cultivation of land or the raising or harvesting of any agricultural or horticultural commodity. This includes operating a nursery or sod farm or raising or harvesting of trees bearing fruit, nuts, or other crop or ornamental trees.[73] Also included in the definition is the raising, shearing, feeding, caring for, training and managing animals. Crop-share landlords are considered engaged in the business of farming if a written lease is executed before the tenant begins significant activities on the land. Proposed regulations state that a sole proprietor, partner, or S corporation shareholder with farm income during the tax year may elect income averaging even without farm income in any prior year.[74] However, the determination of whether an individual is engaged in a farming business excludes services performed as an employee.

**Note.** The farm income averaging provision references IRC §263A(e)(4) in defining a farming business for purposes of income averaging. In addition, the Schedule J instructions specify that "farm business" does not include contract harvesting of a commodity.

## ELECTED FARM INCOME

Taxpayers can average their elected farm income (EFI) over their three prior tax years. They may designate amounts of taxable income attributable to a farming business as EFI, limited by their taxable income. In addition, net capital gain attributable to a farming operation may not exceed total net capital gain for the taxpayer.

EFI includes net Schedule F income, gain from the sale or disposition of property (but **not from the sale of land** or timber) regularly used by a farmer for a substantial period in a farming business, plus the taxpayer's share of net farm income from a pass-through entity.

**Note.** Final regulations specify that both wages received by a shareholder of an S corporation that is engaged in farming and the property owner's share under a crop-share lease may be included in the EFI. It is immaterial whether the property owner materially participates in crop production activities. However, for tax years beginning after 2003, crop-share leases must be in writing.

Under the final regulations, EFI includes all income and gains less deductions and losses (including loss carryovers, carrybacks, and nonfarm losses) attributable to an individual's farming business. However, under the regulations, income, gain or loss from the sale of development rights, grazing rights and other similar rights is not attributable to a farming business.

**Observation.** The election to average farm income results in reducing taxable income by the EFI for the current year and adding one-third of the EFI to the taxable income for each of the three base years.

### Can EFI Be Negative?

IRS Pub. 225, *Farmers' Tax Guide,* states that if a taxpayer's income for any base year is zero because of an excess of deductions over income, the taxpayer may have negative taxable income for that year which can be combined with EFI on the taxpayer's Schedule J.

**Note.** As originally enacted, the law disallowed a negative amount as a base year income. Later legislation, however, allows the entry of a negative taxable income for a base year.

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73. This does not include evergreen trees more than six years old when severed from the roots

74. Prop. Treas. Reg. §1.1301-1(b)



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Taxpayers can use all allowable deductions, including any NOL, to determine taxable income, even if the result is negative. However, the base year taxable amount must include any negative amount that provided a benefit in another tax year. Thus, an NOL carried to other years may not provide a current benefit.[75]

> **Note.** The regulations provide a safe harbor for the disposition of property **after** the taxpayer has ceased farming. Under the regulations, if a gain or loss (from the disposition of property) is realized after the farming business ends, the gain or loss is treated as attributable to the farming business if the property was sold within a reasonable time after the farming business ended. If the sale or other disposition occurred within one year of the end of the farming business, the sale is within a reasonable time. If the sale or disposition occurs later than one year after the farming business ceases, the facts and circumstances determine whether it occurred within a reasonable time.[76]

### Employment Taxes

An income averaging election affects only federal income tax. It has no impact on employment taxes (FICA, FUTA, SECA or income tax withholding). Thus, the allocation of EFI to the base years does not affect other tax determinations.

### Kiddie Tax

Children with investment income in excess of $1,700 are subject to tax on part of that income at their parent's rate instead of at the child's rate. If the parent elects income averaging, computation of the child's tax on investment income uses the parent's rate after allocating EFI. It is not permissible to use any of the child's investment income as the parent's EFI, even if it is attributable to a farming business.

### Alternative Minimum Tax (AMT)

The 2004 Jobs Bill (Sec. 314(a)) specifies that in calculating the AMT, regular tax liability is determined without regard to income averaging. Consequently, taxpayers using income averaging receive the full benefit of the lower tax rates used in the income averaging calculation.

> **Note.** Income tax is determined by allocating EFI to the base years only after making all other adjustments and determinations.

### Amended Returns

If a taxpayer fails to make the election in a prior year for which he would have benefited from income averaging, **he can amend his return**. The election is valid if the time for filing a claim for refund has not expired for that election year. The deadline for filing a claim for refund is the later of three years from the date the original return was filed or two years from the date the tax was paid.



### Election Can be Useful Even if No Current Year Benefit

Making the election to use income averaging in a year when no current year benefit exists can be helpful to reduce taxable income in prior years. This allows the placement of more income from a future year into prior years.

75. Treas. Reg. §1.1301-1(d)(2).

76. Treas. Reg. §1.1301-1(e)(1)(ii)(B)



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**Example 6.** Wanda and Willis have a filing status of married filing jointly. Their taxable incomes before averaging are shown for years 2003-2007. Wanda and Willis have qualifying farm income of $90,000 in 2007 and $42,000 in 2006. They elect to use $90,000 for income averaging in 2007. This results in $28,700 ($90,000 – $61,300) of 2006 income to remain taxed at 25%. Additionally, an amended return making an election for 2006 would tax all taxable income at the 15% rate. This produces tax savings of $2,870.

| | 2007 | 2006 | 2005 | 2004 | 2003 |
|---|---|---|---|---|---|
| **Income averaging election for 2007 only** | | | | | |
| Taxable income before averaging | $150,000 | $60,000 | $15,000 | $10,000 | $15,000 |
| Change to income by averaging | (90,000) | 30,000 | 30,000 | 30,000 | |
| Taxable income after averaging | $ 60,000 | $90,000 | $45,000 | $40,000 | $15,000 |
| **Income averaging election in 2006 and 2007** | | | | | |
| Taxable income before averaging | $150,000 | $60,000 | $15,000 | $10,000 | $15,000 |
| Change to income by 2006 averaging | | (42,000) | 14,000 | 14,000 | 14,000 |
| Taxable income after 2006 averaging | $150,000 | $18,000 | $29,000 | $24,000 | $29,000 |
| Change to income by 2007 averaging | (90,000) | 30,000 | 30,000 | 30,000 | |
| Taxable income after 2007 averaging | $ 60,000 | $48,000 | $59,000 | $54,000 | |
| **Top of 15% tax bracket** | **$ 63,700** | **$61,300** | **$59,400** | **$58,100** | **$56,800** |

When the elected farm income from 2007 is allocated to the three previous tax years there is only a small tax benefit in the Schedule J computation attributable to the 2006 tax year. However, it is still advantageous to elect farm income averaging for 2006 by filing an amended return. This allocates an amount of elected farm income to the three previous tax years even if it results in no significant reduction in the 2006 tax liability. The reduction in 2006 taxable income for the purposes of the 2007 Schedule J calculation results in a tax benefit for 2007.

