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Corrections were made to this workbook through January of 2009. No subsequent modifications were made.

ISSUE 1: SPOUSAL QUALIFIED JOINT VENTURE

The Small Business and Work Opportunity Tax Act of 2007 (SBWOTA)[1] included a provision that allows some husband-wife business ventures to elect out of the partnership rules for federal tax purposes as a qualified joint venture (QJV).[2] While the election will ease the tax reporting requirements for husband-wife joint ventures that can take advantage of the election, the SBWOTA also makes an important change to IRC §1402 as applied to rental real estate activities. In addition, for farmers, the ability to make a QJV election should be considered in light of the impact such election might have on eligibility for federal farm program payments.

JOINT VENTURES AND PARTNERSHIP RETURNS

Definition of Joint Venture

A joint venture is an undertaking of a business activity by two or more persons in which the parties involved agree to share in the profits and loss of the activity. This is similar to the Uniform Partnership Act's definition of a partnership.

The 1997 version of the Uniform Partnership Act (UPA), §101(6), defines a partnership as an association of two or more persons to carry on as co-owners a business for profit formed under §202 of the UPA. Section 202 states that mere co-ownership of property (regardless of the particular form) is insufficient, by itself, to constitute a partnership. Section 202 also states that while a sharing of gross returns is not indicative of a partnership, the sharing of profit from the business does indicate partnership existence unless the profit is received in payment of a debt, for services as an independent contractor or as an employee, or for rent, among other things.

The Code defines a partnership in a negative manner by describing what a partnership is not.[3] The IRS follows the UPA definition of a partnership by specifying that a business activity conducted in a form jointly owned by spouses (including a husband-wife limited liability company (LLC)) creates a partnership that requires the filing of IRS Form 1065 and issuing a separate Schedule K-1 to each spouse. The taxpayers then aggregate the K-1s on the Form 1040, Schedule E, page 2[4] and complete separate Schedules SE. The SBWOTA does not change the historic IRS position.[5]

1. Small Business and Work Opportunity Tax Act of 2007, Pub. L. No. 110-28, enacted May 25, 2007
2. SBWOTA §8215(a), amending IRC §761 by changing existing subsection (f) to (g) and adding new subsection (f)
3. IRC §§761(a) and 7701(a)(2)
4. IRS Form 1065, Instructions, page 2: "Generally, if you and your spouse jointly own and operate an unincorporated business and share in the profits and losses, you are partners in a partnership and you must file a Form 1065." See also Treas. Reg. §301.7701-3(b) (multi-member LLC).
5. The Joint Committee on Taxation's report on the new QJV provision contained in §8215 of the Act clearly states that IRC §761(f) (the new QJV provision) is not meant to change prior law concerning the basic determination of what is a partnership.

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Partnership Return Filing Requirements

While the IRS position creates a tax compliance hardship, in reality, a partnership return does not have to be filed for every husband-wife operation. If the enterprise does not meet the basic requirements to be a partnership under the Code,[6] such as not carrying on a business, financial operation, or venture, the taxpayers can elect out.

A spousal joint venture can elect out of partnership treatment if it is formed for "investment purposes only" and not for the active conduct of business. In addition, the couple's income can be determined without the need for a partnership calculation.[7] The election must be in accordance with the requirements of Treas. Reg. §1.761-2. However, Treas. Reg. §1.761-2(b)(ii) forgives such entities if they were not aware of the need to make a formal election. Once made, the election is binding on the venture until the venture either no longer qualifies or obtains the IRS's permission to revoke the election. Permission must be requested by the end of the first 30 days of the year during which the election was to apply.[8]

Effective for required returns filed after December 20, 2007, the penalty for failure to file a partnership (or S corporation) return is increased to $85 per month, per partner (or shareholder), for a maximum of 12 months.[9] Consequently, the maximum penalty for a husband-wife partnership that fails to file a required partnership return is $2,040. This compares to a $500 maximum penalty under prior law.

The penalty is not imposed if the partnership can show reasonable cause for its failure to file a complete or timely return. Certain small partnerships, with 10 or fewer partners, meet the reasonable-cause test if all the partners are individuals and they all filed income tax returns that fully reported their shares of the partnership's income, deductions, and credits. However, nonresident aliens, estates, and C corporations do not meet the test. Also, the partnership must not have elected to be subject to the rules for consolidated audit proceedings. A written request for relief in accordance with Rev. Proc. 84-35[10] should be sent to the IRS service center where the return is filed. All partners' names and tax identification numbers should be included.

HUSBAND-WIFE QUALIFIED JOINT VENTURE

Effective for tax years beginning after December 31, 2006, the SBWOTA allows a spousal business activity to be treated, by election, as a QJV. The QJV is **not** treated for tax purposes as a partnership.[11] Instead, each spouse files as a sole proprietor to report that spouse's proportionate share of the income and deduction items of the business activity.[12]

Under the provision, a QJV includes only those businesses that are owned and operated by spouses as co-owners, and not in the name of a state law entity, including a general or limited partnership or limited liability company. Consequently, spousal LLCs are **not** eligible for the election.

6. IRC §7701(a)(2)

7. IRC §761(a)

8. Treas. Reg. §1.761-2(b)(3)(i)

9. IRC §6698

10. Rev. Proc. 84-35, 1984-1 CB 509

11. The provision equates the treatment of spousal LLCs in common-law property states with that of community-property states. In Rev. Proc. 2002-69, 2002-2 CB 831, the IRS specified that husband-wife LLCs in community-property states can disregard the entity.

12. SBWOTA, §8215(a) redesignates existing IRC §761(f) as (g) and adds IRC §761(f)(1).

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Electing QJV Status

In order to elect QJV status, all of the following five criteria must be satisfied:

1. The activity must involve the conduct of a trade or business.
2. The only members of the joint venture are spouses.
3. Both spouses elect the application of the QJV rule.
4. Both spouses materially participate in the business.[13]
5. The spouses file a joint tax return for the year.[14]

The IRS instructions to Form 1065 provide guidance on the election. Those instructions specify that the election is made simply by **not filing a Form 1065** and dividing all income, gain, loss, deduction, and credit between the spouses in accordance with each spouse's interest in the venture.

> **Note.** The IRS informally stated that no final Form 1065 is filed for an entity that had previously filed Form 1065. That will likely create issues with computer-generated notices looking for the Form 1065. There is no penalty for filing, so practitioners may want to file a "$0" return marking the "final return" box.

Both spouses must file separate Schedules C, C-EZ, or F reporting their share of income, deduction, or loss. Both spouses also must file separate Schedules SE to report their respective share of self-employment (SE) income from the activity. Thus, both spouses receive credit for their share of the net SE income for social security benefit eligibility purposes.

> **Note.** Apparently, the same rules apply that would have applied if a formal Form 1065 had been prepared; with each spouse reporting "line item" income and expense rather than a single number for what would have represented nonseparately-stated items of income and expense or the summary reports of separately-stated items. Also, apparently the balance of Subchapter K's rules for recognizing the validity of allocations would also apply because IRC §761(f), unlike §761(a), does not remove the entity from Subchapter K's applicability by its terms.

If the income from the business was reported on Schedule E, a QJV election may not be possible. Reporting income on Schedule E constitutes an election out of Subchapter K. A taxpayer can only reelect Subchapter K, and therefore §761(f), with the IRS's permission. This must be requested within the first 30 days of the tax year.

> **Note.** Ventures that filed Schedule E for 2006 would have needed to request IRS permission to utilize Subchapter K (and the QJV provision) within the first 30 days of 2007. But the QJV provision, though effective for tax years after December 31, 2006, wasn't enacted until May 25, 2007. The problem does not occur with spousal businesses utilizing Rev. Proc. 2002-69 in community-property states. Rev. Proc. 2002-69 allows a taxpayer to have a deemed formation of a partnership each year. Thus, such a taxpayer could elect to not disregard the entity and then elect to apply the QJV provisions of IRC §761(f).

13. IRC §761(f)(2). "Material participation" is defined in accordance with the passive activity loss rules of IRC §469(h), except IRC §469(h)(5). Whether a spouse materially participates in the business is determined independently of the other spouse.

14. In general, electing QJV status won't change a married couple's total federal income tax liability or total SE tax liability, but it will eliminate the need to file Form 1065 and the related Schedules K-1.

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RENTAL REAL ESTATE AND SE TAX

Net earnings from self employment are subject to SE tax. **Net earnings from self employment** is defined as income derived by an individual from any trade or business carried on by such individual.[15] Real estate rental income is excluded from the general definition of net earnings from self employment.[16] However, the IRS's position is that otherwise passive farm rental income is subject to SE tax if there is an "arrangement" (or contract) requiring material participation on the landlord's part. Thus, for rental property in a partnership (or rental real estate income of an individual), SE tax is not triggered.

QJV Election and Rental Real Estate

Once a QJV election is made, the exception from SE tax for real estate rentals is lost. The SBWOTA adds IRC §1402(a)(17), which specifies that in a QJV, each spouse's share of income or loss is taken into account as provided for in §761(f) in determining SE tax.[17] The QJV election triggers SE tax and the exception from SE tax for rental real estate income is lost. Indeed, the 2007 Form 1065 Instructions state that if the QJV election is made for a husband-wife rental real estate business, "you each must report your share of income and deductions on Schedule C. You and your spouse each must take into account your share of the income and deductions from the rental real estate business in figuring your net earnings from self employment on Schedule SE."

While the QJV election may not be a problem in the year when a loss results, the SE tax complication can be problematic when there is income for the year. It is not possible to simply elect out of QJV treatment by filing a Form 1065 in an attempt to avoid SE tax.[18] Likewise, it is probably not possible to intentionally fail to qualify for QJV status (by transferring an interest in the business to a nonspouse, for example) to avoid SE tax in an income year after reducing SE income by pass-through losses in a prior year(s).[19] That would allow the IRS to assert that the transfer of a minimal interest to a disqualified person or entity violates the intent of Subchapter K.[20] However, taxpayers in community-property states have the option to use either Rev. Proc. 2002-69 (rental income from real estate is not subject to SE tax) or elect QJV status.

Note. A spousal real estate rental business involving co-owned real estate is not affected by IRC §1402(a)(17). The rental income is not subject to SE tax[21] if a QJV election is **not** made. The instructions to IRS Form 1065 state that a mere co-ownership of property that is maintained and leased or rented is not a partnership.[22] However, a partnership exists if the spouses provide services to the tenant.[23]

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15. IRC §1402(a)

16. IRC §1402(a)(1). See *Mizell v. Comm'r*, TC Memo 1995-571 (Nov. 29, 1995); Tech. Adv. Memo 9637004 (May 1, 1996); but see *McNamara v. Comm'r*, 236 F.3d 410 (8th Cir. 2000) (SE tax not due if fair market rentals charged). The IRS issued a nonacquiescence to the court's opinion. AOD CC-2003-003 (Oct. 20, 2003).

17. SBWOTA, §8215(b)(1), effective for tax years beginning after December 31, 2006

18. Form 1065 Instructions note that the election cannot be revoked without the IRS's consent, and that the partnership (the entity in effect before the QJV election) terminates at the end of the tax year immediately preceding the year the QJV election takes effect.

19. QJV treatment ends in a manner similar to that of an S corporation, and could be terminated, for example, by transferring an interest in the QJV (such as by gift) to a third party or even to a corporation that one or both of the spouses own. QVJs can only exist between spouses and any transfer of an interest to a nonspouse terminates the QJV.

20. Treas. Reg. §1.701-2 (anti-abuse rules). That may especially be the case if the disqualification event seems designed simply to avoid SE tax.

21. IRC §1402(a)(1)

22. The income of a general partner is subject to SE tax. See, e.g., *Norwood v. Comm'r*, TC Memo 2000-84 (Mar. 13, 2000).

23. Real estate that is co-owned by spouses and leased to a separate entity or third party with minimal services provided by the co-owners does not constitute a partnership. The income from such an activity is properly reported on Schedule E.

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IRS Guidance

Irrespective of the clear statutory language, the IRS Chief Counsel's Office issued guidance **reversing** the position described in the 2007 Form 1065 Instructions.[24] In the guidance, the IRS clarifies that a spousal QJV election for a rental real estate business does **not** convert the income derived from the business into net earnings from self employment when the income otherwise would be excluded from SE tax. Therefore, the QJV election does not negate the rental real estate exception of IRC §1402(a)(1). Instead, the guidance notes that the legislative history of the QJV election indicates that its sole purpose is to simplify the reporting burden for spousal business activities. Consequently, rental income from rental activities in which the taxpayer does **not** materially participate is **not** subject to SE tax.

While the QJV election does not eliminate the rental real estate exception when it would otherwise apply, the IRS maintains that a QJV election requires the rental real estate income be reported on a separate Schedule C for each spouse rather than on Schedule E, even though the income is not subject to SE tax. In those situations, the taxpayers enter **"Exempt—QJV"** on their Form 1040, line 58. They should not file Schedules SE, unless either or both spouses have other income subject to SE tax. If the other net earnings from self employment amount to $400 or more, the spouse(s) with the other net earnings from self employment should file Schedule SE and enter **"Exempt—QJV"** and the amount of net profit from the rental real estate business from Schedule C or Schedule F on the dotted line to the left of Schedule SE, line 3. This should not be included on the computation of tax reported on Form 1040, line 58.

TAX REPORTING AND FEDERAL FARM PROGRAM PARTICIPATION

Rules for Spouses — Active-Engagement Test

The Food, Conservation, and Energy Act (FCEA) of 2008 became law on June 18, 2008, and is commonly referred to as the 2008 Farm Bill.[25] This legislation changes the rules regarding the active-engagement test. If one spouse (or the estate of a deceased spouse) is determined to be actively engaged, the other spouse is determined to have met the requirements and qualify for a payment limitation amount. The FCEA also eliminates the 3-entity rule (beginning with the 2009 crop year). It replaces the active-engagement test with a direct-attribution rule. This causes all federal farm program payments to be attributed to a person by taking into account the direct and indirect ownership interests of the person in a legal entity that is eligible to receive the payments.

