Chapter 10: Agricultural Issues and Rural Investments

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Corrections were made to this workbook through January of 2011. No subsequent modifications were made.

ISSUE 1: PREPAID FARM EXPENSES

GENERAL RULE

A farmer using the cash method of accounting can deduct expenses paid during the year according to Rev. Rul. 79-229.[1] The revenue ruling sets forth several tests for determining the deductibility of prepaid expenses:

1. The expenditure must be an actual purchase. It cannot be a mere deposit for a future purchase. In distinguishing between a prepayment and a deposit, the ruling suggests four factors that demonstrate a deposit rather than a purchase.
   a. Absence of a specific quantity of items purchased
   b. A right to a refund of any credit that remains
   c. Treatment of the expenditures as a deposit on the seller's books
   d. A right to substitute other goods for those specified in the purchase contract

Observation. A cash-method farmer should secure an invoice that clearly specifies a definite quantity, quality, and price for the items purchased. There should be no right to a refund or repurchase noted on the invoice.

2. The expenditure must be made for a legitimate business purpose rather than merely being for the purpose of avoiding taxes. Examples of legitimate business reasons include securing adequate quantities, obtaining discounts for early purchase, and locking in price.[2]

1. Rev. Rul. 79-229, 1979-2 CB 210.

2. See, for example, *Van Raden v. Comm'r,* 71 TC 1083 (1979), *aff'd.,* 650 F.2d 1046 (9th Cir. 1981); see *Petersen v. U.S.,* 6 Fed. Appx. 547 (8th Cir. 2001) (valid business purpose for pre-purchases not established).

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3. The expenditure must not result in a material distortion of income. According to Rev. Rul. 79-229,[3] several factors are important for determining whether the deduction results in a material distortion of income:

   a. The relationship between quantity purchased and the quantity projected to be used in the next year

   b. The materiality of the expenditure in relation to total income of the taxpayer for the year

   c. The taxpayer's customary business practices in buying supplies and the business purpose for paying in advance

   d. The relationship between the expenditures and past purchases

   e. The time of year in which the expenditure was made

   f. The effect of deductions of prepaid expenditures on taxes paid by the farmer in previous years

Observation. In general, purchases for the upcoming crop year normally do not constitute a material distortion of income. Likewise, purchases of items such as feed do not normally constitute a material distortion of income if they can reasonably be expected to be consumed within the next 12-month period.

SPECIAL EXCEPTIONS

Farming Syndicates

A farming syndicate is limited to deducting the cost of seed, fertilizer, or similar farm supplies in the tax year in which the supplies are actually used or consumed. A farming syndicate is any proprietorship, S corporation, trust, or entity other than a C corporation engaged in farming that has had its ownership interests offered for sale at any time in an offering required to be registered under federal or state securities regulations, or where more than 35% of the losses during any period are allocated to limited partners or limited entrepreneurs.

Poultry Purchases

The costs of purchased productive poultry must be capitalized and deducted ratably over the lesser of 12 months or their useful life. Poultry purchased for resale may only be deducted in the year sold.[4]

50% LIMITATION

To the extent that prepaid expenses exceed 50% of the deductible non-prepaid farm expenses for the taxable year (including depreciation), the prepaid expenses are only deductible as the purchased items are consumed.[5] For purposes of the test, deductible non-prepaid farm expenses include interest, ordinary and necessary operating expenses of the farm, and taxes paid. Depreciation on farm assets is also included, except for costs that must be inventoried or capitalized.

While it is rare that a farm taxpayer will ever come close to the limit, there are exceptions to the 50% rule. One exception is a farm-related taxpayer that fails the test due to a change in business operations that is directly attributable to extraordinary circumstances. Another exception is when the total prepaid farm supplies expense for the preceding three years is less than 50% of the total other deductible farm expenses for those three years.

Note. A farm-related taxpayer eligible for these exceptions must be a person or family member whose main home is on a farm or whose principal business is farming.

Observation. Among the conditions that can cause challenges to the 50% limitation are rapidly expanding businesses, shifting from crop share to cash rent, and significant price increases of farm supplies.

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3. Rev. Rul. 79-229, 1979-2 CB 210.

4. IRC §464.

5. IRC §464(f).

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Example 1. Tony is a relatively new farm business owner and his main home is on a farm. During 2010, Tony sold all of his 2009 crop and most of his 2010 crop. This resulted in large gross farm income. He has the following expense totals for 2010 and the previous three years. Can Tony deduct all expenses paid in 2010 for the 2011 crop?

Expense Item	2010	2009	2008	2007	2007–2009 3-Year Total
Feed	$290,000	$100,000	$200,000	$ 0	
Fertilizer	300,000	150,000	200,000	40,000	
Seed	160,000	140,000	120,000	20,000	
Depreciation	10,000	250,000	150,000	5,000	
Other farm expenses	100,000	80,000	80,000	10,000	
Total farm deductions	$860,000	$720,000	$750,000	$75,000	$1,545,000
Prepaid expenses	(460,000)	(190,000)	(220,000)	(0)	(410,000)
Non-prepaid expenses	$400,000	$530,000	$530,000	$75,000	$1,135,000

For 2010, Tony's prepaid portion of farm expenses exceeds the allowable 50% limitation by $260,000 (50% × $400,000 = $200,000). While Tony fails the current-year test, he is allowed to use the 3-year exception and he passes this test since $410,000 is less than $567,500 (50% × $1,135,000). Tony may deduct all prepaid expenses paid in 2010 for the 2011 crop.

PREPAYMENT OF RENT

In general, a taxpayer may not prepay rent expense, irrespective of the taxpayer's method of accounting.[6] Instead, prepaid rent is deducted over the term of the rental period to which the prepayment relates. In 2004, the IRS issued final regulations related to the capitalization of costs that are incurred to acquire or create intangible assets. The regulations include a "12-month rule" that has application to many prepaid expenses, including prepaid rent. Under the rule, a taxpayer is not required to capitalize an amount paid in connection with a right or benefit that does not extend beyond the earlier of:

1. 12 months, or after the date on which the taxpayer realizes the right or benefit; or
2. The end of the tax year following the year in which the payment occurs.

The rule makes it clear that a cash method taxpayer prepaying rent that does not extend beyond 12 months is allowed to currently deduct that prepayment.[7]

Note. Accrual method taxpayers may not prepay rent because of the economic performance rules of Treas. Reg. §1.461-4. This regulation states that payment for the use of property (i.e., rent) may only be deducted ratably over the period of time to which an accrual-method taxpayer is entitled to use the property.

Observation. The prepaid rent rule provides yearend planning opportunities for cash-method farmers. However, prepayment of rent in December will likely cause an acceleration of income to the landlord. Consequently, the rule may only have limited practical use. A taxpayer could prepay rent in late December. This requires issuance of a Form 1099-MISC to the landlord, who will likely receive the rent in the next calendar year. The landlord must then make a reconciling adjustment on his tax return.

6. Rev. Rul. 55-540, 1955-2 CB 39.

7. Treas. Reg. §1.263(a)-4(f)(8), Example 10.

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Prepayment of Interest

Deductions for prepaid interest are **statutorily prohibited.** Therefore, interest expenses must be deducted in the period to which they relate.[8]

Miscellaneous Matters

Certain other points should always be kept in mind when a farm taxpayer prepays expenses:

1. Many problems can be created if the farmer fails to document the paid item. Farmers that engage in prepaying expenses should always get an invoice detailing quantity, quality, price per unit, and total price.
2. The manner of payment is important:
   - a. Purchases by credit card are considered payment at the **time the charge is made** even though payment of the credit card bill is made at a later time.
   - b. Payment by check occurs when the check is mailed or delivered to the payee. It does not matter when the check is actually cashed. Thus, having the payee hold the check until a later time after receipt is not an effective deferral technique, nor is postdating a check.

> **Note.** If payment is made by check at a time when the bank account is overdrawn, sufficient funds need to be made available for credit at the time the check is cashed (such as through a bank line of credit). If funds are not available at that time, the prepayment is not a legitimate expense in that calendar year for tax purposes.

3. Payment can be made from borrowed funds, but the funds cannot be borrowed from the vendor or payee in the transaction.
4. Payment by promissory note, even when secured by collateral, does not give rise to a deduction.