## Filing Status

Taxpayer's can make an election to income average even if their filing status is different in the current year from what it was in the base years.

## Taxpayers with Both Ordinary Income and Capital Gain

Under the regulations, taxpayers that have both ordinary income and capital gain can choose how much of the EFI corresponds to capital gain or to ordinary income.[77] The regulations require income allocations in equal portions among the tax brackets for the prior three years if EFI includes both ordinary income and capital gain income. Capital gains that are included in the tax bracket of a prior year do not offset capital losses for that year. Instead, the lesser of the capital gains rate or the ordinary income tax rates for the prior year applies.[78] Net capital losses first offset net capital gains, both farm and nonfarm, before reducing ordinary income. In addition, the rule that capital losses can only offset up to $3,000 of ordinary income per year still applies for purposes of EFI. Therefore, a taxpayer can elect to carryback **only** ordinary income **or** any combination of ordinary income and capital gains after making these adjustments.

> **Note.** A taxpayer can make changes or revoke the election on an amended return if the time statute has not expired.

77. Treas. Reg. §1.1301-1(e)(2)(i)

78. Treas. Reg. §1.1301-1(d)(1)



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**SCHEDULE J (Form 1040)**

Department of the Treasury
Internal Revenue Service (99)

# Income Averaging for Farmers and Fishermen

▶ Attach to Form 1040 or Form 1040NR.
▶ See Instructions for Schedule J (Form 1040).

OMB No. 1545-0074
2007
Attachment Sequence No. 20

Name(s) shown on return | Social security number (SSN)

Draft as of 05/24/2007

| Line | Description | | |
|---|---|---|---|
| 1 | Enter the taxable income from your **2007** Form 1040, line 43, or Form 1040NR, line 40 | | 1 |
| 2 | Enter your **elected farm income** (see page J-1). **Do not** enter more than the amount on line 1 | | 2 |
| 3 | Subtract line 2 from line 1 | | 3 |
| 4 | Figure the tax on the amount on line 3 using the **2007** tax rates (see page J-2) | | 4 |
| 5 | If you used Schedule J to figure your tax for: • 2006, enter the amount from your 2006 Schedule J, line 11. • 2005 but not 2006, enter the amount from your 2005 Schedule J, line 15. • 2004 but not 2005 or 2006, enter the amount from your 2004 Schedule J, line 3. Otherwise, enter the taxable income from your **2004** Form 1040, line 42; Form 1040A, line 27; Form 1040EZ, line 6; or Form 1040NR, line 39. If zero or less, see page J-2. | 5 | |
| 6 | Divide the amount on **line 2** by 3.0 | 6 | |
| 7 | Combine lines 5 and 6. If zero or less, enter -0- | 7 | |
| 8 | Figure the tax on the amount on line 7 using the **2004** tax rates (see page J-3) | | 8 |
| 9 | If you used Schedule J to figure your tax for: • 2006, enter the amount from your 2006 Schedule J, line 15. • 2005 but not 2006, enter the amount from your 2005 Schedule J, line 3. Otherwise, enter the taxable income from your **2005** Form 1040, line 43; Form 1040A, line 27; Form 1040EZ, line 6; or Form 1040NR, line 40. If zero or less, see page J-5. | 9 | |
| 10 | Enter the amount from line 6 | 10 | |
| 11 | Combine lines 9 and 10. If less than zero, enter as a negative amount | 11 | |
| 12 | Figure the tax on the amount on line 11 using the **2005** tax rates (see page J-6) | | 12 |
| 13 | If you used Schedule J to figure your tax for 2006, enter the amount from your 2006 Schedule J, line 3. Otherwise, enter the taxable income from your **2006** Form 1040, line 43; Form 1040A, line 27; Form 1040EZ, line 6; or Form 1040NR, line 40. If zero or less, see page J-8 | 13 | |
| 14 | Enter the amount from line 6 | 14 | |
| 15 | Combine lines 13 and 14. If less than zero, enter as a negative amount | 15 | |
| 16 | Figure the tax on the amount on line 15 using the **2006** tax rates (see page J-8) | | 16 |
| 17 | Add lines 4, 8, 12, and 16 | | 17 |
| 18 | If you used Schedule J to figure your tax for: • 2006, enter the amount from your 2006 Schedule J, line 12. • 2005 but not 2006, enter the amount from your 2005 Schedule J, line 16. • 2004 but not 2005 or 2006, enter the amount from your 2004 Schedule J, line 4. Otherwise, enter the tax from your **2004** Form 1040, line 43;* Form 1040A, line 28;* Form 1040EZ, line 10; or Form 1040NR, line 40.* | 18 | |
| 19 | If you used Schedule J to figure your tax for: • 2006, enter the amount from your 2006 Schedule J, line 16. • 2005 but not 2006, enter the amount from your 2005 Schedule J, line 4. Otherwise, enter the tax from your **2005** Form 1040, line 44;* Form 1040A, line 28;* Form 1040EZ, line 10; or Form 1040NR, line 41.* | 19 | |
| 20 | If you used Schedule J to figure your tax for 2006, enter the amount from your 2006 Schedule J, line 4. Otherwise, enter the tax from your **2006** Form 1040, line 44;* Form 1040A, line 28;* Form 1040EZ, line 11; or Form 1040NR, line 41* | 20 | |
| | ***Do not** include any tax from Form 8814 or 4972 or from recapture of an education credit. Also, **do not** include alternative minimum tax from Form 1040A. | | |
| 21 | Add lines 18 through 20 | | 21 |
| 22 | **Tax.** Subtract line 21 from line 17. Also include this amount on Form 1040, line 44 or Form 1040NR, line 41 | | 22 |
| | **Caution.** Your tax may be less if you figure it using the 2007 Tax Table, Tax Computation Worksheet, Qualified Dividends and Capital Gain Tax Worksheet, or Schedule D Tax Worksheet. Attach Schedule J only if you are using it to figure your tax. | | |

**For Paperwork Reduction Act Notice, see Form 1040 or Form 1040NR instructions.** Cat. No. 25513Y **Schedule J (Form 1040) 2007**

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## ISSUE 6: INSTALLMENT SALE OF A FARM

### OVERVIEW

The installment sale of a farm for a single, sum-total price under an installment contract does not involve the sale of a single asset. Typically, the sale of a farm involves the sale of real and personal property as well as farm inventory items. The seller's principal residence may also be involved. Special rules apply to inventory items and the sale of the principal residence.

