Chapter 11: Agricultural Issues and Rural Investments

Corrections were made to this material through January of 2012. No subsequent modifications were made.

FARM INCOME AVERAGING

OVERVIEW

Taxpayers engaged in farming or fishing can elect to average current farming or fishing income over three prior base years in order to utilize any unused lower income tax brackets from those prior years. The taxpayer can select the amount of current year income that qualifies to be averaged (known as "elected farm income") that will be spread over and taxed at rates applicable for the base years. Thus, if an eligible taxpayer has high income from farming or fishing activities in the election year, the technique shifts some of that income to the base years where it is taxed at lower marginal rates. Taxpayers who have farming or fishing income during the tax year as a sole proprietor, a partner in a partnership, or a shareholder in an S corporation may use income averaging without regard to whether the individual was engaged in a farming or fishing business in any prior year.[1] C corporations, estates, and trusts are not eligible for farm income averaging.

ELIGIBLE TAXPAYERS

Farm Business

A farm business, for income averaging purposes, is defined by a cross-reference to IRC §263A(e)(4). It is a trade or business that involves the following.

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- The cultivation of land
- Raising or harvesting any agricultural commodity
- Operating a nursery or sod farm
- Raising or harvesting trees that bear fruit, nuts, or other crops, horticultural products, or ornamental trees and plants (An evergreen tree must be six years old or less at the time of cutting to be considered an ornamental tree.)

The instructions for Schedule J explain that a farm business does **not** include contract harvesting of a commodity.

1. Prop. Treas. Reg. §1.1301-1(b).

Fishing Operations

Effective for tax years beginning after July 22, 2008, income averaging is available for taxpayers who derive income from catching, taking, or harvesting fish. It does not include processing fish. Fish include finfish, mollusks, crustaceans, and all other forms of marine animal and plant life excluding marine mammals and birds. A taxpayer may treat qualified settlement income as income from a fishing business that is eligible for income averaging. This is limited to interest and punitive damages received in connection with the civil action associated with the Exxon Valdez oil spill off the coast of Alaska.[2] "Fishing business" refers to the conduct of commercial fishing as defined in section three of the Magnuson-Stevens Conservation and Management Act.[3] Thus, a fishing business harvests fish intended for commerce through sale, barter, or harvesting.[4] "Fishing" is defined as catching, taking, or harvesting fish, or attempting to do so, or engaging in any activity reasonably expected to result in catching, taking or harvesting fish. It also includes any operations at sea in support of or in preparation for catching, taking or harvesting fish.

If a taxpayer farms **and** fishes, then income from both operations must be combined for averaging purposes. Farming and fishing income does not include compensation received as an employee. However, a shareholder of an S corporation that is engaged in farming or fishing may treat compensation received from the corporation as farming or fishing income.[5] Likewise, crewmen on a vessel engaged in commercial fishing compensated with a percentage of the catch may also count that income as eligible for income averaging.[6]

> **Note.** A lessor of a fishing vessel is not deemed to be engaged in a fishing business if the lessor receives fixed lease payments. However, lessors of vessels engaged in fishing are eligible to make the election if the lease payments are based on a share of the catch in accordance with a written lease entered into before the lessee begins significant fishing activities that result in the catch.

ELIGIBLE INCOME

In General

Elected farm income (EFI) is the amount of income attributable to any farming business that is specifically elected by the taxpayer for income averaging. Any portion of taxable income attributable to farming may be designated as EFI for averaging purposes. EFI may not exceed taxable income for the taxpayer. Net capital gain attributable to a farming business may not exceed total net capital gain for the taxpayer. Consequently, EFI can be no greater than the taxpayer's total taxable income (after subtracting any net operating loss (NOL) deductions) or the taxable income attributable to farming or fishing operations, whichever is less. This is termed "electable farm income."

EFI includes net Schedule F income and gain from the sale or disposition of farm business property **regularly used** by a farmer for a **substantial period** in a farming business. It does not include the sale of land or timber. EFI includes Schedule F sales, sales of raised dairy and breeding livestock reported on Form 4797, and sales of farm business property including farm property for which depreciation was claimed.

> **Note.** Income from the sale of land is deemed as not attributable to a farming or fishing business. However, income from the sale of structures affixed to the land is deemed as attributable to a farming or fishing business.

EFI also includes the taxpayer's share of net farm income from a partnership, LLC, or S corporation (including wages). Wages from a C corporation are not included in EFI.

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2. TD 9509, 2011-6 IRB 450 (effective for tax years beginning after Dec. 15, 2010).
3. 16 U.S.C. §1802(4).
4. TD 9509, 2011-6 IRB 450 (effective for tax years beginning after Dec. 15, 2010).
5. Treas Reg §1.1301-1(e)(1).
6. Ibid.

Gain from asset sale after farming/fishing activity ceased. While neither the Code nor the committee reports define the phrases "regularly used" or "substantial period," the regulations provide a safe harbor for the disposition of property **after** the cessation of farming. Under the safe harbor, if a gain or loss from the disposition of property is realized after cessation of a farming business, the gain or loss is treated as attributable to a farming business. However, the property must be sold within a **reasonable** time after cessation of the farming business. A sale or other disposition within one year of cessation of a farming business is presumed to be within a reasonable time if the items are not used in a nonfarm business before being sold. Whether a sale or other disposition occurring more than one year after cessation of the farming business is considered within a reasonable time depends on all the facts and circumstances.[7]

Example 1. Guy Wire quit farming at the beginning of 2010 and started a landscaping business. In March 2010, Guy sold his farmland, livestock, outbuildings and the bulk of his farm equipment. He did not sell a tractor, box grader, and truck because he planned to continue to use those items in the landscaping business. However, in mid-2011, he found great deals on newer items and sold his truck, tractor, and grader. The items were sold more than one year after Guy ceased his farming business. This normally triggers application of a facts and circumstances test. Because the assets were used in a nonfarm business before being sold, **none** of the gain on sale of any of the items qualifies for an income averaging election.

Wage and Lease Income

Final regulations provide that wages to a shareholder in an S corporation engaged in farming and the landlord's share of a crop-share lease may be included in EFI. **It does not matter whether the landlord materially participates in the production of the crop.** Thus, rental income received by landlords that report their share of rental income on either Schedule F or Form 4835, *Farm Rental Income and Expenses,* is eligible for the farm income averaging election. However, rental income that is reported on Schedule E (cash rental income) is **not** considered income attributable to a farming operation.

> **Note.** A written lease must be entered into before the tenant begins farming activities in order to establish the existence of the crop-share lease. This rule may require existing leases to terminate in accordance with state law, with the tenancy relationship reestablished in accordance with the written agreement.

Other Matters

The final regulations specify that EFI includes all income and net gains and losses attributable to an individual's farming business. This includes loss carryovers, carrybacks, and net capital loss carryovers. Conversely, the regulations state that income, gain, or loss from "the sale of development rights, grazing rights and other similar rights" are **not** considered attributable to a farming business.

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

Determining Taxable Income

Negative Taxable Income. When determining taxable income, a significant question arises about whether EFI for the election year can be negative. IRS Pub. 225, *Farmer's Tax Guide,* provides guidance.

> *If your taxable income for any base year was zero because your deductions were more than income, you may have negative taxable income for that year to combine with your EFI on Schedule J.*

The answer to the question is **"yes";** negative taxable income in a base year can be used in the income averaging calculation.

> **Note.** The final regulations permit all allowable deductions, including any NOL, to be used to determine taxable income even if the result is negative. However, any negative amount that provided a benefit in another taxable year must be added back to the base year taxable amount. Therefore, an NOL that is carried to other years and provides a benefit may not be used.[8]

IMPACT OF ELECTION

Only Applicable to Income Tax

The regulations specify that income averaging affects only federal income tax and has no application to employment taxes (FICA, FUTA, SECA, or income tax withholding). When calculating AMT, the taxpayer's regular tax liability is determined **without** regard to farm income averaging. Therefore, the election does not increase AMT for the taxpayer. Taxpayers using income averaging receive the full benefit of the lower tax brackets. Income tax is determined by allocating EFI to the base years only after all other adjustments and determinations are made.

CALCULATION

Schedule J requires the taxpayer to subtract EFI from the current year's taxable income. The tax on the remaining income is then calculated using the current year's income tax rates.

The tax on EFI can be calculated using a 5-step procedure.

1. The taxpayer determines a portion of the current year's farming or fishing income and designates all or a portion of it as EFI. Tax is computed on current year income after subtracting the EFI using current year tax rates.
2. The amount designated as EFI from Step 1 is divided by three with an equal amount added to the taxable income of each base year (which may be recomputed as a negative amount in some cases).
3. The tax on each new base year amount is computed in accordance with the tax rates applicable for that year.
4. The previously paid tax for each base year is subtracted from the new base year tax.
5. The tax for the year of election is the sum of the tax on the election year income less the EFI and the amount from Step 4 for each of the base year calculations.

8. Treas. Reg. §1.1301-1(d)(2).

CAPITAL GAIN/ORDINARY INCOME

The regulations allow taxpayers with both ordinary income and capital gain income that is eligible for income averaging to split EFI between capital gain or ordinary income. A taxpayer can carry forward unused lower brackets as ordinary farm income and keep capital gains in current-year taxable income, or select the best combination of ordinary farm income and qualified capital gains consistent with their tax strategy.[9] If the EFI includes both ordinary income and capital gain income, the regulations require this income to be allocated in equal portions among the tax brackets of the three prior years. Capital gains that are included in the tax bracket of a prior year do not offset capital losses from that year. Instead, they are taxed at the lesser of the capital gains rate or the ordinary income tax rates for the prior year. Thus, capital gains could potentially be taxed at 0% if the taxpayer has taxable income in the 15% (or lower) tax bracket.[10] Net capital losses first offset net capital gains, both farm and nonfarm gains, before reducing ordinary income.[11] The rule that capital losses can only offset up to $3,000 of ordinary income per year still applies for purposes of EFI calculations.[12] A taxpayer can elect to carry back only ordinary income, or any combination of ordinary and capital income after making these adjustments.

Note. The final regulations permit a taxpayer to make changes or revoke the election on an amended return if the statute of limitations has not expired.

For purposes of the examples that follow, the top ends of the marginal income tax brackets for years 2008 through 2011 by filing status are listed here.

Note. For 2008 through 2011, all income above the 33% bracket is taxed at 35%.

2008

	10%	15%	25%	28%	33%
Married filing jointly	$16,050	$65,100	$131,450	$200,300	$357,700
Married filing separately	8,025	32,550	65,725	100,150	178,850
Head of household	11,450	43,650	112,650	182,400	357,700
Single	8,025	32,550	78,850	164,550	357,700

2009

	10%	15%	25%	28%	33%
Married filing jointly	$16,700	$67,900	$137,050	$208,850	$372,950
Married filing separately	8,350	33,950	68,525	104,425	186,475
Head of household	11,950	45,500	117,450	190,200	372,950
Single	8,350	33,950	82,250	171,550	372,950

9. Treas. Reg. §1.1301-1(e)(2)(i).
10. Treas. Reg. §1.1301-1(d)(1).
11. Treas. Reg. §1.1301-1(e)(ii), Examples 3–4.
12. Treas. Reg. §1.1301-1(e)(ii), Example 5.

2010

	10%	15%	25%	28%	33%
Married filing jointly	$16,750	$68,000	$137,300	$209,250	$373,650
Married filing separately	8,375	34,000	68,650	104,625	186,825
Head of household	11,950	45,550	117,650	190,550	373,650
Single	8,375	34,000	82,400	171,850	373,650

2011

	10%	15%	25%	28%	33%
Married filing jointly	$17,000	$69,000	$139,350	$212,300	$379,150
Married filing separately	8,500	34,500	69,675	106,150	189,575
Head of household	12,150	46,250	119,400	193,350	379,150
Single	8,500	34,500	83,600	174,400	379,150

Example 2. Kevin and Jane are married with no dependent children.They use the standard deduction rather than itemize. Kevin's Schedule F income for 2011 is $130,000 and the couple's taxable income is $113,600. Without income averaging, their income tax liability would be $20,650. In the past, Kevin and Jane reported taxable income in the 10%–15% bracket. Taxable income for tax years 2008, 2009, and 2010 was $16,000, $17,000 and $18,000, respectively. Approximately $50,000 of additional taxable income would be needed in each of these years to reach the top of the 15% tax bracket.

Kevin and Jane could elect to average up to $113,600 (an average of $37,867 over the three years) of current farm income or gains. They elect $96,600 to be averaged. This moves all of Kevin and Jane's 2011 income (currently in the 25% bracket) to the prior year's 15% bracket ($113,600 taxable income − $96,600 = $17,000, which is the bottom of the 15% bracket for 2011). This reduces their current tax liability by $4,460 (10% of $44,600), which is the amount moved from the 25% bracket to the 15% bracket ($113,600 – $69,000 = $44,600).

Observation. For practical purposes, it is generally advantageous to elect as much farm income as possible in order to reduce the current-year taxable income to the lowest optimal amount. When the current year becomes a prior year in the future, there will be a greater portion of the 15% bracket available to absorb the farm income of future years. Additionally, an income averaging election can be useful when tax rates rise and income remained relatively constant in the election year as compared to the base years. That is an important point because of the possibility that the Bush-era tax cuts will be allowed to expire, resulting in a tax increase for all income groups beginning in 2013. This could result in an effective marginal tax rate of 62% for taxpayers in the highest bracket when state taxes and payroll taxes are included. This does not include the additional 3.8% tax on "investment" income presently scheduled to become effective for tax years after 2012.

Practitioner Note. It is important to remember that when determining whether income averaging will benefit a taxpayer, the taxable income from the prior six years should be considered, since taxpayers can amend any open tax year to elect income averaging.

Caution. Tax preparers may need to verify that the desired election has truly been made on electronically filed returns with no current year Schedule J benefit.