ISSUE 2: FARM NOLs AND THE $300,000 LIMITATION (2010)

The 2008 Farm Bill contains several tax incentives that are designed to encourage conservation practices on farms. These tax breaks are offset, at least partially, by a provision that limits farming losses for certain taxpayers. Historically, the only limitation on farming losses was the passive activity loss rules of IRC §469. The new provision, which is effective for taxable years beginning after December 31, 2009, limits farming losses for taxpayers other than C corporations to the greater of $300,000 ($150,000 for MFS) or the taxpayer's total net farm income for the previous five years for any taxable year in which the taxpayer receives farm program payments or Commodity Credit Corporation (CCC) loans.[9]

DEFINITIONS

Total net farm income is defined as the aggregation of all income and loss from farming businesses for the prior five taxable years.

For purposes of calculating total net farm income for the prior five years, losses that are limited under the provision are taken into account in the year in which they are allowed as a deduction.

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8. IRC §461(g).
9. HR 6124, Sec. 15351, modifying IRC §461.

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Example 2. Frank and Mary, a farm couple, have a $500,000 excess farm loss in 2010 that is not allowed as a deduction until 2012. The calculation in 2011 of total net farm income for the prior five years does not take into account the $500,000 as a farm loss. Instead, the $500,000 loss is included in the calculation of the prior year's total net farm income for taxable years 2013 through 2017.

Farming business is defined in accordance with IRC §263A(e)(4), except that the processing of commodities is included in the definition.

As applied to cooperatives, the farming activities of a cooperative are attributed to each member for purposes of the definition of a farming business. Thus, a member of a cooperative who raises a commodity and sells it to the cooperative for processing is considered the processor of the commodity. Accordingly, patronage dividends received from a cooperative that is engaged in a farming business are considered income from a farming business.

Example 3. In 2010, Claude Hopper has $300,000 of net farm income and $700,000 of nonfarm income. In each of the tax years from 2011–2014, he has $1 million of net farm income. In 2015, Claude incurs a $7 million farming loss. Under the provision, Claude's farming loss in 2015 will be limited to the greater of $300,000 or $4.3 million (total net farm income for the prior five tax years). The $4.3 million farming loss allowed in 2015 may be carried back to the preceding fifth tax year, or can be handled as follows:

- An election can be made to treat the farm loss as a nonfarm loss so that it can be carried back two, three or four years.
- An election can be made to forgo the carryback period and instead carry the loss forward.

This statement assumes the NOL rules applicable in 2010 will also be true in 2015.

The following table displays the 5-year carryback of the $4.3 million limited NOL generated by the $7 million loss in 2015.

	2010	2011	2012	2013	2014	Total
Net farm income	$ 300,000	$1,000,000	$1,000,000	$1,000,000	$1,000,000	$4,300,000
Nonfarm income	700,000					700,000
Loss carryback amount	(1,000,000)	(1,000,000)	(1,000,000)	(1,000,000)	(300,000)	(4,300,000)
Total adjusted net farm income	$ 0	$ 0	$ 0	$ 0	$ 700,000	$ 700,000

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Observation. Assuming that Claude utilizes the 5-year carryback provision, the balance of the unused farm loss is available for Claude's use in future years, subject to the same limitations. If Claude forgoes the carryback option, in 2016 the farming loss will be limited to $4 million (Claude's 2011–2015 net farm income which is $0 for 2015 and $1 million per year from 2011–2014).

Example 4. Claude, from **Example 3,** incurs a $500,000 loss in 2010, but has $550,000 of net farm income over the prior five years. The loss is allowed in full because it is less than Claude's 5-year net farm income.

Example 5. Claude, from **Example 3,** instead incurs a $500,000 loss in 2010, and has $150,000 of net farm income over the prior five years. The loss is limited to $300,000 in 2010 (the greater of $300,000 or $150,000 net farm income for the prior five tax years).

Note. Losses that are limited in a particular year may be carried forward to subsequent years. For partnerships and S corporations, the limit is applied at the partner or shareholder level. Thus, each partner or shareholder takes into account its proportionate share of income, gain, or deduction from farming businesses of a partnership or S corporation as well as any applicable subsidies received by a partnership or S corporation during the taxable year (regardless of whether such items are treated as income for federal tax purposes).

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SCOPE OF THE PROVISION

The provision applies to eligible taxpayers who receive any direct or countercyclical payments under Title I of the 2008 Farm Bill (or any payment elected in lieu of any payment that could have been received under Title I) or any CCC loan.

As previously mentioned, the definition of "farming business" includes the processing of commodities without regard to whether such activity is incidental to the growing, raising, or harvesting of such commodities by a taxpayer otherwise engaged in a farming business with respect to such commodities.

Example 6. Sid incurs a $350,000 farm loss in 2010, but did not receive any farm program payments or CCC loans in 2010. However, Sid did generate $100,000 profit from on-farm processing activities in 2010. Sid is allowed the full loss of $350,000 reduced by the $100,000 profit from his processing activities. The net loss of $250,000 is allowed in full because it is beneath the $300,000 limitation.

Farming losses that arise by reason of fire, storm, or other casualty, or by reason of disease or drought, are disregarded for purposes of calculating the new limitation.

Example 7. Bertha incurs a $400,000 farming loss in 2010. Of the $400,000, $150,000 is attributable to drought. The $150,000 amount is subtracted from the overall $400,000 loss, and the resulting $250,000 loss is allowed in full.

ISSUE 3: LOSS LIMITATION RULES FOR PASSIVE INVESTORS[10]

The passive loss rules apply to trade or business activity when the taxpayer does not materially participate in the activity or participate in rental activity on a basis which is regular, continuous, and substantial. If the passive loss rules apply, deductions (losses) from passive trade or business activities, to the extent the deductions exceed income from all passive activities, may not be deducted against other income (nonpassive activity gains).

For farmers, the passive loss rules are likely to come into play in situations in which the farmer is a passive investor in a separate business venture apart from the farming operation. In that case, the losses from the venture cannot be used to offset the income from the farming operation unless the farmer can **group the activities as a single economic unit** for passive loss purposes. If grouping can be done, the farmer's material participation in the farming activity counts as material participation in the passive business, and the losses offset the farming income.

In recent years, many grain farmers invested in entities that provide access to grain storage or access to marketing outlets. These entities are typically pass-through entities — LLCs or S corporations. Likewise, some hog producers have invested in similar pass-through entities that provide access to hog production facilities (breeder stock or feeder pigs). The typical investment in these entities is passive due to the farmer's lack of material participation. Any resulting pass-through losses are currently nondeductible if the farmer does not have any ownership in other passive investments that generate pass-through income.

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10. Discussion of this issue is based on material prepared by Orville Bloethe, A. David Bibler, and Lee E. Wilmarth and contained in the *Income Tax Manual,* for use at the 2009 Iowa Bar Association Tax School, Des Moines, Iowa, pp. I-49 and I-50, and is used with permission.

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GROUPING OF ACTIVITIES

As noted above, a taxpayer may group multiple activities if the activities constitute an **appropriate economic unit.** Taxpayers may use any reasonable effort to make the grouping determination, although the following factors have the greatest significance:[11]

- Similarities and differences in types of businesses
- The extent of common ownership
- The extent of common control
- Geographical location
- Interdependence between the activities

A rental activity cannot be combined with a business activity unless either is insubstantial in relation to the other.[12] Unfortunately, the regulations do not define the term **insubstantial.**

Example 8. Lynn Gweeny is a sole proprietor grain farmer, but does not have enough grain storage for her crops. The local cooperative, however, is selling memberships in a new LLC that will own and manage a large grain storage facility. If Lynn invests in the LLC, she is guaranteed adequate storage for her crops at what she thinks is a lower out-of-pocket cost than building her own storage facility.

Lynn decides to invest in the facility. The cooperative's management contract with the LLC is structured such that the LLC does not have any net income or expense from operating the facility. LLC members receive their pro-rata share of depreciation deductions from the investment as the only pass-through item on yearly Schedules K-1 from the LLC. Thus, Schedules K-1 always reflect a pass-through loss that will not be currently deductible to Lynn because she does not materially participate and does not have any passive income to offset the loss.

Even though Lynn does not materially participate in the LLC, she can make an election to aggregate her grain farming sole proprietorship with her investment in the LLC. Because she requires adequate grain storage for her crops, this creates an appropriate economic unit. Lynn materially participates in her grain farming operation. Therefore, she also is deemed to be materially participating in the LLC. Any losses reported on the LLC's Schedule K-1 are fully deductible as business losses on Lynn's Form 1040.

Note. Lynn's grouping election does **not** result in income or loss being grouped for SE tax purposes. Lynn makes the election to group activities by filing a statement with her original income tax return for the taxable year. See page 473 of the 2009 *University of Illinois Federal Tax Workbook* for a sample grouping election statement. This can be found on the accompanying CD.