Under an installment sale, the buyer may be obligated to make future payments under a deed of trust, note, land contract, mortgage or some other evidence of indebtedness.

### Primary Benefit of Installment Reporting

The benefit of an installment sale is that the seller is able to spread the gain on the transaction over the life of the contract, and the buyer is able to obtain immediate possession of the property.

### Electing Out of Installment Reporting

A seller receiving at least one payment after the tax year of the sale triggers the installment sale rules. Installment sale treatment is available for reporting gain only; it is not available for reporting loss. If installment reporting is undesirable, an election out of installment reporting is necessary. With such an election, the entire gain on the transaction is reported in the year of sale (even if the seller does not receive the sale proceeds in that tax year). The election is made by reporting the sale on Schedule D or Form 4797 (whichever is applicable). The election out of installment reporting must be made by the due date for the return (including extensions) for the year in which the sale occurs, or on an amended return filed within six months of the due date of the return (including extensions). The taxpayer must write "Filed pursuant to IRC §301.9100-2" at the top of the amended return.

**Note.** In the unlikely event associated unused passive losses exist, the installment sale method is **mandatory.**

### Allocation of Selling Price

Allocation of the total selling price to the assets involved in the sale determines the amount received for each class of asset. The classification as a capital asset or as property used in the taxpayer's trade or business, in conjunction with the holding period of the asset, determines the tax treatment of gain or loss on the sale of each class of assets. Separate computations determine the gain or loss for each asset class sold.

**Note.** If an installment sale triggers depreciation recapture under IRC §1245 or IRC §1250, it is generally taxable as ordinary income in the year of sale even if the seller does not receive any payments in that year.

### Unstated Interest

The IRS computes unstated interest if an installment sale contract provides for little or no interest (regardless of triggering a loss). See Issue 7 in Chapter 11, "Entity Issues" for a discussion on imputed interest rules.

### Reporting the Transaction

Form 6252, *Installment Sales Income,* is used to report income from the sale in the year of sale and for payments received in later years.



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### Seller's Disposition of an Installment Obligation

If the seller disposes of an installment obligation, the seller generally has a reportable gain or loss. If the original installment sale triggers ordinary income, its disposition will trigger ordinary income (or loss). If the original sale resulted in capital gain, its disposition will result in capital gain or loss. With a cancellation of an installment obligation (or if the obligation becomes unenforceable), gain or loss is computed as the difference between the seller's basis in the obligation and its FMV at the time of the cancellation. For related party transactions, the FMV of the obligation cannot be less than its face value.

A disposition does not occur because of the seller's death if the obligation is transferred to someone other than the buyer. The unreported gain on the obligation is not gross income to the decedent, but the taxes on the payments attach to the transferee in the same manner as if the decedent were still living. However, if the obligation transfers to the buyer upon the seller's death, it is a taxable disposition. The same is true if the obligation is canceled or otherwise becomes unenforceable upon death of the seller. In that situation, the decedent's estate must determine whether gain or loss results.

### Other Points

An installment sale of farm property is a tax management strategy. Payments received over the life of the installment contract report gain since they take advantage of lower tax brackets available in the future. Utilizing an installment sale with a farm income averaging election allows a farm taxpayer to spread the gain from a sale over the three prior years, the current year, and future years (based on the length of the installment contract). However, an installment sale does not avoid the AMT and the seller remains at risk as a creditor. When a seller reports taxable income from the installment sale annually, this could increase the amount of social security benefits includible in income. Lower tax brackets have a 0% rate for years 2008, 2009, and 2010. Consequently, reporting income through an installment sale may be a valuable benefit. Higher investment returns for the seller and lower interest cost for the buyer may offer benefits for an installment sale. Higher income from a sale reported in one year or over several years and the resulting impact on many tax computations require careful evaluation. Overall, an installment sale cannot be justified merely for tax management. A sound financial plan that generates higher sales proceeds or allows the farm business to continue must be at the foundation.

## HANDLING THE FARM RESIDENCE

### In General

Under IRC §121, a taxpayer can exclude up to $500,000 of gain on a joint return ($250,000 for a single or separate return) when the taxpayer's principal residence is sold or exchanged. The provision is available to taxpayers who have owned and occupied the residence for at least two out of the last five years before the sale or exchange.

> **Note.** For spousal situations, the exclusion is available if either spouse meets the "ownership test" and if both spouses meet the "use test." A spouse must have neither sold nor exchanged a residence within the two-year period prior to the sale or exchange. Even if one spouse used the exclusion within two years and during a time before the couple was married, the other spouse may still use the $250,000 exclusion amount.

The home sale exclusion rule is available when selling a farm on an installment basis.[79] Thus, it is important to satisfy the requirements for IRC §121.

79. Rev. Rul. 80-249, 1980-2, C.B. 166 (gross profit on installment sale is the amount of gain not excluded from gross income under IRC §121).



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### What is the Extent of the Farm "Residence"?

When selling a farm, it is important to carve out the farm "residence" to utilize the home-sale gain exclusion provision. IRC §121 does not apply to any portion of the property that is sold or exchanged that has not been used as the personal residence. Thus, on the sale of a farm, it is necessary to allocate the gain between the residence portion of the sale and the gain attributable to assets other than the residence. However, no allocation is required for an office in the home (i.e., when both the residential and nonresidential portions of the property are within the same dwelling unit).[80]

In the farm setting, the real question is how extensive the farm "residence" can be. In other words, how much land and other property can legitimately be included with the farm home? The old IRC §1034 regulations only state that the "residence" does **not** include any part of the farm used for the farming business.[81]

> **Note.** If any portion of the residence was used as a home office, depreciation taken since May 6, 1997 will be taxable up to the amount of gain allocated to the residence.