For Example 2

SCHEDULE J (Form 1040) Department of the Treasury Internal Revenue Service (99)	**Income Averaging for Farmers and Fishermen** ▶Attach to Form 1040 or Form 1040NR. ▶See separate Instructions.	OMB No. 1545-0074 2011 Attachment Sequence No. 20

Name(s) shown on return: Kevin and Jane — Social security number (SSN): 999-88-7777

1	Enter the taxable income from your **2011** Form 1040, line 43, or Form 1040NR, line 41			1	113,600
2a	Enter your **elected farm income** (see instructions). **Do not** enter more than the amount on line 1			2a	96,600
	Capital gain included on line 2a:				
b	Excess, if any, of net long-term capital gain over net short-term capital loss	2b			
c	Unrecaptured section 1250 gain	2c			
3	Subtract line 2a from line 1			3	17,000
4	Figure the tax on the amount on line 3 using the **2011** tax rates (see instructions)			4	1,700
5	If you used Schedule J to figure your tax for: • 2010, enter the amount from your 2010 Schedule J, line 11. • 2009 but not 2010, enter the amount from your 2009 Schedule J, line 15. • 2008 but not 2009 or 2010, enter the amount from your 2008 Schedule J, line 3. Otherwise, enter the taxable income from your **2008** Form 1040, line 43; Form 1040A, line 27; Form 1040EZ, line 6; Form 1040NR, line 40; or Form 1040NR-EZ, line 14. If zero or less, see instructions.	5	16,000		
6	Divide the amount on **line 2a** by 3.0	6	32,200		
7	Combine lines 5 and 6. If zero or less, enter -0-	7	48,200		
8	Figure the tax on the amount on line 7 using the **2008** tax rates (see instructions)			8	6,428
9	If you used Schedule J to figure your tax for: • 2010, enter the amount from your 2010 Schedule J, line 15. • 2009 but not 2010, enter the amount from your 2009 Schedule J, line 3. Otherwise, enter the taxable income from your **2009** Form 1040, line 43; Form 1040A, line 27; Form 1040EZ, line 6; Form 1040NR, line 40; or Form 1040NR-EZ, line 14. If zero or less, see instructions.	9	17,000		
10	Enter the amount from line 6	10	32,200		
11	Combine lines 9 and 10. If less than zero, enter as a negative amount	11	49,200		
12	Figure the tax on the amount on line 11 using the **2009** tax rates (see instructions)			12	6,545
13	If you used Schedule J to figure your tax for 2010, enter the amount from your 2010 Schedule J, line 3. Otherwise, enter the taxable income from your **2010** Form 1040, line 43; Form 1040A, line 27; Form 1040EZ, line 6; Form 1040NR, line 41; or Form 1040NR-EZ, line 14. If zero or less, see instructions.	13	18,000		
14	Enter the amount from line 6	14	32,200		
15	Combine lines 13 and 14. If less than zero, enter as a negative amount	15	50,200		
16	Figure the tax on the amount on line 15 using the **2010** tax rates (see instructions)			16	6,693
17	Add lines 4, 8, 12, and 16			17	21,366

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 25513Y **Schedule J (Form 1040) 2011**

For Example 2

Schedule J (Form 1040) 2011 **Kevin and Jane** **999-88-7777** Page **2**

18	Amount from line 17			18	21,366
19	If you used Schedule J to figure your tax for: • 2010, enter the amount from your 2010 Schedule J, line 12. • 2009 but not 2010, enter the amount from your 2009 Schedule J, line 16. • 2008 but not 2009 or 2010, enter the amount from your 2008 Schedule J, line 4. Otherwise, enter the tax from your **2008** Form 1040, line 44;* Form 1040A, line 28;* Form 1040EZ, line 11; Form 1040NR, line 41;* or Form 1040NR-EZ, line 15.	19	1,600		
20	If you used Schedule J to figure your tax for: • 2010, enter the amount from your 2010 Schedule J, line 16. • 2009 but not 2010, enter the amount from your 2009 Schedule J, line 4. Otherwise, enter the tax from your **2009** Form 1040, line 44;* Form 1040A, line 28;* Form 1040EZ, line 11; Form 1040NR, line 41;* or Form 1040NR-EZ, line 15.	20	1,714		
21	If you used Schedule J to figure your tax for 2010, enter the amount from your 2010 Schedule J, line 4. Otherwise, enter the tax from your **2010** Form 1040, line 44;* Form 1040A, line 28;* Form 1040EZ, line 11; Form 1040NR, line 42;* or Form 1040NR-EZ, line 15	21	1,862		
	***Do not** include any tax reported on this line from Forms 8814, 4972, or 8889, or from recapture of an education credit or charitable contribution deduction. Also, **do not** include alternative minimum tax from Form 1040A.				
22	Add lines 19 through 21			22	5,176
23	**Tax.** Subtract line 22 from line 18. Also include this amount on Form 1040, line 44; or Form 1040NR, line 42			23	16,190

Caution. Your tax may be less if you figure it using the 2011 Tax Table, Tax Computation Worksheet, Qualified Dividends and Capital Gain Tax Worksheet, or Schedule D Tax Worksheet. Attach Schedule J only if you are using it to figure your tax.

Schedule J (Form 1040) 2011

Note. The same 2011 tax would result if only $44,600 of EFI was elected to be averaged; however, in the example, the entire 2011 15% bracket is available for averaging purposes in years 2012, 2013, and 2014.

Example 3. Joe and Sue had the following income for the three base years and 2011.

2008	($ 50,000)	(includes $30,000 NOL from a prior year)
2009	15,000	
2010	1,500	
2011	150,000	

Their EFI for 2011 is $93,000. Joe and Sue must eliminate the NOL from the base year 2008. Therefore, the base year income for 2008 becomes ($20,000).

EFI in each of the three base years is as follows.

2008	($20,000)	+	$31,000	=	$11,000
2009	15,000	+	31,000	=	46,000
2010	1,500	+	31,000	=	32,500

2011 income tax **with** income averaging is as follows.

Base Year	Base Year Income Elected as Adjusted	Share of Farm Income	Income after Share of Elected Farm Income	Income Tax with Farm Income Averaging	Income Tax without Farm Income Averaging	Additional Tax Due to EFI
2008	($ 20,000)	$31,000	$11,000 × 10%	$1,100	$ 0	$1,100
2009	15,000	31,000	46,000 × 10%/15%	6,065	1,500	4,565
2010	1,500	31,000	32,500 × 10%/15%	4,038	150	3,888
2011	150,000	(93,000)	57,000 × 10%/15%	7,700		7,700
						$17,253

2011 income tax **without** income averaging is calculated here.

Income		Bracket	Tax
$ 17,000	×	10%	$ 1,700
52,000	×	15%	7,800
70,350	×	25%	17,588
10,650	×	28%	2,982
$150,000			$30,070

Income tax savings equals $12,817 ($30,070 − $17,253).

Example 4. Verlin was eligible for income averaging in 2009, 2010, and 2011. His EFI in 2009, 2010, and 2011 was $15,000, $18,000, and $21,000, respectively. His base income for averaging must reflect the additions which result from his prior income averaging.

	2006	2007	2008	2009	2010	2011
Base income without Schedule J	$10,000	$10,000	$10,000	$45,000	$58,000	$60,000
	5,000	5,000	5,000	(15,000)		
2009 EFI	$15,000	$15,000	$15,000	$30,000		
		6,000	6,000	6,000	(18,000)	
2010 EFI		$21,000	$21,000	$36,000	$40,000	
			7,000	7,000	7,000	(21,000)
2011 EFI			$28,000	$43,000	$47,000	$39,000

KIDDIE TAX

If a farmer elects to use farm income averaging in a year in which he also pays kiddie tax, he uses the tax rate determined after allocating EFI. For example, the farmer may be in a 25% tax bracket before income averaging and a 15% bracket after income averaging. The farmer uses the 15% bracket to calculate the kiddie tax.

In a base year, kiddie tax is not affected by income averaging.

AMT ON FARM LOSSES ASSOCIATED WITH PASSIVE ACTIVITIES

PASSIVE LOSS RULES

The passive loss rules[13] can have a substantial impact on farmers and ranchers as well as on investors in farm and ranch land. Until 1987, it was not uncommon for nonfarm investors to purchase agricultural land and incur losses that they would then use to offset their wages or other income. However, the passive loss rules, enacted in 1986, reduce the possibility of offsetting passive losses against active income. Nondeductible passive losses and credits carry forward indefinitely and can be used against passive activity income in the carryforward years until the activity is sold.[14] The effect of the rules is that deductions from passive trade or business activities, to the extent the deductions exceed income from all passive activities, may not be deducted against other income.[15] The proper characterization of the loss depends on whether the taxpayer materially participates in the business.[16] Even though passive losses can be carried forward and claimed in a carryforward year or offset gain from the sale of agricultural real estate, taxpayers typically want to claim their losses in the current year. Consequently, the rule encourages taxpayers to sell their investments if they cannot currently deduct the losses.

As mentioned, a passive activity is a trade or business in which the taxpayer does not materially participate. Material participation is defined as "regular, continuous, and substantial involvement in the business operation."[17] The regulations provide seven tests for material participation in an activity.[18] The tests are exclusive and stipulate that an individual generally is treated as materially participating in an activity during a year if:

- The individual participates more than 500 hours during the tax year;
- The individual's participation in the activity for the tax year constitutes substantially all of the participation in the activity of all individuals (including individuals who are not owners of interests in the activity) for the tax year;
- The individual participates in the activity for more than 100 hours during the tax year, and the individual's participation in the activity for the tax year is not less than the participation in the activity of anyone else (including nonowners) for the tax year;
- The activity is a **significant participation activity** and the individual's aggregate participation in all significant participation activities during the tax year exceeds 500 hours;
- The individual materially participated in the activity for any five taxable years during the 10 taxable years that immediately precede the tax year at issue;
- The activity is a personal service activity, and the individual materially participated in the activity for any three taxable years preceding the tax year at issue; **or**
- Based on all the facts and circumstances, the individual participates in the activity on a regular, continuous, and substantial basis during the tax year.

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13. IRC §469.
14. IRC §469(b).
15. IRC §469.
16. IRC §469(h).
17. IRC §469(h)(1).
18. Temp. Treas. Reg. §1.469-5T(a)(1)-(7).

If a taxpayer fails to meet the material participation test, there is a fall-back test of active participation. The active participation test allows a taxpayer to deduct up to $25,000 each year if the losses are connected with rental real estate activities.[19]

> **Note.** A major problem in the agricultural community is that the IRS has taken the position that a crop-share lease is a joint venture and not a rental real estate activity.[20] Because crop shares are not "rent," the landlord does not qualify under the active participation test. That means crop-share leases, custom farming operations, or similar arrangements that fail the material participation tests **must be changed to a cash-rent lease** in order to qualify for the $25,000 deduction.

IMPACT OF AMT

Noncorporate taxpayers who are not material participants in a farming business may not deduct losses from such activities in computing alternative minimum taxable income (AMTI).[21] This includes personal service corporations.[22] The rule impacts passive participation in farm syndicates[23] in addition to passive farm activities in which the taxpayer or the taxpayer's spouse is not a material participant.[24]

> **Note.** If the taxpayer is insolvent, the amount of suspended losses must be reduced by the amount of a taxpayer's insolvency during the tax year when required by the rules of nonrecognization of discharged debt income. Insolvency is defined as the excess of a taxpayer's liabilities over the FMV of their assets.

GROUPING ACTIVITIES

For AMT purposes, it is not possible to combine income and loss amounts from various farming passive activities to determine an overall loss or gain. Each activity is regarded separately. A $50,000 loss in one passive activity and a $50,000 gain in another activity cannot be netted for AMTI purposes. Instead, the taxpayer has a $50,000 gain for purposes of computing AMTI. Tax preferences that are included in losses must be adjusted in order to eliminate the preference.

For regular tax purposes, it is possible to group activities together as a single economic unit under the passive loss rules. If grouping can be done, the farmer's material participation in a farming activity counts as material participation in the passive business, and the losses offset the farming income.

Any reasonable method for making the grouping determination can be utilized, although certain factors are given the greatest weight in determining whether activities should be grouped or kept separate. These factors include:

- Similarities or differences in types of businesses,
- Extent of common control,
- Extent of common ownership,
- Geographic location, and
- Business interdependencies.

The election to group activities is made by filing a statement with the taxpayer's original income tax return for the taxable year.

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19. IRC §469(i).
20. Temp. Treas. Reg. §1.469-1T(e)(3)(viii), Example 8.
21. IRC §58(a).
22. See IRC §469(j)(2).
23. IRC §464(c).
24. IRC §469(c).

In Rev. Proc. 2011-34,[25] the IRS explains that real estate professionals who have losses from rental activities can make the grouping election on a retroactive basis. Several requirements must be satisfied to make a retroactive election. The taxpayer must have filed returns that are consistent with single-activity election status for all tax years to which the late election applies. The taxpayer must also have reasonable cause for making the late election.

Procedurally, the election is made by amending the most recently filed return and attaching a statement informing the IRS of the grouping election on a retroactive basis in accordance with the revenue procedure. The taxpayer is then treated as having made a timely election to treat all interests in rental real estate activities as a single rental real estate activity as of the tax year for which the late election is requested.

The effective date of the revenue procedure is June 13, 2011, and it applies to all letter ruling requests that were pending with the IRS on June 13, and to all requests for relief after that date. Persons involved in real estate activities may qualify as a real estate professional for purposes of the passive loss rules. A person can qualify as a real estate professional if they engage in real estate activities for more than 750 hours and do not spend more time in other activities. The IRS takes the position that the 750-hour test must be met for **each activity.** The ability to group multiple activities in order to meet the 750-hour test is very important.

Passive losses must be recomputed using AMT adjustments and preferences rather than those that are applicable for the regular income tax. The AMT adjustment is the difference between the amount reported on Form 1040 and the recomputed amount.

Losses disallowed as deductions from AMTI in one tax year can be claimed as deductions from farm income for that activity in the next tax year. If a taxpayer disposes of their interest in a passive activity, the taxpayer can claim their losses against AMTI.

Note. See Chapter 6, AMT for Individuals, for more information about the effects of AMT.

ALLOCATION OF FARMLAND VALUE TO DEPRECIABLE PROPERTY

OVERVIEW

It is important to allocate value to depreciable property when a farm is acquired. These values should be recorded on the appropriate depreciation schedule beginning with the tax year in which the property is placed in service. This allows taxpayers to convert a portion of the purchase price (or value of the transferred land) into valuable tax deductions. Documentation concerning how the allocations were determined must be kept in the event of an audit. While land is not depreciable, improvements on the land may be depreciable. These include improvements such as fences, drainage tile, buildings, corrals, timber, wells, water lines, irrigation equipment, landscaping costs, and residual fertilizer supply. There may be other property (such as a gravel road) that should also receive a cost allocation. Whether the cost of landscaping is deductible is a fact-based question. In general, landscaping costs are depreciable if the landscaping would be destroyed if buildings were replaced. For instance, in *Everson*,[26] the court did not allow a depreciation deduction for trees and bushes that had been planted as a windbreak to reduce moisture evaporation and soil erosion. The court noted that because the trees at issue did not produce nuts or fruits, they did not produce income but were an inherent part of the land.