RECENT DEVELOPMENTS

A recent Tax Court case illustrates the application of the passive loss rules and activities that can be grouped. In *Senra,*[13] the taxpayer was a majority owner in a C corporation that was engaged in retail sales of granite and marble. The taxpayer was materially involved in the operations of the C corporation and received wage income. The taxpayer also was the sole owner of an LLC that rented a warehouse to the C corporation. The LLC had passive rental losses that flowed through to the taxpayer, and the taxpayer wanted to group his active participation in the C corporation with his passive activities in the LLC for purposes of satisfying the material participation test of the passive loss rules.

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11. The factors are contained in Treas. Reg. §1.469-4(c)(2).
12. Treas. Reg. §1.469-4(d)(1).
13. *Senra v. Comm'r,* TC Memo 2009-79 (Apr. 15, 2009).

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The Tax Court ruled that Treas. Reg. §1.469-4(d)(5)(ii) limited the aggregation of the activities — the activities did not constitute an **appropriate economic unit.** The taxpayer argued that the regulation only applied when unrelated activities are grouped, but the Tax Court rejected that argument. Therefore, because the rental activities in the LLC were per se passive irrespective of whether the taxpayer materially participated in them, the taxpayer had no passive income and the losses were not deductible.

Note. For more information about the *Senra* case, see pages 568–569 of the 2009 *University of Illinois Federal Tax Workbook.* This can be found on the accompanying CD.

In Rev. Proc. 2010-13,[14] the IRS specified how a taxpayer must report changes involving the manner in which the taxpayer is grouping activities for purposes of the passive loss rules. In the revenue procedure, the IRS specified that beginning with 2011 returns, taxpayers must report changes in groupings. The failure to report whether activities are grouped for taxpayers with two or more trade or business activities or rental activities results in each trade or business activity or rental activity being treated as a separate activity under the passive loss rules.

Note. Chapter 14, Rulings and Cases, discusses the *Ajah* case, which also deals with the grouping election. Chapter 5, Individual Taxpayer Problems, also includes a discussion of grouping passive activities.

ISSUE 4: MEDICAL REIMBURSEMENT PLANS

It is possible to generate income tax advantages through various fringe benefits that can be provided to a spouse as an employee of a family business that is not an S corporation. Fringe benefits are statutorily disallowed to the spouse of a more than 2% shareholder of an S corporation.[15]

An entity that is taxed as a partnership can sponsor a written health insurance and/or medical expense reimbursement plan and provide these benefits to employees, including employees who are also spouses of partners, as long as the spouses themselves are not also partners. A spouse who is a bona fide employee is eligible for employer-provided health insurance that can also include other family members. The technique, if done properly, can convert family health insurance premiums into deductible business expenses.

Pursuant to IRC §105, an employer can establish a medical reimbursement plan covering the employer's spouse. While it generates a deduction for the family business for the amount of the health insurance premiums that are paid, the spouse can also use the plan to deduct insurance copays, prescriptions not covered, eye glasses, dental care, orthodontics, and other medical expenses that would otherwise be an itemized deduction on Schedule A subject to the 7.5% floor. In addition, an employee-spouse is entitled to $50,000 of group term life insurance premiums and disability premiums as nontaxable fringe benefits.

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14. Rev. Proc. 2010-13, 2010-4 IRB.

15. IRC §§1372(b) and 318.

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IRC §105

Employees do not generally have to include in income the amounts received from either health insurance that the employer provides or amounts the employer pays for directly. In 1999, the IRS approved the concept in the issuance of two Coordinated Issue Papers.[16] In those publications, the IRS set forth six points outlining its position on the matter. These six points are as follows:

1. The employee-spouse must be a bona fide employee of the business and provide services to the business for which the compensation **and** fringe benefit package represents reasonable compensation. In making the **bona fide employee** determination, the IRS looks to, among other things, the issuance of Forms W-2, appropriate withholding, and the regularity of payments (e.g., biweekly, monthly, etc.). In addition, it is important to document that the employee-spouse is an employee of the business, not a co-owner or partner. The IRS views co-ownership of assets as precluding the use of IRC §105 plans.
2. The employer-spouse deducts 100% of the fringe benefits as a business expense, and the employee-spouse receives a tax-free fringe benefit.
3. The employer-spouse may be covered by the medical benefits as a member of the employee's family.
4. Payments for reimbursement of medical expenses incurred before adopting the fringe benefit arrangement are **not** permitted.[17]
5. The performance of nominal or insignificant services that have no economic substance will be challenged.
6. The medical insurance policy should not be held in the name of the employer-spouse, but should be owned by the employee-spouse.

Observation. The IRS position on this point is questionable. Ownership of the policy would not appear material to the issue of deductibility, and having the employee-spouse own the policy may not be possible due to health issues of the employee-spouse or other cost issues.

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16. UIL 105.06-05 (Mar. 29, 1999) and UIL 162.35-02 (Mar. 29, 1999).

17. See *Wollenburg v. U.S.,* 75 F.Supp.2d. 1032 (D. Neb. 1999). See also *American Family Mutual Insurance Co. v. U.S.,* 815 F.Supp. 1206 (W.D. Wis. 1992); *Seidel v. Comm'r,* TC Memo 1971-238; Rev. Rul. 2002-58, 2002-2 CB 541; Rev. Rul. 71-403, 1971-2 CB 91.

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PLANS FOR SOLE PROPRIETORSHIP OPERATIONS

Medical reimbursement plans do not generally work for sole proprietors, but the IRS issued a revenue ruling in 1971 providing a chance for sole proprietors to use medical reimbursement plans when the spouse of the sole proprietor works for the business.[18] However, the spouse must be a bona fide employee of the business and receive reasonable compensation (including the medical reimbursement) for the services actually rendered.

The following are significant cases that have been decided in recent years involving medical reimbursement plans:

- ***Speltz v. Comm'r,* TC Summ. Op. 2006-25 (Feb. 14, 2006).** The taxpayer prevailed against an IRS attack on the medical reimbursement plan that the taxpayer adopted which covered her employee-spouse. The Tax Court ruled that the spouse was truly an employee of the enterprise and that a proper plan existed. The court was impressed with the quality of the records the taxpayers retained on the work the husband performed. This was the key to the outcome of the case.

- ***Snorek v. Comm'r,* TC Memo 2007-34 (Feb. 8, 2007).** The taxpayer adopted a plan that provided reimbursement of all health insurance premiums and up to $3,000 in other medical expenses to eligible employees and their immediate families. The taxpayer executed an employment agreement with her husband late in 2000 in which she agreed to pay him $480 in wages annually and made him an eligible employee under the plan. During the tax year at issue, the husband was paid $480 in wages and received benefits under the plan of $10,355, of which $3,906 represented health insurance premiums under a policy for the taxpayer. The IRS argued that the taxpayer failed to show that the husband actually paid those premiums or that he was reimbursed by the business if he did. The IRS took the position that those premiums were deductible to the extent of 60%, which was the amount allowed for self-employed persons in 2000. (The deduction was an above-the-line deduction and also would not count as a deduction against SE tax.) The court agreed with the IRS. The taxpayer did not produce any canceled checks, receipts, or premium statements showing that the husband actually paid or had the obligation to pay the premium (which would have made the premium fully deductible).

Observation. The form of the transaction must be correct, not just the substance. Here, all the couple had to do was have the husband pay the premium and then get reimbursed by the wife's business. They tried to short circuit the process and lost some of the tax benefit as a result.

[18] Rev. Rul. 71-588, 1971-2 CB 91.

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- ***Francis v. Comm'r,* TC Memo 2007-33 (Feb. 8, 2007).** The husband was a sole proprietor farmer for 40 years. His wife helped him by doing chores and other miscellaneous odd jobs around the farm, but had never received any compensation for those tasks. The husband adopted a medical reimbursement plan in 1991 that allowed health insurance costs paid for eligible employees, and provided for additional reimbursement for up to $8,000 of other medical expenses.

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

  In the year at issue (2001), the wife performed services for the farm, but there was no documentation of hours worked or what she had actually done. She was reimbursed $9,502 for the year in question, with $5,571 being paid on a joint health insurance policy and a Medicare supplement for the husband. Her total compensation for 2001 was $11,500.