For farm couples who participate in federal farm programs and who both satisfy the **active-engagement** test,[26] each spouse **may** qualify for a payment limitation.[27] To be actively engaged in farming as a separate person, a spouse must satisfy the following three tests:

1. The spouse's share of profits or losses from the farming operation must be commensurate with the spouse's contribution to the operation.[28]
2. The spouse's contributions must be "at risk."[29]
3. The spouse must make a significant contribution of capital, equipment, or land (or a combination thereof) **and** provide active personal labor or active personal management (or a combination thereof).[30]

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24. ILM 200816030 (Mar. 18, 2008)

25. H.R. 6124

26. The "active engagement test" is codified at 7 USC §1308-1(b).

27. 7 USC §1308(e)(2)(C)(ii); 7 C.F.R. §1400.105(a)(2). The statute specifies that qualification of spouses as separate persons under this provision is at the Ag Secretary's discretion. The spouses can be considered separate "persons" for the payment limitation rules if they do not hold, directly or indirectly, a substantial beneficial interest in more than one entity (including the spouses themselves) engaged in farming operations that also receive farm program payments as separate persons, if each spouse meets the other requirements necessary to be considered separate persons. A substantial beneficial interest is defined as generally between 10% and 50%, with the proviso that the Ag Secretary may reduce the level on a case-by-case basis. But ¶ 253.5, Example 1 of 1-PL (Rev. 1), Amendment 23 (dated 4/25/94) sets forth an example of a husband–wife joint farming operation. The wife also has a 25% interest in another farming corporation which is receiving CRP payments. While meeting all of the other tests, the example states that the couple is considered to be one "person" for payment limitation purposes because the wife also receives payments indirectly through the corporation which is a separate person from the wife.

28. 7 USC §1308-1(b)(2)(A)(ii); 7 C.F.R. §1400.6(a)

29. 7 USC §1308-1(b)(2)(A)(ii); 7 C.F.R. §1400.6(b)

30. 7 USC §1308-1(b)(2)(A)(i); 7 C.F.R. §1497.6(b)

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To consider the spouse's contribution "at risk," there must be a possibility that a nonrecoverable loss may be suffered. Similarly, contributions of capital, equipment, land, labor, or management must be material to the operation in order to be considered a "significant contribution." The spouse's involvement, in order to warrant separate-person status, must not be passive.

For a contribution of labor to be considered significant, it must be 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 spouse's commensurate share in the farming operation.[31] For a contribution of management to be considered significant, the spouse must be engaged in activities which are critical to the farming operation's profitability.[32] For contributions of land, capital, or equipment, the contribution must have a value of at least 50% of the spouse's commensurate share of the total value of capital or the total rental values of either land or the equipment necessary to conduct the farming operation.[33]

While the active-engagement test is relaxed for farm operations in which a majority of the "persons" are individuals who are family members, it is not possible for a spouse to apply for farm program payments as a separate person based on a contribution of land the spouse owns in return for a share of the program payments. The use of the spouse's contributed land must be in return for the spouse receiving rent or income for the use of the land based on the land's production or the farming operation's operating results.[34]

Utilizing the QJV Election

Spouses applying for two separate payment limitations under the farm programs are certifying that they each are actively involved in the farming operation and meet the three requirements previously listed. For tax reporting purposes, the couple may have a single enterprise with income reported on a single Schedule F as a sole proprietorship, or on two Schedules F with the income split into two pro rata shares for SE tax purposes. In these situations, the IRS could assert that a partnership filing is required (in common-law property states).[35] Thus, the QJV election could be utilized with the result that two proprietorship returns are filed. This process is simpler than filing a partnership return, and it avoids the possibility of getting the stiffer penalty imposed for failing to file a partnership return. Filing the QJV election subjects the income of both spouses (including each spouse's share of government payments) to SE tax.[36] That eliminates any argument that at least one spouse's income should not be subjected to SE tax on the basis that the spouse was only actively involved (for purposes of the farm program eligibility rules), but not engaged in a trade or business.[37]

Example 1. Barney and Margo have net farm income of $50,000. Barney files as a sole proprietor. This generates SE tax of $7,064. If the QJV election is made and they divide the net farm income equally, each has net farm income of $25,000 and SE tax of $3,532.

Example 2. Hugo and Maria have net farm income of $160,000. Hugo files as a sole proprietor. This generates SE tax of $16,933. If the QJV election is made and they divide the net farm income 75% (Hugo) and 25% (Maria), Hugo has net farm income of $120,000 and SE tax of $15,862. Maria has net farm income of $40,000 and SE tax of $5,652. The combined SE tax under the QJV election is $21,514, which is $4,581 more than the sole-proprietor liability.

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31. 7 C.F.R. §1497.3

32. Regulations define "active personal management" to include the "marketing and promotion" of agricultural commodities produced by the farming operation. 7 C.F.R. §1400.3.

33. Ibid

34. 7 C.F.R. §1400.207

35. Rev. Proc. 2002-69, 2002-2 C.B. 831 allows the couple to disregard the entity in a community-property state.

36. IRC §1402(a)(17) states that each spouse's share of the net income from a QJV is subject to SE tax.

37. IRC §1402(a) defines SE income as income derived from a trade or business that the taxpayer conducts.

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> **Observation.** The argument that one spouse's income should not be subject to SE tax is weak. The active-engagement rules are similar to the rules for determining whether income is subject to SE tax. Those rules define "net earnings from self employment" as income from a trade or business that the taxpayer conducts. That involves an element of risk taking, which is the manner in which the active-engagement test is couched. The existence of a trade or business is determined on a case-by-case basis according to the facts and circumstances.[38] In general, the activity must be conducted on a regular and continuous basis.[39] It is hard to imagine how a spouse could argue that he met the active-engagement test, but is not engaged in a trade or business on a basis that is regular and continuous. The issue is moot if satisfaction of the active engagement test creates a partnership for tax purposes; which it probably does by virtue of the at-risk requirement. That's where the QJV election can be beneficial; not as a means of avoiding SE tax, but as a means of avoiding the need to file as a partnership.

QJV Election's Impact on Other Tax Matters

Making the QJV election should be done with the full knowledge and understanding of its impact on other tax matters. This includes, but is not limited to, health insurance deductions under IRC §105, stepped-up basis of farm assets at death, retirement-plan contributions, social security benefits, social security earnings limitations, earned income credit, child care credit, and wages paid in kind.

IRS Audit Issues

Some IRS examinations have reviewed the proper reporting of farm program payments made to both spouses. They are seeking to match the participation identified at the FSA office with the reporting of income on the individual income tax return. When separate Forms 1099-G are issued to each spouse, IRS examiners allocate income and expense to each spouse.

> **Note.** Practitioners should ensure clients understand the importance of reporting income and expenses consistently with Farm Service Agency (FSA) reporting. The FSA may request copies of filed tax returns.

ISSUE 2: RISING LAND VALUES AND FARMLAND ESTATE VALUATION

The dramatic increase in agricultural land values over the past few years raises an interesting issue concerning how property is valued for estate tax purposes. Normally, the date-of-death value controls for estate tax purposes. However, when land values are significantly higher just a few months after death, can this higher value be used to determine the property's value for federal estate tax purposes? This question is important for two reasons:

1. Even with the increased post-death value, the decedent's estate may remain under the applicable exclusion amount and not be subject to federal estate tax, although the heirs receive a higher income tax basis in the property.
2. In many instances, IRS estate examiners have tried to use post-death sales as date-of-death comparables in a rising market when an increase in tax would result.

38. *Comm'r v. Groetzinger*, 480 U.S. 23 (1987). With respect to USDA land diversion, conservation-type programs, the IRS has taken the position that payments received under such programs are subject to SE tax by reason of the taxpayer merely participating in the program. See Ltr. Rul. 200325002 (May 29, 2003) and IRS Notice 2006-108, 2006-2 CB 1118 (specific to CRP payments), although these pronouncements do not constitute substantial authority.

39. *Batok v. Comm'r,* TC Memo 1992-727 (Dec. 28, 1992)

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BASIC VALUATION CONCEPTS

General Rule

In general, for federal estate tax purposes, the value of property[40] included in a decedent's gross estate is the value of the property as of the decedent's date of death.[41] "Fair market value" is defined as the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of all relevant facts concerning the property.

> **Note.** The price paid for an item in the decedent's gross estate at a public auction or in response to a classified newspaper advertisement is considered the equivalent of retail price. This is acceptable as a fair market valuation. The sales price is only acceptable if the sale is within a reasonable time after the applicable valuation date and there is no substantial change in market conditions between the valuation date and the date of the sale.

Exceptions to the General Rule

Alternate Valuation.[42] An executor can make an election to value the estate property as of six months after the date of the decedent's death if the value of the property in the gross estate **and** the estate's federal estate tax liability are both reduced by making the election and the gross estate exceeds $2 million (for 2008).[43] Under an alternate valuation election, any estate property that is disposed of within six months after the decedent's death is valued at the time of disposition.[44] For property that is not disposed of within six months, the property is valued at its value six months after the decedent's death.[45]

> **Note.** The purpose of the provision is to lessen the federal estate tax burden if the value of the assets contained in the estate decline in the 6-month period immediately following the decedent's death.

The provision is not useful when post-death values increase because it can only be used for estates whose tax burden will be **reduced** by making the election. In this situation, an estate's heirs cannot take advantage of a rising market, value the property at a higher value six months after death, and get a higher income tax basis in the decedent's property. That might be particularly tempting when the increased post-death estate value would remain beneath the applicable federal estate tax exclusion amount ($2 million for deaths in 2008), and the higher valuation would not result in any federal estate tax being due.

> **Observation.** Without a change in current law, the federal estate tax exemption increases to $3.5 million for deaths in 2009. That could provide an even greater incentive to increase the estate value of assets to receive a higher basis in situations where no federal estate tax would result.

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40. Ibid; the term "property" includes both real and personal property as well as tangible and intangible property.
41. Treas. Reg. §20.2031-1(b)
42. IRC §2032
43. Ibid; an alternate valuation election cannot be made unless the election decreases both the value of the gross estate and federal transfer taxes associated with the estate.
44. IRC §2032(a)(1)
45. IRC §2032(a)(2)

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Special-Use Valuation.[46] Another major exception to the date-of-death valuation rule allows real estate that is either used for farming purposes or in another trade or business to be valued at its business-use value (i.e., farm real estate is valued at its income-producing value rather than FMV). For deaths in 2008, the maximum reduction in value that can be achieved by the executor making a special-use valuation election is $960,000. With the substantial increase in farmland values in recent years, special-use valuation has become increasingly important as an estate planning tool to minimize federal estate tax. However, the provision is very complex and its use requires careful planning in advance of death. In addition, the decedent's heirs that receive the property must continue to use it for its business purpose (farm or nonfarm) for 10 years after the date of the decedent's death. If all of the post-death requirements are not satisfied by the decedent's family for the entire 10-year period, the estate tax saved by making the election must be paid back.

IMPACT OF POST-DEATH EVENTS ON VALUATION

While the Code and Regulations consider the date of death the valuation date, they do not rule out the possibility that post-death events can have a bearing on the date-of-death value for assets in a decedent's estate. The real question is **what** post-death events are relevant for determining the actual date-of-death value of property for estate tax purposes. Court cases reveal that consideration may be given to subsequent events that are reasonably foreseeable at the date of death. Those events have a bearing on date-of-death value.

Relevant Court Cases

Numerous court cases illustrate that changes in valuation after death are not immaterial, except for the alternate-valuation election. The following cases are illustrative.

Gettysburg National Bank v. U.S.[47] Under the facts of the case, property was sold to a third party in an arm's-length transaction 16 months after the decedent's death (13 months after its appraisal for estate tax purposes) for less than 75% of the value at which it was included in the gross estate. The court allowed the estate to reduce its value, stating that the subsequent sale may be relevant evidence that the appraised FMV was incorrect.

Estate of Andrews v. U.S.[48] Reasonably foreseeable post-death facts relating to a publication contract under negotiation when the decedent died were germane to the determination of what a willing buyer would pay for the right to use the decedent's name.

Estate of Necastro v. Comm'r.[49] Environmental contamination was discovered five years after the decedent's death and the court allowed the estate to file a claim for refund, reducing the reported value which was based on facts known at the date of death. The revaluation resulted in a reduction of over 33% from the value of the property determined before the contamination was discovered. However, the court's opinion did not address the substantive issue of whether facts discovered after death may influence valuation if willing buyers and sellers had not known the relevant facts as of the valuation date.

Estate of Keller v. Comm'r.[50] The court stated that a "sale of property to an unrelated party shortly after date of death tends to establish such value at date of death." The sold property involved a farm and growing crops. The sale and crop harvesting occurred post-death.

46. IRC §2032A

47. *Gettysburg National Bank v. U.S.,* No. 1: CV-90-1607, 1992 U.S. Dist. LEXIS 12152 (D. M.D. Pa., July 17, 1992)

48. *Estate of Andrews v. U.S.,* 850 F. Supp. 1279 (E.D. Va. 1994)

49. *Estate of Necastro v. Comm'r,* TC Memo 1994-352 (July 26, 1994)

50. *Estate of Keller v. Comm'r,* TC Memo 1980-450 (Oct. 7, 1980)

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Estate of Stanton v Comm'r.[51] The court stated that the sale of the property shortly after death is the best evidence of FMV. Under the facts of the case, the selling price of comparable property sold six months after the decedent's death was also considered with a downward adjustment to reflect the greater development potential of the comparable property and the 10 months of appreciation that occurred after the decedent's death in the actual estate property owned and sold.