Observation. The logic behind this conclusion is that a buyer would likely pay a higher price for land containing good fences, good soil fertility, and a good tile system as opposed to land without those characteristics. Thus, a portion of the purchase price can be allocated to those items and recovered via depreciation.

25. Rev. Proc. 2011-34, 2011-24 IRB 1.

26. *Everson v. U.S.,* 108 F.3d 234 (9th Cir. 1997).

How to properly allocate value to these items has become increasingly important in recent months given the increase in farmland values in many parts of the United States, particularly in the Midwest Corn Belt. The rise in value may indicate that greater amounts can be allocated to depreciable items than in the past.

Observation. Many purchase contracts or transfer documents do not identify any purchase price allocation for the various assets involved. However, the IRS generally respects whatever agreement unrelated parties make.

GENERAL PRINCIPLES

A crucial point upon audit is that all real estate acquisition allocations must be justifiable. If the purchase-price allocation appears to have been done in a reasonable and rational manner, the IRS usually accepts the allocation. In addition, if the primary issue involves IRC §1250 property and raw land, the buyer and seller may be able to come to an allocation agreement not detrimental to the seller's capital gain treatment of the sale proceeds. In that situation, an agreed-upon allocation should be attempted because an agreement between the parties is more difficult for the IRS to contest.

Practitioners must ensure sufficient documentation exists to support the allocations claimed on the tax return. Substantiation is the key. Following are important points to consider when making cost allocations that are likely to survive IRS scrutiny.

1. Determine the reasonable FMV of all items associated with the acquisition. This includes items such as roads, tile line, and fences. The value should be based on the price a reasonable buyer and seller would arrive at if neither party is under compulsion to buy or sell. Both parties must have full knowledge of all of the relevant facts concerning the items in question. For property such as tile lines and fences, **that approach more realistically reflects the value at the time of their acquisition rather than original installation costs.**

2. Make the necessary allocations based on the purchase price. The allocations should be based on the following formula.

   (% of FMV for each item ÷ Total FMV) × Actual purchase price

   If the property was a gift, the allocation is to the donor's basis in the property. If the property was inherited, the allocation is to the value of the property in the estate of the decedent.

3. Establish the appropriate depreciation class lives for the various depreciable assets. Fencing is depreciable over seven years; tile lines and well/water systems are depreciable over 15 years; single-purpose agricultural structures are depreciable over 10 years; and machine sheds and general purpose farm buildings are depreciable over 20 years. The allocation process allows the buyer to create a tax deduction attributable to the depreciable items involved in the acquisition.

Irrigation Equipment

The IRS has specific rules for "irrigation equipment" used in an orchard or grove. For the period prior to an orchard or grove reaching the income-producing stage, the IRS indicated that depreciation on an irrigation system is **not** deductible. The irrigation system must be capitalized and recovered over the useful life of the trees.[27]

In a Tax Court case, the IRS took the position that vineyard trellises and above-ground irrigation systems were depreciable land improvements rather than depreciable agricultural equipment.[28] The taxpayer argued that the trellises and above-ground irrigation systems were not inherently permanent and were used as an integral part of the taxpayer's production activity. The IRS countered that the trellises and irrigation systems, as a whole, were not movable and were, therefore, land improvements with the same 20-plus-year lifespan as the vines. The IRS pointed to the industry-standard applicable to long-term vineyard leases that protect the large investment in such systems and describe them as land improvements.

Observation. Key to the IRS's argument was that to move the system, the taxpayer would have to take the entire system apart and, in the process, pieces of the trellises and irrigation system would be destroyed.

There are six factors the courts use for determining whether property is depreciable tangible personal property.

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

The Tax Court agreed with the IRS regarding the irrigation system and the associated 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 approximately 30 years. Although some of the irrigation system components were above-ground and could be removed, repaired, and maintained, categorizing them as a land improvement was supported by the fact that the systems were for the most part buried underground. The court viewed them as permanent structures that were not readily movable. The entire irrigation system, including the above-ground drip lines, were ruled to be land improvements that are depreciable over 15 years. However, the court held that the trellises were depreciable over seven years. The court reasoned that trellises are synonymous with fencing (also 7-year property) in that they use posts that are not affixed in concrete. Even posts affixed in concrete were ruled to not be land improvements. The court noted that the trellises could be dismantled and moved, and 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.

Drainage Tile

In many parts of the Midwest Corn Belt, drainage tile is common. This creates a question regarding how to determine the proper depreciable cost of drainage tile on an acquired farmland.

Tiling costs have increased recently in concert with the rise in farmland values. This has made allocating tax cost to drainage tile, which is 15-year property, difficult in light of the need to stay within past IRS guidelines. Allocations vary widely. Guidelines for determining the appropriate depreciable cost of drainage tile follow.

27. Rev. Rul. 83-67, 1983-1 CB 74.

28. *Trentadue v. Comm'r,* 128 TC No. 8 (2007).

Basic Concepts. Sufficient documentation is critical to bolstering whatever allocated amount is claimed on the tax return. This is particularly true when the allocation to land improvements (such as drainage tile) is high as compared to nondepreciable real estate.

A 2006 IRS MSSP audit technique guide (ATG) for farmers[29] provided an example of a ranch purchased for $300,000 which included farm equipment plus 40 acres of grape vineyards. The purchase price did not detail any asset allocation, and the ATG warns IRS auditors that the buyer may, as a result, try to assign more than the appropriate amount to depreciable assets. To determine if that occurred, the ATG advises IRS examiners to request the buyer's property tax statement. The property tax statement typically describes the ratio between land and improvements. The ATG points out that if the statement reports the land as 40% of the total property value, then at least 40% is not depreciable. The balance must be allocated among the depreciable assets that were purchased. However, that may only be a partial solution. It could result in too much being allocated to drainage tile even though the total amount allocated to depreciable assets remains within the overall percentage that can be allocated to such assets. In some states, the property tax statement may only be applicable if there are building improvements on the property.

In a previous IRS ATG for farm returns, the IRS suggested that unless sufficient facts and evidence existed, the depreciable cost of tile for a purchased farm with tile should approximate 5% of the cost of the bare land (i.e., the value of the land without tile). It is doubtful that this percentage applies to today's agricultural land market. A 5% allocation to tile on land that is worth $8,000 per acre means that $400 is allocated to tile. That seems low given the present replacement cost of tile, which has risen dramatically in recent years. Replacement cost can be one indicator of market value. Care must be taken to **substantiate any allocation** made to depreciable tile. Without documentation, the IRS may argue that the amount allocated to drainage tile cannot exceed 5% of the cost of the land.

Establishing the Presence of Drainage Tile. The starting point in allocating value to drainage tile is to establish the tile's existence. Tile presents a practical problem in that it cannot readily be seen. There are several methods that can be used to establish the tile's existence. If possible, tile maps should be acquired from the prior owner along with their applicable depreciation schedules. It may be possible to identify subsurface drainage tile by infrared aerial photographs that are taken one to two days after a heavy rain. It may also be possible to obtain records from local USDA offices that establish the existence and extent of drainage tile. For some clients, it may be possible to have them draw existing tile lines on a property map.

Establishing Replacement Cost. One common approach for determining the allocable amount for depreciable tile is to determine the cost of replacing the tile. That cost includes the cost of the tile and the cost of installation. One fairly common approach is to assign a value of $2.00 per foot to 8-inch tile, $1.65 per foot to 6-inch tile and $1.25 per foot to 4-inch tile.[30] Whether those numbers remain valid is an open question.

Other factors that can impact replacement cost might be the proximity of existing tile lines to the tile main, and whether dredge ditches run through the property. Once replacement cost is established, that value must be discounted to reflect the age and quality of the tile at the time the property was acquired.

> **Observation.** Whatever procedure is utilized to determine a value for tile should reflect what a willing buyer believes the tile is worth. While land values and tile cost have risen in recent months, those full increases are not necessarily reflected in an FMV based on an accurate replacement cost approach. The allocation is a percentage of new cost, with the age and quality of the existing tile on the property taken into consideration.

29. *IRS Farmers Audit Technique Guide* (ATG), Training 18894-001 (Jul. 2006).

30. Figures commonly used in Iowa.

Fences

A common approach for allocating cost to fencing has been $1.50 per foot.[31] That tends to work fairly well for fencing that is in good shape. This formula may be inaccurate for broken-down fencing which may not warrant any cost allocation. Fences that are used in the farming business are 7-year property depreciable under the 150% declining balance (DB) method switching to straight line (S/L). Nonfarm fences are classified as 15-year property.

Farm Buildings and Other Structures

Farm buildings are classified as 20-year MACRS property depreciable under the 150% DB method. For this purpose, commodity storage structures that are "buildings" are also 20-year property. In general, the term "building" does not include refrigerated storage areas for apples, potato storage facilities, peanut houses, refrigerated fruit storage shelters, citrus processor's compartments, cooling and holding rooms for fruit, and freezer storage facilities.

The term "building" is not defined in the statute. However, the term was defined for investment tax credit (ITC) purposes as "any structure or edifice enclosing a space within its walls, and usually covered by a roof, the purpose of which is, for example, to provide shelter or housing, or to provide working, office, packing, display, or sales space."[32] For ITC purposes, certain structures were not considered buildings, including refrigerated storage areas for apples, potato storage facilities, peanut houses, refrigerated fruit storage shelters, citrus processor's compartments, cooling and holding rooms for fruit, and freezer storage facilities.

If there is depreciable residential rental property on the farm, it is depreciable over 27.5 years using S/L depreciation. Such property is defined as "a building or structure…for any taxable year only if 80% or more of the gross rental income from such building or structure is from dwelling units."[33] If any portion of a building or structure is occupied by the taxpayer, the gross rental income from the property includes the rental value of the portion occupied. Unless business-use is more than 20% of the structure, the business-use portion should be 27.5-year property. The term "dwelling unit" is defined as a house or an apartment used to provide living accommodations in a building or structure, but does not include a unit in a hotel, motel, inn, or other establishment in which more than half of the units are used on a transient basis.[34]

A farmhouse on the land may be classified as either a farm building which is 20-year property or residential real property which is 27.5-year property. If the farmhouse is used as an integral part of the farming operation (for instance, a farm tenant lives in the house) it is likely classified as a farm building. Although if the farmhouse is occupied by someone who does not operate the farmland, it is properly classified as 27.5-year property and depreciated over 27.5 years under the S/L method. If the farmhouse is not occupied by the owner and no rent is charged, it does not qualify as a dwelling unit and is considered either 20-year property (farm building) or 39-year property (nonresidential real property). **The IRS position on this situation is not clear, and there is no specific classification for farmhouses in general.**

Single-purpose agricultural structures, such as a confinement hog building, as well as trees and vines that produce nuts and fruits are classified under MACRS as 10-year property. Trees and vines are limited to S/L depreciation.

Residual Soil Fertility

It may be possible for the new owner of farmland used previously in a farming operation to claim expense deductions for above average residual soil fertility. However, the party acquiring the property may not have farmed the property during the prior crop year. Tax law allows the new owner to account for the carryover (i.e., residual) fertilization in the soil that was present at the time of the transfer. The rational for this position is that, at least for purchased farmland, a willing buyer would pay more for well-fertilized land.

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31. Ibid.

32. Treas. Reg. §1.48-1(e).

33. IRC §168(e)(2)(A)(i).

34. IRC §168(e)(2)(A)(ii)(1).

Treas. Regs. §§1.180-1(b) and 1.175-4 imply that land not previously used by the taxpayer or tenant in the business of farming is not eligible for the election. In order to deduct costs associated with fertilizer and lime, the taxpayer must be engaged in the trade or business of farming. This requires the taxpayer to be an operator or a landlord under a crop or livestock share lease, or materially participate in the operation or the management of the farm as in the case of a cash rent lease. The same definition of "business of farming" is used as for the soil and water expense deduction under IRC §175. The same regulations specify that, for land used by the immediately preceding owner for farming purposes, the taxpayer is considered to be using the land in farming when the expenditures are made. However, the taxpayer's use of the land must be substantially a continuation of its use in farming. It does not matter whether it is for the same farming use as that of the predecessor or any other permissible use.

Note. IRS Pub. 225, *Farmer's Tax Guide*, states that taxpayers can deduct in the year paid or incurred the cost of fertilizer, lime, and other materials applied to farmland and the cost of application. If the benefits last substantially more than one year, the costs must be capitalized and deducted each year that the benefits last unless the taxpayer chooses to deduct these expenses in the year paid or incurred. Farmland, for these purposes, is land used for producing crops, fruits, or other agricultural products used for the sustenance of livestock. It does not include land never previously used for producing crops or sustaining livestock.

The IRS recognizes the ability to allocate a portion of the purchase price of farmland to residual soil fertility. The IRS takes the position that the cost of fertilizer applied to an existing timber stand may not be deducted immediately and must be amortized.[35] The IRS later withdrew the pronouncement "pending further consideration of the issue." In an MSSP dated July 1995, the IRS stated:

> *The IRS has denied such deductions when the farmer was unable to provide data indicating the level of soil fertility attributable to the previous owner. The farmer should be able to prove beneficial ownership of the residual fertilizer supply, the presence and extent of the residual fertilizer, and that the residual fertilizer is, in fact, being exhausted.*[36]

The MSSP instructs IRS examining agents to determine if the value assigned to each farm asset is reasonable. In general, Form 8594, *Asset Acquisition Statement Under Section 1060*, is not required when only a tract of land is purchased from an existing farming operation and does not comprise the entire farming operation. However, the buyer and seller must generally file Form 8594. Both must attach the form to their tax returns when the purchase involves a group of assets comprising an existing trade or business of the seller, the buyer, or both except when the transaction involves a like-kind exchange or a transfer of a partnership interests.

In a Technical Advice Memorandum (TAM) issued before the MSSP,[37] the IRS said that in order for a taxpayer to amortize the cost of residual soil fertility, the taxpayer must be the beneficial owner of the residual fertilizer supply. The taxpayer must establish the extent and period of effectiveness of the residual soil fertility by adequate and documented measurement. In the TAM, the IRS denied a deduction for residual fertilizer supply on the basis that the taxpayer failed to establish the presence and extent of the fertilizer, and that the taxpayer was actually exhausting the fertilizer in the soil.