  The husband deducted the entire amount of the medical reimbursement on Schedule F. The IRS denied the $9,502 deduction for reimbursed medical expenses and the court agreed. While the court was troubled as to whether there was proof of a bona fide employment relationship, that issue was not determinative of the outcome. Instead, the court held that the couple failed to establish whether any compensation paid to the wife in excess of the $1,998 that was actually paid (the IRS conceded that amount was deductible) was reasonable insomuch as the couple failed to document any hours or times the wife may have performed services for the farm. Therefore, a full deduction might have been available if the couple had kept records.

Observation. The bottom line advice for self-employed persons using "boilerplate" medical reimbursement plans is to pay attention to the details. There is more to the matter than simply adopting a plan and forgetting about it. Attention must be paid to details both in the completion of the written employment agreement and in the recordkeeping of spousal hours worked and services performed.

- ***Albers v. Comm'r,* TC Memo 2007-144 (June 7, 2007).** The court denied a deduction for employee benefit program payments. The husband farmed and established a medical reimbursement plan for his wife. The issue in the case was whether the couple could deduct as a business expense the $8,216 claimed for employee-benefit programs on their Schedule F.

  The court determined that the taxpayers failed to establish that the husband paid his wife, either directly or indirectly under the medical reimbursement plan, the claimed $3,586 of health insurance premiums and the claimed $4,630 of medical and dental expenses to reimburse her for expenses that she incurred or paid. The court also held that the taxpayers failed to establish that any portion of the claimed premiums and expenses was an ordinary and necessary business expense.

- ***Eyler v. Comm'r,* TC Memo 2007-350 (Nov. 27, 2007).** In this case, the IRS disallowed the taxpayers' deduction of health insurance premiums paid by the husband (employer) for the wife (employee). The couple claimed that the amount paid for the premiums was a deductible expense of the husband's employee benefit program under IRC §162(a), and that the premiums were excludible from the wife's income as expenses incurred for medical care and as employer-provided health insurance coverage.

  The court held that the claimed deduction was properly disallowed. The taxpayers failed to produce business records or canceled checks drawn on the business checking account establishing that the husband paid the premiums as the wife's employer rather than as the primary individual insured under the husband's health insurance policy which also covered the wife as spouse.

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- ***Frahm v. Comm'r,*** **TC Memo 2007-351 (Nov. 27, 2007).** The IRS denied deductions under IRC §162(a) for payments made pursuant to a medical reimbursement plan. The husband owned and operated a farming business, in which he employed his wife. The husband, as the employer, provided a medical reimbursement plan for his wife. During the years at issue, pursuant to the plan, the husband (employer) paid, either directly or indirectly, the wife's portion of premiums for various policies covering herself, her husband, and/or both of them. The IRS claimed that any payments for medical expenses made for the husband's benefit were not payments made pursuant to an employee benefit plan. However, the court disagreed with the IRS position. Instead, the court held that the payments were ordinary and necessary business expenses of the farming operation. Therefore, the couple was able to deduct amounts paid by the farming operation through the medical reimbursement plan.

- ***Stephens v. Comm'r,*** **TC Summ. Op. 2008-18 (Feb. 25, 2008).** The court agreed with the IRS in disallowing a deduction on the taxpayers' Schedule F for health insurance and medical expenses of the wife, who was paid $2,000 per year under a medical reimbursement plan. The court held that the payment was not an ordinary and necessary business expense, was paid out of a joint account, and was not a reimbursement. As a result, the amount was deductible only as an above-the-line deduction (60% for tax year 2001 and 70% for tax year 2002).

- ***Shellito v. Comm'r,*** **TC Memo 2010-41 (Mar. 3, 2010).** This case involved a spousal farming operation that the husband operated primarily on leased land. The couple jointly owned three pickup trucks that were used on the farm. The husband individually owned other farm equipment, including a tractor and a combine. The couple had a joint checking account, on which they both wrote checks to pay expenses. They also took out various farm loans, with both of them signing most of the notes for the loans.

  The wife had assisted with farming chores for over 20 years before the medical reimbursement plan was established. In 2001, the couple executed an employment agreement and completed a preprinted application for a medical reimbursement plan. Under the plan, the wife was reimbursed for health insurance premiums for her and the family, up to $15,000 for out-of-pocket medical expenses for her and the family, and $50,000 of term life insurance for herself. The wife also opened a checking account in her name in which she deposited her monthly paycheck of $100. For 2001, the wife paid almost $8,000 in medical expenses and health insurance premiums for herself and the family, for which she was reimbursed pursuant to the reimbursement plan.

  The wife received a Form W-2 for 2001 on which wages of $754 was reported. On the couple's 2001 tax return, they claimed a Schedule F deduction of over $15,000 for **employee benefit programs** and a $700 deduction for **labor hired.** The wife was listed on the return as **"HOUSE WIFE."** The same events occurred in 2002 except that reimbursement for medical expenses was greater and so was the amount paid as wages. That resulted in a $20,897 deduction being claimed on the 2002 return for **employee benefit programs** and a $1,200 deduction for **labor hired.** Again, on the 2002 return, the wife was listed as **"HOUSE WIFE."** For both 2001 and 2002, the IRS disallowed the vast majority of the amount claimed for employee-benefit programs.

  The Tax Court upheld the IRS determination on the basis that the wife was not a bona fide employee of her husband. The court rejected the couple's argument that the 2001 employment agreement simply formalized a pre-existing employer-employee relationship, pointing out that the wife had never been remunerated for her services and, without remuneration, there could be no employment relationship. The court was convinced that nothing happened in 2001 that changed the nature of the economic relationship between the couple and that the low level of compensation that was paid beginning in 2001 was "illusory." Instead, the court determined that the whole arrangement was for the purpose of simply reimbursing family medical expenses and insurance premiums in a tax-deductible fashion.

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The court noted that the funds in the joint account were owned equally by the spouses. As such, the husband (employer) owned the funds equally with the wife and amounts paid from the account were deemed to have been paid equally by each of them. So, the wife was "reimbursed" with her husband's funds. Any resulting economic benefit was directly offset and negated by the wife assuming and paying her husband's liability for the family medical expenses. The end result was that the medical expenses continued to be paid from the joint checking account, just like they had been for many years prior. That further confirmed to the court that there was no bona fide employment relationship between the parties. The end result was that the court disallowed any deduction for employee benefit programs. However, the court did **not** sustain an accuracy-related penalty against the couple because they had relied in good faith on the advice of their CPA in establishing the medical reimbursement plan.

Observation. The court opinions point out that it is critical for farm operations with farm spousal arrangements to ensure that the employment agreement clearly specifies the number of hours that the spouse is required to work, the nature and extent of the work, the days and times the spouse is required to be available for work and, in general, the duties of the spouse as employee. Likewise, it is critical to have the spouse, as employee, document the number of hours the spouse actually works and the nature and extent of the services performed. An easy way to document those items could be by virtue of the use of a notebook or logbook which details the date, hours worked, and the nature of the services performed each day. Also, it is critical to establish a bona fide employment relationship and not use the couple's joint checking account for paying reimbursed medical expenses.

ISSUE 5: FEDERAL ESTATE TAX ISSUES

Caution. There is currently considerable uncertainty surrounding estate taxes. Consequently, attorneys are having a difficult time drafting estate planning documents. While tax preparers are encouraged to leave the drafting of estate planning documents to the legal profession, some knowledge is necessary to properly answer client questions.

Provisions contained in the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) of 2001 specified that the federal estate tax exemption would gradually rise through 2009 combined with a gradual reduction in the estate tax rate. At the same time, the generation-skipping transfer tax (GSTT) and gift tax rates would fall at the same pace. In 2010, the estate tax and GSTT would be repealed, but the gift tax would remain at a 35% rate on taxable gifts above a $1 million exclusion.

If Congress does not enact legislation to deal with the estate tax in 2010, the estate tax will return for deaths in 2011 and thereafter. However, when it returns, the exemption will only be $1 million (for GSTT purposes also) and the tax will have a top marginal rate of 55% (with a 5% surcharge applicable to adjusted taxable estates between $10 million and $17.184 million). Thus, for taxable estates exceeding $17.184 million, the tax will be a flat 55%. The gift tax will return at a 45% rate.

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INCOME TAX BASIS — 2010 DEATHS

2010 Asset Sales

For property acquired from the estate of a 2010 decedent that is sold in 2010, the property's basis in the hands of the heirs is the **lesser of** the decedent's adjusted basis in the property or the property's FMV at the time of the decedent's death. This is known as the **modified carryover basis rule.** The rule means that no automatic step up in basis to the date of death value is allowed. Two significant exceptions may apply:

1. The executor can allocate up to $3 million to increase the basis of assets that pass to the surviving spouse (or to a qualifying trust for the surviving spouse).
2. The executor can allocate an additional $1.3 million (increased by unused losses and loss carryovers) of aggregate basis to other assets (on an asset-by-asset basis).

