Chapter 5: Agricultural Issues and Rural Investments

Corrections were made to this workbook through January of 2013. No subsequent modifications were made.

ISSUE 1: DEDUCTING INPUT COSTS

For farmers on the cash method of accounting, a question often arises concerning when inputs are considered paid and thus qualify for a deduction. Under the constructive receipt doctrine, the IRS may take the position that prepaid items are deductible in the year of purchase rather than the following year when the inputs are used and the resulting product is sold.[1] This may be the same goal sought by taxpayers.

Note. For prepaid expenses to be currently deductible, the payment must relate to a business purpose, not be merely for tax avoidance, not be a deposit, and not materially distort income.[2]

PAYMENT VIA PROMISSORY NOTE AND/OR LETTER OF CREDIT[3]

The purchase of depreciable property on credit generally allows the buyer to receive an income tax basis for the purchase price of the property, including any liability assumed. However, there can be situations in which a payment made in accordance with a promissory note, even if secured by collateral, does not result in a deduction.[4]

The same could be true if the payment is secured by a letter of credit. This can be a particularly important matter in livestock feeding arrangements, in which letters of credit and advance payments for management services are common.

For example, in *Chapman v. U.S.,*[5] a farmer entered into a purchase agreement for cattle feed worth $30,000. The farmer paid one-half of the total amount in cash in 1973. The remaining $15,000 was due and payable when each cattle lot was sold and was subtracted from cattle sale proceeds before any remaining balance was disbursed to the farmer. To ensure payment in the event that the cattle sale proceeds did not cover the amount owed to the seller of the feed, the farmer gave the seller a promissory note for $15,000 and a secured letter of credit for the same amount. The farmer deducted the entire $30,000 in 1973 and recognized income of $15,000 in 1974 when the letter of credit expired. The court held that the letter of credit was synonymous with a promissory note secured by collateral and denied the $15,000 deduction in 1973 that was attributable to the note.

1. See *Crisp v. Comm'r,* TC Memo 1989-668 (Dec. 26, 1989). (The taxpayer argued unsuccessfully that feed was includible in cost of goods sold and deductible in the year the cattle were sold.)
2. Rev. Rul. 79-229, 1979-2 CB 210.
3. For further discussion of the cases discussed in this section see "Tax Accounting Problems," *The Tax Lawyer,* 36 Tax Law 1175 (Summer 1983).
4. Rev. Rul. 77-257, 1977-2 CB 174; See *Helvering v. Price,* 309 U.S. 409 (1940).
5. *Chapman v. U.S.,* 527 F.Supp. 1053 (D. Minn. 1981).

In *Bandes, et al. v. Comm'r,*[6] two taxpayers got into the cattle feeding business by contracting with a cattle company in Guymon, Oklahoma. The cattle company acted as their agent and advisor for the purchase, feeding, and sale of 1,200 head of livestock. The taxpayers agreed to share expenses and proceeds equally. The contract with the cattle company appointed the cattle company as agent to select feedlots, negotiate and execute feeding contracts, and oversee the buying, managing, and selling of the cattle. The cattle company was also authorized to negotiate and contract for the delivery of the cattle by the end of 1972. The cattle company was to receive $8 per head for its management services, and the taxpayers paid the fee on December 12, 1972 ($4,800 for each taxpayer).

The cattle company arranged for a 180-day bank line of credit to each taxpayer. It was set at a maximum of $210,000 per taxpayer at 8% interest. In the summer of 1973, the line of credit was renewed for another 180 days at 9% interest. The feed and livestock served as the security for the loan, and the taxpayers were not personally liable for any advances under the line of credit. The advances from the bank paid a portion of the purchase price of the cattle and feedyard charges and the advances were repaid (except for interest paid in advance by the taxpayers) out of cattle sale proceeds. In addition, advances were only made after each taxpayer had a net equity in the cattle of $90 per head. Thus, on December 15, 1972, each taxpayer opened an account with the bank and deposited $54,000 ($90 × 600 head).

On December 22, 1972, the cattle company purchased feed worth $96,000 on each taxpayer's behalf. In early 1973, the cattle company bought 1,200 head of cattle for $411,352 that were shipped to a feedyard. During the remainder of 1973, the 1,153 surviving cattle were sold for $578,476. Also in 1973, the unused feed was sold for $3,424.

Both taxpayers were on the cash method of accounting and each of them deducted the $4,800 management fee on their respective 1972 returns along with $48,000 for cattle feed. The IRS disallowed the deduction for the cattle feed in accordance with Rev. Rul. 79-229,[7] but the court allowed the deduction on the grounds that the taxpayers had a legitimate business purposes (locking in price) and the payment was not a deposit and did not materially distort income. Further, the court allowed a deduction for one-half of the management fee in 1972 and the other half in 1973, absent evidence as to the value of the services that the cattle company performed.

Key Revenue Ruling

In Rev. Rul. 77-257,[8] a limited partnership was engaged in acquiring and holding land for investment and for farming. The limited partnership used the cash method of accounting. A general partnership was involved in management of farm properties. The two entities were not related and had no common owners. In the year in question, the limited partnership purchased farmland from the general partnership. The limited partnership then entered into a management agreement with the general partnership whereby the general partnership was to provide development services on the farmland produced by the limited partnership. The management expenses were billed monthly and were paid by checks drawn on another partnership bank account. At the end of the development period, the limited partnership gave the general partnership a note for the account receivable on the third partnership account's books.

Rev. Rul. 77-257 cited a 1940 U.S. Supreme Court case in which the court stated that the issuance of a note by a taxpayer on the cash method of accounting, without any disbursement of cash or property having a cash value, does not give rise to a deduction.[9] However, the IRS stated that "the actual payment of an expense with funds **borrowed** from a third party **does give rise to a current deduction." This provides the opportunity to deduct costs that are paid using vendor financing.**

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6. *Bandes, et al. v. Comm'r,* TC Memo 1982-355 (Jun. 23, 1982).
7. Rev. Rul. 79-229, 1979-2 CB 210.
8. Rev. Rul. 77-257, 1977-2 CB 174.
9. *Helvering v. Price,* 309 U.S. 409 (1940).

VENDOR-FINANCED INPUTS

Sometimes a farmer buys inputs that are financed by a lending subsidiary of the input supplier. Typically, the interest rate is set below the prime lending rate to enhance sales. Rev. Rul. 77-257 specifies that when the funds are borrowed from a third party, a deduction for expenses incurred can be taken in the year the funds are loaned. But what happens when the lender is a wholly-owned subsidiary of the vendor? In that situation, is the lender really a "third-party" lender?

Input financing by a wholly-owned subsidiary of the vendor when the farmer does not pay by check raises serious questions as to current deductibility. The vendor typically argues that the financing is provided by a different legal entity within the vendor's group, which constitutes third-party financing. However, when that legal entity is wholly-owned by the vendor, the distinction may be immaterial. It becomes very challenging for farmers to identify the true nature of all parties involved in a transaction.

FINANCED IMPROVEMENTS TO DEPRECIABLE PROPERTY

Improvements to property that are financed by a promissory note or other obligation do not add to the property's basis until the obligation is paid. **This is different than paying for the cost using borrowed funds** and affects timing for claiming depreciation.

In *Owen v. U.S.,*[10] the taxpayers financed **improvements** to office condominiums by promissory notes issued to an entity that the taxpayers owned and controlled. The taxpayers did not make any payment on the notes before selling the improved property. The taxpayers argued that the issuance of the notes for payment of the improvements increased their basis in the property, but the court distinguished the case (which involved a subsequent adjustment to basis) from situations involving the taxpayer's initial cost basis in property. The court noted that cash-basis taxpayers do not recognize income or expenses until cash is actually received or paid. Thus, the issuance of a promissory note as payment for benefits received was not a cash payment that allowed the taxpayers to take a current-year deduction, and did not increase the basis in the condominiums by the cost of the improvements. Therefore, no depreciation deductions were allowed.

The *Owen* decision raises interesting questions (which the court did not address), including how a taxpayer should handle the sale of property purchased and financed by the taxpayer and subsequently sold while the taxpayer remains personally liable on the note.