Note. For property acquired from a decedent's estate, residual soil fertility is measured as of the date of the decedent's death. The estate and/or the beneficiaries that receive the real estate may amortize any excess amount.

35. GCM 39844 (Apr. 16, 1991).

36. MSSP — Guidelines on Grain Farmers (Training 3149-122) (July 1995).

37. TAM 9211007 (Dec. 3, 1991).

> **Note.** Taxpayers engaged in farming can make an annual election to expense the cost of soil conditioners (such as fertilizer, lime, or potash). In order to be currently deductible, expenditures must be paid or incurred during the tax year for the "purchase or acquisition of fertilizer, lime, ground limestone, marl, or other materials to enrich, neutralize, or condition land used in farming."[38] The term "land used in farming" is defined as land used by the taxpayer or tenant for the production of crops, fruits, or other agricultural products used for the sustenance of livestock.[39] By implication, the election indicates congressional intent that soil fertility costs are capital expenditures similar in nature to expenses for tile lines and fences.

For current-year applications of fertilizer, the election is made by deducting the expense on the current year's return. If not expensed, the costs must be capitalized and recovered over the useful life of the conditioners. Useful life is probably three to five years by an operating farmer or crop-share or cash-rent landlord. The general 15-year amortization rule of IRC §197 **does not apply** to excess fertilizer supply. If a residual supply of soil fertility is being measured, it must be amortized. IRC §180 does not allow the residual supply to be expensed.

> **Observation.** Presently, excess soil fertility rates range from $50 to $300 per acre in north-central Iowa.

Measurements and Valuation. Typically, grid soil samples are utilized to assist in measuring soil fertility. Likewise, agronomists have established guidelines for determining average (base) soil fertility for various soil types. The grid soil samples can be compared to base fertility on comparable soil types to establish the amount of excess fertility (if any) on any particular tract of farmland.

It may be helpful for practitioners to advise agronomists of the need to determine the value of the land without residual fertilizer and the value of the residual fertilizer. It may not be appropriate to simply deduct the value of the residual fertilizer supply as determined by an agronomist. It can be argued that to arrive at the appropriate deduction for above-average soil fertility, the purchase price of the farmland must be prorated by the FMV of the farmland without any residual fertilizer supply and the value of the residual fertilizer supply itself.

Example 5. Pete Moss bought 80 acres of Iowa farmland for $8,000 per acre. A real estate appraiser determined that the tract was worth $6,500 per acre without a residual fertilizer supply, and an agronomist established that the residual fertilizer supply enhanced the value of the land by $1,700 per acre. Pete can allocate $6,341 per acre (($6,500 ÷ $8,200) × 8,000) to the land and $1,659 per acre (($1,700 ÷ $8,200) × $8,000) to the residual fertilizer supply. If Pete and the seller did not account for the existence of the residual fertilizer supply in negotiating the selling price of the farmland, the allocation of the purchase price to the land is $6,598 per acre (($8,000 ÷ $9,700) × $8,000) and $1,402 per acre to the residual fertilizer supply (($1,700 ÷ $9,700) × $8,000).

> **Observation.** If possible, soil sampling should be completed no later than the time the party acquiring the property takes possession. If that cannot be done, soil samples must be taken before any additional fertilizer is applied.

Documentation. Normally, a purchase contract for farmland does not document existing soil fertility. The person acquiring the property must utilize expert opinion, such as from a professional agronomist, to determine the extent of soil fertility that it is above average when compared to comparable land. The expert also can determine the timeframe over which the additional amount of soil fertility diminishes due to crop production. The documentation is necessary to substantiate the deduction because the taxpayer must establish the extent and period of effectiveness of the residual soil fertility.

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38. IRC §180(a).

39. IRC §180(b).

Income Tax Considerations on Allocation. The portion of the purchase price allocated to depreciable items such as fences, tile, and residual fertilizer supply can trigger ordinary income to the seller. The IRS monitors inconsistent allocations on the returns of the buyer and seller by comparing the tax returns of each. Consistent tax reporting is essential.

Example 6. Land Holding, LLC, purchases a 160-acre farm for a total price of $960,000. The property includes a house, machine shed, hog-finishing facility, electrical system, and 30,000 bushels of grain storage. Eighty acres of the farm were recently tiled. Land Holding, LLC, allocates the purchase price as follows with the tax deduction attributes noted.

Land	$725,000	No depreciation, basis addition only
House (residential rental)	60,000	27.5 years depreciation
Machine shed	30,000	20 years depreciation
Hog-finishing facility	90,000	10 years depreciation, eligible for §179
Electrical system	5,000	7 years depreciation, eligible for §179
Grain storage	18,000	7 years depreciation, eligible for §179
80 acres tiled	32,000	15 years depreciation, eligible for §179
Total purchase price	$960,000	

The potential §179 deduction is $145,000 or 15.1% of the total purchase price.

EXPENSE METHOD AND BONUS DEPRECIATION

EXPENSE METHOD DEPRECIATION (IRC §179) — STATUS OF THE LAW

For tax years beginning in 2010 and 2011, the Small Business Jobs Act of 2010 (SBJA) increased the expense method depreciation limits. The aggregate basis of the assets that are placed in service during the year and are eligible to be expensed increased to $500,000. The SBJA also increased the beginning of the phaseout range from $800,000 to $2 million. Thus, expense method depreciation is phased out on a dollar-for-dollar basis if the cost of qualifying property exceeds $2 million. No expensing is available if $2.5 million of the eligible assets are acquired in the tax year.

The phrase "placed in service" is defined as the point in time in which property is in a state of readiness for use in the taxpayer's trade or business. It is not enough to buy eligible property during the year; **the property must be placed in service.**

The maximum allowable deduction per year is reduced by half for MFS individuals. Similarly, members of a controlled group of corporations must allocate the annual limit. For a partnership or S corporation, the limitation applies to both the partnership/S corporation and each of the partners/shareholders. Any excess allocated amount within the overall limitation, which cannot be deducted by the partner/shareholder because of the income limitations on their personal return, can be carried forward and deducted in later years. However, if the overall limitation is exceeded, the excess amount is lost.[40] Of course, the partnership/S corporation could file an amended return to reduce the amount expensed. If that is not done, the partner's/shareholder's tax basis in one or more of the entities must be reduced by the excess IRC §179 allocation. The partner/shareholder only receives a benefit for the lost deduction when their interest in the partnership/S corporation is liquidated.

Without subsequent legislation, the expense method limit will be $125,000 in 2012 and $25,000 in 2013, with the phaseout beginning at $500,000 in 2012 and $200,000 in 2013.

Note. There have been no changes in the income limitation. The §179 deduction cannot exceed the qualified income on the taxpayer's return.

40. See, e.g., Rev. Rul. 89-7, 1989-1 CB 178.

TECHNICAL RULES

Expense method depreciation is elected by claiming the items as an expense on Form 4562, *Depreciation and Amortization*, of the original tax return. For tax years beginning in 2003 through 2011, the election can be made on an amended return. Generally, Form 4562 must be attached to either an original (first) tax return filed for the tax year that the property was placed in service or an amended return filed by the due date (including extensions) for the tax year the property was placed in service.[41]

Expense method depreciation can be claimed only to the extent of the taxpayer's taxable income from the active conduct of a trade or business. For purposes of IRC §179, Form W-2 wages count as income from a trade or business.

If a short tax year is involved, no proration of the IRC §179 amount is required. However, any regular MACRS depreciation must be prorated.

ELIGIBLE PROPERTY

General Rules

Property eligible for expense method depreciation is tangible, depreciable personal property that is purchased for use in the taxpayer's business. Certain items of depreciable personal property are not eligible for expense method depreciation. In general, any property that was not eligible for the investment tax credit (under the rules when the investment tax credit was available) is ineligible for expense method depreciation. The expensing election is available for IRC §1245 property that is used in the taxpayer's business. This includes drainage tile, fencing, storage structures, and single-purpose agricultural structures.

> **Note.** Legislation enacted in 1990 substituted "Section 1245 property" (as defined in IRC §1245(a)(3)) for "Section 38 property" in IRC §179(d)(1). The phrase "Section 38 property" referred to property that was eligible for the investment tax credit when it was in effect. For purposes of IRC §179, "trade or business" or "business of farming" is not defined. However, assets that would otherwise qualify for IRC §179 must be used in the taxpayer's business for purposes of expense deductibility under IRC §162.

Other property that qualifies for IRC §179 treatment includes the following.

- Horses acquired by purchase for use in the active conduct of a trade or business[42]
- Purchased breeding stock
- A storage facility used for the bulk storage of fungible commodities
- Off-the-shelf computer software

Qualified Real Property

The SBJA specifies that **for tax years beginning in 2010 or 2011**, certain qualified real property is also eligible for up to $250,000 of expense method depreciation. The dollar limit only applies to the aggregate cost of qualified real property. To qualify, the real property must be subject to an allowance for depreciation, and be purchased for use in the active conduct of a trade or business. The phrase "qualified real property" is defined to include qualified leasehold improvement property,[43] qualified restaurant property,[44] and qualified retail improvement property.[45]

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41. Treas. Reg. §1.179-5(a). The original return may be either a timely filed return or a delinquent return (not timely filed).
42. IRC §179(d).
43. As described in IRC §168(e)(6).
44. As described in IRC §168(e)(7) and without regard to the dates specified therein.
45. As described in IRC §168(e)(8) and without regard to subparagraph (E) thereof.

No amount attributable to qualified real property may be carried over to a tax year beginning after 2011. For these disallowed amounts, such property is treated as if no expense method depreciation election was made for the property. This is different than the general rule for property subject to an expense method depreciation election. Under the general rule, any excess amount not utilized in the current tax year (due, for example, to the business income limitation) can be carried forward indefinitely subject to the overall limitation for the particular carryforward year. If gain or loss is not recognized upon the sale or other disposition of property for which there is a carryover of expense method depreciation, the basis of the transferred property is increased immediately before the transfer by the amount of the carryover that is attributable to that property. Neither the transferee nor the transferor is allowed to claim the unused carryover as a deduction.

Because of the different carryforward rules and the different limit on the aggregate cost of qualifying property, the amount of qualified real property is computed separately from other property that qualifies for expense method depreciation. The overall limitation on the deduction remains at $500,000.

Example 7. In 2011, Otto Matics placed in service qualified real property that cost $350,000 and other qualified IRC §179 property that cost $450,000.The maximum amount of qualified real property eligible for expensing is $250,000. Given the overall limitation of $500,000, that means only $250,000 of other §179 property is eligible if Otto claims the full $250,000 on the qualified real property. If Otto's taxable income for 2011 is $200,000, that results in a $300,000 carryover amount associated with the §179 deduction. Because of the §179 limitation on carryover attributable to qualified real property, an allocation must be made. The allocation can be made in the following manner.

1. Compute the percentage of the amount of each type of property placed in service as a percentage of the whole.

Qualified real property	$350,000	43.75%
Other qualified property	450,000	56.25%
Total amount of property placed in service	$800,000	100.00%

2. Apply limitations.

Overall limitation	$500,000
Qualified real property limitation	(250,000)
Balance	$250,000
Taxable income limitation	$200,000

3. Compute carryover amount: $500,000 − $200,000 = $300,000

4. Apply allocation percentages to carryover amount:

Qualified real property	.4375 × $300,000 = $131,250
Other qualified property	.5625 × $300,000 = $168,750

Otto can carry over the $168,750 attributable to other qualified property indefinitely until it is fully used. The carryover amount attributable to the qualified real property ($131,250) cannot be carried over beyond 2011. The carryover amount is treated as having been placed in service in 2011 and may be depreciated but not expensed.

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Note. The SBJA specifies that taxpayers can revoke an expense method depreciation election for any tax year that begins before 2012. Because the IRS previously stated that the statutory provision concerning revocations of expense method depreciation elections (IRC §179(c)(2)) also applies to **making** such elections, a taxpayer may make an expense method depreciation election on an amended return for tax years beginning before 2012. Legislation enacted in late 2010 extends the ability to revoke an expense method election on an amended return through 2012. In Info. Ltr. 2009-59 (Feb. 17, 2009), the IRS stated that taxpayers can make or revoke an expense method depreciation election on an amended return involving an open tax year beginning after 2007 and before the date specified in IRC §179(c)(2) **without the need for Treasury regulations to be issued.** The late 2010 amendment to IRC §179(c)(2) extended the date to tax years through December 31, 2012. In the Info. Ltr., the IRS stated that taxpayers can rely on the guidance set forth in Rev. Proc. 2008-54, Section 7, for **making and revoking** such elections.

INELIGIBLE PROPERTY

IRC §179(d) details certain property that is **not** eligible for an expense method election. The following property is not eligible.

- Residential real estate and apartment building furnishings
- Air conditioning and heating units
- Property owned by estates and trusts
- Property acquired from a related party (defined as a spouse, lineal descendant, or ancestor, and a more-than-50% controlled entity)
- The carryover part of basis attributable to property that is traded (i.e., the boot is eligible)
- Property acquired by gift or inheritance
- Property not used in the taxpayer's trade or business at the time the property is acquired is **not** eligible, and can never become eligible
- Property otherwise eligible but used less than 50% in the taxpayer's trade or business (If the property is used 50% or more in the taxpayer's business, only the fractional share of business use is eligible.)
- Property used in connection with providing lodging as defined by IRC §50(b)(2) does not qualify. Therefore, household furnishings provided as part of employee lodging are ineligible. However, furnishings for hotels and motels qualify. IRC §50(b)(2) and Treas. Reg. §1.48-1(h) specify that if more than half of the living quarters are used for tenants on a transient basis (defined as rental periods of 30 days or less), the establishment is not considered as used to furnish lodging.

Example 8. Kay Oss purchased a pickup truck in 2011 for $30,000. Kay used the pickup 75% of the time for use in her farming business during 2011. She may elect to expense up to $22,500 ($30,000 × 75%) of the cost of the truck if her active trade or business income in 2011 is at least $22,500.

Note. The use of expense method depreciation for a vehicle **disqualifies** the taxpayer from using the standard mileage rate on the vehicle in later years.