Estate of Trompeter v. Comm'r.[52] The Tax Court decision was reversed for failing to sufficiently articulate the basis for its decision regarding omitted assets and the rationale for the valuation discount selected. However, the court nevertheless considered the value of assets using post-death developments, including redemption for $1,000 per share of stock valued at $10 per share **16 months earlier,** and a coin collection returned at roughly half the value subsequently assigned to it by the taxpayer's estate in an effort to enjoin auction of that asset.

Morris v. Comm'r.[53] The court considered speculative post-death commercial development events for purposes of valuing farmland in the decedent's estate as of the date of the decedent's death. The decedent's farmland was approximately 15 miles north of downtown Kansas City and approximately five miles west of the Kansas City airport. At the time of death, plans were in place for a sewer line to service the larger of the two tracts the decedent owned. Also, residential development was planned within two miles of the same tract. In addition, significant roadways and the site for the planned construction of a major interstate were located close to the property. While none of these events had occurred as of the date of death, the court found them probative for determining the value of the farmland as of the date the decedent died. The decedent's son, the owner of the farmland as surviving joint tenant, tried to introduce evidence of the failed closing of some post-death sales to support his claim that the post-death events were speculative. But, the court disagreed, establishing the value of the farmland at $990,000 rather than the estate's valuation of $332,151.

Observation. The court's opinion makes it look like the evidence to confirm an appraiser's date-of-death prediction of future events is more likely to be received than evidence produced to prove wrong an appraiser's prediction concerning future events. In any event, the case stands for the proposition that post-death events are relevant for establishing time-of-death value — even if they are somewhat speculative.

Okerlund v. U.S.[54] The court dealt with the issue of stock valuation in a closely-held company for stock that was gifted shortly before the company founder died and the company (a milk-processing operation) suffered a salmonella outbreak.

The taxpayers argued that these events should result in a lower gift tax value of the stock, with the issue being the relevance of post-death events on the value of the gifts. The court stated that "[i]t would be absurd to rule an arms-length stock sale made moments after a gift of that same stock inadmissible as post-valuation date data... The key to use of any data in a valuation remains that all evidence must be proffered in support of finding the value of the stock on the donative date."

The court ultimately affirmed the trial court's denial of a lower gift tax valuation based on the reality that the risk factors (the founder's death and matters that could materially affect the business) had already been accounted for in the valuation of the stock.

Summary. It is crystal clear that post-death events and other facts that are reasonably predictable as of the date of death or otherwise relevant to the date-of-death value can serve as helpful evidence of value and allow either an increase (to obtain a higher income tax basis) or decrease (to reduce federal estate tax) in value as a matter or record. For farmland (and other real estate) the market is not static as of the date of death. Thus, appraisers can reasonably look to the period of sales extending from pre-death dates to post-death dates in arriving at the date-of-death value.

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51. *Estate of Stanton v Comm'r,* TC Memo 1989-341 (July 18, 1989)
52. *Estate of Trompeter v. Comm'r*, 279 F.3d 767 (9th Cir. 2002)
53. *Morris v. Comm'r*, 761 F.2d 1195 (6th Cir. 1985)
54. *Okerlund v. U.S.,* 365 F.3d 1044 (Fed. Cir. 2004)

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VALUATION PENALTIES

While valuation figures can incorporate post-death factors, appraisers must not be overly aggressive and must be aware of enhanced penalties.[55] Those provisions address appraisal reform and impose stiffer accuracy-related penalties for appraisers who aid or assist in the substantial valuation misstatement of tax.[56]

PRE-DEATH PLANNING

2008 is the first of four consecutive years in which the applicable federal exclusion from estate tax will change. The exemption is $2 million for deaths in 2008, $3.5 million in 2009, $0 in 2010 (because the federal estate tax is repealed for deaths in 2010), and $1 million in 2011. The fluctuation in the exemption amount complicates estate tax planning. The issue is further complicated by rapidly rising farmland values to record high levels and whether this will continue, or if a land-value decline is in the future. Those factors may place a premium on appropriate property ownership patterns between spouses, creation of entities, the use of disclaimers, and pre-death gifting or sale of assets. Although the amount of the federal exemption in the year of planning may indicate that no division of property between spouses or creation of a credit trust in the first estate is needed, the potential for future inflation in farmland values may suggest that such inflation should be hedged against in the planning arrangements.

COMPUTING THE §2032A ADJUSTMENT

When computing the §2032A adjustment, the value of a farm is determined by a computation of net income instead of using an FMV appraisal. The computation includes the following steps:

- Determine the average annual gross cash rental income for comparable land, and subtract the average annual real estate taxes for the comparable land; and
- Divide this net income by the average annual effective interest rate for Federal Land Bank loans as published by the IRS.

Each average annual computation is done using the five most recent calendar years ending before the decedent's death. The result is the special-use value; this amount can be used for valuing the qualifying farmland of the decedent instead of the FMV.

Example 3. John owned 240 acres of qualifying farmland at his death in 2008. The property meets all criteria to qualify for the §2032A special-use valuation. An appraiser established the FMV of the property as $6,000 per acre for a total of $1.44 million. John's executor identified comparable land and learned the average annual gross cash rent was $180 per acre and the average annual real estate taxes were $16 per acre. The result is $164 net annual income per acre ($180 – $16). The Federal Land Bank interest rate for 2008 is 6.38% (as specified by IRS for deaths in 2008 in the Agribank District). Dividing the net income of $164 by the interest rate of 6.38% gives a value of $2,571 ($164 ÷ . 0638) per acre for a total of $617,040 ($2,571 × 240).

FMV by appraisal	$1,440,000
Special-use value	(617,040)
Reduced value of farmland	$ 822,960
	× 45%
Maximum possible estate tax savings	$ 370,332

Note. Special-use valuation requirements apply on a tract-by-tract basis. Failure to satisfy all post-death requirements on a single tract of farmland will trigger recapture tax on only the disqualified tract.

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55. Pension Protection Act of 2006 (PPA); H.R. 4, P.L. 109-280

56. See *2006 University of Illinois Federal Tax Workbook,* chapter 14, page 548.

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2008 Workbook

IRC §2032A CHECKLIST

The fiduciary obligations of the executor require an evaluation of the special-valuation election because of its great potential impact on the estate tax liability. This evaluation cannot be avoided merely on the grounds of difficulty and complexity. As such, practitioners may find it helpful to develop a systematic process for determining special-use eligibility for any particular client. The following questions can be used to create a worksheet for a client:

1. Is the decedent a citizen or resident of the United States?
2. Has the special-use election been made on the first filed Form 706?
3. Which items on the return are to be valued under §2032A?
4. What is the adjusted value of all real property subject to qualified use which passes to a qualified heir (FMV less debts, liens, or mortgages under §2053(a)(4))?
5. What is the adjusted value of all qualified personal property passing to a qualified heir (FMV less debts, liens or mortgages under §2053(a)(4))?
6. What is the adjusted value of the gross estate (FMV less debts, liens, or mortgages under §2053(a)(4))?
7. Does the estate meet the 50% requirement (ratio of Items 4 and 5 to Item 6)?
8. Does the estate meet the 25% requirement (ratio of Item 4 to Item 6)?
9. What is the special-use value under the rent capitalization approach of §2032A(e)(7)?
10. Is there a written appraisal to indicate FMV?
11. Was the real estate used for a qualified purpose by the decedent or a member of the decedent's family for five out of the eight years immediately preceding the decedent's death?
12. Who are the persons receiving an interest in the special-use elected property from the decedent?
13. Who is the designated agent of the estate?
14. Will all the heirs with an interest in the property execute the agreement required by Form 706, Schedule A-1 to be personally liable in the event of an early disposition of the property or early cessation of qualified use?
15. Who will maintain the qualified use of the elected property?
16. If the estate qualifies for special-use valuation, what procedures will be followed for future follow-up action due to the potential for early disposition of the property or early cessation of qualified use?

SUMMARY

The substantial increase in farmland values in recent years presents estate-planning challenges and raises issues concerning valuation of land in a farmer's estate. While date-of-death value normally is used to determine property value for estate tax purposes and to establish the property's income tax basis in the hands of the heirs, post-death factors are relevant in determining death-time value. Post-death factors could be used to obtain a higher income tax basis in the hands of the heirs when this results in an increase in estate value that remains beneath the applicable exclusion. On the other hand, the IRS could use the same principles to increase values when an increase in estate tax would result.

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ISSUE 3: CHAPTER 12 BANKRUPTCY TAXATION

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA)[57] is the most far-reaching revision of bankruptcy law since 1978. With respect to agriculture, the changes are principally in two areas:

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

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

Note. The *2006 University of Illinois Tax School Workbook* covered the BAPCPA changes to Chapter 12 eligibility rules on pages 436–457. In general, while the BAPCPA tends to favor creditors, the Chapter 12 provisions ease eligibility rules for family farmers and also cover "family fishermen" (although under pre-BAPCPA rules).

INCOME TAX CONSEQUENCES OF DEBT RESOLUTION

The tax issues associated with troubled farm debtors can usually be organized into five steps:

1. A determination of whether the particular indebtedness involved is recourse or nonrecourse debt
2. A determination of the FMV of the property to be transferred to creditors and the debtor's income tax basis in the property
3. For recourse debt, computation of gain or loss on sale or other turnover of the assets to creditors, and a computation of discharge of indebtedness income
4. For nonrecourse debt, a computation of discharge of indebtedness income
5. For any resulting discharge of indebtedness income, a determination of whether an exception to the general rule of income recognition applies

INCOME TAX ISSUES FOR DEBTORS IN CHAPTER 12 BANKRUPTCY

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

Confirmation of the Chapter 12 Plan — The Issue of Feasibility

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

1. The plan conforms to all bankruptcy provisions.
2. All required fees have been paid.
3. The plan proposal was made in good faith without violating any law.
4. Unsecured creditors do not receive less than the amount the unsecured creditors would receive in a Chapter 7 liquidation.
5. Each secured creditor either accepts the plan and retains the lien securing the claim (with the value of the property to be distributed for the claim's allowed amount, as of the plan's effective date, to equal not less than the claim's allowed amount), or the creditor receives the property securing the claim.
6. The debtor will be able to make all payments under the plan and to comply with the plan.

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57. S. 256, Pub. L. No. 109-31, Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, enacted April 20, 2005

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

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

Pre-BAPCPA Tax Treatment

Prior to the BAPCPA, the deed-back of collateral to a secured creditor, as well as asset sales conducted in an attempt to downsize a farming operation, carried tax consequences to the debtor that could negatively affect the feasibility of the debtor's reorganization plan. Such taxes were a priority claim in the bankruptcy estate and had to be paid in full on a deferred basis.[58] Thus, if, as part of a proposed reorganization plan, the debtor proposed to downsize the farming operation by selling assets or turning them over to secured creditors, the tax liability triggered by transactions often significantly affected the feasibility of the debtor's plan. This is true when the debtor did not have the means to pay the taxes (which was likely). The result was the debtor's reorganization plan likely would not be confirmed.[59]

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

BAPCPA Chapter 12 Tax Provision

Under the BAPCPA, a Chapter 12 debtor can treat claims arising out of "claims owed to a governmental unit" as a result of "sale, transfer, exchange, or other disposition of any farm asset used in the debtor's farming operation" as an unsecured claim. This is provided the debtor receives a discharge and the claim is **not entitled to priority** under Section 507(a) of the Bankruptcy Code.[60] The provision became effective upon enactment. The amended statutory language specifies that a Chapter 12 plan must:

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

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

(B) the holder of a particular claim agrees to a different treatment of that claim;...[61]

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

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

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

60. BAPCPA, §1003, amending 11 USC §1222(a)(2) by the addition of subsection (A)

61. Ibid

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The amendment was designed to address a major taxable gain problem faced by many family farmers filing Chapter 12 bankruptcy. The amendment minimized the IRS's veto power over a debtor's plan by reducing a claim owed to the government related to sale of farm assets to that of an unsecured claim.[62]

Unfortunately, the new statutory provision does not detail the procedure a debtor follows to take advantage of the nonpriority claim treatment. There is a possible approach for debtors who liquidate assets used in the farming operation within the tax year of filing or liquidating assets used in the farming operation after the filing as a part of the Chapter 12 plan and depreciation recapture and capital gains taxes are incurred. They should provide in the reorganization plan that there shall be no payments to unsecured creditors until the amount of the tax owed to governmental bodies for the sale of assets used in the farming operation is ascertained. Then, the 11 USC §1222(a)(2) claims would be added to the pre-petition unsecured claims to determine the percentage distribution to be made to the pre-petition unsecured claims as well as the claims of the governmental units that are being treated as unsecured creditors not entitled to priority. Thus, all claims that 11 USC §1222(a)(2) requires to be treated the same[63] are treated equitably.

Similarly, if the debtor determines post-confirmation that in order to ensure financial viability, assets used in the farming operation must be liquidated, the Chapter 12 plan could be modified. The modification would allow the sale of the assets as long as the modified plan made provision to make payment to the taxing bodies in an amount that would pay the appropriate dividend. Then, upon entry of the Chapter 12 discharge, the governmental taxing body's post-petition claim for taxes on the sale of assets used in the debtor's farming operation would also be discharged.

CASELAW UPDATE

To date, there are four bankruptcy court opinions construing 11 USC §1222(a)(2)(A). The following is a brief summary of how each court ruled on the issues involved.

In re Knudsen[64]

Issue 1. What is a "farm asset" that qualifies for nonpriority treatment?

> **The IRS's Position:** 11 USC §1222(a)(2)(A) must be defined in accordance with the Code. Thus, the phrase "farm assets" is restricted in meaning to include only "capital assets" that are used in farming. Accordingly, the debtors' sale of breeding stock, farrowing equipment, and a livestock trailer are entitled to nonpriority treatment. However, the sale of hog inventory in order to facilitate a change in the debtors' farming operation remains a priority claim.
>
> **Debtors' Position:** The IRS's position is contrary to Congressional intent and renders the statute a nullity. The statute is clear that it does not specifically limit governmental claims to only those taxes resulting from the sale of capital assets.
>
> **Holding of the Court:** 11 USC §1222(a)(2)(A) does **not** apply to income from the sale of all farm assets, just those **used** in the debtors' farming operation that are contained within the meaning of IRC §1231(b)(3).