Some property is not eligible for a basis increase. Ineligible property includes property that the decedent acquired by gift within three years of death (unless it was received from the decedent's spouse), income in respect of a decedent (IRD), and property that constitutes the right to receive IRD (such as qualified retirement plan benefits).[19]

Note. Only an executor can allocate the basis increase; however, the term "executor" is not defined in IRC §1022. Under Treas. Reg. §20.2203-1, the term "executor" includes an executor or administrator, but if there is no executor or administrator, the term means "any person in actual or constructive possession of any property of the decedent," and the term can actually include "the decedent's agents and representatives; safe-deposit companies, warehouse companies, and other custodians of property in this country; brokers holding as collateral securities belonging to the decedent; and debtors of the decedent in this country."

Therefore, for assets received and sold from a 2010 decedent's estate in 2010, the heirs incur tax liability on amounts not covered by the basis increase rules.

Once the amount of additional basis allocation is determined, the executor must decide how much of that amount to allocate to each individual asset. This can be a particularly difficult task in an estate with multiple assets and multiple beneficiaries inheriting assets with different basis starting points. The statute and regulations do not provide guidance; thus, the executor may either:

1. Divide the allotted amount equally among the assets without looking to the final basis;
2. Equalize the final basis amounts (even if it means that one asset receives a greater allocation of the allowable basis increase); or
3. Allocate the allowable basis increase entirely to particular assets to the exclusion of other assets.

Note. State fiduciary law requires that the executor make the allocation in a manner that is "fair." Thus, it may be wise for estate planners to include language in testamentary instruments that holds the executor harmless for basis allocation decisions.

19. IRC §1022(d)(1)(C) and (D).

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Revocable Trusts. For property to qualify for the step up in basis under the 2010 modified carryover basis rule, an asset must be considered owned by the decedent under IRC §1022(d) and considered acquired from the decedent under IRC §1022(e). It seems clear that property owned by a revocable trust at death that was established by the decedent would be acquired from the decedent as a result of the decedent's death. It is also fairly clear that those assets are considered as having been **owned** by the decedent. **Qualified revocable trusts** are listed under IRC §1022(d)(1)(B)(ii) as assets that are considered owned by the decedent, and are also contained in the list of assets passing from a decedent under IRC §1022(e)(2)(A). A qualified revocable trust is a revocable trust for which an election has been made to treat the trust as part of the decedent's estate for income tax purposes under IRC §645(b)(1). Thus, it appears that assets in all revocable trusts qualify as an inheritance under IRC §1022(e)(1), and also under IRC §1022(e)(2)(B) when the decedent had reserved rights to alter or amend. That is especially the case if the executor of the estate and trustee of the trust make the election under §645(b)(1) to treat the trust as a qualified revocable trust for income tax purposes.

Note. Property that qualifies for the $3 million spousal basis increase must be "qualified spousal property" as defined in IRC §1022(c)(3). That provision includes "outright transfer property" which is defined as any property that is "acquired from the decedent by the surviving spouse." As such, the definition does **not** include all interests for which the marital deduction would have been available. While a general power of appointment trust would not be eligible for a basis increase under the definition (but would qualify for the marital deduction), property contained in a qualified terminable interest (QTIP) trust would qualify for the spousal basis increase (with no election necessary). However, property in a QTIP trust at the **surviving spouse's death** would not qualify for the $1.3 million basis increase in the surviving spouse's estate because it is not "acquired from" the decedent.

Life Estates. As noted above, to qualify for the step up in basis under the 2010 modified carryover basis rule, an asset must be considered owned by the decedent under IRC §1022(d) at the time of the decedent's death **and** considered acquired from the decedent under IRC §1022(e).

IRC §1022(d) does not specifically mention that a life estate is considered owned by the decedent; however, life estates could be covered by the general rule. This is particularly the case for a reserved life estate. A reserved life estate is a possessory interest that is owned at the time of death. In many states, a life tenant has exclusive possession of the entire property during the life tenant's lifetime. The life tenant is entitled to all the rents and profits from the property and pays all current real estate taxes. The holders of the remainder interest do not have the right to petition for partition because they do not have a present possessory interest in the premises. Upon the life tenant's death, the life tenant has an ownership interest to the exclusion of the holders of the remainder interests. Thus, a reserved life estate should be within the ownership test of §1022(d).

Similarly, since the entire possession of a reserved life estate transfers upon the life tenant's death, that makes the argument fairly solid that a reserved life estate also satisfies the "acquired from the decedent" test of §1022(e).

Power of Appointment. IRC §1022(d)(1)(B)(iii) specifically states that a "decedent shall not be treated as owning any property by reason of holding a power of appointment with respect to such property." That excludes property subject to a power of appointment (created by third parties in the decedent's favor and powers that the decedent's spouse creates) from the modified carryover basis rule. However, under §1022(e)(2)(B), a basis increase is available for property "with respect to which the decedent reserved the right to make any change in the enjoyment thereof through the exercise of a power to alter, amend or terminate the trust." Thus, a trust with a reserved power of appointment seems to be deemed "acquired" from the decedent under §1022(e).[20]

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20. A reserved power of appointment causes the power holder to be treated during lifetime as the owner of the trust for income tax and capital gains tax purposes under the grantor trust rules in IRC §§671–679. This bolsters the argument that property subject to a reserved power of appointment in a trust is eligible for a step up in basis.

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2011 Asset Sales

EGTRRA specifies that its provisions "shall not apply to taxable. . . years beginning after December 31, 2010."[21] This language indicates that the modified carryover basis rule which applies to estates of decedents dying in 2010 is only applicable to assets inherited and sold in 2010. For assets inherited in 2010 and sold after 2010, the tax year at issue for computing capital gain tax on the heir's return is a post-2010 year. Thus, by its express language, the EGTRRA modified carryover basis provision does not apply for purposes of computing the tax liability on an heir's return. Instead, the pre-EGTRRA basis rule providing for a stepped-up basis applies. Consequently, the income tax basis for gain computation purposes on the heir's return is the FMV of the assets at the time of the decedent's death. Consequently, for deaths in 2010, there is no estate tax, and the heirs still retain an FMV basis if the inherited assets are sold after 2010. This point is further bolstered by Sec. 901(b) of EGTRRA, which states that the Code "shall be applied and administered to years, estates, gifts, and transfers [after December 31, 2010,] as if the provisions and amendments [of EGTRRA] had never been enacted."[22]

Caution. As of the date that this chapter was written, the IRS has not made any public pronouncement of its view of whether the modified carryover basis rule will or will not apply to assets inherited from a 2010 decedent's estate that are sold in 2011 or later years.

DRAFTING IMPLICATIONS FOR DEATHS IN 2010

Standard Formula Clause Language

For married couples, a common estate planning technique that has been utilized for many years for potentially taxable estates is to utilize drafting language in wills and trusts that eliminates federal estate tax upon the first spouse's death and minimizes estate tax upon the surviving spouse's death by dividing the first spouse's estate into two packages:

1. Formula clause language leaves the maximum amount of property to the surviving spouse in a form that does not qualify for the marital deduction, so as to fully utilize the deceased spouse's applicable exclusion against the estate tax. Therefore, the clause language leaves the maximum amount of property to the surviving spouse in life estate form and eliminates estate tax in the first spouse's estate. This is typically referred to as the "bypass trust."[23]

2. The balance of the estate is designated an outright gift to the surviving spouse (or a trust for the surviving spouse's benefit, also known as the "marital trust"). It passes tax free via the unlimited marital deduction.

Note. Some estate planners, especially when handling very large estates, utilize formula drafting language which has each spouse gift the GSTT exemption to a trust for the children and grandchildren, with the balance of the estate passing either to the surviving spouse or the children.

For deaths occurring in 2010 while no estate tax exists, a question is raised as to the effect of any formula-derived gift when formula clause language is tied to the level of the exemption at the time of death in order to minimize tax over both spouse's estates. For example, typical drafting language may specify that the credit shelter amount (the "bypass trust" amount) is pegged as "the largest amount that can pass free of federal estate tax."

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21. H.R. 1836, P.L. No. 107-16, Sec. 901 (a).