**Rulings.** Over the years, there have been a number of rulings on the issue of how broadly to define "personal residence." The following is a synopsis of the more helpful rulings that involved the pre-1997 sale and reinvestment rule (IRC §1034):

- 5 acres out of 236[82]
- 1.5 acres out of 7[83]
- 65 acre tract[84]
- 43.5 acres out of 51[85]

> **Observation.** Cases reveal that facts of each particular situation determine the definition of "personal residence."

> **Note.** The pre May 7, 1997, over-age-55 taxpayer rule used the same definition of "residence" as the sale and reinvestment rule. Under the IRC §1034 regulations, the term "new residence" was defined very broadly and included a house trailer, houseboat, or stock held by a tenant-stockholder in a cooperative housing association in addition to a conventional dwelling. However, in any event, the taxpayer must use the dwelling as the principal residence.

---

80. Treas. Reg. §1.121-1(e)

81. Treas. Reg. §1.1034-1(c)(3)(i). See also *Reid v. United States,* 24 AFTR 2d 69-5230 (E.D. Cal. 1969)(two thirds of ranch residence held to be principal residence).

82. *Estate of Campbell v. Comm'r,* TC Memo 1964-83, March 31, 1964

83. *Lokan v. Comm'r,* TC Memo 1979-380, September 17, 1979

84. *Bennett v. United States,* 8 AFTR 2d 5593 (N.D. Ga. 1961)

85. *Schlicher v. Comm'r,* TC Memo 1997-163, April 1, 1997

86. Treas. Reg. §1.1034-1(c)(3)(ii)



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Final regulations issued after the 1997 Tax Act (for purposes of the retooled IRC §121) address the eligibility of vacant land for the exclusion from gain as being part of the principal residence.[87] Under the regulations, **vacant land is not considered part of the residence** unless it is adjacent to the land containing the residence, and the taxpayer owned or used the land as part of the residence. In addition, the taxpayer must sell or exchange the residence in a transaction that satisfies IRC §121 within two years before or after the sale of the land. In addition, the exclusion requirements must be satisfied with respect to the sale of the land.

**Observation.** The final regulations under IRC §121 may serve to limit the amount of land that can be combined with the residence for purposes of exclusion from gain.

### Calculating Gain with Value of the Residence Excluded

Once the residence portion of the farm is valued, a 2-step process is used to calculate the gain excluded under IRC §121 and the gain reportable under the installment method.

**Example 7.** Candace farmed for many years with her husband Earl. Earl died in 2000 leaving Candace the farm outright. Candace and Earl had four children. Only Dee is interested in continuing the farming operation. Candace moved to town in early 2007 and plans to sell the farm and residence to Dee. As of mid-2007, the residence had a FMV of $200,000 and a $50,000 adjusted basis. Candace incurred $2,000 of selling expenses and $1,500 of repair expenses to fix several items in the home before the sale. The farmland was valued at $600,000 and had an income tax basis of $100,000. Candace incurred $5,000 of selling expenses associated with the sale of the farmland. Candace and Earl had no indebtedness since 1990. In August of 2007, Candace sold the farm and residence for $800,000 to Dee under an installment contract. The contract called for a 10% down payment to be paid in 2007 and equal annual payments of principal over a 10-year period.

The computation is shown on the following page.

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[87] Treas. Reg. §1.121-1(b)(3)



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**Tax Computation.**

**Step 1. Calculate the amount of gain excluded under IRC §121:**

| | | |
|---|---|---|
| Residence selling price | | $200,000 |
| Less: | | |
| Selling expenses | $2,000 | |
| Repair expense | 1,500 | |
| | $3,500 | (3,500) |
| Adjusted selling price | | $196,500 |
| Less: adjusted basis | | (50,000) |
| Gain on transaction | | $146,500 |
| Excluded gain | | $146,500 |

**Step 2. Calculate Candace's gain under the installment sale:**

| | | |
|---|---|---|
| Farmland selling price | | $600,000 |
| Less: | | |
| Adjusted basis | $100,000 | |
| Selling expense | 5,000 | |
| | $105,000 | (105,000) |
| Gross profit | | $495,000 |

**Note.** The contract price is the selling price minus the mortgage assumed minus the selling price of assets with gains fully reported in year of sale or excluded from income.

| | |
|---|---|
| Total contract price | $600,000 |
| Gross profit | $495,000 |
| Reportable gain (gross profit ÷ total contract price) | $495,000 ÷ $600,000 = .825 |
| Installment method payment portion (contract price ÷ selling price) | $600,000 ÷ $800,000 = .75 |
| Principal payment in year of sale × installment method payment portion | $80,000 × .75 = $60,000 |
| Taxable amount of principal payment reported as long term capital gain | .825 × $60,000 = $49,500 |
| Nontaxable return of basis | .175 × $60,000 = $10,500 |

Interest received is reported by Candace as ordinary income on Schedule B. Form 1099-INT is filed by Dee (buyer).

## ISSUE 7: INFORMATION REPORTING OF 4-H LIVESTOCK SALES

In 2005, the National 4-H Headquarters in Washington, D.C., produced a "Fact Sheet" in which they took the position that 4-H Extension Councils sponsoring livestock sales at county fairs were responsible for issuing Forms 1099-MISC directly to the 4-H member whose livestock had been sold at the event. Likewise, the National Headquarters stated that if a sale account or livestock committee administers the purchase money for the livestock, the entity (group or person) acting as the broker for the transaction that issues the check is responsible for issuing the Form 1099-MISC to the person who received payment for livestock. The "Fact Sheet" also implies that gross income received on the sale of such animals is not taxable if it is less than $600.

The positions of National 4-H Headquarters appeared to be inconsistent with existing Internal Revenue Code and applicable regulations.



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In early 2007, the IRS Office of Governmental Liaison addressed the matter, correcting the 4-H Headquarters' positions. Specifically, the IRS noted that there is no basis for the position that only income in excess of $600 is taxable. Instead, IRC §61 defines gross income as "all income from whatever source derived." As for the reporting requirements for income received from the sale of animals at auction, the IRS pointed out that existing treasury regulations provide an exception for certain sales of agricultural commodities, including spot or forward sales of agricultural commodities.