Example 1. Jim sells Blackacre for $350,000. He previously purchased Blackacre and an associated building on the property for $150,000 in cash and made $100,000 of improvements to the building that he financed with a promissory note from the supplier. Does Jim report $100,000 or $200,000 of gain? Apparently, the *Owen* decision requires Jim to report $200,000 of gain followed by a reduction in gain as he makes payments on the note's principal.[11]

Observation. If this result is correct, a taxpayer in Jim's position would have to amend the tax return for the year of sale each year that a principal payment is made. If the statute of limitations expires before the taxpayer makes all the principal payments, the taxpayer will have gain recognition without any basis offset and will have to continue to make principal payments.

10. *Owen v. U.S.*, 34 F.Supp. 2d 1071 (W.D. Tenn. 1999).

11. This example is from Zimmerman, John C. (2000, Jan.). Obtaining Basis for Promissory Notes: Is an Original Purchase Different from an Improvement? *Journal of Taxation*, 92 (1), 55.

Example 2. Use the same facts as **Example 1,** except Jim is released from liability on the $100,000 note. Apparently, Jim has $200,000 of capital gain to report and $100,000 of discharge of indebtedness income (ordinary income). This results in Jim having $300,000 of income recognition on property that was sold for a profit of $200,000.[12]

Note. *Owen* indicates that the difficult (and unresolved) issues arising from the case can be avoided if a taxpayer simply borrows the necessary funds and pays cash for the improvements in return for a nonrecourse note. Vendor-financing of the **purchase** of a depreciable asset remains permissible — depreciation begins when the asset is placed in service.

Observation. To date, the IRS has focused on the input side of vendor financing, rather than vendor financing of capital purchases.

LIVESTOCK MAINTENANCE FEES

The IRS ruled that monthly maintenance fees paid under an agreement involving the purchase of cattle are not deductible for the period before the purchase of the cattle.[13] When an advance payment is made for management services for the current year and the succeeding year, the Tax Court has allocated the fee between the two years and allowed a deduction for the amount related to the current year.[14]

ISSUE 2: DEFERRED PAYMENT ARRANGEMENTS

Agricultural producers typically have income streams that are less consistent from year-to-year when compared to nonfarm salaried individuals. Consequently, these taxpayers often structure transactions in an attempt to even out income across tax years and for other tax-related purposes. One technique used to accomplish these goals involves the use of deferral arrangements. These transactions can be structured in various ways.

Note. Chapter 9 of the Farmers Audit Technique Guide (ATG) provides a summary of income deferral and constructive receipt rules.[15] The ATG provides examining agents with a procedural analysis for use in evaluating deferred payment arrangements.

The general rule for cash-basis taxpayers is that income is accounted for in the tax year that it is either actually or constructively received. The IRS published regulations specifying when income is deemed to be constructively received. The **constructive receipt doctrine** is the primary tool that the IRS uses to challenge deferral arrangements. Under the regulations, even though a taxpayer does not have actual possession of income, the taxpayer is deemed to have constructively received that income when **any** of the following occurs.[16]

- The income is credited to the taxpayer's account.
- The income is set apart for the taxpayer.
- The income is made available for the taxpayer to draw upon, or it could be drawn upon if notice of intent is given.

Note. Under the regulations, the definition of constructive receipt does not include situations in which the taxpayer's control of receipt of the income is subject to substantial limitations or restrictions.[17]

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12. Ibid.
13. Rev. Rul. 84-35, 1984-1 CB 31; GCM 39202 (Mar. 26. 1984).
14. *Bandes v. Comm'r,* TC Memo 1982-355 (Jun. 23, 1982).
15. The ATG is available online at [www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Audit-Techniques-Guides-(ATGs)] Accessed on Sep. 6, 2012.
16. Treas. Reg. §1.451-2(a).
17. Ibid.

STRAIGHTFORWARD DEFERRAL ARRANGEMENTS

The most likely way for a seller of agricultural commodities to avoid an IRS challenge of a deferral arrangement is for the farmer to enter into a **sale contract** with the buyer that requires payment in the subsequent tax year. This type of contract simply involves the buyer's **unsecured** obligation to purchase the agricultural commodities from the seller on a particular date. Under this type of deferral contract, the price of the goods is set at the specified time for delivery, but payment is deferred until the next year. The deferral will not be challenged by the IRS if the contract is bona fide and entered into at arm's length, the farm seller has no right to demand payment until the following year, and the contract and the sale proceeds are nonassignable, nontransferable, and nonnegotiable.[18]

DEFERRAL CONTRACTS WITH LETTERS OF CREDIT OR ESCROW ACCOUNTS

After an agricultural commodity is delivered to the buyer but before payment is made, the seller is an unsecured creditor of the buyer. In an attempt to provide greater security, a farmer-seller may use letters of credit or an escrow arrangement. This could be successfully challenged by the IRS on the basis that the letters of credit or the escrow can be assigned, with the result that deferral is not accomplished. Generally, funds placed in escrow as security for payment are not constructively received in the year of sale. However, is critical for a farmer-seller to clearly state that the buyer is being looked to for payment **and** that the escrow account serves only as security for this payment.

> **Note.** Funds held in escrow and the interest accrued on these funds is taxable as income in the year that it provides an economic benefit to the taxpayer. Simply because an escrow account bears interest **does not mean** that the account constitutes an economic benefit.[19]

Key case law pertaining to letters of credit or escrow accounts used in the context of deferral arrangements includes the following.[20]

- In *Watson v. Comm'r,*[21] the court held that the receipt of a letter of credit was equivalent to receiving cash in the year of sale. The taxpayers sold cotton bales under a deferred payment agreement in return for a letter of credit that was to be honored and accepted after the end of the tax year in which it was received. The court noted that the letter of credit could be assignable under state (Texas) law and also could be readily marketable.
- In *Griffith v. Comm'r,*[22] 16,000 bales of cotton were sold in 1973 under a deferral contract specifying that the buyer would pay the selling price in five annual installments beginning in 1975. The interest rate on unpaid installments was set at 7% annually. The buyer was given a warehouse receipt for the cotton. The seller received a letter of credit for the full face amount of the cotton's total deferred purchase price that specified that prepayment was not allowed and the letter of credit was not transferable. The letter of credit allowed the seller to draw on the buyer's account but only after a certification had been received that the buyer was in default on the contract. The court ruled that the full contract amount was constructively received in the year the contract was executed. Importantly, even though the standby letter of credit was nontransferable, the proceeds were transferable under state law. The court also determined that the seller did not have a nontax business purpose for entering into the deferral arrangement.

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18. See, e.g., Rev. Rul. 58-162, 1958-1 CB 234. (The deferral of income from the sale of grain was effective to delay income recognition until the year of actual receipt; the IRS noted that if the taxpayer could control timing of payment, then constructive receipt occurred.)

19. See, e.g., *Stone v. Comm'r,* TC Memo 1984-187 (Apr. 16, 1984).

20. For further discussion of the following cases, see Sedo, Kathryn J., and Brenden, Mychal S., Fairness and Taxation: The Law of Deferred Income Recognition for the Members of Agricultural Cooperatives, 23 *Akron Tax J.* 81 (2008); Mauer, Michael T., and Harl, Neil E., Using Escrow Accounts and Letters of Credit to Assure Payment Under Credit Sales Agreements, 14 *Journal of Agricultural Taxation and Law* No. 1, pp. 3–24 (Spring 1992).

21. *Watson v. Comm'r*, 613 F.2d 594 (5th Cir. 1980).

22. *Griffith v. Comm'r,* 73 TC 933 (1980).