62. One of the chief sponsors of the Chapter 12 amendments to BAPCPA was Iowa Senator Charles Grassley. During debate on the Chapter 12 governmental claim priority status provision, Senator Grassley stated, "Under the Bankruptcy Code, the IRS must be paid in full for any tax liabilities generated during a bankruptcy reorganization. If the farmer cannot pay the IRS in full, then he can't keep his farm. This isn't sound policy. Why should the IRS be allowed to veto a farmer's reorganization plan? 'Safety 2000' takes this power away from the IRS by reducing the priority of taxes during proceedings. This will free up capital for investment in the farm, and help farmers stay in the business of farming." 145 Cong. Rec. S.750-02.

63. These claims include the 11 USC §1222(a)(2) tax claims as well as the unsecured claims without priority.

64. *In re Knudsen,* 356 B.R. 480 (Bankr. N.D. Iowa 2006) [decided Nov. 20, 2006]

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Issue 2. Does 11 USC §1222(a)(2)(A) apply to pre-petition taxes?

The IRS's Position: The amended statute applies to pre-petition taxes, but the pre-petition sale of farm assets used in the debtors' farming operation remains collectible after the entry of the Order of Discharge in the Chapter 12 proceeding.

Debtors' Position: The statute applies to pre-petition taxes and converts the taxes arising from the sale of farm assets to unsecured claims.

Holding of the Court: 11 USC §1222(a)(2)(A) applies to taxes triggered by pre-petition asset sales.

Issue 3. Does the amended statute apply to post-petition taxes?

The IRS's Position: The statute has no application to taxes arising from asset sales occurring post-petition.

Debtors' Position: The statute does apply to post-petition asset sales.

Holding of the Court: The amended statute applies to taxes arising from post-petition asset sales. The debtors can pay as an administrative expense the taxes incurred during the pendency of the case as a nonpriority claim. These taxes can be discharged with the pre-petition unsecured debt after completion of the reorganization plan.

Issue 4. How are the tax claims and priority status amounts determined?

The IRS's Position: Tax claims and priority status are determined by use of a proportional approach — a proration of the income tax between the ordinary income and the gain triggered by asset sales. This approach guarantees that some of the resulting income tax obligation is taxed at each rate attributable to the debtor.

Debtors' Position: Tax claims and priority status are determined by use of a marginal approach — use of a pro forma tax return that excludes income from the sale of the debtors' farm assets used in the farming operation and then subtracting the resulting tax from the income tax due as shown on the debtors' actual return. The difference is the priority claim that must be paid in full (i.e., the tax subject to treatment under 11 USC §1222(a)(2)(A).

Holding of the Court: The court did not address the issue. However, the district court must address the issue because the IRS agreed, in the bankruptcy court, that the amended statute applied to the debtors' sale of breeding hogs and farrowing equipment.

In re Hall[65]

Issue 1. What is a "farm asset" that qualifies for nonpriority treatment?

Holding of the Court: The issue was not raised by the parties and not addressed by the court.

Issue 2. Does 11 USC §1222(a)(2)(A) apply to pre-petition taxes?

Holding of the Court: The issue did not arise under the facts of the case, but as a result of the court's analysis of the post-petition tax issue, the court reasoned that the amended statute would apply to taxes arising from pre-petition asset sales.

[65] *In re Hall,* 376 B.R. 741 (Bankr. D. Ariz. 2007)

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Issue 3. Does the amended statute apply to post-petition taxes?

The IRS's Position: No. A Chapter 12 bankruptcy estate is not a separate taxable entity. Consequently, the tax liability arising from post-petition asset sales is not incurred by the "estate" and remains the debtor's responsibility.

Debtors' Position: Yes. This is based on the court's holding in *Knudsen*.

Holding of the Court: The amended statute does not apply to taxes arising from post-petition asset sales. "Priority administrative expenses" are those allowed under 11 USC §503(b), which includes any tax incurred by the bankruptcy estate. Thus, because there is no separate taxable entity in a Chapter 12 bankruptcy, the debtors' post-petition sale of farmland could not generate a tax "incurred" by a bankruptcy estate. The court based its reasoning on *In re Brown* (a Massachusetts Bankruptcy Court case involving a Chapter 13 bankruptcy).

Issue 4. How are the tax claims and priority status amounts determined?

Holding of the Court: The court did not address this issue.

In re Schilke[66]

Issue 1. What is a "farm asset" that qualifies for nonpriority treatment?

Both the debtor and the IRS agreed that the assets at issue (farm real estate and breeding livestock) were farm assets used in the debtor's farming operation.

Issue 2. Does 11 USC §1222(a)(2)(A) apply to pre-petition taxes?

Not an issue in the case.

Issue 3. Does the amended statute apply to post-petition taxes?

The IRS's Position: No. A Chapter 12 bankruptcy estate is not a separate taxable entity. Consequently, the tax liability arising from post-petition asset sales is not incurred by the "estate" and remains the debtor's responsibility.

Debtors' Position: Yes. This is based on the court's holding in *Knudsen*.

Holding of the Court: The amended statute applies to taxes arising from post-petition asset sales based on the policy of Chapter 12, and because 11 USC §503(b)(1) regarding any tax "incurred by an estate" is not limited in application to just those situations where the estate itself is a separate taxable entity from the debtor.

Issue 4. How are the tax claims and priority status amounts to be determined?

Holding of the Court: The court did not address this issue.

In re Dawes[67]

Issue 1. What is a "farm asset" that qualifies for nonpriority treatment?

This issue was not before the court.

Issue 2. Does 11 USC §1222(a)(2)(A) apply to pre-petition taxes?

This issue was not before the court.

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[66]. *In re Schilke,* 379 B.R. 899 (Bankr. D. Neb. 2007)

[67]. *In re Dawes,* 382 B.R. 509 (Bankr. D. Kan. 2008)

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Issue 3. Does the amended statute apply to post-petition taxes?

The IRS's Position: No. A Chapter 12 bankruptcy estate is not a separate taxable entity. Thus, the tax liability arising from post-petition asset sales is not incurred by the "estate" and remains the debtor's responsibility.

Debtors' Position: Yes. This is based on the holding of the courts in *Knudsen* and *Schilke*.

Holding of the Court: The phrase "incurred by the estate" contained in 11 USC §503(b)(1)(B)(1) is ambiguous — it could refer to the time tax liability accrues or the entity liable for the tax. Consequently, legislative history is necessary to determine Congressional intent. History indicates that Congress intended the phrase to refer to the time the tax liability was incurred, not the entity liable for the tax. In addition, other courts have held that taxes arising from post-petition sales could be treated as administrative expenses. Along that line, the IRS has taken the position in other Chapter 12 cases that a claim arising from the debtors' failure to pay post-petition employment taxes as they became due was an administrative expense subject to 11 USC§1222(a)(2). The debtors' position also promoted the Congressional intent of allowing farmers to put together a feasible reorganization plan without the complication of having to pay tax claims in full as a result of asset sales designed to further the existence of the farming business.

Appellate Decision in *Knudsen*[68]

On appeal, the Federal District Court for the Northern District of Iowa reversed in part and affirmed in part the bankruptcy court opinion rendered in late 2006. The following is a summary of how the District Court decided the issues:

- A "farm asset" that is eligible for nonpriority status is not limited to assets used in the taxpayer's trade or business, which are eligible for capital gain treatment under IRC §1231 and IRC §1221. As such, the debtors' taxes triggered by the sale of slaughter hogs and grain were eligible for nonpriority treatment. This reverses the bankruptcy court.
- In allocating tax claims between those attributable to the sale of farm assets eligible for nonpriority treatment (allowing possible discharge) and those taxes that remain in priority status, the appropriate method is the "marginal" approach, rather than a prorated approach. This reverses the bankruptcy court.
- The BAPCPA amendment applies to taxes generated by post-petition transfers even though a separate estate from the debtor is not created. Such claims can be treated as administrative expenses (i.e., handled as an unsecured claim). This affirms the bankruptcy court.
- The BAPCPA amendment applies to taxes generated by pre-petition transfers. This affirms the bankruptcy court.

The end result was that the debtors' reorganization plan was confirmed.

> **Note.** On August 6, 2008, the IRS filed a Notice of Appeal with the United States Court of Appeals for the 8th Circuit in *Knudsen*.

Appellate Decision in *Hall*

On appeal, the Federal District Court for the District of Arizona reversed the bankruptcy court and held that 11 USC §1222(a)(2)(A) applies to taxes arising post-petition.

68. *In re Knudsen*, 389 B.R. 643 (N.D. Iowa 2008)

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Summary of Litigation

Given the outcome of the appellate opinions in *Knudsen* and *Hall,* the following can be stated concerning the *Knudsen, Hall, Schilke,* and *Dawes* cases:

- 11USC §1222(a)(2)(A) applies to taxes generated pre-petition (*Knudsen* and *Hall,* not an issue in *Schilke* and *Dawes*).
- 11USC §1222(a)(2)(A) applies to taxes generated post-petition (*Knudsen, Hall, Schilke,* and *Dawes*).
- 11U.S.C §1222(a)(2)(A) is not limited to assets used in the taxpayer's trade or business that are eligible for capital gain treatment (*Knudsen;* not an issue in *Hall, Schilke,* or *Dawes*).
- Tax claims and priority status amounts are to be determined under the "marginal" approach (*Knudsen; Hall, Schilke,* and *Dawes* did not address the issue).

ISSUE 4: WINE INDUSTRY TAX ISSUES

DEPRECIATION OF VINE TRELLISES AND IRRIGATION EQUIPMENT

In *Trentadue,*[69] the Tax Court's opinion shed light on the appropriate depreciation classification for vine trellises and irrigation equipment used in grape-growing operations.

Facts. The Trentadues operate a large Sonoma County, California, grape-growing operation. They treated all of the property (trellises, drip irrigation systems, and a well) as agricultural equipment depreciable over seven years. The IRS position was that vineyard trellises and above-ground irrigation systems were depreciable land improvements rather than depreciable agricultural equipment. Land improvements are depreciable over 15 years as property with a 20-year class life, while agricultural equipment is depreciable over 7 years with a 10-year class life. The impact of the IRS position on the Trentadues meant that they owed an additional $30,000 on their 2002 tax return.

A 1975 Tax Court case[70] sets forth the tests to utilize in determining whether an item is depreciable tangible personal property:

- Whether the property is capable of being moved
- Whether the property is designed or constructed to remain permanently in place
- Whether there are circumstances that show that the property may or will have to be moved
- How difficult and time-consuming it is to move the property
- How much damage the property will sustain if moved
- How the property is affixed to the land

Taxpayer's Argument. The taxpayer argued that the trellises and above-ground irrigation systems are not inherently permanent and are used as an integral part of the taxpayer's production activity. As such, the factors for determining whether property is depreciable tangible personal property favored the taxpayer.

The IRS's Argument. The IRS argued that the trellises and irrigation systems, as a whole, are not moveable. Therefore, they are land improvements with the same 20-plus-year lifespan as the vines. The IRS pointed to the industry-standard long-term vineyard leases that protect the large investment in such systems and describe them as land improvements. Key to the IRS's argument was that to move the system, the taxpayer had to take the entire system apart and, in the process of taking it apart, pieces of the trellises and irrigation system are destroyed.

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69. *Trentadue,* 128 TC 91 (2007)

70. *Whiteco Industries, Inc., v. Comm'r,* 65 TC 664 (1975)

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The Court's Holding — A Split Decision. The Tax Court agreed with the IRS about the irrigation system and the well. The evidence established that the well, which was permanently affixed to and not readily removable from the earth, was a permanent land improvement that could be expected to work for a long time — approximately 30 years. While some of the irrigation-system components were above-ground and could be removed, repaired, and maintained, the land-improvement categorization was overall supported by the fact that the systems in great part were buried underground. As such, the court viewed them as permanent structures that were not readily movable. The entire irrigation system, including the above-ground drip lines, were held to be land improvements depreciable over 15 years.

The court held that the trellises were depreciable over seven years as agricultural equipment. The court reasoned that trellises are synonymous with fencing (fencing is agricultural equipment) in that they use posts that are not affixed in concrete (even posts affixed in concrete have been held to not be land improvements). The trellises could be dismantled and moved. The court noted that the taxpayer had actually done so in the past. The court also reasoned that the trellises were like machines inasmuch as the posts, stakes, and wires could be adjusted to train grapevines to produce high-quality grapes.

The court's holding that trellises can be depreciated as farm equipment is positive for the wine industry. The trellises were the most expensive part of the case for the taxpayers. The case might be appealed. In that event, the main focus of the case may be on the proper classification of the above-ground irrigation drip lines. Also, the appellate court may address the potential application of a 1974 U.S. Court of Claims opinion in which the court held that something as permanent as a whiskey maturation facility (warehouse), when integral to the production of the product, is tangible personal property. The Tax Court didn't address the potential application of that case (it was raised in the taxpayer's brief). If it was deemed applicable, that could mean that all the items at issue are depreciable over seven years as agricultural equipment.

Note. In *Trentadue,* the Tax Court stated that there was no question that the assets involved were depreciable. The only question was over what period. Thus, there appears to be no question that water wells with a determinable life that are used in the taxpayer's business are depreciable.

UNIFORM CAPITALIZATION RULES

The uniform capitalization rules apply to taxpayers that have a long-term crop with more than a 2-year preproductive period and require the taxpayer to add the associated costs to their tax basis in the crop.

Note. Production costs can include everything from direct labor and material costs to indirect rents, taxes, and other costs.