Leased Property

IRC §179 is not available to noncorporate taxpayers for cash leased property unless **two requirements** are satisfied.[46]

1. The term of the lease, taking into account options to renew, must be less than 50% of the class life of the leased property.[47]

2. The taxpayer's IRC §162 business expenses (not including taxes, interest, and depreciation) for the leased property claimed during the initial 12-month period following the transfer of the property to the lessee must exceed 15% of the rental income produced by the property.

> **Observation.** In combination, the tests allow leased property to be eligible for expense method depreciation treatment if the property is leased under a short-term lease and there are significant nonrental expenses in the business.

Thomann illustrates the application of the noncorporate lessor rule.[48] The taxpayers were a farm couple who owned and operated a 504-acre farm. Sometime around 2000, the couple orally agreed to lease 124 acres of their farmland along with buildings, grain storage bins, and equipment to their own corporation that was a hog farrow-to-finish business. Under the oral agreement, the taxpayers would annually receive $70,000 cash rent. They also leased the balance of their farmland to an unrelated corporation via an oral lease. The husband entered into the oral farming agreement with the unrelated corporation that was put in writing in 2006 to state that the agreement "covered any future year's crops, so long as neither party requested a change on or before September 1 of the calendar year."

In 2004, 2005, and 2006, the couple purchased property that qualified for expense method depreciation. On their tax return for 2004, they expensed $52,000 for drainage tile and a fence that was installed on the land that they leased to the unrelated corporation, and $10,000 for material they purchased to remodel their farm office, including furniture and fixtures. For 2005, they expensed $63,488 for a grain bin. For 2006, they expensed $8,467 for a pickup truck and $31,000 for a grain bin and grain dryer. The bin and dryer (and, presumably, the pickup truck) were orally leased to their hog operation for the $70,000 annual "cash rent." The IRS disallowed all of the expense method depreciation deductions for the farm-related property citing the noncorporate lessor rule.

As for the office equipment, the court agreed with the IRS that the couple did not substantiate the deduction on their return and, as such, the court could not determine whether the office items were "other property" under IRC §1245. Importantly, the court **did not hold** that the office items were **not** IRC §1245 property, but did hold that the taxpayers failed to present sufficient evidence to allow the court to determine whether the office items were not "structural components" and would, therefore, be eligible for expense method depreciation. Thus, an expense method deduction was denied for those items. The court did not address the noncorporate lessor rule with respect to the office equipment.

As for the grain bins, grain dryer, drainage tile, pickup truck, and fence, the noncorporate lessor rule was applicable. The couple claimed that they met the first test under the noncorporate lessor rule because they renewed their leases involving the farm property every year. Thus, they claimed, the lease term was a series of 1-year leases and was, therefore, less than 50% of the class life of the farm-related property. However, the IRS and the court disagreed. The court noted that none of the leases were in writing and the couple did not provide any evidence of the actual lease terms. As a result, the court concluded that the leases were for an indefinite period of time and could not be claimed to have a term of less than 50% of the class life of the property. Because the first part of the test was not satisfied, the second part was immaterial. The court also imposed an accuracy-related penalty.

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46. The restriction does not apply to property that a lessor manufactures or produces.

47. IRC §179(d)(5)(B).

48. *Thomann v. Comm'r,* TC Memo 2010-241 (Nov. 1, 2010).

Observation. The Tax Court did not address the cash-rent nature of the leases. Cash leased assets do not qualify to be expensed because they are not acquired for use in the taxpayers' trade or business. Under the facts of the case and based solely on an examination of whether the cash leased assets were used in the taxpayers' trade or business, the grain bin, grain dryer, and pickup truck leased to the taxpayers' farrow-to-finish hog operation would likely have satisfied the test. If the taxpayers were materially participating in the hog operation, a *Mizell*-type argument would lead to the conclusion that the assets leased to their hog operation **would** be deemed to have been used in the taxpayers' trade or business. However, the drainage tile and fences on the land cash leased to the unrelated corporation would not meet the test, and the noncorporate lessor rule would not have been necessary to deny expense method treatment on those assets.

Even though the court did not address the trade or business requirement, it is **not** safe to assume that if the noncorporate lessor rules are satisfied, the trade or business rule does not have to be a concern in leasing situations.

RECAPTURE

If property subject to an IRC §179 election is not used more than 50% in the taxpayer's trade or business, recapture is required. The recapture amount is calculated by subtracting the amount of depreciation that would have been claimed from the time the property was placed in service had the property not been expensed from the amount expensed. Any ordinary depreciation already taken on the asset is also subtracted. The excess amount that was expensed is reported on Part IV of Form 4797 and as income on the form where the IRC §179 amount was deducted. For tax years following year of recapture, the deductions under IRC §168(a) are determined as if no IRC §179 election for the property was made.[49] In essence, the recaptured amount adds to basis for future depreciation.

BONUS DEPRECIATION — STATUS OF THE LAW

The SBJA renewed bonus depreciation on a retroactive basis to January 1, 2010, at the 50% level. Under the provision, bonus depreciation is available for qualified property placed in service during 2010.

Note. Under the act, contractors who could not complete contracts within the same year in which they commenced are able to benefit from bonus depreciation. This is because the provision decouples bonus depreciation from allocation of contract costs under the percentage of completion method rules for assets with a depreciable life of seven years or less.

December 2010 legislation increased bonus depreciation from 50% to 100% for qualified assets placed in service after September 8, 2010, through December 31, 2011. Unless modified by further legislation, bonus depreciation is limited to 50% of the qualified property's adjusted basis for 2012. The legislation also specifies that a taxpayer can elect to accelerate some AMT credits in lieu of bonus depreciation for the 2011 and 2012 tax years.

The 100% bonus is not available for assets placed in service before September 8, 2010. IRC §168(k)(5) specifies as follows.

> *In the case of qualified property acquired by the taxpayer (under rules similar to the rules of clauses (ii) and (iii) of paragraph (2)(A)) after September 8, 2010, and before January 1, 2012, and which is placed in service by the taxpayer before January 1, 2012, (January 1, 2013, in the case of property described in subparagraph (2)(B) or (2)(C)), paragraph (1)(A) shall be applied by substituting "100%" for "50%."*

Note. It appears that there is no elective treatment for prior acquisitions. The provision is based on "acquired," not "placed in service." Therefore, a taxpayer who buys an asset before September 8, 2010, and places it into service after that date must use the 50% rule. Likewise, the only elective option for post-September 8, 2010, acquisitions is regular MACRS.

49. Treas. Reg §1.179-1(e)(1).

Eligible Property

Bonus depreciation applies to **new** property having a recovery period of 20 years of less.[50] Farm buildings are depreciable over a 20-year life and are eligible for bonus depreciation.

Example 9. Oliver signed a contract on March 1, 2011, for the construction of a new tractor shed that is not eligible for expense method depreciation. The shed was constructed and Oliver placed it in service on August 15, 2011. Oliver paid $300,000 for the shed. Oliver's taxable income for 2011 is $225,000. Oliver claims 100% bonus depreciation on the tractor shed, generating a $300,000 deduction for 2011 which creates a $75,000 NOL. Oliver can carry the farm NOL back for up to five years and seek a refund of taxes for the carryback year or elect to forgo the carryback period and carry the loss to 2012.

Note. If Oliver had signed the contract for construction of the tractor shed in 2010 instead of 2011 and it was not completed by September 8, 2010, Oliver could still claim 100% bonus depreciation on the shed if he placed it in service after September 8, 2010, and before January 1, 2012. However, if Oliver bought farmland from someone else that had the shed on it, the shed would not be eligible for bonus depreciation because the shed is not new.

Under the facts in **Example 9,** the legislation would not provide any option for Oliver to use 50% bonus instead of 100% bonus. However, in accordance with Rev. Proc. 2011-26,[51] a taxpayer may elect 50% bonus depreciation for assets that qualify for 100% bonus depreciation, but only if the tax year at issue includes September 9, 2010.

A different result can arise when the rule is applied on behalf of a fiscal year taxpayer as opposed to a calendar year taxpayer. Projects that began by January 1, 2008, can qualify for 100% bonus depreciation if the involved assets were placed in service after September 8, 2010, and before January 1, 2012.

Note. For newly constructed farm buildings on which bonus depreciation is to be claimed, the buildings must be used exclusively for farm purposes. Mixing farm and nonfarm uses of the building **may** disqualify the building for bonus depreciation. This can be a distinct possibility in farm settings. Many farm clients are also involved in nonfarm businesses, and if part of a building is used to house equipment or other uses related to these nonfarm businesses, the building may no longer be considered a farm building eligible for bonus depreciation. **There is no bright-line test to apply in determining how much incidental nonfarm use is permissible before the entire building is tainted for bonus depreciation purposes.**

While Rev. Proc. 2011-26 allows 50% bonus depreciation instead of 100% in certain situations, a taxpayer still cannot claim bonus depreciation on a portion of the cost of a building and depreciate the balance as 20-year MACRS property. For all assets of the same asset type and class, a taxpayer must either take bonus depreciation on all original-use assets in that class type **or** elect to take normal MACRS depreciation. However, it is possible to claim bonus depreciation on one type of asset, such as a combine, and elect **not** to claim bonus depreciation on a different class of assets, such as a farm building. This issue further magnifies the need to properly classify depreciable property.

Observation. This technique may allow a farmer to optimize the use of bonus depreciation so that a large NOL is not shown on the return. If property for which no bonus depreciation is claimed is eligible to be expensed under IRC §179, that property could still be expensed under §179.

50. IRC §168(k)(2)(A)(i)(I).

51. Rev. Proc. 2011-26, 2011-16 IRB 664.

The requirement that the property be new means that the original use of the property must commence with the taxpayer.

> **Note.** See Chapter 1, Depreciation, for a discussion of original use of property.

> **Note.** A good argument can be made that a heifer that has yet to deliver a calf **and** is newly purchased from the party who owns the heifer qualifies for bonus depreciation. Arguably, the party who raised the heifer is in the same position as a manufacturer with inventory that, once serviced, is ready to be put into use by the purchaser. At the present time, the IRS has not ruled on this specific issue.

The requirement that the property be depreciable (specifically, the property must be property with a MACRS life of 20 years or less) means that the property must be used in the taxpayer's trade or business **or** held for the production of income.[52] Therefore, otherwise eligible property that is used by the taxpayer directly in the taxpayer's business or under a material participation share lease qualifies for bonus depreciation. Eligible property that is leased under a nonmaterial participation lease or a cash lease also likely qualifies because the taxpayer is using the property for the production of income.

Application to Luxury Autos. When 100% bonus depreciation was enacted, Congress did not make conforming changes to the rules limiting depreciation for automobiles. These are the so-called "luxury auto" rules that generally apply to vehicles costing $18,450 or more in 2011. Consequently, taxpayers would only be entitled to deduct the first $11,060 of the cost of a new vehicle unless they elect out of bonus depreciation. This assumes no personal use of the vehicle in the year it is placed in service (2010 or 2011). Taxpayers cannot take additional depreciation deductions until year seven. In Rev. Proc. 2011-26, the IRS provided a safe harbor allowing taxpayers to claim deductions in years two through six. Using the safe harbor, the depreciation in years subsequent to the year the vehicle is placed in service is calculated on the remaining basis as though the taxpayer claimed 50% bonus depreciation rather than 100% bonus depreciation in the first year.

Possibility of Recapture. Under the general rule, bonus depreciation is not subject to recapture.[53] There appears to be no restriction on the ability to apply 100% bonus depreciation toward the cost of a new vehicle that exceeds 6,000 pounds. Therefore, it is not subject to the deduction limitations that apply to passenger automobiles and the taxpayer could use it for at least a year in the taxpayer's business and then convert it to personal use. Such a technique would allow the entire purchase price to be deducted in a single year, after which the vehicle becomes a personal-use vehicle. However, the vehicle is still classified as "listed property."[54] As such, if the use of the vehicle drops below 50% in any year during its life, all depreciation taken that exceeds what S/L depreciation would have allowed is recaptured in that tax year.

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52. Under IRC §168(k)(1)(A), eligible property must satisfy the test of IRC §167(a).

53. Temp. Treas. Reg. §1.168(k)-1T(f)(6)(iv).

54. IRC §280F(d)(4).

SUMMARY OF KEY RULES

Expense Method Depreciation

The expense method is available on new and used tangible personal property that is used directly in the taxpayer's trade or business or under a qualified lease, and for qualified real estate.

- On assets that qualify for both expense method depreciation and bonus depreciation, the ordering rules require that the expense method be taken first, bonus depreciation be taken second, and regular depreciation taken last.
- An income limitation may apply when using the expense method.
- Expense method depreciation is based on when the tax year begins.
- This method cannot be used by estates and trusts.
- For traded property, expense method depreciation applies only to boot (if any).

Bonus Depreciation

- The bonus depreciation is only available on newly purchased property with a MACRS life of 20 years or less.
- In order to use bonus depreciation, the property must be depreciable property that is held for use in a trade or business or for the production of income.
- There are no income limitations when using bonus depreciation.
- Use of bonus depreciation depends on when an asset is placed in service.
- Bonus depreciation can be used by estates and trusts.
- For traded property, bonus depreciation applies to boot (if any) and the remaining basis of the traded property.

MAXIMIZING THE BENEFIT

From a tax planning perspective, there are general rules to apply when coordinating the use of expense method and bonus depreciation for the maximum tax benefit. For farm clients, the following steps can be used to maximize the tax benefit.

1. Claim the expense method depreciation on the qualified assets with the longest depreciable lives.
2. Claim expense method depreciation on all equipment.
3. Claim bonus depreciation on all qualified new assets.
4. Claim regular depreciation on any remaining value.

If an NOL is desired so that it can be carried back to a prior year, bonus depreciation will be preferable over the expense method. An NOL can be generated with bonus depreciation, but typically cannot be generated with expense method depreciation.

Note. See Chapter 1, Depreciation, for more information concerning depreciation.

PARTNERSHIP OWNERSHIP SUCCESSION WITH NEGATIVE CAPITAL ACCOUNTS

OVERVIEW

The substantial increase in expense method depreciation in recent years and the availability of bonus depreciation has been a significant inducement to some taxpayers to overuse the election. In a highly leveraged partnership, the use of such accelerated depreciation can lead to significant negative capital accounts which, in turn, can trigger income tax problems in transitioning the business to a subsequent generation.