- In *Reed v. Comm'r,*[23] the court held that a taxpayer's "unconditional right to future payment from an irrevocable escrow account" did not constitute taxable income in the year the escrow account was created. The key, the court said, was whether the taxpayer received a present beneficial interest in the escrow funds such that the funds were, in reality, the same as investment income. An unconditional promise that the taxpayer would ultimately be paid was not enough to create a beneficial interest that would cause the funds in the account to be presently taxable.
- In *Busby v. Comm'r,*[24] the taxpayer established a deferred payment arrangement with a cotton gin. The gin created an irrevocable escrow account. The court held that deferral was achieved because the taxpayer did not have any right to the funds in the account until the year following the year of the cotton's sale and the deferral arrangement resulted from arm's-length negotiation between the parties.
- In *Scherbart v. Comm'r,*[25] the IRS challenged a deferral arrangement that a member of a farmer's cooperative had with the cooperative pertaining to value-added payments paid late in the tax year. The taxpayer entered into a "uniform marketing agreement" with the cooperative that served as the taxpayer's agent under the agreement. The agreement obligated the taxpayer to deliver corn to the cooperative in a specified amount, and the cooperative made "value-added" payments to members in the year following the year in which corn deliveries were made. However, the cooperative also had the discretion to issue value-added payments near the end of the year in which the corn deliveries were made. The court held that the deferral arrangement for the value-added payments involved self-imposed limitations on the receipt of income and that the cooperative was the taxpayer's agent. The court also held that the value-added payments were not installment payments that the taxpayer could report using the installment method provided under IRC §453.

THIRD-PARTY SALES[26]

When a deferral arrangement is structured by using a third party such as a broker or cooperative, agency principles are important in determining whether the farmer-seller is held to be in constructive receipt of the sale proceeds in the year in which the arrangement is initiated.

The following is a summary of some key cases and rulings involving deferral arrangements with a third party.

- *U.S. v. Pfister*[27] involved the sale of cattle through a commission company. The commission company sold the cattle and mailed the net proceeds to the farmer on December 12, 1946. Although the check was in the farmer's post office box before the end of 1946, the farmer did not check the box until January 1, 1947. The court held that the commission company acted as the farmer's agent and its receipt of the sale proceeds was attributable to the farmer. Thus, the farmer was deemed to be in constructive receipt of the sale proceeds in 1946.

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23. *Reed v. Comm'r,* 723 F.2d 138 (1st Cir. 1983).

24. *Busby v. Comm'r,* 679 F.2d 48 (5th Cir. 1982).

25. *Scherbart v. Comm'r,* 453 F.3d 987 (8th Cir. 2006).

26. For further discussion of the following cases and others, see Sedo, Kathryn J., and Brenden, Mychal S., Fairness and Taxation: The Law of Deferred Income Recognition for the Members of Agricultural Cooperatives, 23 *Akron Tax J.* 81 (2008); Mauer, Michael T., and Harl, Neil E., Using Escrow Accounts and Letters of Credit to Assure Payment Under Credit Sales Agreements, 14 *Journal of Agricultural Taxation and Law* No. 1, pp. 3–24 (Spring 1992).

27. *U.S. v. Pfister,* 205 F.2d 538 (8th Cir. 1953).

Note. Livestock deferral arrangements can be difficult due to the Packers and Stockyards Act (PSA).[28] The court noted that under the PSA, a livestock market cannot buy consigned animals for resale via its owners, officers, agents, or employees. The IRS took the position that livestock sales under the PSA are consignment contracts that create an agency relationship.[29] However, one court held that a deferral arrangement involving the sale of livestock was effective in spite of the PSA provision because the arrangement imposed "substantial qualifications and restrictions" that defeated constructive receipt and amounted to a substantial limitation.[30] The IRS does not agree with the court's opinion.[31]

- In *Warren v. U.S.,*[32] the taxpayers grew cotton that they marketed to separate cotton gins in 1969 and 1970. The cotton gins also accepted bids from buyers at the taxpayer's request. The cotton buyer paid a set fee per bale purchased and the farmer paid the cost to gin the cotton. Bids were accepted by the taxpayer who then instructed the gin to complete the sale, with the taxpayer having the option to receive the sale proceeds in the following year. One gin deposited the sale proceeds in its own account and later paid the grower directly, but the other gin deposited the funds in an escrow account from which the bank later issued a check to the grower. For both 1969 and 1970, the taxpayer reported the income from these sales in the following year. The IRS determined that the income from the sales should have been reported in 1969 and 1970, respectively. The court held that the gins acted as the taxpayer's agent, with the result that the taxpayer recognized the income from the cotton sales in the year of the sale. The only limitation on receipt of the funds was self-imposed.
- In Rev. Rul. 72-465,[33] a farmer entered into a deferred-payment arrangement with a livestock market corporation in which the farmer received the sale amount the following year. Deferral was not permitted because the farmer could reclaim the livestock before their resale, and the buyer could return the livestock if they failed to sell.
- In Rev. Rul. 73-210,[34] a farmer was a member of a cooperative and was required to market his cotton through the cooperative after it was ginned. Upon delivery to the cooperative, the farmer had the option of deferring payment for the cotton. The farmer entered into a deferral arrangement on October 1, 1970, with payment to be made in January 1971. The deferral arrangement was effective because at the time the farmer entered into the deferred-payment contract, he had no unqualified right to receive any payments in that year and the contract was a bona fide arm's-length transaction.

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28. 7 USC §§181–229b.
29. Rev. Rul. 70-294, 1970-1 CB 13.
30. *Levno v. U.S.,* 440 F.Supp. 8 (D. Mont. 1977).
31. Rev. Rul. 79-379, 1979-2 CB 204.
32. *Warren v. U.S.,* 613 F.2d 591 (5th Cir. 1980).
33. Rev. Rul. 72-465, 1972-2 CB 233.
34. Rev. Rul. 73-210, 1973-1 CB 211.

INSTALLMENT REPORTING

For cash-basis farmers, income deferral can be achieved for the sale of farm products by using the installment method of reporting income. For eligible transactions, installment reporting is automatic unless the taxpayer elects out. An installment sale is a sale of property in which the taxpayer receives at least one payment after the tax year of the sale.[35] Thus, if a farmer sells and delivers grain in one year and defers payment until the next year, the transaction constitutes an installment sale. If desired, the farmer can elect out of the installment sale method and report the income in the year of sale and delivery.

> **Observation.** Tax legislation that retroactively reinstates larger depreciation allowances could make electing out a useful strategy.

> **Note.** Installment reporting is available for income derived from the sale of property that is not required to be included in inventory under the taxpayer's method of accounting. Crops and livestock, as inventory-type property, are eligible for installment reporting if they are not required to be reported in inventory under the taxpayer's method of accounting (which is the case under the cash method of accounting).

Example 3. Tom harvests his grain crop in the fall of 2012 and delivers and sells it in accordance with a deferred sales contract in December 2012. The contract specifies that Tom will be paid in January 2013. This contract qualifies for installment sale treatment. Tom can elect to report the income under the contract in 2012.

In the preceding example, because the election out of installment sale reporting is on an all-or-nothing basis, Tom must either report the income under the installment method or elect out of installment reporting for **all** of the grain covered by the contract. The election is made by reporting the income on the tax return and filing it by the due date, including extensions, of the tax return for the year of sale. Once made, the election can only be revoked with IRS approval.

> **Observation.** Because of the all-or-nothing feature (on a per-contract basis) for electing out of installment reporting, it may be advisable for farm taxpayers to utilize multiple deferred payment sales contracts in order to better manage income from year to year.

Manufacturers and sellers of farm equipment are not eligible for installment reporting.[36] In addition, the Code specifies that the Treasury can issue regulations denying installment sale treatment for property that is of a kind "regularly traded on an established market."[37] If such regulations were issued, they could potentially apply to a wide array of agricultural products.

An installment sale contract should provide for interest. If it does not or sets the interest rate at something less than the minimum rate allowed, the Code specifies that part of any deferred payment is deemed to be unstated interest.[38]

> **Note.** A discussion of imputed interest can be found in 2012 Volume C, Chapter 8: Investment Income.

35. IRC §453(b).

36. *Thom v. U.S.,* 134 F.Supp. 2d 1093 (D. Neb. 2001), *aff'd* 283 F.3d 939 (8th Cir. 2002).

37. IRC §453(k)(2).

38. IRC §483(a). Unstated interest is determined in accordance with IRC §1272(a).

Installment Sales and Death of Seller

Installment payments are treated as income in respect of a decedent (IRD).[39] Thus, if the seller dies before receiving all the payments, the beneficiary does not receive a stepped-up basis at the seller's death. The beneficiary of the payments includes the gain on the beneficiary's return subject to tax at the beneficiary's applicable rate. The character of the payments is tied to the seller. For example, if they were long-term capital gain to the seller, they will be long-term capital gain to the beneficiary.