For plants, the preproductive period begins when the seed is planted or the plant is first acquired by the taxpayer. The preproductive period ends when the plant is ready to be produced in marketable quantities or when the plant can reasonably be expected to be sold or otherwise disposed of. The preproductive period, however, is determined not in light of the taxpayer's personal experience but in light of the weighted average preproductive period determined on a nationwide basis.

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In Notice 2000-45,[71] the IRS specified that the following plants that are grown in commercial quantities in the United States have a nationwide weighted average preproductive period in excess of two years:

Almonds	Coffee beans	Kumquats	Oranges	Pomegranates
Apples	Currants	Lemons	Papayas	Prunes
Apricots	Dates	Limes	Peaches	Raspberries
Avocados	Figs	Macadamia nuts	Pears	Tangelos
Blackberries	Grapefruit	Mangoes	Pecans	Tangerines
Blueberries	Grapes	Nectarines	Persimmons	Tangors
Cherries	Guavas	Olives	Pistachio nuts	Walnuts
Chestnuts	Kiwifruit	Plums		

The uniform capitalization rule is particularly problematic for grape growers. If the rule requires that all the expenses associated with growing grapes be capitalized until the time the wine is sold, this would be very difficult for wineries because the wine-making process can take many years. The IRS treats grape growing and winery functions as separate businesses, even though:

1. The grapes are never subject to sale or other disposition as those terms are used in tax law, and
2. The taxpayer does not operate the business as two separate and distinct businesses.[72]

In conjunction with that reasoning, the IRS's view is that the actual preproductive period of a grape crop grown for self use ends no later than the crushing of the grapes.

As for costs incurred between the grapes' harvest and blossoming of a later crop, the IRS requires that a taxpayer must capitalize the direct costs and an allocable portion of the indirect costs of producing the vine. Direct and indirect costs include administration costs, depreciation, and repairs on farm buildings and farm overhead.[73] A special exception for "field costs" such as irrigating, fertilizing, spraying, and pruning applies to the period between harvesting and the sale of the crop. These costs are not required to be capitalized because they do not benefit, and are unrelated to, the harvested crop. They merely maintain and improve the health of the vines, but they do not provide any benefits to the crop that has already been severed from the vines. However, this field crop exception ends when the preproductive period of the crop ends, which is the onset of the crush. Thus, preproductive period costs incurred between the end of the preproductive period and the blossoming of the later crop are generally deductible as the costs of maintaining the vine.

Costs incurred between the crop's harvest and the end of the preproductive period must be capitalized unless they are "field costs" that provide no benefit to the already severed crop.

ISSUE 5: FARMLAND LEASES — LEGAL, ECONOMIC, AND TAX CONSIDERATIONS

TAX CONSIDERATIONS

Farmland leases may be either fixed-cash rent, flexible-cash rent, or some variation of a crop-share lease. The type of lease has income tax and estate tax implications.

Reporting Lease Income

Farmland lease income may be reported on one of three possible IRS forms:

- Schedule F, *Farm Income and Expenses*
- Form 4835, *Farm Rental Income and Expenses*
- Schedule E, *Supplemental Income and Loss*

71. Notice 2000-45, IRB 2000-36, 234 (Sept. 5, 2000)
72. ILM 200713023 (Nov. 20, 2006)
73. Ibid

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The form which is appropriate for a particular situation depends upon whether the landlord is "materially participating" in the farming operation. Generally, a landlord receiving cash rent files Schedule E. A share-rent landlord, who meets the tests for material participation, files Schedule F. If a share-rent landlord is **not** materially participating, the landlord files Form 4835.

> **Note.** If Schedule F is filed, the income under the lease is subject to SE tax. SE tax is due on the net income from the production of agricultural or horticultural commodities on the land. Rent received from real estate improvements, such as buildings or grain bins, are not subject to SE tax. This portion of rent should be reported on Schedule E.

Tests for Material Participation

The classification of crop-share lease arrangements involves the determination of two completely different tests of material participation. One is a test that determines whether the landlord reports the activity on Schedule F, subject to SE tax, or on Form 4835. The second test is used to determine whether the income or loss of an activity reported on Schedule F is active or passive.

Material Participation Test for SE Tax Purposes. For purposes of IRC §1402, a landlord materially participates if **all three** of the following conditions are met.

1. There is an arrangement between the owner (landlord) of the property and another person. This agreement provides that the other person produces agricultural or horticultural commodities on that land.
2. Under the "arrangement," the landlord materially participates in the production or the management of the production of the commodities.
3. The landlord actually materially participates.

   A landlord materially participates if he satisfies **any one** of the four following tests:

   Test 1: The landlord does any **three** of the following:

   - Advance, pay, or stand good for at least half the direct cost of producing the crop;
   - Furnish at least half the tools, equipment, and livestock used in producing the crop;
   - Consult with the tenant; or
   - Inspect the production activities periodically.

   Test 2: The landlord regularly and frequently makes, or takes an important part in making, management decisions substantially contributing to or affecting the success of the enterprise.

   Test 3: The landlord works 100 hours or more spread over a period of five weeks or more in activities connected with crop production.

   Test 4: The landlord does things that, **considered in their total effect,** show that the landlord is materially and significantly involved in the production of the farm commodities.

> **Note.** While not required, a written lease makes material participation or lack thereof easier to establish.

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Summary of the Rule. From the landlord's perspective, cash rents from real estate and from personal property leased with real estate are excluded from the definition of net earnings from self employment.[74] Likewise, income from crop-share and/or livestock-share rental arrangements (including farm program payments) for landlords who are not materially participating in the farming operation are not subject to SE tax. Only crop- or livestock-share leases in which the landlord materially participates generate SE income. In that situation, if the landlord receives agricultural program payments, the payments are subject to SE tax. Income received under a cash-rental arrangement is not subject to SE tax. Income from cash-rent and nonmaterially participating share-rents do not count towards the earned income threshold for social security benefit recipients.

Notable Exception. An exception to this rule exists if the landlord leases land to an entity in which the landlord is materially participating.[75]

> **Note.** The IRS has won several cases in which they successfully attributed the lessor's material participation in the entity to the leasing arrangement. This resulted in the passive cash-rent income being transformed into material participation income subject to SE tax.[76] However, in the U.S. Circuit Court of Appeals for the Eighth Circuit (which includes Arkansas, Iowa, Minnesota, Missouri, Nebraska, North Dakota, and South Dakota), if the rental income represents a fair market rate, the rental income is **not** subject to SE tax.[77]

Material Participation Test for Passive Activity Determination. Under this test, a person is materially participating if he is involved in the operations of the activity on a basis that is regular, continuous, and substantial.

> **Note.** This rule is applied by considering services provided both by the taxpayer and by the taxpayer's spouse, whether or not a joint return is filed.

The **seven requirements** for meeting this material participation test are as follows:[78]

1. The individual participates in the activity for more than 500 hours during the tax year.
2. The taxpayer's participation in the activity is substantially all the participation in the activity by all individuals.
3. The taxpayer participates in the activity for more than 100 hours during the tax year and participates for at least as many hours as any other individual.
4. The activity is a significant participation activity, and the taxpayer's participation in all significant participation activities during the year exceeds 500 hours.
5. A taxpayer who materially participated in an activity during five of the past 10 years (without regard to this test) is treated as materially participating in the current year.
6. A taxpayer who has materially participated in a personal-service activity for at least three years is treated as materially participating in that activity for the rest of the taxpayer's life.
7. A taxpayer who participates for more than 100 hours and, based on the facts and circumstances, participates on a regular, continuous, and substantial basis, is treated as materially participating.

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74. IRC §1402(a)(1)

75. *Mizell v. Comm'r*, TC Memo 1995-571 (Nov. 29, 1995)

76. *Bot v. Comm'r,* TC Memo 1999-256 (Aug. 3, 1999); *Hennen v. Comm'r,* TC Memo 1999-306. (Sep. 16, 1999); *McNamara v. Comm'r,* TC Memo 1999-333 (Oct. 4, 1999)

77. *McNamara v. Comm'r*, 236 F.3d 410 (8th Cir. 2000). The IRS has issued a nonacquiescence in the McNamara opinion. AOD CC-2003-003 (Oct. 20, 2003).

78. Temp. Treas. Reg. §1.469-5T(a)

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The following table summarizes many of the key distinctions between the various types of farm leases.

Issue	Cash Lease	Nonmaterial Participation Share Lease	Material Participation Share Lease
Report income and expense on:	Schedule E	Form 4835	Schedule F
Self-employment tax applies	No	No	Yes
Rental income is treated as gross farm income for purposes of the IRC §6654(l) exception to the estimated tax penalty	No	Yes	Yes
The landlord qualifies for IRC §175 treatment of soil and water conservation expenses	No	Yes	Yes
The landlord qualifies for IRC §126 exclusion of cost sharing payments	Yes	Yes	Yes
Passive-loss rules limit deductions	Yes	Yes	Possibly
The $25,000 rental real estate exception applies	Yes	Yes, unless the lease is treated as a joint venture	N/A
The owner qualifies for the §179 deduction	No	Yes, unless the noncorporate lessor rules of §179(d)(5) apply	Yes
Donations of commodities trigger income	N/A	Yes	No
Commodities owned at death are treated as IRD	N/A	Yes	No
Fertilizer and lime costs are deductible by election	No	No	Yes
Farm-related business interest is deductible	Yes [a]	Yes [a]	Yes

[a] May be limited by passive-loss rules

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Estate Tax and Social Security Benefit Planning

While material participation can cause problems with respect to social security benefits, material participation is required by the taxpayer or a member of the taxpayer's family for **five of the last eight years** before the earlier of retirement, disability, or death if a special-use valuation election is going to be made for the agricultural real estate included in the decedent-to-be's estate.[79]

> **Note.** Material participation, for the purposes of IRC §2032A, is determined in accordance with the material participation test for SE tax purposes outlined earlier in this section. In addition, any landowner who satisfies the material participation test is considered to be materially participating for purposes of the passive-activity rules. However, a surviving spouse who inherits farmland that is subject to a special-use valuation election need only actively participate in the farming operation for the required 10-year post-death period.

Planning strategies involving the appropriate type of lease may be necessary to establish qualification of a future estate for special-use valuation. For instance, if a family member can be utilized as the tenant, the strategy may be to have a not-yet-retired landlord **not** materially participate, but rent the elected land to a materially-participating family member or hire a family member as a farm manager. If a family member is not available to serve as the tenant, the strategy may be to have the landlord retire at age 65 or older, materially participate during five of the eight years immediately preceding retirement, and then during retirement rent out the farm under a nonmaterial participation crop-share or livestock-share lease.

> **Observation.** Managing earned income in retirement years can be important and may have an impact on the leasing arrangement. Persons age 65–70 can receive an unlimited amount of income without loss of social security benefits. However, for persons age 62–65, the earnings limit in 2008 is $13,560. For excess amounts, benefits are reduced $1 for every $2 over the limit. Consequently, for retired farm landlords under age 65, they may not be able to receive full social security benefits if they materially participate under a lease.

FARM LEASES AND FARM PROGRAM BENEFITS

The type of lease can affect eligibility for farm program payments. In general, to qualify for farm program payments, an individual must be "actively engaged in farming." Each "person" who is actively engaged in farming is eligible for one payment limit of federal farm program payments. A tenant qualifies as actively engaged in farming through the contribution of capital, equipment, active personal labor, or active personal management. Likewise, a landlord qualifies as actively engaged in farming by the contribution of the owned land if the rent or income for the operation's use of the land is based on the land's production or the operation's results. The income cannot be cash rent based on a guaranteed share of the crop. In addition, the landlord's contribution must be "significant," must be "at risk," and must be commensurate with the landlord's share of the profits and losses from the farming operation.

A landlord who cash leases land is considered a landlord under the payment-limitation rules and may not be considered actively engaged in farming. In this situation, only the tenant is considered eligible. Under the payment limitation rules, there are technical requirements that restrict the cash-rent tenant's eligibility to receive payments to situations in which the tenant makes a "significant contribution" of:

1. Active personal labor and capital, land, or equipment; or
2. Active personal management and equipment.

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79. IRC §2032A

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Leases in which the rental amount fluctuates with price and/or production, so called "flex" leases, can raise a question as to whether or not the lease is really a crop-share lease which thereby entitles the landlord to a proportionate share of the government payments attributable to the leased land. Under Farm Service Agency (FSA) regulations,[80] a lease is a "cash lease" if it provides for only a guaranteed sum certain cash payment or a fixed quantity of the crop — for example, cash, pounds, or bushels per acre. All other types of leases are share leases. In April 2007, the FSA issued a Notice stating that if any portion of the rental payment is based on gross revenue, the lease is a share lease.[81] However, according to the FSA, if a flex or variable lease sets the rental payments to a fixed amount of production based on future market value that is not associated with the farm's specific production, it is a cash lease.[82]

Observation. During the debate over the 2007 Farm Bill, opponents of a lower cap on payment limits argued that lowering the cap would lead to a shift to cash-rent leases, which would shift more of the farm risk to tenants. However, the FSA rules clearly state that lease payments can be based on gross revenue without the lease being deemed a cash lease for payment-limitation purposes. Practitioners should think through the flexibility offered by the FSA position and determine how best to handle lease risk issues for their clients and the necessary language to include in farm leases to accomplish this task.

ISSUE 6: WIND TURBINE TAX ISSUES

RENEWABLE ENERGY PRODUCTION CREDIT

Both the federal government and numerous states provide incentives to encourage wind energy development. The federal renewable energy production tax credit provides an income tax credit per kilowatt-hour for the production of electricity from a qualified wind energy facility placed in service after December 31, 1993, and before January 1, 2009.[83] The credit is presently $.021 per kilowatt-hour and is adjusted annually for inflation. The credit applies to each kilowatt-hour of electricity produced from wind that is sold to unrelated parties during the first 10 years after a wind energy facility is placed in service. Unless it is renewed, the credit expires at the end of 2008.[84] The credit is claimed on Form 8835, *Renewable Electricity, Refined Coal, and Indian Coal Production Credit,* and is transferred to Form 1040, page 2, Other Credits. The credit may also be allocated to taxpayers from pass-through entities or cooperatives.