In the context of a gift of a partnership interest, gain is recognized by a donor if the partner's share of partnership liabilities exceeds the donor's adjusted basis of the gifted partnership interest.[55] Generally, such gain is measured by the amount of the donor partner's negative capital account balance. The gain is capital in nature, but if certain hot assets (unrealized receivables, appreciated inventory or depreciable equipment) exist in the partnership, some or all of the gain is taxed as ordinary income.[56]

> **Observation.** The hot asset gain is a partner-level item, not a partnership item, when the gain is the result of a taxable sale (deemed or actual) of a partnership interest. The hot-asset treatment exists to change the character of the gain, not to create an actual partnership-level transaction. Consequently, there normally is no offset.

From the donee's perspective, basis equals the donor's basis plus the donee's share of partnership liabilities. If an IRC §754 election is in place, then the donee is entitled to a step up in basis for the partnership assets (the inside basis).

A complicating factor occurs when the donor's basis exceeds the FMV of the gifted partnership interest.

Example 10. Partnership AB is formed with the partners Alex and Bart agreeing to contribute future services only. AB borrows $500,000 to purchase a combine. AB's initial balance sheet was as follows.

	Assets	Liabilities
Combine	$500,000	$500,000

	Capital Accounts	Basis
Alex	$0	$250,000
Bart	0	250,000

In the first year of operations, the partnership's depreciation deduction was $300,000. All other expenses were offset by revenues. At the end of the first year, AB's balance sheet was as follows.

	Assets	Liabilities
Combine	$200,000	$500,000

55. Treas. Reg. §1.1001-1(e).

56. IRC §751(a); Treas. Reg. §1.751-1(a)(2).

	Capital Accounts	Basis
Alex	($150,000)	$100,000
Bart	(150,000)	100,000

On the first day of year two, Alex decided to gift his entire partnership interest to his son, Clyde. Alex is relieved of $250,000 of partnership liabilities. IRC §752(b) indicates that such debt relief is equivalent to a distribution of money to Alex. IRC §731(a)(1) requires Alex to recognize gain to the extent money distributed to him exceeds his basis. In this situation, Alex is required to recognize $150,000. The gain is ordinary (not capital) to Alex because of the depreciation taken on the combine.[57] Alex is left with a zero basis which transfers to Clyde. Clyde's gifted basis from Alex is supplemented by Clyde's assumption of half of the partnership liabilities, or $250,000.[58] After the gift, the balance sheet of AB is as follows.

	Assets	Liabilities
Combine	$200,000	$500,000

	Capital Accounts	Basis
Clyde	($150,000)	$250,000
Bart	(150,000)	100,000

Note. Because the parties are related, Clyde receives a basis in the gifted partnership interest equal to Alex's original basis plus the gain recognized.

POTENTIAL SOLUTIONS

There are potential solutions to the problem of transitioning partnership interests to a child when a negative capital account exists.

- **Use of a profit interest.** Under this technique a profits interest is transferred instead of a capital interest. The value of the interest is decreased for estate tax purposes while simultaneously allowing the transferor to maintain control.
- **Transfer is a true gift.** If the terms of the partnership agreement allow, the transfer could be transformed into a true gift without shifting any debt along with the interest.
- **Assets that are not hot assets could be gifted.** The donor could gift all assets except for depreciable equipment and inventory. Land could be spun-off if desired with the hot assets remaining in the entity. This allows the donor to retain an interest in the existing hot assets and recognize income upon their subsequent sale. As new hot assets are acquired, the donee can participate without triggering IRC §751(a), which requires amounts realized from a sale or exchange to be treated as ordinary income.

Observation. While the accounting and legal work may be complex for this possible solution and take years to even out, the technique could work. However, it requires removing assets from the partnership for gifting purposes, which may create a problem when other partners are involved.

57. Treas. Reg. §1.751-1(a)(2).

58. IRC §751(a).

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- **Place property in trust.** The property could be placed in a trust until the time of the donor's death. Upon the donor's death, the property receives a stepped-up basis in the hands of the heir in addition to a zero capital account. This may be the easiest and best option in many situations.
- **Contribute cash to partnership.** The partner could contribute cash or other property to increase their capital account value.

In general, each technique is designed to avoid the transfer or relief of debt which triggers sale treatment under IRC §§751(a) and 752 with taxable gain equal to the negative capital account. The IRC §§751(a) and 752 gain is recognized. Any loss is not recognized until the donee sells the interest. The selling price equals the amount of debt relief with taxable gain equal to the amount of debt relief less basis. There may also be IRC §751 gain on the percentage of the partnership interest that is sold, which may exceed the taxable income associated with the debt relief. Finally, the donee assumes the donor's loss associated with the IRC §751 gain upon disposition of the donee's interest.

OTHER ALTERNATIVES

Another possible alternative is to have the parent gift a percentage interest (say 5%) in the partnership to the child with both the parent and the child remaining personally liable for the debt. Under Treas. Reg. §1.752-2(a), if a partner or related person bears the economic risk of a liability, then the partner is allocated the liability for basis purposes. Thus, if the parent remained liable through an indemnification agreement, the liability would still be allocated to the child (as the new partner).

> **Observation.** Lenders typically require all partners to sign for recourse debt. An indemnification/subrogation agreement only comes into play when the entity defaults on the indebtedness and the partners must personally pay the lender. In addition, the debt is secured by the inventory and equipment and cannot realistically be carved out. If a partnership interest is transferred, the recourse debt is transferred as well.

TAX ISSUES ASSOCIATED WITH "TRADING DOWN"

OVERVIEW

For complete gain deferral under a IRC §1031 like-kind exchange, the value and equity in the replacement property must be equal to or greater than the relinquished property. This is considered trading up or trading equal. A taxpayer's basis in the replacement property is the FMV of the replacement property less the amount of the gain deferred by the taxpayer from the exchange.

> **Note.** A trade up refers to a situation in which the taxpayer's net sales price, after routine closing costs, does not exceed the acquisition cost of the replacement property. In addition, all the taxpayer's equity generated from the sale of the relinquished property is reinvested.

If the requirements for a trade up are not met, the taxpayer is taxed on the greater of the trade down in value or equity from the relinquished property. This is only to the extent of the realized gain from the exchange. "Equity" is defined as the FMV of the property, less exchange expenses, less any mortgage on the property.

Trading down always results in boot in the form of cash and/or debt reduction. Boot received is offset by any exchange expenses that are paid. The term "boot" is not defined in the Code. Boot refers to the money, debt relief, or the FMV of other property that the taxpayer receives in an exchange. "Money" includes all cash equivalents that the taxpayer receives. "Debt relief" refers to any net debt reduction which occurs as a result of the exchange, taking into account the debt on the relinquished property and the replacement property. "Other property" refers to property that is not like-kind, such as personal property received in an exchange of real property, property used for personal purposes, or "nonqualified property." "Other property" also includes a promissory note received from a buyer (commonly referred to as seller financing).

> **Note.** The amount of net boot generated is first applied to any triggered depreciation recapture. Any remaining boot is applied toward gain once all the depreciation recapture is recognized and taxed. The **taxpayer's cost basis is not prorated**, which results in the entire amount of boot being taxable until the taxpayer has fully recognized all taxable gain. Therefore, it is possible to trade too far down in value and trigger a fully taxable gain with the transaction resulting in no deferral.

A taxpayer can trade down either in value or in equity. While it is possible that a trade down can be part of a taxpayer's overall income tax plan, the decline in the nonfarm land real estate market in recent years has increased the possibility that a trade down might occur. For instance, the taxpayer may have suspended passive activity losses that would offset the depreciation recapture and/or gain recognized by trading down. Or, the taxpayer could have another loss on the sale of other property that could also offset the depreciation recapture and/or gain triggered by a partial §1031 tax-deferred exchange. Likewise, the taxpayer may simply want to pull cash out for other uses or increase the taxpayer's cash reserve for unexpected expenses.

> **Observation.** The significant drop in real estate value in many areas of the United States in recent months can put a real estate investor in a distressed position and force the investor into a fire sale, short-sale or foreclosure, or deed-in-lieu of foreclosure situation. In many situations, real estate owners focus solely on the financial aspects to the exclusion of income tax consequences when structuring solutions for distressed properties. Similarly, real estate investors often assume that there are no tax consequences due to the absence of equity remaining in the property.

There are two primary causes of a trade down.

1. The taxpayer receives boot in the exchange instead of reinvesting that equity in the like-kind replacement property.
2. The replacement property is worth less than the relinquished property because the taxpayer reinvested all of the relinquished property's equity but incurred fewer liabilities for the replacement property than the liabilities that were given up on the relinquished property.

Given the current "bubble" in the value of agricultural land in many areas, it is possible that a taxpayer could trade up in value, but trade down in equity.

Example 11. John exchanges bare farmland with an FMV of $800,000, a mortgage of $250,000 (i.e., equity of $550,000), and an adjusted basis of $500,000 for another tract of bare farmland with an FMV of $900,000, a mortgage of $400,000 (i.e., equity of $500,000) and $50,000 of cash. John incurred exchange expenses of $20,000.

	Relinquished Property	Replacement Property
FMV	$800,000	$900,000
Debt	250,000	400,000
Equity	550,000	500,000
Basis	500,000	N/A
Exchange expenses	20,000	N/A

John traded up in value by $100,000; however, he traded down in equity by $50,000. Thus, John has gain recognition on the exchange. John is taxed on the greater of the trade down in value (which is zero) or equity (which is $50,000), but only to the extent of his $280,000 realized gain ($800,000 − $500,000 − $20,000).

John's trade down in equity is reduced by exchange expenses of $20,000. Therefore, John has taxable gain of $30,000. John's basis in the replacement property equals the purchase price of the replacement property ($900,000) less the gain deferred on the exchange of $250,000 ($280,000 of realized gain − $30,000 of recognized gain).

> **Observation.** John could avoid the taxable receipt of cash caused by his trade down in equity by increasing debt on the relinquished property before the exchange or the replacement property after the exchange.

Form 8824, *Like-Kind Exchanges,* follows a similar approach[59] to that utilized in the example for determining the amount of taxable recognized gain. Form 8824 requires the taxpayer to calculate realized gain and then calculate the amount of money or other property received in the transaction.

AGRICULTURE-RELATED RULINGS AND CASES

CONSERVATION EASEMENT DONATIONS

Several court opinions in recent months illustrate the perils associated with attempts to obtain a charitable deduction associated with the donation of a conservation or similar easement.

In *DiDonato, et ux. v. Comm'r,*[60] the Tax Court ruled that the taxpayer was properly denied a charitable deduction for the donation of a conservation easement to a county because the taxpayer failed to satisfy the substantiation requirements of IRC §170(f)(8).

In *McNeil, et ux. v. Comm'r,*[61] the Tax Court dealt with the issue of the proper characterization of the income generated from the sale of state conservation tax credits. The taxpayer sold a conservation easement on approximately 580 acres of land to the American Farmland Trust in a bargain sale transaction, and another easement on 520 acres in a bargain sale transaction to Ducks Unlimited. The easement sales generated a state (CO) conservation credit of $260,000. The taxpayer sold $231,600 of the credit for $178,332. The court, based on a prior holding in *Tempel v. Comm'r,*[62] held that state credits are capital assets and that the amount received on the sale was a short-term capital gain. The capital gain was short-term in nature because the taxpayer could not attach the holding period attributable to the land to the holding period in the credit because the credit never became part of the taxpayer's real property rights.

In Boltar, LLC v. Calabria,[63] a partnership acquired undeveloped rural land and granted a conservation easement over a portion of property. The partnership claimed a charitable deduction tied to the land's value as if it were developed for condominium usage. The IRS moved to exclude the plaintiff's experts' report as unreliable and irrelevant under Fed. R. Evid. 702. The court held that the standards of reliability and relevance apply in nonjury trials (including the Tax Court), and are subject to the discretion of the trial court judge. Here, the plaintiff's experts did not apply the correct legal standard by not using the before-and-after valuation method, did not value contiguous parcels that the plaintiff owned, and assumed development that was not feasible on the property due to multiple zoning restrictions, wetland rules, population decline in the area, and the lack of land with development potential.

> **Observation.** The court's opinion is of major significance when a property's valuation is based on an appraisal that is at issue in the case. Such appraisals and associated appraiser testimony offered into evidence must withstand judicial scrutiny under Fed. R. Evid. 702 and as developed by the U.S. Supreme Court in *Daubert v. Merrell Dow Phamaceutical, Inc.*[64]

59. The IRS approach is based on Treas. Regs. §§1.1031(b)-1(c); 1.1031(d)-1; and 1.1031(d)(2).

60. *DiDonato, et ux. v. Comm'r,* TC Memo 2011-153 (Jun. 29, 2011).

61. *McNeil, et ux. v. Comm'r,* TC Memo 2011-109 (May 23, 2011).

62. *Tempel v. Comm'r,* 136 TC No. 15 (2011).

63. *In Boltar, LLC v. Calabria,* 136 TC No. 14 (2011).

64. *Daubert v. Merrell Dow Pharmaceutical, Inc.,* 509 U.S. 579 (1993).

In *1982 East LLC, et al. v. Comm'r,*[65] a charitable deduction for the donation of a "qualified conservation contribution" of $6,570,000 was disallowed for an LLC that donated a lot and townhouse constructed in 1894 in New York City to a qualified organization. The donation failed to meet the perpetuity requirement of IRC §170(h)(5)(A). The lender agreement concerning the property clearly stated that the lender retained a "prior claim" to all condemnation and insurance proceeds in preference to the donee until the mortgage was satisfied and discharged. Consequently, until the mortgage was repaid, a possibility existed that the lender could deprive the donee of the value required to be dedicated to the conservation purpose. That meant there was noncompliance with the perpetuity requirements of Treas. Reg. §1.170A-14(g)(6)(ii)).

In *Kaufman v. Comm'r,*[66] the court held that the contribution of a façade easement did not comply with the enforceability-in-perpetuity requirements of Treas. Reg. §1.170A-14(g)(6). The cash payments to the charity that accepted the façade easement remained conditional at the end of 2003 and, therefore, were not deductible. However, cash payments made in 2004 were deductible. The court applied an accuracy-related penalty for the deduction of the cash payments in 2003.

Similarly, in *Schrimsher v. Comm'r,*[67] the court held that the taxpayer was not entitled to a charitable deduction for the contribution of a façade easement due to the lack of substantiation. There was no contemporaneous written acknowledgment of the easement as required by IRC §170(f)(8)(B)(iii). Likewise, in *Evans, et ux. v. Comm'r,*[68] the IRS successfully challenged a charitable deduction for a donated façade easement. There was no credible evidence offered about the easement's FMV.