Livestock is defined as an agricultural commodity under the regulations, which define a spot sale as a "sale resulting in a subtantially contemporaneous delivery of the commodity." Accordingly, the IRS pointed out that there is no Form 1099 filing requirement for the sale of animals at auction. However, a Form 1099 must be issued by the payor of a **premium** associated with said livestock. A premium is a prize or award rather than a spot sale, and thus is not exempt from the Form 1099 filing requirement.

## ISSUE 8: WORK OPPORTUNITY TAX CREDIT (WOTC) EXPANDED TO BENEFIT RURAL EMPLOYERS

### OVERVIEW

On May 25, 2007, the president signed into law the Small Business and Work Opportunity Act of 2007.[88] The act makes several amendments to the work opportunity tax credit (WOTC).[89] The most important change to the WOTC from agriculture's standpoint is that it now has expanded application for employers that hire new employees in a "rural renewal county."

### THE WOTC

For many years, federal tax law provided employers with a tax credit for hiring disadvantaged workers such as those who qualify for food stamps or SSI recipients.[90] The credit is significant – generally, a maximum of $2,400 for each eligible employee that is hired (credit of 40% of the first $6,000 of wages paid to an eligible employee that works for at least 400 hours during the first year of employment). For agriculture, a significant problem with the credit has been that the type of eligible employee required by the statute is often not available for the type of employment that exists in many small towns and rural areas. The act addresses this issue.

#### Hiring A "Designated Community Resident" Living in a "Rural Renewal County"

The act amends the WOTC to expand its availability to businesses in rural communities that hire a "designated community resident."[91] A **designated community resident** is any person who is at least 18 years of age, but under age 40 as of the date of hire, and whose principal place of residence is established in a "rural renewal" area. A **rural renewal area** is a county outside of a metropolitan statistical area that has experienced net population declines from 1990-1994 and 1995-1999.[92] The IRS identified 31 states that have counties with the required population decline on page four of the Form 8850 Instructions.

Form 8850, *Pre-Screening Notice and Certification Request for the Work Opporttunity Credit,* is shown on the following pages.

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88. H.R. 2206, 110th Cong., 1st Sess. 2007. Sec. 8211. Sec. 8211 is part of a larger bill known as the U.S. Troop Readiness, Veterans' Care, Katrina Recovery, and Iraq Accountability Appropriations Act of 2007.

89. IRC §51

90. Ibid.

91. Act, §8211 (b), *amending* IRC §51(d).

92. Ibid.



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Form **8850**
(Rev. June 2007)
Department of the Treasury
Internal Revenue Service

# Pre-Screening Notice and Certification Request for the Work Opportunity Credit

▶ See separate instructions.

OMB No. 1545-1500

**Job applicant: Fill in the lines below and check any boxes that apply. Complete only this side.**

Your name ______________________ Social security number ▶ ______

Street address where you live ______________________

City or town, state, and ZIP code ______________________

Telephone number ( ) -

If you are under age 40, enter your date of birth (month, day, year) / /

**1** ☐ Check here if you are completing this form **before** August 28, 2007, and you lived in the area impacted by Hurricane Katrina on August 28, 2005. If so, please enter the address, including county or parish and state where you lived at that time.

______________________

**2** ☐ Check here if you received a conditional certification from the state workforce agency (SWA) or a participating local agency for the work opportunity credit.

**3** ☐ Check here if **any** of the following statements apply to you.

- I am a member of a family that has received assistance from Temporary Assistance for Needy Families (TANF) for any 9 months during the past 18 months.
- I am a veteran and a member of a family that received food stamps for at least a 3-month period during the past 15 months.
- I was referred here by a rehabilitation agency approved by the state, an employment network under the Ticket to Work program, or the Department of Veterans Affairs.
- I am at least age 18 but **not** age 40 or older and I am a member of a family that:
  **a** Received food stamps for the past 6 months, **or**
  **b** Received food stamps for at least 3 of the past 5 months, **but** is no longer eligible to receive them.
- During the past year, I was convicted of a felony or released from prison for a felony.
- I received supplemental security income (SSI) benefits for any month ending during the past 60 days.

**4** ☐ Check here if you are a veteran entitled to compensation for a service-connected disability **and,** during the past year, you were:

- Discharged or released from active duty in the U.S. Armed Forces, **or**
- Unemployed for a period or periods totaling at least 6 months.

**5** ☐ Check here if you are a member of a family that:

- Received TANF payments for at least the past 18 months, **or**
- Received TANF payments for any 18 months beginning after August 5, 1997, **and** the earliest 18-month period beginning after August 5, 1997, ended during the past 2 years, **or**
- Stopped being eligible for TANF payments during the past 2 years because federal or state law limited the maximum time those payments could be made.

**Signature—All Applicants Must Sign**

Under penalties of perjury, I declare that I gave the above information to the employer on or before the day I was offered a job, and it is, to the best of my knowledge, true, correct, and complete.

**Job applicant's signature ▶** **Date** / /

**For Privacy Act and Paperwork Reduction Act Notice, see page 2.** Cat. No. 22851L Form **8850** (Rev. 6-07)



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Form 8850 (Rev. 6-07) Page 2

**For Employer's Use Only**

Employer's name ______ Telephone no. (   )   - ______ EIN ▶ ______

Street address ______

City or town, state, and ZIP code ______

Person to contact, if different from above ______ Telephone no. (   )   - ______

Street address ______

City or town, state, and ZIP code ______

If, based on the individual's age and home address, he or she is a member of group 4 or 6 (as described under Members of Targeted Groups in the separate instructions), enter that group number (4 or 6) . . . . . . . . . . . . ▶ ______

Date applicant: Gave information __/__/__ Was offered job __/__/__ Was hired __/__/__ Started job __/__/__

**Complete Only If Box 1 on Page 1 is Checked**

State and county or parish of job ______

☐ Check if the individual was not your employee on August 28, 2005, and this is the first time the employee has been hired by you since August 28, 2005.

Under penalties of perjury, I declare that the applicant completed this form on or before the day a job was offered to the applicant and that the information I have furnished is, to the best of my knowledge, true, correct, and complete. Based on the information the job applicant furnished on page 1, I believe the individual is a member of a targeted group. I hereby request a certification that the individual is a member of a targeted group.