For electricity produced from wind energy, the term "facility" under §45(d)(1) means each separate wind turbine, together with the tower on which the turbine is mounted and the supporting pad on which the tower is situated.[85] Although IRC §45 does not define "placed in service," the term is defined for purposes of the deduction for depreciation and the investment tax credit. For these purposes, property is considered placed in service in the taxable year that the property is placed in a condition or state of readiness and available for a specifically-assigned function.[86]

80. 7 C.F.R. §1412.504(a)(2)

81. Notice DCP-172 (Apr. 2, 2007)

82. Ibid

83. IRC §45

84. IRC §45(c)(1) defines "qualified energy resources" to include wind. IRC §45(d)(1) defines a "qualified facility" in the case of a facility using wind to produce electricity as any facility owned by the taxpayer that is originally placed in service after December 31, 1993, and before January 1, 2009.

85. Rev. Rul. 94-31, 1994-1 CB 16

86. Treas. Regs. §§1.46-3(d)(1)(ii) and 1.167(a)-11(e)(1)(i)

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Partnership Allocation of the Credit

A partner's distributive share of income, gain, loss, deduction, or credit is determined by the partnership agreement.[87] A partner's distributive share of income, gain, loss, deduction, or credit (or item thereof) is determined in accordance with the partner's interest in the partnership.[88] This is determined by taking into account all facts and circumstances, if:

1. The partnership agreement does not provide for the partner's distributive share of income, gain, loss, deduction, or credit or item thereof; or
2. The allocation to a partner under the agreement of income, gain, loss, deduction, or credit or item thereof lacks substantial economic effect.

The IRS issued guidance to wind project companies, developers, and investors for purposes of determining partners' interests in the partnerships regarding IRC §45 production tax credits derived from wind.[89] The guidance specifies the requirements for partnerships such as wind project companies, developers, and investors to meet a safe harbor in allocating the §45 credits.

Basically, if the wind-generated electricity is produced and sold by a partnership, the resulting wind energy credits must be allocated among the partners in the same proportion that the partners share any income arising from those sales and the allocation of gross profits is independently valid under IRC §704(b).[90]

The safe harbor, effective for transactions entered into after November 4, 2007, describes 10 requirements, all of which must be met for a project company or investor to qualify for using the safe harbor allocation method. Specifically, the safe harbor defines the terms "investors" and "related party," sets a 1% threshold for a partner's minimum partnership interest, and requires a minimum unconditional investment by the investor. The safe harbor also addresses purchase and sale rights, guarantees and loans, "separate activity" considerations for purposes of the passive-activity loss rules, and the IRC §45 allocation provisions as they apply to partnerships. The safe harbor requires that the tax credit be allocated as described in Treas. Reg. §1.704-1(b)(4)(ii).

Except for IRC §38 property, allocations of tax credits and their recapture are not reflected by adjustments to the partners' capital accounts.[91] Therefore, the allocations cannot have economic effect under Treas. Reg. §1.704-1(b)(2)(ii)(b)(1). The tax credits and tax credit recapture must be allocated in accordance with the partners' interests in the partnership as of the time the tax credit or tax credit recapture occurs. Deductible and nondeductible partnership expenditures can create a tax credit in a partnership taxable year. They can also create valid allocations of a partnership loss or deduction or other downward capital account adjustments for the year. If this occurs, the partners' interests in the partnership with respect to the credit or the cost giving rise to it are in the same proportion as the partners' respective distributive shares of the loss or deduction and adjustments.

MACRS DEPRECIATION

For depreciation purposes, renewable energy systems placed in service after 1986 are classified as 5-year property utilizing the double-declining balance method. At the state level, some states exempt renewable energy property from state property tax.[92]

87. IRC §704(a)
88. IRC §704(b)
89. Rev. Proc. 2007-65, 2007-45 IRB 1
90. Ibid
91. Treas. Reg. §1.704-1(b)(4)(ii)
92. See, e.g., Kan. Stat. Ann. §79-201.

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STATE TAX INCENTIVES

Numerous states provide tax incentives for electricity that is generated by wind power. Presently, 34 states have tax incentives for wind development, including property tax breaks, sales tax exemption on wind energy equipment purchases, and corporate and financing incentives.

LANDOWNER TAX REPORTING ISSUES

When an agreement is entered into with a wind energy company, the landowner commonly receives three different types of payments:

1. The payment for the company's acquisition of an easement or a lease over a part of the landowner's property
2. Crop damage payments
3. Annual payments associated with turbines or the amount of production from the turbines.

Easement Payments. The sale of an easement is treated as the sale of an asset.[93] However, if the taxpayer retains more than naked legal title to the property affected by the easement, the consideration received is treated as a return of capital.[94] As a result, the proceeds are applied as a reduction of the taxpayer's basis in the property, with any excess treated as capital gain.[95]

The Regulations provide the following as a general rule:

> *When a part of a larger property is sold, the cost or other basis of the entire property shall be equitably apportioned among the several parts, and the gain realized or loss sustained on the part of the entire property sold is the difference between the selling price and the cost or other basis allocated to such part. The sale of each part is treated as a separate transaction and gain or loss shall be computed separately on each part. Thus, gain or loss shall be determined at the time of sale of each part and not deferred until the entire property has been disposed of.*[96]

Therefore, the Treasury Regulation presents two tax issues associated with allocating the landowner's income tax basis in the property:

- The allocation of basis between the portion of the property that is subject to the easement and the balance of the property that is not subject to the easement[97]
- The allocation of basis between the rights created by the easement and the balance of the rights in the property

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93. Generally, if the grant of an easement deprives the taxpayer of practically all the beneficial interest in the land, except for the retention of mere legal title, the transaction is considered a sale of the land that the easement covers. In such cases, gain or loss is computed in the same manner as in the case of a sale of the land itself under IRC §§1221 or 1231. See Rev. Rul. 54-575, 1954-2 CB 145.

94. *Conway v. U.S.,* 73-1 U.S.T.C. ¶9,318 (W.D. Ky. 1973)

95. Rev. Rul. 59-121, 1959-1 CB 212; *Wineberg v. Comm'r,* 326 F.2d 157 (9th Cir. 1963). Under Kentucky law, warranty deed conveying right-of-way constituted conveyance of an easement and not fee simple title to real estate; under facts of case, interest conveyed was easement because title would revert to taxpayer upon abandonment and because no grantee could relinquish fee simple title by abandonment. Taxpayers also reserved mineral rights and right of ingress and egress across easement; accordingly, taxpayer entitled to apply easement grant proceeds to reduction of basis in remaining tracts of land.

96. Treas. Reg. §1.61-6(a)

97. If the easement affects only a specific portion of the tract, only the basis allocable to the affected portion is reduced by the price received from the easement. Rev. Rul. 68-291, CB 1968-1, 351.

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Based on the Regulation, a taxpayer cannot compare the entire basis in the property from which an easement is acquired with the sale price of the easement. For example, in *Iske,*[98] the taxpayer sold easements during condemnation proceedings and did not include the compensation in gross income on the tax return for that year. The taxpayer argued that he did not receive a taxable gain on the sale of the easements. However, the court disagreed with the taxpayer's position. The court reasoned that Treas. Reg. §1.61-6(a) required the taxpayer to apportion his basis in the property between the land sold and the land retained. The taxpayer could not use his entire basis in the two parcels involved to offset the amount he received for the easements.

Example 4. Garrulous Energy Company paid $4,000 for an easement along the eastern boundary of Marcia's farm for the construction of an access road to the location on her farm where a wind turbine will be erected. The easement covers approximately five acres of Marcia's 160-acre farm. She has an income tax basis of $750 per acre in her farmland. For purposes of reporting gain from the $4,000 easement payment, Marcia can offset the $4,000 payment by the $3,750 income tax basis that is allocable to the five acres that the easement affects ($750 per acre basis × 5 acres). Thus, Marcia must only report $250 of gain from the sale of the easement.[99]

If the easement affects the taxpayer's entire property (which is uncommon), the amount received for the easement reduces the taxpayer's basis in the entire property for purposes of computing taxable gain.

Example 5. Larry sells multiple easements to Tumescent Wind Corporation for access to a major wind turbine project on Larry's farm. The easements cover 50 acres and bisect Larry's property. Tumescent constructed fences on each side of every easement and installed gates in the fences so that Larry could move his livestock through the easements. For purposes of reporting gain from the sale of the easements, Larry reduces the basis in all of his ranchland by the amount he received for the easements. That is the result if Larry can establish that the easements affected his use of all of his property, rather than just the 50 acres covered by the easements.[100]

Income tax basis must also be allocated between the rights that the taxpayer retains and the easement rights that are sold. For purposes of this basis allocation, the general rule is that the allocation of basis in the property must be allocated between the interest sold and the interest retained in the proportions that their respective FMVs bear to the FMV of the entire property.[101] However, if it is not possible to allocate basis of the entire property between the sold interest and the retained interest, then the amount received for the easement can be used to reduce the basis in the entire property affected.[102]

An important issue to resolve is the actual amount of a client's property that is affected by a wind farm project. First, the tax practitioner should examine the terms of the particular easement. Many easements prohibit the landowner from building anything else on the property that would interfere with the maintenance of the windmill or block the wind that drives the windmill. In that case, the landowner has a reasonable argument that the easement affects **all** the landowner's property. If there is sufficient basis in the land to absorb the easement payment, the landowner will not have any gain to report.

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98. *Iske v. Comm'r*, TC Memo 1980-61 (Mar. 5, 1980)

99. The gain would be IRC §1231 gain. For further guidance on the calculation technique utilized in the example, see Rev. Rul. 68-291, CB 1968-1, 351.

100. *Bledsoe v. U.S.,* 67-2 USTC ¶9,581 (N.D. Okla. 1967); *Conway v. U.S.,* 73-1 USTC ¶9318 (W.D. Ky. 1973)

101. Rev. Rul. 77-413, 1977-2 CB 298

102. Rev. Rul. 77-414, 1977-2 CB 299

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Example 6. Tom owns an 80-acre tract of farmland with no improvements. It is entirely pastureland, and Tom paid $45,000 for the tract in 1983. Tom has been approached by a wind energy company to construct three wind turbines on his property. The company is willing to pay Tom $20,000 for an easement. The easement terms prevent Tom from building anything on this property that would obstruct the company's access to the wind turbines or that would block the wind to the turbines. Tom reduces the basis in his entire tract by the amount of the easement payment. That results in his remaining basis being $25,000 ($45,000 – $20,000), and Tom would report the transaction on his tax return showing no gain or loss.

Note. If the wind energy company pays Tom an additional amount for the right to construct additional wind turbines on his property in a future year, Tom again reduces his remaining basis in his tract by the amount of the payment. To the extent the payment exceeds Tom's basis in his property, Tom has taxable gain that is reported on Form 4797, Part 1 (where it is netted with other IRC §1231 gains and losses).

There is caselaw supporting the argument that an easement can affect **all** of a taxpayer's property and, hence, allows the taxpayer's entire basis in the property to be applied against the easement payment.

- *Bledsoe v. U.S.*[103] The landowner sold nine perpetual easements to the U.S. Army Corps of Engineers to allow road access to a dam. Although the easements covered only 47.3 acres, the court allowed the landowner to reduce the basis of the entire property because the easements restricted his use of the property. The easements varied in width from 100 to 400 feet and bisected his ranch. The easement holder then constructed a fence along the road on both sides and built gates in the fences so that the taxpayer could move his cattle across the easements. The court noted that the easements were not sales (contrary to the general rule) and that the taxpayer was entitled to apply the easement proceeds against the basis in the property.
- *Inja Land Com, Ltd., v. Comm'r.*[104] The City of Los Angeles paid the landowner $50,000 for an easement that allowed the city to flood the land when it diverted water into a river that flowed through the land. The easement did not cover the entire tract, but because it affected the use of the entire tract, the court allowed the payment for the easement to reduce the basis of the entire tract.

Crop Damage Payments. Payments that are made to a landowner (or a tenant) for damage to crops are reported as payments received for sale of the crop. Consequently, the landowner reports the payment on Form 1040, Schedule F, line 4, as crop proceeds.

Lease Payments. In addition to the payment for the easement, landowners commonly receive annual lease payments. Because these payments are not for land used in agricultural production, they are not subject to SE tax regardless of the landowner's participation in the activity.[105] Accordingly, the annual lease payment income is reported on Schedule E (Form 1040), with associated rental expenses.

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[103] *Bledsoe v. U.S.*, 67-2 USTC §9,581 (N.D. Okla. 1967)

[104] *Inja Land Com., Ltd., v. Comm'r*, 9 TC 727 (1947)

[105] IRC §1402(a)(1)

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ISSUE 7: TAX ISSUES ASSOCIATED WITH ETHANOL PLANT INVESTMENTS

The decreased profitability of ethanol plants in recent months has led to an increased incidence of investors liquidating their interests in the enterprises. Lower profitability has also led to a greater frequency of ethanol plants filing bankruptcy. The following does not consider the tax implications arising from plant bankruptcies; instead, the liquidation of member interests is addressed. Because practically all ethanol plants are organized either as limited liability companies (LLCs) or limited partnerships (LPs), the discussion focuses first on how to handle current losses, and then on the partnership tax issues associated with the liquidation of an LLC member's interest.