Caution. Grain farmers often carry a large inventory that may include grain delivered under a valid deferred payment agreement. Grain included as inventory but more properly classified as an installment sale may not qualify for a stepped-up basis if the farmer dies after delivering the grain but before all payments are received.

Observation. The only way to avoid possible IRD treatment on installment payments appears to be for the seller to elect out of installment sale treatment. IRD includes sales proceeds "to which the decedent had a contingent claim at the time of his death."[40] With respect to installment payments, the courts have held that the appropriate inquiry is whether the transaction created the right to receive the payments for the decedent at the time of death.[41] This means that if the decedent holds a contingent claim at the time of death that does not require additional action by the decedent, the installment payments are IRD.[42]

ISSUE 3: OPTIONS IN WILLS

As part of an estate plan, an heir may be given an option to buy certain assets of the decedent at a specified price. In agricultural estates, such an option is typically associated with the decedent's farmland and often gives the person with the option a significantly discounted purchase price for the property upon exercise of the option.[43]

There is no question that an option can be included in a will. A testator generally has the right to dispose of their property as they wish. However, some conditions cannot be placed on bequests made under a will, and property cannot be bequested or devised for an illegal purpose. Although every state has statutory provisions limiting a decedent's testamentary power, the only significant limitation on testamentary freedom involves the inability to completely disinherit a spouse. Even if the will leaves nothing for the surviving spouse, under state law the surviving spouse has a right to an elective share entitling them to "elect" to take a portion of the estate regardless of what the deceased spouse's will says (unless a valid prenuptial agreement was executed). Under most state laws, a surviving spouse's elective share comprises anywhere from one-third to one-half of the decedent's estate. In addition, in some states, the spousal elective share can include retirement assets or life insurance.

39. IRC §691(a)(4).

40. Treas. Reg. §1.691(a)-1(b)(3).

41. See, e.g., *Estate of Bickmeyer v. Comm'r,* 84 TC 170 (1985).

42. See, e.g., *Lindeman v. Comm'r,* 213 F.2d 1 (9th Cir. 1954), *cert. denied,* 348 U.S. 871 (1955). (Grapes delivered to cooperative that had not been marketed at the time of the decedent's death were IRD.)

43. For a discussion of options in wills see generally, *Estate Planning,* Harl, Neil E., PM 993, Iowa State University Extension, Revised December 2005 by Roger A. McEowen; Harl, Neil E., Be Careful in Using Discounted Land Values in Sales to On-Farm Heirs, 22 *Agric. Law Digest* No. 11 (Jun. 10, 2011); For a recent illustrative case on the issue see *In re Estate of Stevens,* 2012 Ohio 1860 (Ohio Ct. App. 2012).

TAX ISSUES

The exercise of an option results in no tax consequence to the decedent's estate. That is the case because an option created by will has an income tax basis in the hands of the optionee equal to its FMV at the time of the decedent's death.[44] This amount is determined by subtracting the option price from the FMV of the property subject to the option at the time of the decedent's death.[45] Thus, when the option is exercised, the optionee's basis in the property is the sum of the basis of the option and the price of the option. Consequently, the exercise of the option, followed by the sale of the property by the estate to the holder of the option does not result in gain or loss to the estate.

In Ltr. Rul. 8210074,[46] the decedent's son was given an option under the terms of a parent's will to purchase some of the parent's farmland at $350 per acre. The son exercised the option and paid the estate $26,668 for the land. At the time the option was exercised, the farmland was worth $114,293 (as valued on the parent's estate tax return). The IRS determined that the combined basis of the option and the real estate subject to the option was $114,293 with $26,668 of that allocable to the land. Thus, when the real estate was sold for $26,668, it equaled the basis in the land in the hands of the estate, resulting in neither gain nor loss to the estate. Although the ruling does not address the issue of basis, the son's basis in the property would be the basis of the option plus the option price ($87,625 + $26,668 = $114,293).

ISSUE 4: AVOIDING DEALER STATUS ON SALE OF REAL ESTATE

The strength of the agricultural real estate market in recent months has encouraged some agricultural landowners to sell their land. This is particularly true for those at or beyond retirement age who do not have heirs interested in continuing the farming operation or owning the land. In some situations, the landowner realizes a greater return by selling the farmland in various tracts rather than as a single parcel.

On the sale of land, any gain is taxed at capital gain rates if the taxpayer held the land for more than one year. In addition, it is possible for the seller to defer any gain by structuring the transaction as an installment sale or as a like-kind exchange. However, the favorable capital gain rates or deferral provisions are not available if the taxpayer is considered a dealer for the property that is sold.

WHEN IS THE SELLER A "DEALER"?

A taxpayer is a dealer if the property sold was held primarily for sale to customers in the ordinary course of the taxpayer's trade or business. If the taxpayer is a dealer, any gain on the sale of dealer property is taxed as ordinary income and, for an individual taxpayer, is also subject to self-employment (SE) tax.

> **Observation.** Classification as a dealer is a risk for any taxpayer who engages in multiple sales of real estate over a relatively short period of time.

AVOIDING DEALER STATUS

There are two ways to avoid dealer status.

1. The taxpayer can establish that, in accordance with IRC §1221(a)(1), the property was not held primarily for sale to customers in the ordinary course of the taxpayer's trade or business.
2. The sale of the property qualifies for capital gain treatment under IRC §1237.

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44. *Cadby v. Comm'r,* 24 TC 899 (1955), *acq.,* CB 1956-1.
45. Ltr. Rul. 200340019 (Jun. 25, 2003).
46. Ltr. Rul. 8210074 (Dec. 10, 1981).

IRC §1221

Under IRC §1221(a)(1), the definition of a capital asset excludes property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business. Taxpayers engaged in the business of selling real estate achieve dealer status if they sell real estate held primarily for sale to customers in the ordinary course of their business. If the taxpayer holds property for sale in a trade or business or has achieved dealer status, capital gain treatment is not allowed and the transaction cannot be structured to allow for gain deferral. The determination of whether IRC §1221(a)(1) is satisfied is based on the facts of each particular situation. In *U.S. v. A.B. Winthrop,*[47] the U.S. 5th Circuit Court of Appeals set forth seven factors that are critical for determining whether capital gain treatment is warranted. The factors are as follows.

1. The nature and purpose of the property acquisition and the duration of ownership
2. The extent and nature of the taxpayer's efforts to sell the property
3. The number, extent, continuity, and substantiality of the sales
4. The extent of subdividing, developing, and advertising to increase sales
5. The use of a business office for the sale of the property
6. The character and degree of supervision or control exercised by the taxpayer over any representative selling the property
7. The time and effort the taxpayer habitually devoted to the sales

Observation. Strategies for avoiding dealer status under IRC §1221 are difficult to formulate. The many cases involving the issue reveal that each case turns on its own specific facts and circumstances. The taxpayer should:

- Avoid being in the real estate business;
- Separate investment activities from dealer activities;
- Document any change in purpose if the property was originally acquired for the purpose of resale;
- Show that the property was sold for the purpose of liquidating the taxpayer's investment, if applicable;
- Extend the length of time the taxpayer held the property before sale; or
- Hold the property in a corporate entity.

47. *U.S. v. A.B. Winthrop*, 417 F.2d 905 (Oct. 22, 1969).

IRC §1237 Safe Harbor

IRC §1237 creates a safe harbor provision for taxpayers other than C corporations that ensures capital gain treatment on the sale of subdivided lots from a single tract of land. The provision applies when subdividing is the only economically practical way to market a tract of real estate. However, certain requirements must be satisfied.[48]

- The taxpayer **must not** have ever held any part of the tract for sale to customers in the ordinary course of business (unless IRC §1237 applied at that time), or hold any other real property for sale to customers in the ordinary course of a trade or business during the year in question.
- The taxpayer **must not** have made an improvement to the tract that substantially enhances the value of the property. This does not include changes in the market value of the tract that were not related to improvements made by the taxpayer.

> **Note.** If the tract was held by the taxpayer for at least 10 years, an election is available whereby an improvement is considered a necessary improvement not subject to the limitations of IRC §1237(a)(2). The **full** 10-year period **must** elapse even if the tract is inherited, and the improvement must consist of the building or installation of water, sewer, drainage facilities (either surface, subsurface, or both), or roads, including hard surface roads, curbs, and gutters.