**Employer's signature ▶** ______ **Title** ______ **Date** __/__/__

## Privacy Act and Paperwork Reduction Act Notice

*Section references are to the Internal Revenue Code.*

Section 51(d)(13) permits a prospective employer to request the applicant to complete this form and give it to the prospective employer. The information will be used by the employer to complete the employer's federal tax return. Completion of this form is voluntary and may assist members of targeted groups in securing employment. Routine uses of this form include giving it to the state workforce agency (SWA), which will contact appropriate sources to confirm that the applicant is a member of a targeted group. This form may also be given to the Internal Revenue Service for administration of the Internal Revenue laws, to the Department of Justice for civil and criminal litigation, to the Department of Labor for oversight of the certifications performed by the SWA, and to cities, states, and the District of Columbia for use in administering their tax laws. We may also disclose this information to other countries under a tax treaty, to federal and state agencies to enforce federal nontax criminal laws, or to federal law enforcement and intelligence agencies to combat terrorism.

You are not required to provide the information requested on a form that is subject to the Paperwork Reduction Act unless the form displays a valid OMB control number. Books or records relating to a form or its instructions must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and return information are confidential, as required by section 6103.

The time needed to complete and file this form will vary depending on individual circumstances. The estimated average time is:

**Recordkeeping** . . . .5 hrs., 30 min.
**Learning about the law or the form** . . . . . . . . 24 min.
**Preparing and sending this form to the SWA** . . . . . . . . 30 min.

If you have comments concerning the accuracy of these time estimates or suggestions for making this form simpler, we would be happy to hear from you. You can write to the Internal Revenue Service, Tax Products Coordinating Committee, SE:W:CAR:MP:T:T:SP, 1111 Constitution Ave. NW, IR-6406, Washington, DC 20224.

Do not send this form to this address. Instead, see *When and Where To File* in the separate instructions.

Form **8850** (Rev. 6-07)





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- Tacoma, WA
- Yakima, WA
- Milwaukee, WI

## Rural Renewal Counties

A rural renewal county is a county in a rural area that lost population during the 5-year periods 1990 through 1994 and 1995 through 1999. Rural renewal counties are listed below.

**Alabama.** The counties of Butler, Dallas, Macon, Perry, Sumter, and Wilcox.

**Alaska.** The census areas of Aleutians West, Wrangell-Petersburg, and Yukon-Koyukuk.

**Arkansas.** The counties of Arkansas, Chicot, Clay, Desha, Jackson, Lafayette, Lee, Little River, Monroe, Nevada, Ouachita, Phillips, Union, and Woodruff.

**Colorado.** The counties of Cheyenne, Kiowa, and San Juan.

**Georgia.** The counties of Randolph and Stewart.

**Illinois.** The counties of Alexander, Edwards, Franklin, Gallatin, Greene, Hancock, Hardin, Jasper, Knox, McDonough, Montgomery, Pulaski, Randolph, Richland, Scott, Warren, Wayne, and White.

**Indiana.** Perry County.

**Iowa.** The counties of Adair, Adams, Appanoose, Audubon, Butler, Calhoun, Cass, Cherokee, Clay, Clayton, Emmet, Floyd, Franklin, Fremont, Hancock, Humboldt, Ida, Keokuk, Kossuth, Montgomery, Osceola, Palo Alto, Pocahontas, Poweshiek, Sac, Taylor, Union, Wayne, Winnebago, and Worth.

**Kansas.** The counties of Atchison, Barber, Barton, Brown, Clay, Cloud, Comanche, Decatur, Edwards, Elk, Ellsworth, Gove, Graham, Greeley, Greenwood, Harper, Hodgeman, Jewell, Kiowa, Labette, Lane, Lincoln, Marshall, Mitchell, Montgomery, Ness, Osborne, Phillips, Rawlins, Republic, Rooks, Rush, Russell, Scott, Sheridan, Sherman, Smith, Stafford, Trego, Wallace, Washington, Wichita, and Woodson.

**Kentucky.** The counties of Bell, Caldwell, Floyd, Harlan, Hickman, Leslie, Letcher, Pike, and Union.

**Louisiana.** The parishes of Bienville, Claiborne, Franklin, Jackson, Morehouse, St. Mary, Tensas, Vernon, and Webster.

**Maine.** The counties of Aroostook and Piscataquis.

**Michigan.** The counties of Gogebic, Marquette, and Ontonagon.

**Minnesota.** The counties of Big Stone, Chippewa, Cottonwood, Faribault, Jackson, Kittson, Koochiching, Lac Qui Parle, Lincoln, Marshall, Martin, Murray, Norman, Pipestone, Red Lake, Redwood, Renville, Stevens, Traverse, Wilkin, and Yellow Medicine.

**Mississippi.** The counties of Adams, Coahoma, Humphreys, Montgomery, Quitman, Sharkey, Tallahatchie, and Washington.

**Missouri.** The counties of Atchison, Carroll, Chariton, Clark, Holt, Knox, Mississippi, New Madrid, Pemiscot, and Worth.

**Montana.** The counties of Carter, Daniels, Dawson, Deer Lodge, Fallon, Garfield, Hill, Liberty, McCone, Petroleum, Phillips, Powder River, Prairie, Richland, Roosevelt, Rosebud, Sheridan, Valley, and Wibaux.

**Nebraska.** The counties of Antelope, Banner, Boone, Box Butte, Boyd, Burt, Cedar, Chase, Deuel, Dundy, Fillmore, Franklin, Garden, Garfield, Greeley, Hayes, Hitchcock, Holt, Jefferson, Johnson, Logan, Nance, Nemaha, Nuckolls, Pawnee, Perkins, Red Willow, Richardson, Rock, Sheridan, Sherman, Thayer, Thomas, Valley, Webster, and Wheeler.

**Nevada.** The counties of Esmeralda, Lander, and Mineral.

**New Hampshire.** Coos County.

**New Mexico.** The counties of Harding and Quay.

**New York.** The counties of Clinton and Montgomery.

**North Dakota.** The counties of Adams, Barnes, Benson, Billings, Bottineau, Burke, Cavalier, Dickey, Divide, Dunn, Eddy, Emmons, Foster, Golden Valley, Grant, Griggs, Hettinger, Kidder, LaMoure, Logan, McHenry, McIntosh, McKenzie, McLean, Mercer, Mountrail, Nelson, Oliver, Pembina, Pierce, Ramsey, Ransom, Renville, Sargent, Sheridan, Slope, Stark, Steele, Stutsman, Towner, Traill, Walsh, Wells, and Williams.