Handling Current Losses

Investors in ethanol plants that incur a current operating loss on their investment that flows through to them may attempt to treat the loss as an ordinary loss. The IRS may try to recharacterize the loss as a passive loss and thereby limit its current deductibility. The proper characterization of the loss depends on whether the taxpayer is materially participating in the business. The standard of material participation for a limited partner is higher than that of a general partner. A general partner need only satisfy one of the seven tests for material participation set forth in the regulations.[106] However, a limited partner needs to meet one of the three tests set forth in Temp. Treas. Reg. §1.469-5T(a)(1), (5), and (6).

The outcome may depend on how state LLC law distinguishes between limited and general partners. For example, in *Gregg,*[107] the question was whether the taxpayer, a member of an LLC, should be treated as a limited partner or a general partner in a limited partnership for purposes of IRC §469. The IRS relied on the Regulations which, for purposes of IRC §469, treats a partnership interest as a limited partnership interest if "the liability of the holder of such interest for obligations of the partnership is limited, under the law of the State in which the partnership is organized, to a determinable fixed amount..." Thus, in the IRS's view, all members of an LLC are treated as limited partners because of their limited liability under state law. However, the court held that the regulation was obsolete when applied to LLCs, because the LLC statute created a new type of business entity materially distinguishable from a limited partnership. The court concluded that in the absence of a regulation asserting that an LLC member should be treated as a limited partner of a partnership, the higher standard of material participation for limited partners should not be applied to the taxpayer.

Note. While the *Gregg* case involved an interpretation of Oregon LLC law, a similar analysis could be made under most states' LLC statutes. There are three factors that distinguish an LLC from a limited partnership:

1. An LLC does not have at least one general partner and one limited partner if all members are treated as limited partners;
2. The LLC members retain their limited liability regardless of their level of participation in the entity's management; and
3. An LLC permits active involvement in the management of the business while affording the members limited liability.

[106] Temp. Treas. Reg. §1.469-5T(a)(1)-(7)

[107] *Gregg v. U.S.,* 186 F. Supp. 2d 1123 (D. Ore. 2000).

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LIQUIDATING INTERESTS IN ETHANOL PLANTS

Note. The following discussion is meant only to alert tax practitioners that the tax consequences from the liquidation of a partner's interest are not as easy as they may appear. The liquidation of an LLC interest is a very complex subject that requires a lengthy analysis. IRS Pub. 541, *Partnerships,* provides a good discussion of the tax rules associated with the distribution of partnership property and is recommended to practitioners for further guidance.

General Rules

At first glance, the rules for a complete liquidation of an LLC member's interest appear simple. A membership interest is a capital asset of the member. Therefore, a sale of the membership interest normally results in a gain or loss equal to the difference between the sales proceeds and the member's basis in the interest.[108] However, the general rule often is not applicable. For instance, no gain is recognized in a distribution of property and cash to a partner, even in a liquidation of interest, unless the cash distributed exceeds the basis of their partnership interest.[109] Likewise, loss is never recognized by a partner in liquidation unless the property distributed consists entirely of cash, unrealized receivables, inventory, or a combination of the three.[110] If the member receives property upon liquidation of the member's interest, the property's basis equals the member's basis in the partnership interest, reduced by any cash received in the liquidation.

Holding Period

The holding period for the distributed property generally begins when the partnership interest was acquired. If the membership interest was originally received in exchange for a contribution of property, the holding period began when the property was acquired by the contributor rather than when the partnership interest was received. A contribution of inventory is an exception to this holding-period calculation. Multiple contributions of cash or other property to the partnership results in multiple holding periods for the distributed assets. Generally, distributions do not trigger gain or loss to the partnership, regardless of whether the distribution is cash, property, or a combination of both.

Note. Most investors in ethanol plants acquired their interest with the contribution of cash and not property. Usually, a withdrawing partner will not need to consider the issue of gain on contributed assets. The liquidation of an operating ethanol plant may include IRC §751 assets such as unrealized receivables or depreciation recapture. Generally, a partner's distributive share of these items will be calculated at the partnership level and shown in an attachment to Form 1065, Schedule K-1 of the withdrawing or liquidating partner.

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108. IRC §741

109. IRC §731(a)(1)

110. Treas. Reg. §1.731-1(a)(2)

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COMPLICATING FACTORS

Hot Assets

IRC §751 requires recognition of gain from "hot assets" as ordinary income. "Hot assets" include unrealized receivables, substantially-appreciated inventory, and depreciation recapture.[111]

Whenever a partner's share of these asset categories is disproportionately reduced, the withdrawing member must recognize this reduction as ordinary income. This includes gross cash-basis trade receivables, not netted with the related cash-basis accounts payable. IRC §751 includes the receivables in the definition of assets covered, but the definition does not include cash-basis accounts payable. The income is treated as ordinary to the liquidated partner, but the related accrued expense is not. This can produce surprising results.

Example 7. Mashcooker, LLC, has $100,000 of cash-basis accounts receivable (AR), $90,000 of cash-basis accounts payable and net equity of $10,000. It liquidates a 20% partner's interest for $15,000. The member's share of AR is $20,000 and it is reduced to zero. Therefore, there is up to $20,000 of IRC §751 gain to recognize as ordinary income. As a result, the entire $15,000 of cash distributed, less basis, is reported on the Schedule K-1 of the liquidated partner as ordinary income.

Note. Although seemingly logical, the calculation and allocation of this income can be challenging, especially when there are other factors such as loans, special allocations, and multiple-member withdrawals to consider.

Gain on Contributed Assets

IRC §704(c) gain on contributed property may also need to be recognized under §737. If the liquidated partner makes a contribution before the liquidation and receives property in liquidation, §707 may recast the liquidation as a disguised sale. In that situation, a §754 election to make a basis adjustment of partnership assets under §734 may be necessary. The rules under §734 may require a mandatory "step-down" even if a §754 election is not in place. If the liquidating payments are determined with regard to LLC income, §736(a)(1) precludes classification as the sale of a capital asset. If payments are made for past services or use of capital, §736(a)(2) results in guaranteed payment treatment for the distribution.

Built-In Gain. Distributions made **within seven years** to a member that contributed property with §704(c) built-in gain (BIG) triggers a special allocation of the BIG.[112] The definition of distributions under §737 does not differentiate between liquidating and nonliquidating distributions. Thus, §737 can be triggered in a liquidating distribution. The contributing partner must recognize gain equal to the lesser of the remaining unrecognized §704(c) gain or the excess of the current FMV of the distributed property over the adjusted basis of the member's interest.

Note. Thus, §704(c) **requires** BIG on contributed property to be specially allocated to the member that contributed it. If the contributing partner is no longer a member at the time the underlying property is sold, this cannot be accomplished. However, §737 ensures that the contributing partner recognizes the gain on property that the partner has effectively converted to another form, either through cash distributions from the LLC or through receiving other property. Gain recognized is limited to the difference between the FMV of the property received less the LLC basis at the time of distribution. The potential for a special allocation of the §704(c) gain is then gone when the contributing partner leaves.

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111. IRC §751(b)

112. IRC §737

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The partner who contributed the property has then paid tax on the precontribution gain from the original property. IRC §737(c)(2) provides the partnership with a step up in basis equal to the gain recognized by the departing partner.

Example 8. Abe and Becky form partnership AB. In exchange for their respective 50% interests in the partnership, Abe transfers $1,000 cash, and Becky transfers property worth $1,000 with an adjusted basis of $200. The partnership takes the property contributed by Becky with carryover basis of $200. Abe's basis in his partnership interest is $1,000, while Becky's basis in her partnership interest is $200. Abe and Becky agree to share profits and losses equally. If the partnership sells the property for $1,000, the gain of $800 recognized by the partnership is allocated $400 each to Abe and Becky. As a result of this allocation, Abe's basis becomes $1,400 ($1,000 + $400), and Becky's basis becomes $600 ($200 + $400).

If the partnership liquidates and distributes its $2,000 cash equally to Abe and Becky, Abe recognizes a loss of $400 ($1,000 – $1,400) and Becky recognizes a gain of $400 ($1,000 – $600) on the liquidation.

If Becky sold the property herself and contributed the cash proceeds of $1,000 to the partnership, she would have realized a gain of $800 ($1,000 – $200) on the sale. By contributing the property to the partnership, she still realizes the same $800 gain ($400 gain on sale and $400 gain on liquidation). However, the timing and character of the gain is substantially affected. Under these circumstances, Becky has managed to defer recognition of $400 of gain until liquidation of the partnership, and has the potential to change the character of the gain from ordinary income to capital gain.

Similarly, Abe was taxed on $400 of gain (on the sale of the property) despite the fact that he realized no economic benefit, and the offsetting loss is deferred until liquidation of the partnership. In addition, the gain recognized on the sale of the property may be ordinary income, while Abe's loss on liquidation of the partnership is a capital loss.

If the transaction is subject to the provisions of IRC §704(c), the built-in gain on the sale of the property contributed by Becky in the amount of $800 is allocated completely to Becky upon the sale of the property by the partnership. As a result, Becky's basis in the partnership increases to $1,000, the same as Abe's. Upon a liquidation of the partnership and a distribution of $1,000 each to Abe and Becky, neither recognize any gain or loss.

ISSUE 8: TAX-PLANNING STRATEGIES FOR HIGH-INCOME FARMERS

The current economic condition of many agricultural clients, particularly producers engaged in Midwest crop agriculture, presents tax counsel with the need to consider strategies to minimize income tax liability. While each situation is unique, certain principles are pervasive and should be considered and either utilized or eliminated on a case-by-case basis.

Effective tax management can often lead to large tax savings with a small investment of time. The objective is to maximize the client's after-tax income over time, not necessarily minimize tax in the short run. Clearly, tax decisions should be made while simultaneously considering the impact on the client's overall business operations.

There are two basic categories of tax management strategies for high-income farm clients:

1. Control the flow of income between tax years and tax entities
2. Defer income and taxes

CONTROLLING INCOME STREAMS

In a progressive tax system, where higher incomes are taxed at a higher rate, an income that fluctuates from year to year creates a greater tax liability than when income across years remains stable. Reducing the annual variation in taxable income should be an objective of increasing after-tax income.

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Two general strategies can be used to equalize marginal tax rates:

- Shift taxable revenue from the higher tax bracket year to the lower tax bracket year
- Shift tax-deductible expenses from the lower tax bracket year to the higher tax bracket year

Effective use of these two strategies depends heavily on projecting the taxable incomes (and marginal tax rates) for the current and upcoming years. That is not an exact science. For some taxpayers, it may be a good strategy to report very high income in one year to allow other years to remain in lower tax brackets. Use of income averaging, having income over the social security tax threshold, and limiting social security benefits that are taxable are some criteria to consider for this plan.

Delaying Sales

The opportunity for farmers to use this strategy depends on the perishability of the commodity involved. For example, dairy farmers may not be able to delay milk sales, but may be able to control timing of cull cow and calf sales. Grain and hay producers can postpone sales for several months. However, added storage costs and a potential decline in commodity prices during the postponement period could offset the income tax benefits.

Sales can be delayed and income deferred without assuming the risk of product price reversals by selling the product at a specified price before the end of the year but deferring payment until after the first of the year via a deferred payment/price contract. Care should be taken to avoid constructive receipt of the income under the contract in the year the contract is entered into. In addition, the seller can obtain security by arranging for a letter of credit from the buyer's bank. Letters of credit and other third-party guarantees are not taxable income.

Accelerating Operating Expenses

By purchasing inputs to be utilized in a following year, taxes are reduced. A dollar of expense is worth more in tax savings when moved to a higher tax bracket. However, any advance purchase of supplies must be done in accordance with IRS guidance as set forth in Rev. Rul. 79-229. That guidance specifies that all three of the following criteria must be satisfied:

1. There must be an actual payment for the supplies, not just a deposit.
2. There must be a valid business purpose for advancing purchases.
3. The prepayment must not materially distort income.

To satisfy the criteria, the taxpayer should utilize a written, binding contract with the supplier stating that the prepayment is nonrefundable and the purchases must be reasonable in light of short-term business needs; and the taxpayer should build a case for purchasing early so as to guarantee an adequate supply or to get a price break. Certain expenses cannot be deducted when prepaid — they must be prorated over the period the input is used. Interest, rent, and insurance generally cannot be prepaid. A taxpayer that is not a "qualified farm-related taxpayer" is limited in the amount of prepaid expense deductions to 50% of the expenses that were actually used in the current year. The limit does not apply for taxpayers that are "farm-related" and either:

1. The prepaid farm supplies are more than 50% of other deductible expenses due to a change in operations caused by unusual circumstances; or
2. The total prepaid supplies for the preceding three years is less than 50% of other deductible expenses for those three years. With increasing farm sizes and much higher input costs, it is increasingly likely that farm-related taxpayers can be affected by the prepayment limitation.

Example 9. Maxwell, a farm-related taxpayer, has 2007 total deductible farm expenses of $450,000. Of this amount, $100,000 was prepaid in 2007 and used in 2008. The limit on prepaid farm expenses for Maxwell in 2008 will be $175,000 ($450,000 – $100,000 = $350,000 × 50% = $175,000). The result is different if he can pass items 1 or 2 listed above.

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Another acceleration strategy may be to shift depreciation deductions to the current year from future years. Purchases of depreciable property generally qualify for one-half year of depreciation, but if more than 40% of the total basis of depreciable property placed in service during the current year is placed in service during the last three months of the year, the mid-quarter convention is utilized. Under the mid-quarter convention, depreciation on all property placed in service during the year is computed from the midpoint of the quarter the property was placed in service, thus reducing allowable depreciation for that year. Depending on the timing of purchases and the amount acquired in each quarter, it is possible that current year depreciation deductions can increase when using the mid-quarter convention.

Accelerated depreciation can be utilized on qualified asset purchases made during the year. Taxpayers can use:

1. Expense-method depreciation; and
2. First-year "bonus" depreciation.

For tax years beginning in 2008, the §179 deduction is increased to $250,000 with the phaseout threshold increased to $800,000. For fiscal-year taxpayers, the deduction applies to the fiscal year beginning in 2008. Eligible property can be either new or used property but must generally be §1245 property. As for traded property, the provision applies **only** to any boot involved in the trade.