- The tract **must have been** held by the taxpayer for **at least five years,** unless it was inherited. In that case, there is no holding period requirement. However, the regulations specify that neither the survivor's half of community property nor property acquired by survivorship in a joint tenancy is considered inherited property. The holding period for the surviving spouse or joint tenant begins on the date the property was originally acquired.

Full capital gain treatment under the safe harbor is limited to the first five lots or parcels sold from a tract. In computing the number of parcels sold, two or more contiguous lots sold to a single buyer in a single sale is counted as only one parcel. Finally, the taxpayer must elect not to adjust the basis of the lot sold or any other property held by the taxpayer for any part of the cost of an improvement attributable to the lot and not to deduct any part of the cost as an expense.

ISSUE 5: DEPRECIATING FARM ASSETS[49]

GENERAL

After 1988, property used in a farming business is limited to the 150% declining-balance method.[50] If the taxpayer is not engaged in the trade or business of farming, the 200% declining-balance method of claiming depreciation may be used. For this purpose, "farming business" is defined in IRC §263A(e)(4).

> *The term "farming business" means the trade or business of farming . . . [and] . . . shall include the trade or business of . . . operating a nursery or sod farm, or the raising or harvesting of trees bearing fruit, nuts, or other crops, or ornamental trees. For [this purpose,] an evergreen tree which is more than 6 years old at the time severed from the roots shall not be treated as an ornamental tree.*

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48. IRC §1237(a).

49. For additional coverage of the items discussed in this issue, including the application of the principles to farm buildings, see Neiffer, Paul, and Hesse, Chris, "When Does 200% DB Depreciation Apply to Farming Assets?," *Farm Tax Network,* LarsonAllen Agribusiness Group, Release No. 2011-006, Sep. 7, 2011.

50. IRC §168(b)(2)(B).

Thus, crop farming clearly meets the definition, and the assets used in such an operation are subject to the 150% declining-balance method unless the taxpayer elects the straight-line method or has assets that must be depreciated under the straight-line method (such as vineyards and orchards).[51]

Observation. Office equipment used in a farming operation is subject to the 150% declining-balance method as well.

CUSTOM HARVESTING ACTIVITIES

The IRS took the position that a taxpayer who provided custom grain harvesting services was not engaged in the trade or business of farming, with the result that the taxpayer's equipment remained eligible for the 200% declining-balance method.[52] Under the facts of TAM 9748002, the taxpayer contracted with farmers to cut and haul their grain, and the taxpayer was compensated on a per-acre-harvested basis. The taxpayer did not grow grain, did not own the land on which the grain was grown, and did not own any of the places where the harvested grain was to be delivered. The IRS determined that the equipment was being used in a nonfarm service activity and allowed the taxpayer to depreciate the equipment using the 200% declining-balance method. The taxpayer was not using the equipment in a farming business.

Observation. The TAM points out that the focus for determining the appropriate depreciation method is the **taxpayer's** business use of the asset, not the actual end-use of the asset.

For a taxpayer who is a farmer and also conducts custom farming activities, the appropriate depreciation method for the asset used in the activities is determined by the predominant use of a particular asset. For assets used equally in both activities, it may be necessary to allocate the depreciation between Schedule F and Schedule C.

PROCESSING ACTIVITIES

Processing activities related to agricultural commodities do not fit within the definition of farming business for purposes of determining the appropriate depreciation method. Thus, for farmers that engage in processing activities for commodities that are raised as part of the farming business, the issue is whether the processing activities are incidental to the growing, raising, or harvesting of the commodities. If the processing activities are incidental to the farming business, the assets used in the processing activity are subject to the 150% declining-balance method. If the processing activity is a distinct business, then the assets of the processing activity are depreciable using the 200% declining-balance method.

Example 4. Barb is in the business of growing and harvesting wheat and other grains. She also processes the grain that she harvests in order to produce breads, cereals, and other similar food products, which Barb then sells to customers in the ordinary course of business. Although Barb conducts a farming business with respect to the growing and harvesting of grain, she is not engaged in the business of farming for processing grain to produce food products.[53]

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51. IRC §§168(e)(3)(D) and 168 (b)(1). Straight-line depreciation is also required when an election to avoid the UNICAP rules has been made.

52. TAM 9748002 (Jun. 27, 1997).

53. This example is contained in Treas. Reg. §1.263A-4(a)(4)(iii).

Example 5. Clem is in the business of raising poultry and other livestock. He also operates a meat processing activity in which the poultry and other livestock are slaughtered, processed, and packaged or canned. The packaged or canned meat is sold to Clem's customers. Although Clem is in the farming business with respect to raising poultry and other livestock, he is not engaged in the farming business for slaughtering, processing, packaging, and canning to produce the food products.[54]

Note. Although separation of the processing activity from the farming activity is necessary to utilize the 200% declining-balance method, a possible problem with a separate processing activity is that the activity may be subject to accrual accounting.[55] Accrual accounting is required for processing activities in which the taxpayer does not participate in the raising or growing of a significant portion of the commodities that are processed **and the activity has average annual gross receipts of more than $1 million.[56]**

For vertically integrated farming operations in which crops are raised, harvested, and then processed into another form for subsequent sale up the supply chain, a study of the regulations leads to the conclusion that only those assets used in the actual raising and harvesting of crops are subject to the 150% declining-balance method.

LEASING SITUATIONS

A lease of assets by a nonfarmer to an active farmer can raise questions as to both the proper depreciation method and the proper MACRS recovery period. The **depreciation method** to use in such a situation is determined in accordance with **the use to which the owner of the asset** (the taxpayer) **puts the asset rather than the use to which the asset is applied.** Thus, property that is leased to an active farmer is **not** subject to the 150% declining-balance method simply because it is used by a farmer in a farming business. Instead, the focus in such situations is on the lessor as the taxpayer. If the lessor is cash leasing the asset, the lessor is using the asset in a leasing activity rather than a farming activity and the asset remains eligible for the 200% declining-balance method.

Caution. If farm assets are leased in conjunction with a crop-share or livestock-share lease and the lessor pays SE tax on the lease income, the IRS could take the position that the asset owner is using the farm assets in a farming business with the result that the lessor would be limited to the 150% declining-balance method.

However, for purposes of determining the **appropriate recovery period**, the focus is on the end **use of the asset** by the lessee. The IRS defined applicable MACRS recovery periods in Rev. Proc. 87-56[57] and ties various assets to a particular recovery period by reference to how the asset is used**. Thus, in a leasing situation, the depreciable life of an asset is determined by the lessee's use of the asset.**

Note. Sometimes the recovery period of an asset (determined by the lessee's use of the asset in a leasing situation) determines the depreciation method. For example, property with a 15- or 20-year recovery period is not eligible for the 200% declining-balance method.[58]

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54. Ibid.

55. IRC §448(b)(1) allows a farming business to use cash accounting. However, farm taxpayers that also conduct other nonfarm activities cannot report the nonfarm activities (such as a processing activity that is not incident to the growing, raising, or harvesting of an agricultural commodity) using the cash method. Treas. Reg. §1.263A-4(a)(4)(ii) specifies that a "farming business" does not include processing of commodities beyond those activities necessary for the initial sale of the commodity.

56. Rev. Proc. 2001-10, 2001 CB 272 permits taxpayers with average annual gross receipts of $1 million or less to use the cash method.

57. Rev. Proc. 87-56, 1987-2 CB 674 as clarified and modified by Rev. Proc. 88-22, 1988-1 CB 785.

58. IRC §168(b)(2)(A).

ISSUE 6: LEASES FOR AGRICULTURAL CLIENTS

FARMLAND LEASES

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

Self-Employment Tax

Farm lease income may be reported on one of three tax forms. How the lease income is reported determines whether it is subject to SE tax.

1. Schedule F, *Profit or Loss from Farming.* The income is subject to SE tax and eligible for income averaging.
2. Form 4835, *Farm Rental Income and Expenses.* The income is not subject to SE tax and is eligible for income averaging.
3. Schedule E, *Supplemental Income and Loss.* The income is not subject to SE tax and is not eligible for income averaging.