**Ohio.** The counties of Crawford, Monroe, Paulding, Seneca, and Van Wert.

**Oklahoma.** The counties of Alfalfa, Beaver, Cimarron, Custer, Dewey, Ellis, Grant, Greer, Harmon, Harper, Kiowa, Major, Roger Mills, Seminole, Tillman, and Woodward.

**Pennsylvania.** The counties of Venango and Warren.

**South Carolina.** Marlboro County.

**South Dakota.** The counties of Aurora, Campbell, Clark, Day, Deuel, Douglas, Faulk, Grant, Gregory, Haakon, Hand, Harding, Hutchinson, Jones, Kingsbury, Marshall, McPherson, Miner, Perkins, Potter, Sanborn, Spink, Tripp, and Walworth.

**Texas.** The counties of Andrews, Bailey, Baylor, Borden, Briscoe, Brooks, Castro, Cochran, Coleman, Collingsworth, Cottle, Crane, Culberson, Deaf Smith, Dimmit, Eastland, Fisher, Floyd, Foard, Gray, Hall, Hardeman, Haskell, Hemphill, Hockley, Hutchinson, Kenedy, Kent, Knox, Lamb, Martin, McCulloch, Morris, Nolan, Oldham, Reagan, Reeves, Refugio, Roberts, Scurry, Stonewall, Terrell, Terry, Upton, Ward, Wheeler, Wilbarger, Winkler, Yoakum, and Zavala.

**Virginia.** The counties of Buchanan, Dickenson, Highland, and Lee and the independent cities of Clifton Forge, Covington, Norton, and Staunton.

**West Virginia.** The counties of Calhoun, Gilmer, Logan, McDowell, Mercer, Mingo, Summers, Tucker, Webster, Wetzel, and Wyoming.

**Wyoming.** The counties of Carbon and Niobrara.



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### Other Eligibility Requirements

For an employer to claim the credit, the state workforce agency for the employer's location must certify an employee at or near the time of hire. **An employer has only 28 days after an uncertified employee begins working to submit a certification request to the state workforce agency via Form 8850, *Pre-Screening Notice and Certification Request for the Work Opportunity Credit*.** After submission of the form, the agency sends the employer a certification letter. In addition to filing Form 8850, the employer must file either an ETA Form 9062, *Conditional Certification Form,* or an ETA Form 9061, *Individual Characteristics Form,* with the employer's state WOTC coordinator for the state workforce agency.[93]

The employee cannot have previously worked for the employer, or be the employer's dependent, or a related party to the employer, and must work at least 120 hours for any portion of the credit to be claimed. However, the employee need not be a low-income person or be in a disadvantaged category. To receive the full credit, the employee only needs to reside in a rural renewal county and remain living there until $6,000 wages have been paid. Thus, employees at all income levels can qualify the employer for the credit.

While many agricultural employers are exempt from paying FUTA because of the $20,000 or 10 or more employees per quarter, agricultural wages qualify for the WOTC. However, payment-in-kind wages are not considered wages for the WOTC.

### Credit Amount

For the employer to be entitled to any portion of the credit, the employee must work at least 120 hours in the first 12 months from date of hire. If the employee works more than 120 hours, but less than 400 hours during the first year, the credit is 25% of the first $6,000 of wages paid to the employee. For qualified employees that work 400 hours or more, the credit is 40% of the first $6,000 of wages paid.

### Claiming the Credit

The employer claims the credit on IRS Form 5884, *Work Opportunity Credit,* and attaches it to the employer's income tax return.

> **Example 8.** Joe Nippan operates Nippan Farms. Nippan Farms hired Sam on August 1, 2007, as temporary seasonal help on the farm. Sam is 24-years old and resides in a rural renewal county. Sam is the only employee of the farm that is paid a wage. Nippan Farms filed a certification request with the appropriate state agency within 28 days of Sam's hire using Form 8850. For 2007, Sam worked 500 hours for Nippan Farms and was paid $9,400 of cash wages.
>
> The credit reduces the employer's wages paid deduction that is claimed on Schedule C (or Schedule F). Therefore, line 24 will show $7,000 as the wage deduction. That is the $9,400 wages paid less the $2,400 WOTC credit.
>
> Nippan Farm's Form 5884 and Form 3800 for 2007 are shown on the following pages.



### SUMMARY

The re-tooled WOTC is effective for persons hired after May 25, 2007, and before September 1, 2011. It has the potential to be a significant benefit to employers in rural renewal counties. Claiming the credit will result in tax reduction because for tax years beginning after 2006, it offsets both regular and alternative minimum tax.[94]

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93. ETA Form 9061 is available from the employer's local public employment service office or at www.doleta.gov/business/Incentives/opptax.

94. Act. §8214



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**For Example 8**

Form **5884** | **Work Opportunity Credit** | OMB No. 1545-0219

Department of the Treasury
Internal Revenue Service

► Attach to your tax return.

**2007**
Attachment Sequence No. 77

Name(s) shown on return: Joe Nippan | Identifying number: 333-33-3333

Draft as of 08/23/2007

**Part I Current Year Credit**

| | Description | Line | Amount |
|---|---|---|---|
| 1 | Enter on the applicable line below the total qualified first- or second-year wages paid or incurred during the tax year, and multiply by the percentage shown, for services of employees who are certified (if required) as members of a targeted group. | | |
| a | Qualified first-year wages of employees who worked for you at least 120 hours but fewer than 400 hours . . . . . . . . $ ______ × 25% (.25) | 1a | |
| b | Qualified first-year wages of employees who worked for you at least 400 hours . . . . . . . . . . . . . $ 6,000 × 40% (.40) | 1b | 2,400 |
| c | Qualified second-year wages of employees certified as long-term family assistance recipients . . . . . . . . . $ ______ × 50% (.50) | 1c | |
| 2 | Add lines 1a, 1b, and 1c. See instructions for the adjustment you must make for salaries and wages | 2 | 2,400 |
| 3 | Work opportunity credit from partnerships, S corporations, cooperatives, estates, and trusts | 3 | |
| 4 | Add lines 2 and 3. Partnerships and S corporations, report this amount on Schedule K; all others, go to line 5 | 4 | 2,400 |
| 5 | Work opportunity credit included on line 4 from passive activities (see instructions) | 5 | |
| 6 | Subtract line 5 from line 4 | 6 | |
| 7 | Work opportunity credit allowed for 2007 from a passive activity (see instructions) | 7 | |
| 8 | Carryforward from 2006 of the New York Liberty Zone business employee credit and carryback from 2008 of the work opportunity credit (see instructions) | 8 | |
| 9 | Add lines 6 through 8. Cooperatives, estates, and trusts, continue on to line 10. All others, use this amount to complete Part II | 9 | |
| 10 | Amount allocated to patrons of the cooperative or beneficiaries of the estate or trust (see instructions) | 10 | |
| 11 | Cooperatives, estates, and trusts, subtract line 10 from line 9. Use this amount to complete Part II | 11 | |