For new assets purchased in 2008, first-year "bonus" depreciation applies at the 50% level unless the taxpayer elects out. Most assets used on a farm or ranch qualify, even structures such as machine sheds that cannot be expensed. Eligible property must:

- Have a recovery period of 20 years or less,
- Have its original use commence with the taxpayer, and
- Be acquired and placed in service in 2008.

If a written binding contract for purchase of an otherwise qualified asset was signed before January 1, 2008, the asset is not eligible for bonus depreciation, even if the asset was not delivered to the buyer until 2008. An asset that is purchased under a written binding contract in 2008 is still required to be placed in service by December 31, 2008. However, a one-year extension of the placed-in-service date applies to certain transportation property and certain property with a recovery period of ten years or more

An election out of bonus depreciation is available, but the election must be made by property class: the 3-, 5-, 7-, 10-, 15-, and 20-year recovery period classes. If "bonus" depreciation is utilized on a particular asset, all other assets purchased in 2008 that are in the same recovery period and otherwise meet the requirements of bonus depreciation also must use bonus depreciation. In addition, the election out of bonus depreciation must be made for all additions within an asset class placed in service during 2008. Bonus depreciation must be claimed for both regular tax and AMT purposes.

Caution. While both of the depreciation provisions are available for 2008 only, the effective dates of each of them need to be considered carefully. There is no problem for calendar-year taxpayers. For fiscal-year taxpayers, the §179 deduction applies to the fiscal year beginning in 2008. Bonus depreciation applies to property acquired from January 1 to December 31, 2008. A farm corporation with a fiscal year beginning November 1, 2007, may not use the §179 deduction on any purchases made in their 2007–2008 tax year. However, it may use the bonus depreciation on purchases made after January 1, 2008, and through December 31, 2008.

During high-income years, it is prudent to review depreciation schedules to determine if any purchases or trades have been omitted in prior years and use the "catch-up" provision allowed by Rev. Proc. 2002-9. If an expense election amount was not allowed in a prior year, the return can be amended and the election taken and carried forward to the current year, where it can be deducted. Or, a retroactive election can be made to remove a §179 deduction in a prior year to allow a higher current year depreciation deduction.

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Expensing Items Rather Than Capitalizing

Sometimes, a taxpayer has the option to expense rather than capitalize an item. If expensed, the taxpayer gets the deduction in the current tax year. On the other hand, a capitalized item must be depreciated with the tax deduction recovered through depreciation over several years. By opting to expense expenditures made in a higher tax bracket year, the taxpayer can move deductions from later years with lower marginal tax rates to the current year with a higher marginal tax rate, thereby saving taxes.

Selected situations provide taxpayers with some degree of latitude to either expense or capitalize associated expenditures, such as:

- Certain repairs,
- Small tools,
- Soil and water conservation expenses, and
- Development costs for fruit and nut crops.

Observation. 2008 may be the year to update buildings and structures in order to generate deductible current expenses. Obviously, these deductions are worth more to the taxpayer in years when the taxpayer is in a higher marginal tax bracket.

Postponing Crop Insurance and Disaster Assistance Proceeds

Under the general rule, crop insurance and disaster assistance proceeds are taxable income in the year of receipt. However, if the payments are received in the year of crop failure and the taxpayer would have normally marketed the associated crop in the following year, the taxpayer has the option of declaring the payments as income for the following year.

If the current year is the year of both a crop failure and a higher tax bracket, the taxpayer will realize tax savings by postponing the taxation of insurance proceeds until the following tax year.

Weather-Related Livestock Sales

Livestock sold by a cash-basis taxpayer due to weather-related conditions may result in being treated for tax purposes as either an involuntary conversion or as a 1-year deferral of income.

For involuntary conversion treatment:

- Livestock includes animals, other than poultry, held for draft, dairy, or breeding purposes.
- The replacement period is four years, unless it is not feasible to reinvest the proceeds in property that is similar or is related in use. In that event, the proceeds can be reinvested in other property used for farming purposes, except real estate, but subject to a 2-year replacement period.
- Replacement livestock must be held for the same purpose as the animals disposed of because of the weather-related condition.
- The area must be designated as eligible for assistance by the federal government.

For deferral treatment:

- The taxpayer's principal business must be farming, even though he may have some off-farm income.
- The election is valid if made during the applicable replacement period for the livestock under the involuntary conversion rule.

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Postponing Taxation of Commodity Credit Corporation Loans

A farmer has the option of treating a CCC loan as income in the year the loan is received or in the subsequent year when the grain is either forfeited or reclaimed and sold. By electing to have the income taxed in a later year, income may be shifted to a lower tax bracket. IRS guidance allows the treatment of CCC loans either as loans or as income in the current year using an automatic consent by filing Form 3115.

Acceleration of Itemized Personal Deductions

In a higher tax bracket year, it may be wise to move selected itemized deductions normally paid the following year to the current year. That may result in total deductions in the current year exceeding the standard deduction. The standard deduction can then be used in the following year.

Observation. This strategy moves personal deductions to a higher tax bracket year, resulting in additional income tax savings. Medical expenses, state income taxes, real estate taxes, and charitable contributions are examples of personal deductions that may readily be advanced to the current tax year.

Trade, Rather Than Sell, Capital Assets

If machinery, equipment, or vehicles are sold at a price above their undepreciated basis, the depreciation recapture is taxable in the year of disposition and the capital gain is taxable in the year the sale proceeds are received. However, that same gain on a trade reduces the basis on the replacement item. This results in a smaller depreciation deduction in later years. By opting to trade rather than sell and buying replacement property the following tax year, taxable income is shifted from the current, high-tax-bracket year to later years with lower tax brackets.

Sell, Rather Than Trade, Capital Assets

If machinery, equipment, or vehicles are sold and the same amount is used to purchase other depreciable assets in the same tax year and the total purchases can be deducted using the §179 election, SE income may decrease. Sales of depreciable property do not generate income subject to SE tax; and depreciation deductions may lower SE tax. By opting to sell rather than trade and buying replacement property the same tax year, SE tax liability may be reduced.

Use Installment Sales

When the sale of real or personal property results in a gain and payment of all or part of the purchase price occurs in a year subsequent to the year of the sale, the sale qualifies as an installment sale. Depreciation recapture related to §1245 property is taxable in the year of disposition. Other depreciation recapture and capital gains are recognized over the installment period.

The installment sale method is automatically effective unless the taxpayer "elects out" on the return filed for the year of sale.

Use Charitable Remainder Trusts

In high-income years, another relevant tax-planning strategy may involve the use of a charitable remainder trust (CRT) to avoid ordinary income sales. A CRT allows the tax-free sale of assets, with income paid to the donor during the donor's lifetime and the trust corpus paid to a named charity upon trust termination. The CRT must be irrevocable, comply with state law, and be organized as either a charitable remainder annuity trust (CRAT) or charitable remainder unitrust (CRUT).

A **CRAT** provides for payment each year back to the donor of either a fixed amount or a percentage of the initial value of the trust. The trust term must either be for the donor's life, the donor's life coupled with another beneficiary, or for up to 20 years. A CRAT may not accept additional contributions in later years.

Note. The IRS provided sample copies of pre-approved annuity trust instruments in Rev. Procs. 2003-53 through 2005-60, IRB 2003-31.

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A **CRUT** provides for an annual payment back to the donor, or donor and beneficiary, or for a term certain computed as a percentage of an annual revaluation of the market value of the trust assets. A CRUT may accept additional contributions in later years.

> **Note.** The IRS provided sample copies of pre-approved unitrust instruments in Rev. Procs. 2005-52 through 2005-59, IRB 2005-34.

The unitrust, with its potentially fluctuating income based on the value of trust assets, generally produces a smaller charitable deduction at formation.

Basic Procedure. To utilize this planning tool, the following steps can be taken:

- Create the trust with the trust terms requiring an annual income stream back to the donor, but with the remainder value passing to a charitable organization at the death of the donor/beneficiary or after a specified term of years.
- Donor then transfers appreciated long-term capital gain assets such as corporate stock or appreciated real estate to the trust, and claims a charitable income tax deduction for the market value of the asset reduced by the value of the retained income interest.

  Charitable remainder trust donations are deductible for both regular tax and AMT purposes. In addition, the donor's charitable deduction is subject to the 30% AGI annual limitation with a 5-year carryover.

> **Note.** The amount of the charitable deduction depends on: (1) the amount or percentage of the retained income interest; (2) the term of years of the retained income interest; and (3) the IRS 120% annual mid-term AFR interest rate, which must be selected from either the current month or 2-month period before the charitable transfer.[113]

- Charitable trust sells the asset without reporting gain.
- Charitable trust invests the sale proceeds to provide a source of income to allow payment of the specified income interest to the donor.
- At the death of the donor/income beneficiary, the trust corpus passes to the charity without being included in the decedent's estate.

Ltr. Rul. 9413020 (Dec. 22, 1993). In this ruling, the IRS approved a cash-method farmer's transfer of crops and raised beef cattle to a CRUT. The IRS ruled that the farmer did not recognize any taxable income or SE income upon the transfers of the farm inventory items to the CRUT. In addition, the expenses the farmer incurred in raising the cattle and crops before transfer to the CRUT were still allowed as deductions on the farmer's return. The CRUT would not recognize any income on its later sale of the farm inventory items, even if the sale occurred within a short period of time after the farmer's donation. This is provided the sale was not a pre-arranged transaction and was independently enacted by the trustee of the CRUT. The annual distributions from the CRUT to the farmer-donor would be ordinary income, but would not be SE income.

> **Observation.** All the transfers in the ruling were ordinary income property. Thus, the farmer would not receive any charitable deduction at the time of the transfers to the CRUT. However, that wasn't the purpose for creating the CRUT. The farmer's objective was to convert grain, livestock, and machinery into cash at retirement without incurring tax and receive an income stream from the cash.

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113. See Table 5 of the monthly AFRs.

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BALANCING INCOME AMONG TAX ENTITIES

Income taxes paid on the farm's income may be reduced by more equally distributing (or leveling) income among the various tax entities potentially associated with the business. Through a more equal distribution of income, income can be moved from an entity with a higher tax bracket to another entity with a lower tax bracket, thereby reducing income taxes on total farm income.

Income leveling opportunities may include:

1. Paying children for work performed on the farm;
2. Gifting income-generating property to an individual in a lower tax bracket;
3. Forming a partnership or S corporation and channeling income to various partners and shareholders, respectively; and
4. Forming a C corporation and shifting income between the corporate and shareholder entities via salaries paid to employee-shareholders.

HIGH INCOMES CAN CAUSE LOSS OF TAX BENEFITS

Not only do higher incomes generate higher proportional tax liabilities due to higher tax brackets, but liabilities can increase by the loss of a variety of tax benefits. Some of the items that can be affected by higher taxable incomes include:

- Saver's credit
- Roth IRA contributions
- Tax-free social security benefits
- Full AMT exemptions
- Child credit
- Non-kiddie tax rates
- Education credits
- Medical expense deductions
- College financial aid benefits
- Reduction in itemized deductions and exemptions
- Traditional IRA deductions
- Limited passive losses
- Earned income credit
- Higher Medicare Part B premiums

FARM INCOME AVERAGING

Perhaps the ultimate tool that farmers can use to balance tax brackets from year to year is an income-averaging election. Effective January 1, 1998, individuals engaged in a farming business can elect to spread whatever portion of current income is desired, termed "elected farm income," evenly over the three prior taxable years. The current year's income tax liability is calculated by determining the current year's tax without the amount of elected farm income plus the increases in income tax for each of the three prior taxable years by taking into account the allocable share of elected farm income for each of those years. Any adjustment for any taxable year is taken into account for income-averaging purposes in subsequent tax years.

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Note. The IRS issued final and temporary regulations under IRC §1301 concerning farm income averaging effective for tax years beginning after July 22, 2008.[114] The regulations specify that a **fixed-lease payment is not eligible for averaging.** In addition, the maximum amount of income that a taxpayer may elect to average is the total of the individual's farm and fishing income and gains, reduced by any farm and fishing deductions or losses allowed as a deduction in computing taxable income.

A "farming business" means a trade or business involving the cultivation of the land or the raising and harvesting of any agricultural or horticultural commodities, but does not include the processing of commodities or products "beyond those activities which are normally incident to the growing, raising or harvesting of such products."[115]

Eligibility for Income Averaging

The following are eligible for income averaging:

- Individuals with farm income that are engaged in farming, including:
    - Landlords that bear the risk of production and risk of price change under the lease.
    - A nonmaterially-participating landlord, if the landlord's share of a tenant's production is set in a written rental agreement before the tenant begins significant activities on the land.
- Individual members, shareholders, or partners of pass-through entities.

Estates, trusts, and C corporations are not eligible for income averaging because they are not individuals.

Income Eligible to Average

The following types of income are some of the types eligible for income averaging:

- Gains from the "sale or other disposition of property other than land that is regularly used by the taxpayer in a farming business for a substantial period"
- Taxpayer's share of elected farm income from a pass-through entity
- Gains from the sale of assets considered to be part of the land, such as buildings, fences, and tile lines

Gains from the sale of land are not eligible for income averaging.

An income-averaging election can be made on a late or amended return if the period of limitations for filing a claim for credit or refund has not expired. In addition, a previous election can be changed or revoked if the period of limitations has not expired. For tax years after 2003, in computing AMT, the regular tax liability for farmers and fishermen is determined without regard to income averaging. Therefore, a farmer or fisherman receives the full benefit of income averaging.

Note. See page 431 of the *2007 Federal Tax Workbook* for more information on income averaging.

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[114] TD 9417, 73 Fed. Reg. 42522 (Jul. 22, 2008)

[115] Temp. Treas. Reg. §1.263A-4T(c)(4)(i)(C)

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