Which form is appropriate for a particular situation depends on whether the landlord materially participates in the farming operation. The Code defines SE income as net earnings from self-employment derived by an individual from any trade or business carried on by such individual.[59] The Supreme Court defined the phrase "trade or business" in the same manner as it is defined under IRC §162, which requires the taxpayer to be involved in the activity on a basis that is regular and continuous.[60]

Trade or Business Activity — Material Participation Tests. Generally, a landlord receiving cash rent should file Schedule E. However, a share-rent landlord can be deemed to be engaged in the activity on a regular and continuous basis as measured by certain tests for material participation. In that event, the landlord should report the income on Schedule F. If a share-rent landlord is **not** materially participating, the landlord should file Form 4835.

> **Note.** If Schedule F is filed, the income under the lease is subject to SE tax. SE tax is due on the net income from the production of agricultural or horticultural commodities on the land received under a material participation lease. However, rent received from **nonfarm** real estate or farm real estate in which the rent is received under a cash lease or nonmaterial participation lease is **not** subject to SE tax.[61]

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

For purposes of IRC §1402 (SE tax), a landlord materially participates if **all three** of the following conditions are satisfied.

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

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59. IRC §1402(a).

60. See, e.g., *Comm'r v. Groetzinger,* 480 U.S. 23 (1987).

61. IRC §1402(a)(1).

A landlord materially participates if the landlord satisfies **any one** of the four following tests.[62]

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

- Pay, using cash or credit, at least half the direct costs of producing the crop
- Furnish at least half the tools, equipment, and livestock used in producing the crop
- Consult with the tenant
- Inspect the production activities periodically

Test 2. The landlord regularly and frequently makes or takes an important part in making management decisions that substantially contribute to or affect the success of the enterprise.

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

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

Note. Although not required, a written lease makes material participation easier to establish.

Observation. Only crop or livestock-share leases in which the landlord materially participates generate SE income. In that situation, if the landlord also receives agricultural program payments, the payments are subject to SE tax. On the other hand, income received under a cash-rental arrangement is **not** subject to SE tax, nor does such income reduce eligibility for social security retirement benefits.

Personal Property Leased with Real Estate. The Code contains a specific exclusion from the definition of net earnings from self employment that applies to "rentals from real estate and from personal property leased with the real estate" unless a share rental is involved with material participation.[63] Thus, if only personal property is leased **and no trade or business exists,** the income is not subject to SE tax and the lease income should be reported on Form 1040, line 21 (other income), with associated expenses reported on line 36.

Note. Rental income from an activity that does not constitute a trade or business should be reported as "other income." Related expenses should be reported on the total deduction line with a notation of "PPR" (personal property rentals) on the dotted line next to the amount.

Perhaps the safest approach is to combine the lease of personal property with the lease of real estate. The statutory exclusion shields the rental income from SE tax if the lease is not a material participation lease. In that case, the rental income is reported on Schedule E.

62. IRS Pub. 225, *Farmer's Tax Guide.*

63. IRC §1402(a)(1).

Material Participation under the "Arrangement" Theory. If a farm landlord leases land to an entity in which the landlord materially participates, the IRS has taken the position that the lease income is subject to SE tax irrespective of the type of lease.[64]

> **Note.** The IRS won several cases in which it successfully attributed the lessor's material participation in the entity to the leasing arrangement, with the result that passive cash-rent income is transformed into material participation income subject to SE tax.[65] However, in the U.S. 8th Circuit Court of Appeals,[66] rental income is **not** subject to SE tax if it represents a fair market rate.[67]

Passive Loss Rules — Material Participation Tests. Even though passive losses are usually only deductible against passive income,[68] there is an exception that allows up to $25,000 of rental real estate losses to be deducted against nonpassive income.[69] To qualify for this exception, the taxpayer must **actively participate** in the rental real estate activity. However, an individual is not treated as actively participating if, at any time during the applicable period, the individual's interest is less than 10% (by value) of all interests in the activity (the interests of husband and wife are combined for this purpose). Active participation requires the taxpayer to merely participate in the making of management decisions that are relevant to the economic viability of the business.

If the exception does not apply, the taxpayer must satisfy a material participation test to avoid application of the passive loss rules. Tests for determining the presence of material participation under the passive loss rules are different from those utilized for SE tax purposes.

Temp. Treas. Reg. §1.469-5T(a) sets forth the following seven tests for meeting the material participation requirement for purposes of the passive loss rules. These tests are applied by considering services provided both by the taxpayer and the taxpayer's spouse, regardless of whether a joint return is filed.

1. The individual participates in the activity for more than 500 hours during the tax year.
2. The taxpayer's participation in the activity is substantially all the participation in the activity by all individuals.
3. The taxpayer participates in the activity for more than 100 hours during the tax year and participates for at least as many hours as any other individual.
4. The activity is a significant participation activity, and the taxpayer's participation in all significant participation activities during the year exceeds 500 hours.
5. A taxpayer who materially participated in an activity during five of the past 10 years is treated as materially participating in the current year.
6. A taxpayer who materially participated in a personal service activity for at least three years is treated as materially participating in that activity for the rest of the taxpayer's life.
7. A taxpayer who participates for more than 100 hours and, based on the facts and circumstances, participates on a regular, continuous, and substantial basis, is treated as materially participating.

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

65. *Bot v. Comm'r,* TC Memo 1999-256, *aff'g* U.S. Court of Appeals (8th Cir. 2003); *Hennen v. Comm'r,* TC Memo 1999-306, *aff'g* U.S. Court of Appeals (8th Cir. 2000); *McNamara v. Comm'r,* TC Memo 1999-333 (Oct. 4, 1999).

66. The 8th Circuit includes Arkansas, Iowa, Minnesota, Missouri, Nebraska, North Dakota, and South Dakota.

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

68. IRC §469.

69. IRC §469(i).

A taxpayer who satisfies the material participation test is deemed to be engaged in the trade or business, and **losses** from the activity **are not limited** by the passive loss rules.

Note. Losses from real estate rental activities are normally deemed passive. Passive losses are deductible to the extent of other "passive income" unless the losses are incurred by a taxpayer who is a materially participating real estate professional. To be a real estate professional, the taxpayer must work at least 750 hours in real estate trades or businesses as an owner and work more in the real estate businesses than in all of the taxpayer's other activities.[70] In addition, the taxpayer must materially participate in the rental real estate business.[71] For additional information on grouping activities, see 2012 Volume A, Chapter 3: Individual Taxpayer Topics.

LEASING PERSONAL PROPERTY

Note. For an extensive discussion of the tax issues surrounding the decision to lease or sell farm machinery or equipment, see Chapter 5 of the 1999 *University of Illinois Farm Income Tax Workbook*. This can be found online at **www.TaxSchool.illinois.edu/taxbookarchive.**

Given the cost of farm machinery, farmers are increasingly leasing it from other farmers. There is also a tax reason for utilizing leases. If the transaction is an installment sale rather than a lease, IRC §1245 requires all depreciation deductions to be recaptured as ordinary income in the year of sale. In addition, leasing may allow the lessee to deduct the lease payments. Because the maximum amount eligible for IRC §179 deductions in 2012 and 2013 is reduced compared to prior years, leasing deductions may be more desirable. The lessor can report the lease payments as ordinary income when they are received with the possibility of SE tax consequences.

If the transaction is an installment sale, a portion of each payment is treated as imputed interest, and the seller reports the IRC §1245 recapture amount along with the imputed interest in the year of the sale. The lessee has imputed interest expense in accordance with IRC §483 and depreciates the purchase price.

Note. The proper characterization of any given transaction depends on the intent of the parties and how the transaction is structured. IRS Pub. 225, *Farmer's Tax Guide*, provides a list of factors that the IRS utilizes in determining whether an agreement between the parties qualifies as a lease.[72]

OIL AND GAS LEASES

Oil and gas drilling activity has increased recently on private land. This raises tax issues for the recipients of royalty income, bonus payments, delay rental payments, and payments for rights-of-way and surface damages.[73]

Note. For a detailed discussion of the tax issues associated with rights-of-way and surface damage payments in the context of wind energy agreements (the same analysis applies in the context of oil and gas leases), see Chapter 6 in the 2009 *University of Illinois Federal Tax Workbook*. This is available online at **www.TaxSchool.illinois.edu/taxbookarchive.**

70. An election can be made to group activities. See IRC §469(c)(7).

71. See, e.g., *Manalo v. Comm'r*, TC Summ. Op. 2012-30 (Apr. 9, 2012). (The petitioner qualified as a real estate professional by virtue of being a full-time real estate broker who worked at least 750 hours in real estate trades or businesses as an owner, and worked more in real estate than in all of the petitioner's other jobs. However, the petitioner did not satisfy the material participation test in either of her rental real estate activities due primarily to the fact that she did not keep a daily log of time spent on rental activities.)