In *Trout Ranch LLC, et al. v. Comm'r,*[69] the taxpayer was an LLC that was taxed as a partnership. The LLC granted a conservation easement to a qualified organization, and the IRS reduced the charitable contribution from approximately $2.2 million to under $500,000 and then later to $0. The land at issue was acquired with the intent to subdivide and develop the property along the river. The case involved a battle over valuation approaches. The court ultimately held that the value of the contributed easement was $560,000 with a contribution limit of 30% of the taxpayer's contribution base. In addition, the court noted that the charitable contribution was a partnership item because the contribution was made by the LLC.

In *Whitehouse Hotel Limited Partnership, et al. v. Comm'r,*[70] the U.S. 5th Circuit Court of Appeals vacated the Tax Court's valuation of a plaintiff's charitable contribution for a donation of historic preservation façade easement and imposition of an accuracy-related penalty. There was no dispute that the contribution qualified for a charitable deduction, but there was controversy surrounding the valuation of the donated easement. The court held that the Tax Court erred in relying solely on the IRS expert's comparable-sales method to value the easement. Instead, the Tax Court should have considered that method along with methods used by the plaintiff's expert. The Tax Court failed to rule on the highest and best use of the property in determining the property's FMV which was whether the highest and best use was as a luxury hotel or a nonluxury hotel. The court held that the Tax Court should have determined whether the easement had any effect on a contiguous building that the plaintiff also owned. That was important, the court reasoned, because the plaintiff had plans to combine the buildings into a single property.

65. *1982 East LLC, et al. v. Comm'r,* TC Memo 2011-84 (Apr. 12, 2011).

66. *Kaufman v. Comm'r,* 136 TC No. 13 (2011).

67. *Schrimsher v. Comm'r,* TC Memo 2011-71 (Mar. 28, 2011).

68. *Evans, et ux. v. Comm'r,* TC Memo 2010-207 (Sep. 22, 2010).

69. *Trout Ranch LLC, et al. v. Comm'r,* TC Memo 2010-283 (Dec. 27, 2010).

70. *Whitehouse Hotel Limited Partnership, et al. v. Comm'r,* 615 F.3d 321 (5th Cir. 2010).

ASSIGNMENT OF INCOME DOCTRINE

The assignment of income doctrine provides that a taxpayer cannot escape tax liability for income by transferring the income they earned to another person or entity. This doctrine is sometimes problematic especially when an ongoing business changes form in the middle of the business cycle. For example, when a sole proprietorship farming operation incorporates, a mid-stream incorporation may occur. The farmer may have incurred substantial pre-incorporation expenses in putting the crop in the ground and then have income from the sale of the crops post-incorporation. If the expenses are reported on the farmer's individual return with no offsetting income, an NOL could result. If the income is reported as corporate income, that could result in the income being taxed at lower corporate rates, and SE tax being minimized. In such situations, the IRS may challenge the reporting as improper.

In *Slota v. Comm'r*,[71] the petitioners were a farm couple. The husband operated a sole proprietorship corn and soybean farming operation. In September 2005, the couple formed a corporation and named themselves sole shareholders and directors. They did not execute a deed, sales contract, or any written agreement that transferred or leased their farmland to the corporation. They transferred $10,000 from their personal bank account to the corporation to establish the corporate account. In October 2005, they deposited all (except one) of their 2005 federal farm program payments into their personal account. One government payment was deposited into the corporate account. Later in October, they transferred the balance of the USDA payments and the crop sale proceeds to the corporate account. In 2005, the petitioners reported $195,938 from crop sales and $61,416 in farm program payments on a Form 1040 Schedule F. They claimed an expense deduction for $44,165 of USDA payments and $20,532 of crop sale proceeds they had put in the corporate account. They reported $481 of SE tax liability. For the fiscal year ending September 30, 2006, the corporation reported $370,647 of income but completely offset the income with expenses.

The IRS disagreed with the petitioner's reporting and attributed all of the funds that were deposited into or transferred to the corporate account in 2005 to the petitioners, with the exception of the one government payment. The IRS increased their tax liability to $28,445 under the assignment of income doctrine. While the petitioners argued that they transferred their crops to the corporation, the IRS did not agree. The IRS noted that the petitioners had already reduced the crops to income before transferring the crop income to the corporation and, consequently, had earned the income before the transfer. Also, because the USDA payments were issued in the petitioner's name, the payments were not corporate income.

The court agreed with the IRS and applied the assignment of income doctrine. The court specifically noted that the petitioners had no documents indicating that they had actually transferred the land or the crops to the corporation. All they transferred were the proceeds of the crops and the government payments that had been paid to them personally. The petitioners also made a strange argument that they should not be taxed on the income because they organized the corporation tax-free in an IRC §351 exchange. The court did not analyze that argument and simply noted that it was misplaced.

The court also assessed an accuracy-related penalty. The petitioners did not reasonably rely on their return preparer and did not provide any evidence concerning the preparer's experience or qualifications, or that they had provided the preparer with all the necessary and accurate tax information to prepare their returns.

71. *Slota v. Comm'r,* TC Summ. Op. 2010-152 (Oct. 12, 2010).

TAX AVOIDANCE SCHEMES

Economic Substance Doctrine

Under the facts of *Sundrup v. Comm'r*,[72] a married couple operated a trucking business out of their home, dating back to 1967. In 2000, they established three new entities (two C corporations and an LLC). The couple's trucking operation was placed in one of the C corporations. The other C corporation was a consulting business that provided management services to the trucking business. The LLC contained the couple's real estate. The LLC was treated as a partnership for tax purposes. A series of payments between the entities resulted in the C corporations having no taxable income, and reduced the couple's income that was reported on Form 1040.

For some unexplained reason, the couple testified at the trial. The Tax Court, found the testimony to be "in certain material respects questionable, implausible, vague, inconsistent, unpersuasive and/or self-serving." The court also said the arrangements amounted to a tax-avoidance scheme.

> *Based upon our examination of the entire record before us, we find that the only intended objective of the respective transactions between (1) (a) Transfer and Consulting and (b) Leasing and Consulting, under which Consulting purported to provide to each of those companies certain services, and (2) the [taxpayers] and Consulting, under which Consulting purported to agree to buy the [taxpayers'] residence, was the . . . tax-avoidance objective of having Consulting pay the [taxpayers'] personal living expenses with funds which Transfer and Leasing paid to Consulting and for which Transfer and Leasing claimed tax deductions for their respective taxable years at issue. . .*
>
> *On that record, we find that the respective transactions at issue were not entered into for nontax business reasons, were entered into only for tax-avoidance reasons, and did not have economic substance."*

The Tax Court imposed a 20% accuracy-related penalty (equaling approximately $20,000). The Tax Court refused to reduce the penalty due to reasonable cause, even though the couple's legal counsel established the entities and leases and prepared their tax returns.

> **Note.** IRC §6662(b)(6), as amended by the Patient Protection and Affordable Care Act of 2010, provides for a **40% nonwaivable** penalty for tax understatements attributable to transactions that lack "economic substance."

Existence of Partnership

In *Rigas v. United States*,[73] the taxpayer claimed that income reported on the tax return should be taxed as capital gains rather than as ordinary income. The taxpayer was a limited partner in an entity that had an LLC as a general partner. The entity entered into a management agreement with another company to provide servicing, management, administration, and other services. The entity was paid a performance fee of approximately $20 million as compensation for services. The entity filed a partnership tax return for the tax year at issue characterizing the amount as gross profit income. The LLC issued a Schedule K-1 to Rigas who reported the share (approximately $4 million) as ordinary income. The tax return was later amended reporting the $4 million as capital gain income, and the taxpayer sought a refund of approximately $800,000.

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72. *Sundrup v. Comm'r,* TC Memo 2010-249 (Nov. 16, 2010).

73. *Rigas v. U.S.,* No. H-09-3770, 2011 U.S. Dist. LEXIS 46730 (S.D. Tex. May 2, 2011).

The IRS disallowed the refund claim, characterizing the amount as ordinary income that was compensation for services. The IRS motioned for summary judgment. The court granted the motion because it viewed the entity's compensation arrangement as involving shared profits (net profits) with the corporation which did **not** establish a partnership. The contract between the entities specifically stated that the relationship was not a partnership. Importantly, the entity provided its own funds in performing functions. While this was considered a capital contribution which normally indicates partnership status, the entity could not withdraw funds from the other business, could not increase owner's capital commitment to assets, and could not enter into binding contracts in the name of the other business or dispose of assets without owner approval. Additionally, the entity did not have title to any of the other businesses assets and did not share control over bank accounts. There were no partnership tax returns filed by the combined entities and the entity did not hold itself out as a partner. **Consequently, the sharing of net profits was insufficient, by itself, to create partnership interest.**

CHAPTER 12 BANKRUPTCY TAXATION

Under an amendment made by The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA),[74] 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. The debt is **not entitled to priority** under Section 507(a) of the Bankruptcy Code, as long as the debtor receives a discharge.[75] The provision became effective upon enactment on April 20, 2005.

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 either of the following apply.

1. The claim is 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 that case, the claim is treated as an unsecured claim that is not entitled to priority under section 507. **However, the debt is treated in such manner only if the debtor receives a discharge.**
2. The holder of a particular claim agrees to a different treatment of that claim.

Application to Post-Petition Tax Claims

The statute prompted numerous legal issues and cases. One issue that remains judicially unresolved and is now before the U.S. Supreme Court is whether the provision applies to taxes generated from a post-petition sale of farm assets. As of the date this chapter was written, three U.S. Circuit Courts of Appeal have rendered decisions on the matter.

In re Knudsen. The debtors (a married couple) owned 160 acres with two large hog finishing facilities on them. For many years, the debtors operated a farrow-to-finish operation. The debtors also farmed cropland in conjunction with the husband's father and brother, and shared machinery and labor. The debtors grew corn and soybeans on the portion of their property not occupied by hog buildings and rented two additional farms consisting of approximately 300 acres for crop production.

The debtors switched to a contract production operation in 2003. As a result, they sold their sows, discontinued farrowing, and sold all their fat hogs. The farrow-to-finish operation began winding down in late 2003 and was completed in September 2004 when the last of the fat hogs was sold. The contract-feeding arrangement began in May 2004 in the nursery buildings and went into full swing in the finishing buildings in July of 2004. During 2004, the debtors sold their entire hog herd, including $339,487 worth of fat hogs, as well as some of their farming equipment so they could begin the contract feeding arrangement.

The debtors filed Chapter 12 bankruptcy after the BAPCPA Chapter 12 tax provisions were enacted. Their reorganization plan proposed the sale of 120 acres, with a projected $360,000 long-term capital gain.

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74. S. 256, PL No. 109-31, signed into law on April 20, 2005.

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

Both the Bankruptcy Court[76] and the District Court[77] determined that the taxes arising post-petition qualified for nonpriority treatment. On further review, the 8th Circuit agreed,[78] holding that a Chapter 12 debtor may treat post-petition income taxes that are imposed on the debtor's income that was earned during a pending bankruptcy case as an administrative expense under 11 U.S.C. §503. On that point, the court concluded that the plain language of 11 U.S.C. §1222(a)(2)(A) did not restrict its application to pre-petition sales, and that post-petition sales can be treated as an administrative expense. The court rejected the IRS's argument that post-petition taxes would be treated as a priority claim. The court reasoned that there is no separate bankruptcy estate created in a Chapter 12 petition; thus, the taxes are not "incurred by the estate" as required by 11 U.S.C. §503(b)(1)(B); and the Internal Revenue Code rather than the Bankruptcy Code creates a separate taxable entity upon the filing of a Chapter 7 petition (as opposed to a Chapter 11 or 12 case). The court also noted that the majority of courts that have considered the issue have also reached the same conclusion.

In re Hall. The debtors filed for Chapter 12 relief and sold their farm for $960,000 after filing a Chapter 12 petition. The sale generated tax on capital gains of approximately $29,000. The debtors' amended plan proposed to treat the tax on capital gains as an unsecured claim which would be paid in full if funds were available, and pro rata with other like claims if funds were insufficient. The remaining balance would be discharged. The IRS objected on the basis that a Chapter 12 bankruptcy estate is not a separate taxable entity. The IRS argued that the tax liability that resulted from the debtor's post-petition sale was not incurred by the estate and remained the debtor's responsibility.

The Bankruptcy Court noted that to qualify as an unsecured claim, the claim must be within a priority category of 11 U.S.C. §507 and either be an administrative expense, or an allowed, **pre-petition** unsecured claim of a governmental unit.[79] The court noted "priority administrative expenses" are those allowed under 11 U.S.C. §503(b), which includes any tax **incurred by the bankruptcy estate.** The Bankruptcy Court held that because there is no separate taxable entity created in a Chapter 12 bankruptcy, the debtor's post-petition sale of farmland could not generate a tax incurred by a bankruptcy estate. Because the capital gains taxes were incurred post-petition and because no separate taxable entity exists in the context of Chapter 12 bankruptcy, they did not fall within the exception of 11 U.S.C. §1222(a)(2)(A). As such, the court noted that 11 U.S.C. §1222(a)(2)(A) only treats taxes arising from pre-petition sale, transfer, or exchange of farm assets as an unsecured nonpriority claim.

On appeal, the Federal District Court for the District of Arizona reversed the Bankruptcy Court and held that 11 U.S.C. §1222(a)(2)(A) applies to taxes arising post-petition.[80]

On further review, the U.S. 9th Circuit Court of Appeals reversed the district court.[81] The appeals court noted that, by its terms, 11 U.S.C. §1222(a)(2)(A) applies only to "claims entitled to priority under section 507." Section 507 lists two categories that include taxes. These are sections 507(a)(8), which involves pre-petition taxes, and section 507(a)(2), which involves administrative expenses that are allowed under section 503(b). Therefore, to be within the scope of section 503(b), the debtors' post-petition sale of land had to be "incurred by the estate." The court noted that it was not possible because IRC §1399 specifies that a Chapter 12 estate cannot incur taxes. Because a Chapter 12 estate cannot incur tax, it cannot benefit from 11 U.S.C. §1222(a)(2)(A).