22. Ibid.

23. Also, the "bypass trust" property could pass outright to the decedent's children.

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Will the trust fail because the formula clause language that was utilized refers to a nonexistent tax and/or exemption? This could occur automatically beginning in 2010 either because of Congressional inaction or a specific Congressional action. If the trust fails, the entire estate might pass to unintended persons. In addition, such formula clause language could inadvertently result in the complete defunding of charitable bequests. The surviving spouse's estate would be inadvertently "overstuffed," resulting in a higher tax than would have been the case had the formula clause language worked as anticipated in the first estate.

Another concern is that while all the property may go to the surviving spouse, it may pass to the spouse in life estate form rather than outright. That gives the surviving spouse an income interest in the property for life, but no outright control. This could raise a question as to whether the income stream from the life estate property is enough for the surviving spouse. The answer to that question depends on the age and lifestyle of the surviving spouse.

Note. For deaths in 2010, only those assets that pass outright to the surviving spouse or pass to the surviving spouse via a marital trust qualify for a basis increase. Therefore, if the formula clause results in the first spouse's assets passing entirely to the surviving spouse in life estate form, **none of the assets would be eligible for a basis increase.**[24] Another potential problem with formula clause language can occur if the language results in the funding of the bypass trust with an amount that exceeds any state-level exemption. Some states still have an estate tax that applies to those excess amounts. States presently with an estate tax are Connecticut, Delaware, Hawaii, Maine, Maryland, Minnesota, New York, Ohio, Oregon, Vermont, and Washington. Also, the District of Columbia has an estate tax.

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24. In addition, property that is contained in an IRC §1022(c)(5) QTIP trust is not eligible for a basis increase ($1.3 million) in the estate of the surviving spouse because it is not owned by the spouse/life beneficiary, and is not mentioned specifically in IRC §1022(d)(1). In order to qualify such property for a $1.3 million basis increase upon the surviving spouse's death, the surviving spouse should separately own the property, or it should be passed from the first spouse to die to the surviving spouse in a form that will qualify it for a basis increase.

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Modifying Existing Plans in 2010

Based on the 1-year lapse of the federal estate tax for 2010, the change in the basis rule, and the pending return of the estate tax for deaths after 2010, clause language in existing estate plans may need to be modified. All that might be necessary is that a codicil to an existing will be executed or that trust language be amended. However, clients must take action to update their plans, or practitioners should review existing client plans and take the initiative to get clients to make the necessary changes. Some clients may delay doing anything, preferring instead to wait and see what, if anything, Congress chooses to do. This could be a real client counseling issue, and the "wait-and-see" approach may not be the best strategy.

For clients needing assistance with estate planning, the following are suggested strategies:

- Revise the existing estate planning clause language to specify that if death occurs at a time when the federal estate tax is not in effect, a specified pecuniary amount will pass either outright or in trust for the children so as to reduce the amount passing to the surviving spouse.
- Revise the existing clause language to specify that if death occurs when there is no estate tax, all property passing to the surviving spouse is in trust with the spouse as beneficiary. The trust should have language designed to minimize or eliminate the impact of any estate tax that may be in effect at the surviving spouse's death.
- For GSTT planning purposes, revise the existing clause language to specify that property that would have passed outright to children now passes in trust for their benefit. Because the GSTT is also repealed for deaths in 2010, one consideration may be to make transfers to "skip" generations (e.g., grandchildren) in an amount that is less than the transferor's $1 million gift tax exemption. As a hedge against reenactment of the estate tax and the GSTT, property could instead be placed in trust for the surviving spouse with the grandchildren designated as beneficiaries, leaving the maximum amount to the grandchildren free of GSTT. Under this approach, however, the donor would need to make a QTIP election on a timely filed gift tax return. Also, grandchildren could be named as remainder beneficiaries on various types of charitable trusts.

Note. Some states have taken legislative action that would treat decedents dying in 2010 as having died on December 31, 2009, for purposes of construing formula clause and other tax-relevant language in wills and trusts. Estate planning must also consider state-level rules, exemption amounts, and tax rates in effect for 2010 and how these may change for 2011 and later years.

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Planning Techniques for 2010

Estate planners should not lose sight of common planning techniques that are still in play. Such techniques include the use of annual exclusion gifts (presently $13,000 per donee per year), and taxable gifts that utilize the $1 million gift tax exclusion (as well as other techniques that shift future asset value to later family generations) to keep the estate size manageable in the event the estate tax again becomes law. For instance, from a gift tax planning standpoint, techniques that either take advantage of the repeal of the GSTT or the present (relatively low) 35% gift tax rate should be considered. Such strategies might include using the $1 million gift tax exemption to fund a "Crummey"-type trust for children and grandchildren.[25] If a higher gift tax rate applies in the future (which looks likely at the present time), an aggressive gifting strategy could be utilized with the result that taxable gifts would be taxed at 35% rather than an anticipated higher future rate. This strategy dovetails with an estate tax minimization strategy if it is believed that the estate tax will return (which also appears likely at the present time).

Another strategy is the use of QTIP trusts to benefit a surviving spouse. This allows the surviving spouse to adopt a "wait and see" approach as to whether a QTIP election should be made based on whether the estate tax is in existence.

Disclaimer wills are a popular tool. Disclaimer language in estate planning documents gives a surviving spouse a set period of time after the death of the first spouse (typically nine to 15 months, depending on the type of disclaimer language utilized) to determine the relative size of the marital and nonmarital portions of the first spouse's estate. Such language allows a degree of flexibility to the surviving spouse in order to reap a greater benefit, depending on the level of the federal estate tax exemption in effect at the date of death of the first spouse.

Observation. If the estate tax returns in 2011 with only a $1 million exemption and a 55% top rate, the impact could be particularly severe on small businesses, including farms and ranches. It is believed that there are a significant number of small businesses that fall in the $1 million to $3.5 million range. For an estate containing farm real and personal property, a special-use valuation election[26] may be available to reduce the value of the farm real estate in the decedent's estate. Numerous requirements must be satisfied in order to qualify for the election, and the decedent's family members must, in general, continue the farming operation for 10 years after the date of the decedent's death to avoid recapture of the tax benefits.

In addition, the payment of any estate tax liability must be made within nine months after death, which may be at a time that is particularly inconvenient for an ongoing family business or farming operation. While the 9-month timeframe may not be sufficient time to raise the cash necessary to pay the estate tax liability and insurance may not be practical for various reasons, it is possible to make an election on the decedent's estate tax return to pay the tax in installments over a 15-year period at a favorable interest rate.[27] Numerous requirements must be satisfied to make the election and not all estates qualify. This can be a particular problem for a small business or family farming operation in which it is impractical to sell a fraction of the business to pay estate tax due to a lack of a recognizable market for noncontrol interests that are not actively traded. However, the capital gains tax can be timed and managed by the heirs to minimize interference to existing business operations. Consequently, a premium will be placed on liquidity-generating techniques to address this potential problem.

25. See *Crummey v. Comm'r,* 397 F.2d 82 (9th Cir. 1968).

26. IRC §2032A.

27. IRC §6166.

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FILING REQUIREMENTS FOR DEATHS IN 2010

At the time this chapter was written, the IRS had not yet created draft forms associated with deaths in 2010. While the estate tax has lapsed for 2010, the elimination of the rule of FMV basis for inherited assets (other than income in respect of decedent items) will require practitioners to establish basis under the modified carryover basis rule to the satisfaction of the IRS. This is particularly true for inherited assets that are also sold in 2010. Clearly, some type of basis determination worksheet should be prepared that shows how income tax basis was determined for the assets involved and how either the $3 million or $1.3 million step-up basis increase is being allocated.

Pre-EGTRRA law required that a federal estate tax return (Form 706) be filed to get a basis increase. IRC §1022(d)(3) states that a basis increase must be allocated "on the return required by Section 6018." IRC §6018 pertains to the filing of federal estate tax returns — a return that is not required for 2010 decedent's estates. Under pre-2010 law, Form 706 was due nine months after the date of the decedent's death and could be extended for six months. A temporary amendment to IRC §6075 provides that Form 706 is normally due when the decedent's final federal income tax return is due. IRC §1022 does not mention whether a basis increase can be allocated on a late-filed return. These deadlines are important to note, even for assets inherited from a 2010 decedent's estate that are sold post-2010. If assets are inherited in a year before the sale of those assets, the deadline for the executor to allocate the stepped-up basis increase may have already passed.