72. See also *Tillman v. Comm'r*, TC Memo 1996-8 (Jan. 8, 1996).

73. The tax issues in this section (except for the comment on depletion) also have application to landowners that enter into agreements with timber production companies for the harvesting of timber on their property.

A "delay rental" is an amount paid for the privilege of deferring development of the property and which could have been avoided if the oil and gas producer abandoned the lease, began development operations, or started production.[74] For the producer, a delay rental payment is an ordinary and necessary business expense that is normally deductible. However, the IRS issued a Coordinated Issue Paper in 1997 in which it took the position that delay rental payments are preproduction expenses that must be capitalized under IRC §263A. For the landowner (lessee), a delay rental payment is ordinary income that is not subject to SE tax.

A "bonus payment" is made by the producer in consideration for the grant of the lease. A bonus payment is generally treated as an advance royalty that must be capitalized by the producer. For the landowner (lessee), bonus payments are ordinary income and are not subject to SE tax.

A "shut-in payment" is a payment to the landowner (lessee) under the terms of a mineral lease that allows the lessee to defer production from a well capable of producing but which is "shut-in" for lack of a market or marketing facilities. The payments are ordinary income to the lessee and are not subject to SE tax.

Oil and gas royalty income is considered ordinary income and is not subject to SE tax.

> **Note.** IRS Pub. 535, *Business Expenses,* explains how to handle depletion of mineral interests and how the deduction should be allocated between the landowner and the producer. A depletion deduction for the landowner can help offset the royalty income that is received.

74. Treas. Reg. §1.612-3(c).

FARM LEASES — SUMMARY TABLE[75]

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

Issue	Cash Lease	Nonmaterial Participation Share Lease	Material Participation Share Lease
Where to report income and expense	Schedule E	Form 4835	Schedule F
Does SE tax apply?	No	No	Yes
Is rental income treated as gross farm income for purposes of the IRC §6654(l) exception to the estimated tax penalty?	No	Yes	Yes
Does the landlord qualify for IRC §175 treatment of soil and water conservation expenses?	No	Yes	Yes
Does the landlord qualify for IRC §126 exclusion of cost-sharing payments?	Yes	Yes	Yes
Do the passive loss rules limit deductions?	Yes	Yes	Possibly
Does the $25,000 rental real estate exception apply?	Yes	Yes, unless the lease is treated as a joint venture	N/A
Does the owner qualify for IRC §179 deduction?	No	Yes, unless the noncorporate lessor rules of IRC §179(d)(5) apply	Yes
Do charitable donations of commodities trigger income?	N/A	Yes	No
Are commodities owned at death treated as IRD?	N/A	Yes	No
Are costs of fertilizer and lime expected to last more than one year?[76]	No	No	Yes
Is farm-related business interest deductible?	Yes	Yes	Yes
Does income qualify for income averaging?	No	Yes	Yes
Does the owner qualify for use of bonus depreciation?	Yes	Yes	Yes

75. *Tax Issues For Farm Rental Agreements*. Ohio State University Extension. [http://ohioline.osu.edu/fr-fact/0006.html] Accessed on July 25, 2012.

76. IRC §180 and Treas. Reg. §1.180-1(b)(2). The election is made by deducting the amount on Form 1040, Schedule F.

ISSUE 7: MF GLOBAL AND RELATED HEDGING/SPECULATION ISSUES

The bankruptcy filing of MF Global, a global financial derivatives broker, on October 31, 2011, has raised important issues for farmers. The company provided exchange-traded derivatives, such as futures and options, along with other financial investments. The company's predecessor, ED&F Man, engaged in cash commodities trading and commodity futures, establishing a futures brokerage in 1981.

MF Global grew rapidly through acquisitions in the hedge fund management business. In 2008, the firm was fined over $10 million for unauthorized trading in the wheat futures market. On October 25, 2011, MF Global reported a quarterly loss of $191.6 million from trading activity on European government bonds, and its credit ranking was reduced to "junk." On October 30, 2011, a unit of the company reported a "material shortfall" of hundreds of millions of dollars in segregated customer funds to the Chicago Mercantile Exchange and the Commodity Futures Trading Commission. On October 31, 2011, MF Global filed Chapter 11 bankruptcy. Approximately two months earlier, the Commodity Futures Trading Commission stated that MF Global had $7.3 billion in customer assets. However, after the bankruptcy filing, regulators began investigating the company for approximately $1.2 to $1.6 billion that was missing from client accounts. According to the bankruptcy trustee, the shortfall is the result of MF Global commingling customer funds and using them for its own account prior to the bankruptcy filing.

Note. Farm and ranch taxpayers buy and sell commodity futures and options to hedge against fluctuating prices and to speculate. Gain and loss from hedging transactions generate ordinary income and loss[77] and are not subject to the loss deferral rules and the "mark-to-market" rules that apply to speculative transactions. Gains and losses from speculation are treated as capital gains and losses and are subject to the loss deferral and mark-to-market rules.[78] Hedging transactions result in gain or loss subject to SE taxes; speculative transactions do not. Therefore, distinguishing between hedging and speculation is important for tax purposes.

ESTIMATED TAX PENALTY RELIEF

Because of MF Global's collapse, many farmers who hedged commodities through the company received their Forms 1099 from the company after March 1, 2012. The late issuance of these Forms 1099 meant that the affected farmers could not file their tax returns by March 1. Farmers (and fishermen) are not required to pay estimated tax if they file by March 1. Thus, the late Forms 1099 created a potential for penalties to be imposed if affected farmers had not paid estimated tax and were not able to file by March 1. Consequently, on March 23, 2012, the IRS announced that it was forgiving the late penalties for affected farmers and fishermen.[79] In the announcement, the IRS set forth the procedure for requesting relief.

> *To request a waiver of the estimated tax penalty, complete Form 2210-F, Underpayment of Estimated Tax by Farmers and Fisherman. As stated in the instructions to Form 2210-F, a short statement should be attached to the form stating that you received a late 1099 from MF Global. At the top of your Form 2210-F, write "MF Global." Taxpayers should be aware that the Form 2210-F and accompanying Form 1040 cannot be submitted electronically. In the case of farmers who have filed their tax returns and an estimated tax penalty is assessed, please contact the IRS, identify this relief and the penalty will be abated.*

77. IRC §1221; Treas. Reg. §1.1221-2. According to the IRS, the regulations are the exclusive means by which gain or loss from a hedging transaction qualifies as ordinary gain or loss. Treas. Reg. §1.1221-2(a)(3).

78. Capital gains can offset capital losses. For individuals, capital losses deductible against ordinary income are capped at $3,000 per year. Corporations are not eligible for the $3,000 deduction against ordinary income.

79. IRS Ann. IR-2012-37 (Mar. 23, 2012).

REPORTING GAINS AND LOSSES

The MF Global collapse also presents a tax reporting issue for farm clients.

Example 6. Joe Chaffe profited on commodity trades with MF Global in 2011 and received a Form 1099 for $40,000. However, as a result of the MF Global problems, Joe received only $24,000. Joe has to report $40,000 of either speculative or hedging gains and pay tax on that amount on his 2011 return. Joe may be able to deduct $16,000 (or the net unrecovered amount) as a theft loss in the year in which it is finally determined that the $16,000 is not recoverable. This did not occur in 2011 but may occur in 2012 if the amount of the theft loss is known as of the end of the year. Otherwise, the loss may not be deductible until a later year.

Note. As of May 2012, it appeared that the recovery rate on claims filed with MF Global (of which there have been close to 26,000) was at approximately 72%. The trustee agreed to turn over $168 million of "excess collateral." If that occurs, the recovery rate could exceed 80%. As of late May, active claims that traded hands were recovering over 90 cents per dollar. That means any loss sustained should be less than 10% of the total amount of any particular taxpayer's claim.