**Part II Allowable Credit**

| | Description | Sub-line | Sub-amount | Line | Amount |
|---|---|---|---|---|---|
| 12 | Regular tax before credits (see instructions) | | | 12 | |
| 13 | Alternative minimum tax (see instructions) | | | 13 | |
| 14 | Add lines 12 and 13 | | | 14 | |
| 15a | Credits from Form 1040, lines 47 through 50 and 52 through 54 (or Form 1040NR, lines 44, 45, and 47 through 49) | 15a | | | |
| b | Foreign tax credit | 15b | | | |
| c | Credits from Forms 5735 and 8834 | 15c | | | |
| d | Non-business alternative motor vehicle credit (Form 8910, line 18) | 15d | | | |
| e | Non-business alternative fuel vehicle refueling property credit (Form 8911, line 19) | 15e | | | |
| f | Add lines 15a through 15e | | | 15f | |
| 16 | Net income tax. Subtract line 15f from line 14. If zero, skip lines 17 through 20 and enter -0- on line 21 | | | 16 | |
| 17 | Net regular tax. Subtract line 15f from line 12. If zero or less, enter -0- | | | 17 | |
| 18 | Enter 25% (.25) of the excess, if any, of line 17 over $25,000 (see instructions) | | | 18 | |
| 19 | Subtract line 18 from line 16. If zero or less, enter -0- | | | 19 | |
| 20a | General business credit (Form 3800, line 19) | 20a | | | |
| b | Empowerment zone and renewal community employment credit (Form 8844, line 26) | 20b | | | |
| c | Add lines 20a and 20b | | | 20c | |
| 21 | Subtract line 20c from line 19. If zero or less, enter -0- | | | 21 | |
| 22 | **Credit allowed for the current year. Cooperatives, estates, and trusts.** Enter the smaller of line 11 or 21. Report this amount on Form 1120-C, Schedule J, line 5c; or Form 1041, Schedule G, line 2c. If line 21 is smaller than line 11, see instructions. **All others.** Enter the smaller of line 9 or 21. Report this amount on Form 1040, line 55; Form 1040NR, line 50; Form 1120, Schedule J, line 5c; or the applicable line of your return. If line 21 is smaller than line 9, see instructions | | | 22 | |

**For Paperwork Reduction Act Notice, see instructions.** Cat. No. 13570D Form **5884** (2007)



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**For Example 8**

Form **3800**

Department of the Treasury
Internal Revenue Service (99)

# General Business Credit

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

OMB No. 1545-0895
2007
Attachment Sequence No. 22

Draft as of 06/26/2007

| Name(s) shown on return | Identifying number |
|---|---|
| Joe Nippan | 333-33-3333 |

**Part I** Current Year Credit

**Important:** You may not be required to complete and file a separate credit form (shown in parentheses below) to claim the credit. For details, see the instructions.

| | Description | Line | Amount |
|---|---|---|---|
| 1a | Investment credit (attach Form 3468) | 1a | |
| b | Welfare-to-work credit (Form 8861) | 1b | 2,400 |
| c | Credit for increasing research activities (Form 6765) | 1c | |
| d | Low-income housing credit (Form 8586) (enter EIN if claiming this credit from a pass-through entity: ____ - ______________) | 1d | |
| e | Disabled access credit (Form 8826) (do not enter more than $5,000) | 1e | |
| f | Renewable electricity production credit (Form 8835, Section A only) | 1f | |
| g | Indian employment credit (Form 8845) | 1g | |
| h | Orphan drug credit (Form 8820) | 1h | |
| i | New markets credit (Form 8874) (enter EIN if claiming this credit from a pass-through entity: ____ - ______________) | 1i | |
| j | Credit for small employer pension plan startup costs (Form 8881) (do not enter more than $500) | 1j | |
| k | Credit for employer-provided child care facilities and services (Form 8882) (enter EIN if claiming this credit from a pass-through entity: ____ - ______________) | 1k | |
| l | Qualified railroad track maintenance credit (Form 8900) | 1l | |
| m | Biodiesel and renewable diesel fuels credit (attach Form 8864) | 1m | |
| n | Low sulfur diesel fuel production credit (Form 8896) | 1n | |
| o | Distilled spirits credit (Form 8906) | 1o | |
| p | Nonconventional source fuel credit (Form 8907) | 1p | |
| q | Energy efficient home credit (Form 8908) | 1q | |
| r | Energy efficient appliance credit (Form 8909) | 1r | |
| s | Alternative motor vehicle credit (Form 8910) | 1s | |
| t | Alternative fuel vehicle refueling property credit (Form 8911) | 1t | |
| u | Hurricane Katrina housing credit (only from S corporations, partnerships, estates, and cooperatives) | 1u | |
| v | Mine rescue team training credit (Form 8923) | 1v | |
| w | Credit for contributions to selected community development corporations (Form 8847) | 1w | |
| x | General credits from an electing large partnership (Schedule K-1 (Form 1065-B)) | 1x | |
| 2 | Add lines 1a through 1x | 2 | 2,400 |
| 3 | Passive activity credits included on line 2 (see instructions) | 3 | |
| 4 | Subtract line 3 from line 2 | 4 | 2,400 |
| 5 | Passive activity credits allowed for 2007 (see instructions) | 5 | |
| 6 | Carryforward of general business credit to 2007. See instructions for the schedule to attach | 6 | |
| 7 | Carryback of general business credit from 2008 (see instructions) | 7 | |
| 8 | **Current year credit.** Add lines 4 through 7 | 8 | 2,400 |

**For Paperwork Reduction Act Notice, see separate instructions.** Cat. No. 12392F Form **3800** (2007)

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