ESTATE TAX REMNANTS STILL REMAIN

In one sense, the estate tax is not completely gone for 2010. Even though the estate tax is repealed for deaths in 2010, for estates that have elected special-use valuation, the qualified family-owned business deduction (for deaths before 2004), or have elected to pay the estate tax in installments from pre-2010 deaths, the recapture rules continue to apply in 2010 through the end of the applicable recapture period.

ISSUE 6: DETERMINING INCOME FOR FARM PROGRAM ELIGIBILITY[28]

OVERVIEW

The 2008 Farm Bill[29] and subsequent regulations established new adjusted gross income (AGI) and adjusted gross farm income (AGFI) limitations for program eligibility.[30] The new limitations are considerably lower than the previous limitation of $2.5 million and could impact more producers than the limitation under prior law. As a result, the correct computations of AGI and AGFI are critical for ensuring that a producer remains eligible for farm program payments.

INCOME LIMITATION RULES

The new income limitations are effective beginning with the 2009 crop year. The applicable payment limitation on direct payments for crop years 2008–2012 for a person or entity (whether received directly or indirectly) is $40,000. The payment limit is reduced for participation in the average crop revenue (ACRE) program in years 2009–2012.[31] The countercyclical payment limit amount is $65,000 for crop years 2008–2012 and is reduced if the recipient participates in the ACRE program in years 2009–2012.[32] For commodity and price support programs, a producer must have nonfarm AGI of $500,000 or less to be eligible for direct and countercyclical program (DCP) payments or price-support benefits, and AGFI of $750,000 or less to be eligible for direct payments under the DCP.

Note. These limits also apply to both disaster assistance and the milk income loss compensation programs.

28. This issue is adapted from articles authored by Robert E. Moore and Roger A. McEowen and posted on the website for the Center for Agricultural Law and Taxation. [www.calt.iastate.edu] Accessed on Aug. 4, 2010.

29. P.L. No. 110-234.

30. See 7 USC §1308-3a(e).

31. 7 USC §1308.

32. 7 USC §7991(d).

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For conservation program benefits, the nonfarm AGI limit is $1 million unless two-thirds of AGI (both farm and nonfarm) is derived from farming, ranching, and forestry operations.[33] The 2008 Farm Bill also expands the definition of average AGI derived from farming, ranching, and forestry to include income and benefits from the production of all types of livestock; farm-based renewable energy; and the processing, packing, storing, shedding, and transporting of farm, ranch, and forestry commodities (including renewable energy). In addition, the bill gives the Agriculture Secretary the discretion to include the income from any additional activity related to farming, ranching, or forestry.

Note. The income from the sale of equipment used to conduct farm, ranch, or forestry operations, and income from the provision of production inputs and services to farmers, ranchers, foresters, and farm operations is included as farm income if two-thirds or more of the individual's or entity's AGI is farm income.

The calculation of average AGI is computed over an applicable 3-year period. For the 2009 program year, the 3-year period involves tax years 2005–2007.

Note. Annual certifications of AGI compliance are required from each individual and legal entity that requests CCC payments either directly or indirectly. For pass-through entities, AGI certifications are required from each member who is an individual or entity and from each embedded interest holder. For other entities, the entity that is the interest holder in the entity must provide an annual AGI certification if they hold either a direct or indirect interest. The certifications can be made on Form CCC-926 or by providing the Farm Service Agency (FSA) with an acceptable statement from a CPA or attorney. Compliance with the AGI rules is tracked through four levels of ownership in an entity. Any noncompliance within those levels results in the payment being reduced by an amount that is commensurate with the ineligible share.

KEY DEFINITIONS

AGI is defined by the U.S. Department of Agriculture (USDA) as it is under IRC §62.[34] For tax purposes, this is gross income minus trade and business deductions and various other deductions. In essence, AGI is a producer's net income minus above-the-line deductions on the front of the producer's Form 1040. AGI is the amount reported on line 37 of Form 1040.

The definition of AGFI is less straightforward. For tax purposes, gross farm income is the producer's gross income or gross revenue attributed to the taxpayer. However, the FSA's concept of AGFI is different. For FSA purposes, AGFI is the net income from farming and related operations. Indeed, the USDA regulation defining AGFI states that AGFI is the "portion of the AGI of the person or legal entity that is attributable to farming, ranching. . . "[35] Because AGI is clearly defined as net profit in accordance with IRC §62, the portion of AGI that is AGFI must also be net profit.

Note. The instructions to FSA Form CCC-926 confirm that both AGI and AGFI are a net income concept.

33. 7 USC §1308-3a(e). This limitation can be waived on a case-by-case basis for environmentally-sensitive land of special significance.

34. 7 CFR §1400.3.

35. Ibid.

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DETERMINING AGFI

Determining AGFI is not as simple as referring to the amount on line 18 of Form 1040 (farm income or loss). Instead, AGFI is net farm income on line 18 of Form 1040 plus additional income from the sale of such items as agricultural-related land, breeding livestock, agricultural/conservation easements, and farm-related machinery.[36] These additional sources of income are generally reported on Schedule D, Form 4797, or Schedule E (for royalty income, real estate rental income, and pass-through income from an entity) and on lines 13, 14, and/or 17 of Form 1040.

Therefore, the determination of a farmer's AGFI begins with net farm income reported on line 18 of Form 1040 plus farm-related income on lines 13, 14, and/or 17. From that total, the amount of any above-the-line deductions is subtracted. The result is AGFI.

REPORTING AGI AND AGFI TO THE FSA

For farm program eligibility-determination purposes, a producer must report its 3-year average AGI and AGFI to the FSA on Form CCC-926. Page 3 of Form CCC-926 provides guidance on determining AGI and states that "for persons that file the IRS Form 1040, specific lines on that form represent the adjusted gross income and the income from farming, ranching or forestry operations." The instructions then explain how to compute AGI and AGFI from specified lines on Form 1040 which are net income amounts.

AGFI: A NET INCOME CONCEPT

Clearly, AGFI is a net income concept. It is not a producer's gross farm revenue. It is the producer's net farm income. If a producer reported gross farm income instead of net farm income, he could mistakenly believe that he was ineligible for program payments.

Example 9. Guy Wire has a 3-year average AGFI over $750,000 and is ineligible for direct payments. Guy produces soybeans on 1,000 acres and corn on an additional 640 acres. For 2005–2007, Guy's soybean crop yielded an average of 50 bushels per acre and he received an average of $9.00 per bushel. Thus, Guy's gross farm income solely from the bean crop averaged $450,000 each year. Over the same time period, Guy's corn crop yielded an average of 225 bushels per acre and he received an average of $4.00 per bushel. Guy's gross farm income solely from the corn crop averaged $576,000, and his gross farm income from both crops combined averaged $1,026,000. If Guy uses his gross farm income for purposes of the CCC-926, he would be ineligible for direct payments. To properly determine his eligibility for DCP or price-support payments, Guy must take care to reduce his gross income amounts by any deductions attributed to his farm income.

Observation. The new AGI and AGFI definitions and the lower dollar limit for program eligibility contained in the 2008 Farm Bill require care on the part of producers to make sure that income amounts are reported properly. As the producer may look to his tax preparer for assistance, it is important the tax preparer understands the proper calculation of income amounts for payment-limitation purposes.

FSA AGI VERIFICATION PROCESS

The USDA and the IRS recently announced a joint program under which producers' tax data is shared in order to verify the AGI of producers receiving program payments.[37] The program is intended to strengthen the integrity of FSA programs and reduce abuse and fraud.

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36. See FSA Notice PL-185 for an expansive list of income sources. Importantly, Notice PL-185 does not list wages or dividends received by a shareholder of a C corporation.

37. See USDA Notice PL-202 (Jan. 4, 2010). The final rule was published in the Federal Register on Jan. 7, 2010. 75 Fed. Reg. No. 4, pp. 887–900 (Jan. 7, 2010).

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CONSENT FORMS

Effective in 2010, the FSA and the Natural Resources Conservation Service provide producers with consent forms to complete and submit to the IRS. The consent authorizes the IRS to disclose information to the USDA. Two consent forms, one for individuals (CCC-927) and one for legal entities (CCC-928), are used.

> **Note.** Producers may obtain the consent form at their local USDA offices or via the FSA website.
>
> The completed consent forms are not to be sent to the USDA. USDA offices will not accept or retain the completed consent forms. Producers mail completed consent forms directly to the IRS. The deadline to submit the forms for 2010 was June 15, 2010.