The court found the rationale of *Knudsen* entirely unpersuasive. The court noted that the *Knudsen* opinion failed to cite even a single provision in Chapter 12 stating that a bankruptcy estate can incur taxes. In addition, the ability to retain property does not mean the ability to incur tax. The court noted that the Internal Revenue Code clearly states that according to IRC §§1398 and 1399, a Chapter 12 bankruptcy estate cannot incur taxes. It was noted that Congress had repeatedly indicated their awareness that the taxable entity provisions of the Internal Revenue Code are relevant to the Bankruptcy Code. Consequently, the court determined that it was clearly justified in relying on IRC §§1398 and 1399 to interpret the application of 11 U.S.C. §1222(a)(2)(A) to taxes arising post-petition in a Chapter 12 bankruptcy.

76. *In re Knudsen,* 356 B.R. 480 (Bankr. N.D. Iowa 2006).

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

78. *Knudsen v. IRS,* 581 F.3d 696 (8th Cir. 2009).

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

80. *In re Hall,* 393 B.R. 857 (D. Ariz. 2008).

81. *U.S. v. Hall,* 617 F.3d 1161 (9th Cir. 2010).

The court refused the debtors' reliance on legislative history, noting that the Senate report referenced by the debtors (and which was relied on by *Knudsen*) involved language in an unenacted version of 11 U.S.C. §1222(a)(2)(A). That section of the Code never became law and was proposed six years before the section was actually enacted with different language. In addition, the court noted that in the Senate report the reference to taxes incurred by the "trustee" actually meant taxes the "estate" incurs because the trustee acts on behalf of the bankruptcy estate. Because a Chapter 12 estate cannot incur tax, the language was not helpful to the debtors' post-petition tax argument. While the court noted that the congressional intent of 11 U.S.C. §1222(a)(2)(A) may have indeed been as the debtors proposed, the text of the statute was different and the court was bound by what the Congress wrote, not what it intended.

Note. On June 13, 2011, the U.S. Supreme Court agreed to hear the case.[82]

In re Dawes. The debtors, a married couple, were part of the tax protestor movement and had been criminally convicted of tax fraud and sentenced to prison in the late 1980s. In 1985 and 1986, the debtors established fraudulent trusts to hold their real estate and serve as a means of funneling farm income to themselves on a tax-free basis. They did not pay federal income taxes for 1984, 1986–1988, and 1990. Their primary creditor was the IRS, which held a judgment against them for $1,541,604, plus interest for their 1982 through 1990 income taxes.

The debtors filed bankruptcy in 2006, and the IRS received relief from the automatic stay as to eight parcels of the debtors' real estate which had been placed in a fraudulent trust. The debtors' Chapter 12 plan proposed to surrender the parcels to the IRS for payment of the IRS's claim. The parcels were sold with the sales proceeds exceeding $900,000. The sale of the parcels also triggered capital gains tax, and the debtors' reorganization plan proposed to treat the IRS claim and state tax claims as general unsecured claims not entitled to priority in accordance with 11 U.S.C. §1222(a)(2)(A).

The debtors filed a motion for partial summary judgment on the basis that they could provide in their reorganization plan that the post-petition capital gains tax resulting from the IRS's forced sale of the parcels was an unsecured claim. The IRS opposed the motion and also moved for summary judgment on the issue.

The precise issue before the Bankruptcy Court was whether the claim for capital gains taxes arising from the post-petition sale of real property is a priority claim under 11 U.S.C. §507, which is treated as an unsecured claim not entitled to priority in accordance with 11 U.S.C. §1222(a)(2)(A). The court first noted that one category of priority claims under 11 U.S.C. §507 is for administrative expenses allowed under 11 U.S.C. §503(b). The IRS agreed such administrative expenses include tax claims that are incurred by the estate and are not a pre-petition liability that becomes a tax claim after the petition is filed. Also, the capital gains taxes were not a pre-petition liability that became a tax claim after the debtors filed their petition, so the only issue was whether the taxes were incurred by the estate.

The court believed that the phrase "incurred by the estate" in 11 U.S.C. §503(b)(1)(B)(i) was ambiguous.[83] The court noted that while a bankruptcy estate is created when a Chapter 12 petition is filed, the phrase "incurred by the estate" could refer to the **time** tax liability accrues or could refer to the entity liable for the tax. Given the ambiguous nature of the statute, the court turned to legislative history to determine congressional intent. That legislative history indicated that the Congress intended "incurred by the estate" in 11 U.S.C. §503(b)(1)(B)(i) to refer to the time the tax liability was incurred, not to the entity liable for the tax.

On appeal, the District Court affirmed the Bankruptcy Court.[84]

82. *U.S. v. Hall,* 617 F.3d 1161 (9th Cir. 2010), *cert. granted,* No. 10-875, 2011 U.S. LEXIS 4460 (U.S. Sup. Ct. Jun. 13, 2011).

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

84. *In re Dawes,* 415 B.R. 815 (D. Kan. 2009).

On further review, the 10th Circuit reversed and held that 11 U.S.C. §1222(a)(2)(A) does **not** apply to income taxes the debtor incurs post-petition.[85] The court noted that a determination of who "incurs" a tax hinges on who is "liable" for the tax. The court also noted that the question, absent guidance to the contrary, turns on applicable **tax** law.

For individuals filing under Chapter 7 or 11, the trustee is responsible for filing a separate return on behalf of the bankruptcy estate and paying any resulting taxes from the estate. Those taxes are "incurred" by the bankruptcy estate and the estate is responsible for the tax obligation. However, the court noted that in Chapter 12 and 13 bankruptcies, the debtor bears the sole responsibility for filing and paying post-petition federal income taxes. Only the debtor is liable for such taxes, and this result answers the question posed by 11 U.S.C. §503(b). It is not determinative of who owes the tax debt even though:

- The estate may have possessed the assets in question that were sold,
- The bankruptcy court may have authorized the sale of the assets, and
- The estate might have caused a tax liability to arise.

By statute, the court noted the debtors are clearly responsible. The court pointed out that this was also a pragmatic result because, when the reorganization plan is confirmed, the estate property and any post-petition income join the post-petition income taxes in the debtor's hands, resulting in the filing of a single return by the debtor.

The court specifically rejected the rationale of the 8th Circuit in *Knudsen* that "tax incurred by the estate" means "tax incurred during bankruptcy." Because there must be a liability for a tax before such a tax can be incurred, the issue was "who" incurred the tax rather than "when the tax was incurred." On this point, the court explained that Chapter 12 and Chapter 13 estates are treated similarly for tax purposes. Thus, because Chapter 13 allows the government the option to choose whether to have post-petition taxes incurred by the debtor treated as part of the bankruptcy proceeding and dealt with in the reorganization plan, converting the 11 U.S.C. §503(b) issue from a liability issue to a timing issue would eliminate that option. Likewise, the court noted that the Bankruptcy Code specifically prohibits state and local income taxes from being either "taxed to" or "claimed by" a Chapter 12 estate.

The court stated that its conclusion was consistent with congressional intent, insomuch as the Congress made no attempt to coordinate the various provisions of the Internal Revenue Code and the Bankruptcy Code to produce the result that the debtors desired. The court also noted that statements of legislators made in different congressional sessions when the pertinent statutes were enacted did not control.

HOBBY LOSSES

The United States Court of Federal Claims in *Morton v. U.S.,*[86] utilized the "unified business enterprise theory" so that the taxpayer could aggregate losses in one enterprise that had no profit with the taxpayer's other activities to determine if an overall profit motive was present for purposes of IRC §183. While the facts of the case are not specific to agriculture, the principles of the court's opinion can be of significant importance for a farmer that cannot show a profit from farming activities but has income from related activities. Procedurally, the case was on a summary judgment motion. The taxpayer claimed entitlement to a refund because the IRS denied business expense and depreciation deductions and required the plaintiff to recognize gain on a transaction designed to qualify as a like-kind exchange involving aircraft. The taxpayer argued that business expense deductions should be allowed because the taxpayer's personal business activities and the business activities of the taxpayer's corporate entities were intertwined sufficiently to be viewed as a "unified business enterprise."

85. *In re Dawes,* No. 09-3129, 2011 U.S. App. LEXIS 12477 (10th Cir. Jun. 21, 2011).

86. *Morton v. U.S.,* No. 08-804C, 2011 U.S. Claims LEXIS 661 (Fed. Cl. Apr. 27, 2011).

The taxpayer was a significant owner of the Hard Rock Cafe restaurant chain and used aircraft owned in various S corporations in conducting business for the chain. The IRS disallowed business expense deductions related to the aircraft because the S corporations were not operated for profit. However, the court applied the "unified business enterprise theory." In this regard, the losses generated by the S corporations could be aggregated with the taxpayer's other activities conducted either individually or through commonly controlled entities to determine if an overall profit motive was present for purposes of the hobby loss rules of IRC §183.

On the like-kind exchange issue, categorizing the aircraft transaction as a like-kind exchange was dependent on the substantiation of business expenses. Therefore, the court made no ruling on the validity of the like-kind exchange treatment. The end result, therefore, was that the taxpayer's motion for summary judgment was granted in part and denied in part, and the IRS motion for summary judgment was denied.

Note. The court's analysis was specific to S corporations and other pass-through entities. The unified business enterprise theory typically arises for transactions in which the taxpayer owns property that is leased to a related business operation. The opinion is likely not applicable to C corporations.

In *Stromatt v. Comm'r,*[87] the court determined that the taxpayers were engaged in a 15-acre cattle ranching activity with an actual and honest profit objective. As a result, their claimed losses were not limited by IRC §183. The taxpayers cleared land for use as pasture (hay cultivation) which bore an "economic relationship" with the cattle operation that started after the land was cleared. The taxpayers sold hay until the property was fully ready for cattle grazing. In addition, the taxpayers utilized the advice of an experienced farmer in preparing for the beginning of the cattle operation. The court also found that the facts did not reveal any recreational aspect to the activity, and that the activity added value to the property. There was also no lengthy period of time with a history of losses. While certain other factors favored the IRS's position, they were insufficient to outweigh the factors in the taxpayers' favor.

MEDICAL REIMBURSEMENT PLANS

Note. For a more complete discussion of medical reimbursement plans and recent IRS and court rulings, see pages 358–363 in the 2010 *University of Illinois Federal Tax Workbook.* This can be found on the accompanying CD.

Shellito v. Comm'r[88]

The taxpayers, a married couple, conducted a farming operation primarily on leased land. The couple jointly owned three pickup trucks that were used on the farm, and 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.[89] In 2001, the couple executed an employment agreement and filled out a preprinted application for an Agriplan/BIZPLAN medical reimbursement plan. Under the plan, the wife and the family were reimbursed for health insurance premiums, for out-of-pocket medical expenses up to $15,000, and for $50,000 of term life insurance for the wife only. The agreement stated that the husband employed his wife as a farm hand but did not specify her work hours or compensation. However, the wife kept a daily log of the hours that she worked on the farm — which totaled 1,169 hours in 2001 and 2,226 hours in 2002 (the years at issue in the case).

87. *Stromatt v. Comm'r,* TC Summ. Op. 2011-42 (Apr. 6, 2011).

88. *Shellito v. Comm'r,* TC Memo 2010-41 (Mar. 3, 2010).

89. The wife assisted with planting and harvesting activities, operating farm equipment, feeding and caring for livestock, building and repairing fences, repairing equipment, and keeping the farm's books.

The wife also opened up a checking account in her name in which she deposited her monthly "paycheck" of $100 plus the reimbursements she received for medical bills. The amounts were from their joint checking account. For 2001, the wife paid almost $8,000 in medical expenses and health insurance premiums for herself and the family out of the account for which she was reimbursed under the plan.

The wife received a 2001 Form W-2 on which wages of $700 plus $54 in payroll tax were reported. On the couple's 2001 tax return, they claimed a Schedule F deduction of $15,593 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 the 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."

Observation. The couple followed the details of the medical reimbursement plan. Each year, they submitted detailed accountings of amounts claimed for medical expenses and insurance premiums to AgriPlan/BIZPLAN and received a yearend report showing the total allowable benefit amount that they could report as a business expense deduction.

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.

The court noted that the funds in the joint account were owned equally by the spouses. As such, the husband (the 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. Thus, 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. Indeed, the wife's occupation was denoted on the couple's tax return as "HOUSE WIFE." The end result was that the court disallowed any deduction for employee benefit program.[90]

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On appeal, the 10th Circuit vacated the Tax Court's decision and remanded the case.[91] The court noted that *Frahm v. Comm'r*[92] was directly on point, involved substantially similar facts, and resulted in a finding by the IRS that the wife was an employee. There was no challenge by the IRS of the fact that the payments originating from the couple's joint checking account ended up in the wife's individual account.

The court also noted that the taxpayers carefully followed all the rules for properly establishing an employment relationship and deducting amounts paid under the plan for medical expense reimbursements. The court specifically rejected the IRS's position that the deductibility of medical reimbursements hinges on whether or not the expenses might be paid from another source, even if that source has an obligation to pay. This IRS position lacks any support in case law.

90. While the IRS had levied an accuracy-related penalty against the couple, the court did not sustain it because they had relied in good faith on the advice of their CPA in establishing the medical reimbursement plan.

91. *Shellito v. Comm'r,* No. 10-9002, 2011 U.S. App. LEXIS 17724 (10th Cir. Aug. 24, 2011).

92. *Frahm v. Comm'r,* TC Memo 2007-351 (Nov. 27, 2007).

The court also held that reimbursed amounts were not disqualified from deductibility simply because they originated from the couple's joint account. That argument, the court noted, had never been used in previous cases and is not mentioned in Rev. Rul. 71-588.[93]

On remand, the Tax Court is to determine whether the wife was a bona fide employee by applying the common law principles of agency. This will require the Tax Court to determine whether the husband had the right to direct and control the means and manner in which the wife's farm work was done and what was accomplished. A multi-factored test will be utilized to make that determination.

REPEAL OF FUTA SURTAX

Effective July 1, 2011, the FUTA surtax of 0.2% expired. The FUTA tax after that date is 6.0% rather than 6.2%. The surtax was never a permanent part of the law and was extended many times.

For 2011, the impact of the reduction will require taxpayers to keep separate records. They must track wages paid from January 1, 2011, through the end of June and keep those separate from wages paid for the second half of 2011. This applies to employers who pay $20,000 or more in wages in any calendar year quarter for 2010 or 2011 and employ at least 10 workers in any one day for any 20-week period during 2010 or 2011. The IRS will revise Form 940 accordingly.

> **Note.** The Administration's 2012 proposed budget would have made the surtax permanent.

93. Rev. Rul. 71-588, 1971-2 CB 91.