The forms were mailed to the IRS at the following address:

Internal Revenue Service — USDA
PO Box 24033
Fresno, CA 93779

Producers farming within business entities need to provide both a Form CCC-927 for themselves and a Form CCC-928 for the entity. USDA Notice PL-202 states that completed Forms CCC-927 and CCC-928 are not accepted or retained in any FSA or USDA Service Center Office. The forms must be signed by the producer and submitted to the IRS within 60 calendar days of the signature date. FSA Power of Attorney forms do not authorize others to sign the CCC-927. Thus, each individual producer must sign a Form CCC-927.

Producers who do not voluntarily submit the consent form receive a notice of the requirement in order to avoid interruption of program payments. Producers who did not submit consent forms by June 15, 2010, are ineligible for future payments and could be required to pay back all 2009 payments.

AGI VERIFICATION

The IRS verifies both the individual producer's and the entity's AGI for compliance. AGI calculations for 2009 are computed based on the 2005, 2006, and 2007 tax years, and the AGI calculations for 2010 are computed based on the 2006, 2007, and 2008 years. The IRS reports the result of its examination of any particular producer or entity's data to the FSA on a regular basis.

> **Note.** Based on its examination, the IRS reports to the FSA whether the participant appears to meet all average AGI limitations, the number of years in the applicable 3-year period that tax data was available for the participant, and the IRS forms on file that were used in the data comparison for each participant.

A producer with an AGI that appears to exceed the minimum eligibility requirements is notified in writing of the results. Upon receipt of such notice, a producer has the opportunity to provide the FSA with a third-party verification from a CPA or attorney demonstrating that the AGI limits were not exceeded. If the FSA determines that a producer is not in compliance with the applicable AGI limitations, the producer has the right to appeal the determination to the state FSA committee or National Appeals Division. County offices are not involved with AGI appeals.

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PROBLEM AREAS

While the computation of AGI applies individually to each spouse, married couples filing jointly may be a likely source of an adverse notice from FSA. A married couple's combined AGI may exceed the AGI limitations without either spouse's individual AGI exceeding the limitations. Unless the IRS analyzes the various schedules, Forms 1099, Schedules K-1, and Forms W-2 associated with a joint return, the IRS is unable to determine how to allocate AGI between the spouses.

Note. Given current staffing and budget issues that the IRS is facing, this level of scrutiny may not be performed on a wide scale. However, the IRS National Office has identified the issue and hopefully will provide guidance on how this will be implemented.

RECEIPT OF ADVERSE NOTICE

Upon receipt of an adverse notice, a producer should seek verification from a tax professional or attorney. It is important for producers to realize that an adverse notice from the FSA does not automatically mean that they have exceeded AGI limitations. In many cases, the producers only need to provide third-party verification to overcome the adverse notice.

USE OF TAX INFORMATION

While producers may be concerned about granting the IRS permission to release tax information to the FSA, this income verification approach appears the least invasive of the alternatives. For example, instead of the present AGI verification program, the FSA could have required producers to deliver tax returns, business records, or signed third-party verifications to county offices. This would have likely presented numerous administrative and confidentiality issues.

Observation. The AGI verification program implemented by the FSA seems a reasonable balance between the need to enforce program payment rules and the need to protect taxpayers' personal income tax information. At present, it remains to be seen whether the verification process will function in a workable manner and whether FSA appeals can be properly processed and adjudicated.

ISSUE 7: OTHER AGRICULTURAL ISSUES

ELIGIBILITY FOR EXTENDED REPLACEMENT PERIOD FOR LIVESTOCK SOLD DUE TO DROUGHT

IRC §1033 allows nonrecognition of gain for involuntarily converted property that is replaced with property that is similar or related in service or use. A farmer who sells an excess number of livestock (other than poultry) that have been held for draft, breeding, or dairy purposes can treat the excess sold as an involuntary conversion if the livestock is sold or exchanged solely on account of drought, flood, or other weather-related conditions. **Excess** is defined as more than is typically sold in the normal course of business. The livestock must be replaced with like-kind livestock. Normally, the replacement period is four years from the close of the first tax year in which any part of the gain from the conversion is realized. The Treasury Secretary has been given the discretion to extend the replacement period for taxpayers affected by prolonged drought. In those areas, the replacement period is extended until the end of the taxpayer's first tax year **ending after the first drought-free year.** The purpose of the change was to give livestock producers in areas that have sustained long periods of drought additional time to find replacement property and be eligible for deferred gain.

Note. If an area is designated as having a drought for the tax year, the extended replacement period applies.

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By the end of September every year, the IRS issues a notice announcing the extension of the replacement period for livestock that farmers must sell because of severe weather conditions and publishes a list of affected areas.

Another way to determine whether a taxpayer is in an area that has experienced exceptional, extreme, or severe drought is to refer to the U.S. drought-monitor maps that are produced on a weekly basis by the National Drought Mitigation Center. These maps are found at **www.drought.unl.edu/dm/archive.html.**

EXPANDED REPORTING REQUIREMENTS

Form 1099

One of the many tax provisions contained in the Patient Protection and Affordable Care Act (known as the Health Care Reform Bill) expands the information-reporting requirement beginning in 2012.[38] Under the provision, corporations are no longer exempt from the Form 1099 reporting requirement. Form 1099 will be required for all payments by businesses for property or services aggregating $600 or more per year to all payees other than tax-exempt entities.

The provision will have a significant impact on many agricultural operations. Under current law (until the new provision becomes effective), a Form 1099 is required by an individual or entity that is engaged in a trade or business that paid $600 or more in a calendar year to another individual or noncorporate entity for rent, interest, and nonemployee compensation. For payments made after 2011, corporations (unless tax exempt) are no longer exempt payees for purposes of the Form 1099 reporting requirement. For payments after 2011, "amounts in consideration for property" is added to the list of expenses requiring the issuance of a Form 1099. Thus, farm businesses (and other types of businesses) must obtain the names, addresses, and taxpayer identification numbers for all persons and taxable entities to which payment was made in excess of $600 during the calendar year.

Observation. Unless Congress clarifies the term "property," any farm product purchased in the conduct of a farming business is covered by the new provision. This will lead to an increased compliance burden on farmers. Likewise, tax preparation fees will likely rise due to the significant increase in the number of Forms 1099 that must be prepared and issued. The National Taxpayer Advocate report estimates the new reporting requirement will affect over 2 million farmers.[39]

Note. In July 2010, House Democrats and Republicans proposed repealing this provision. The small business community has warned that the provision would be overly burdensome. This is the first time that both parties have gone on record to support repealing a piece of the health care law.

38. P.L. No. 111-148, Sec. 9006, amending IRC §6041, effective for payments made after Dec. 31, 2011.

39. IRS, *National Taxpayer Advocate Report to Congress Fiscal Year 2011 Objectives*, Publication 4054, Catalogue Number 34427X.

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Form W-2

Also included in the Health Care Reform Bill is a provision that will affect farm and ranch businesses with employees who are provided with health insurance. For tax years beginning after 2010, employers must file a Form W-2 reporting the value of health benefits for each employee that the employer covers. The premium cost reported does not include the cost associated with policies that cover specific diseases or events (e.g., cancer policies, long-term care insurance or accident insurance). The total premium cost is reported on the Form W-2 regardless of how the cost is split between the employer and the employee. Payments made to an employee's health savings account or medical savings account are excluded from this provision and continue to be reported on Form W-2, box 12.

Note. The amount reported on the 2011 Form W-2 is for informational purposes only. It is not included in the employee's taxable income. The federal government will use the information to verify health insurance coverage for other provisions in the health care legislation. Some reports have indicated that the amount of health benefits reported on the Form W-2 will be taxed. While that is not true initially, the additional tax on health benefits under the health care legislation starts in 2018. At that time, insurers must pay a 40% tax on the portion of employer-sponsored health plan benefits exceeding certain limits. While the tax will be imposed on insurers, insurers can be expected to pass the cost on to employers. Employers, in turn, will likely pass the cost on to employees by reducing coverage via increasing deductibles so that the premiums remain under the tax threshold.

Note. See Chapter 12, New Legislation, for extensive coverage of the health care legislation.

IRS SYSTEMIC FARM ISSUE

Over the past three to five years, the IRS noted that some filed farm returns include both Schedule J and Schedule D. On these returns, tax liability is being incorrectly calculated. There does not appear to be any consistency on these returns as to whether tax was computed using Schedule D or Schedule J. The issue was referred to the IRS Taxpayer Advocate and was input into the Systemic Advocacy Management System. Samples of the notices and returns were gathered to determine whether a problem exists.

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