Classification of Gains and Losses

The MF Global problems illustrate the importance of proper classification of gains and losses. A hedging transaction is defined as a transaction that a taxpayer enters into in the normal course of the taxpayer's trade or business, primarily:

- To reduce (as opposed to simply manage) the risk of price changes or currency fluctuations for ordinary property, or
- To reduce the risk of interest rate, price, or currency fluctuations for borrowing or ordinary obligations.[80]

A taxpayer uses a hedge to lock in a position in a particular commodity. Once locked in, if the physical commodity increases in value, the taxpayer's futures position value should decrease. One should offset the other with the net result that the hedge maintains the taxpayer's position.

The courts emphasize two tests in evaluating commodity futures transactions as hedges or as speculative ventures.

1. The direct relation test
   a. For a transaction to receive hedge treatment, there must be a direct relation between the taxpayer's business and the commodity market transaction.
   b. The amount of futures trading in the commodity and the timing of the purchases and sales must be related to the taxpayer's position.
2. The insurance test
   a. If futures' trading is used to offset price changes in actual commodities, the futures transactions are hedges.
   b. If the commodity transactions are an integral part of the taxpayer's business in which the futures contracts are used as insurance against subsequent price increases for raw materials or price decreases for production to be sold, then they are considered hedges.

80. IRC §1221(b)(2)(A); Treas. Reg. §1.1221-2(a). Property is "ordinary property" if its sale or exchange by the taxpayer could not produce capital gain or loss regardless of the holding period. Thus, an obligation is an "ordinary obligation" if the taxpayer's performance or termination of the obligation could not produce capital gain or loss. Treas. Reg. §1.1221-2(c)(2).

Example 7. Jack Frost planted 200 acres of soybeans and expected a yield of 50 bushels per acre, for a planned production of 10,000 bushels. Jack bought multiple October put options on the Chicago Board of Trade (CBOT) before he planted the crop and during the time the crop was growing. These options totaled 10,000 bushels of soybeans and created a complete hedge position. Jack loses $1,500 on the options and sells the soybeans produced for $55,000. Put options allow the owner the right to sell, creating a short options position. The growing soybeans represent a long cash position.

Jack reports the transaction as follows.

	Where Reported	Amount
Sale of soybeans	Schedule F, line 2(b)	$55,000
Hedge loss	Schedule F, line 8(b)	(1,500)

Speculation can be illustrated by the farmer who harvests corn, sells the corn, and buys futures in the marketplace in anticipation of prices rising, believing that this strategy is better than storing the commodity. This is speculation and is subject to the mark-to-market rules.[81]

The mark-to-market rules require taxpayers to report gains and losses from regulated futures contracts and other §1256 contracts on an annual basis.[82] These transactions are reported on Form 6781, *Gains and Losses From Section 1256 Contracts and Straddles.* The mark-to-market rules close out speculative transactions as of December 31. They are marked to market by treating each contract held by the taxpayer as if it were sold for fair market value on the last business day of the tax year, thereby requiring profit or loss to be reported on the taxpayer's income tax return. The net gain or loss is treated as 40% short term and 60% long term.[83]

Note. The wash sale rules do not apply to losses taken into account when an IRC §1256 contract is marked to market.[84]

Example 8. Use the facts from **Example 7,** except that Jack, after selling the soybeans, bought 10,000 bushels on the CBOT and purchased put options (the right to sell) for 10,000 bushels of soybeans with a value of $55,000. This is speculation because Jack no longer has an opposite position in the cash market. He sold the contract on January 5 of the following year. The contract was valued at $70,000 on December 31, resulting in a mark-to-market gain of $15,000.

The gain is reported on Form 6781 and then carried to Schedule D as follows.

Short-term capital gain	$6,000 ($15,000 × 40%)
Long-term capital gain	9,000 ($15,000 × 60%)

Note. In the event a contract is not closed by the end of the year of the purchase, the contract is subject to the mark-to-market rules. The taxpayer receives Form 1099-B, *Proceeds From Broker and Barter Exchange Transactions*, reporting the value of the contract.

81. IRC §1256.

82. IRC §1256 contracts include regulated futures contracts, foreign currency contracts, nonequity options, dealer equity options, and dealer securities futures contracts.

83. IRC §1256(a)(3).

84. IRC §1256(f)(5).

METHOD OF ACCOUNTING

The accounting method used for a hedging transaction must **clearly reflect** income and reasonably match the timing of the transaction with the timing of the item(s) being hedged. Treasury Regulations detail the accounting methods for various transactions.[85] The regulations require taxpayers to maintain books and records containing a description of the accounting method used for each type of hedging transaction in sufficient detail to demonstrate how the clear reflection standard is met.[86]

Accrual accounting can present interesting issues. In *Monfort of Colorado, Inc. v. U.S.,*[87] the taxpayer (a corporation engaged in the cattle feeding business) participated in the cattle futures market as a hedge against fluctuations in its inventory cost. The company used futures market gains and losses as adjustments to its ending inventory. It treated hedging gains as reductions in the cost of cattle (and reduced its closing inventory by a similar amount), and losses were treated as increases to the company's ending inventory. The result was an increase in the cost of goods sold and a decrease in the taxpayer's taxable income — at least on a deferred basis. The court held that the taxpayer's hedging activity was an accurate and acceptable accounting method. The hedging activity, the court noted, was an integral part of the taxpayer's overall operation and related to cost control. Therefore, the method reflected the actual cost of acquiring cattle, and the hedging adjustments to the taxpayer's ending inventory did not result in a change of accounting method.

Observation. The deferral lasted until there was no liquidation of the closing inventory in a later year. However, if the cattle were sold, their lower value would increase income by a similar amount. Because the taxpayer utilized the LIFO method, the devalued cattle were deemed sold at a later time than if FIFO had been used. The IRS contended that this approach did not clearly reflect income and that it constituted a change in accounting method without IRS consent. It is not entirely clear from the court's opinion whether the court's rationale can be extended to other situations given the unique set of facts in the case.

Rev. Rul. 74-223[88] provides an approved method of accounting for dealers in cotton and other commodities that are treated similarly. The IRS specified that the taxpayer may determine gross income by taking into account gains and losses at the end of the tax year based on the market value of open futures contracts to which the taxpayer is a party that are hedges against spot or cash transactions or forward sales or purchases. However, the IRS did not require dealers to estimate the accrued gain or loss on forward crop acreage contracts because those types of contracts do not denote quantity, delivery date, or grade.

IDENTIFICATION RULE

To receive tax treatment as a hedge, the transaction must be identified by the taxpayer as a hedging transaction before the close of the day on which the hedge is initiated.[89] The hedged item must be identified no more than 35 days after the hedging transaction.[90] If the transaction is not timely identified as a hedge, the straddle rules[91] and mark-to-market rules[92] may apply. In addition, the failure to identify a hedge may trigger disclosure requirements under the tax shelter regulations if a large loss is generated. Identification for book (or financial statement) purposes is not sufficient, unless the taxpayer's books and records indicate that the identification is also being made for tax purposes.[93]

85. Treas. Reg. §1.446-4.1
86. Treas. Reg. §1.446-4(d)(1).
87. *Monfort of Colorado, Inc. v. U.S.,* 561 F.2d 190 (10th Cir. 1977).
88. Rev. Rul. 74-223, 1974-1, CB 23.
89. IRC §1221(a)(7); Treas. Reg. §1.1221-2(f)(1).
90. Treas. Reg. §1.1221-2(f)(2)(ii). If an existing hedging transaction is "recycled" to hedge a different asset or liability, it must be re-identified on the same day that it is recycled. Treas. Reg. §1.1221-2(f)(1).
91. IRC §§1092 and 263(g).
92. IRC §1256.
93. Treas. Reg. §1.1221-2(f)(4).

Making the Identification

Identification is made by placing an unambiguous statement on the taxpayer's books and records identifying the transaction as a hedge for tax purposes by specifically referencing the tax rules for hedge treatment. The regulations provide guidance on making the identification and note that the taxpayer can designate a particular ledger account as containing only hedging transactions. The taxpayer can also place a statement in the taxpayer's books and records designating all future transactions in a particular commodity as hedging transactions.[94] The identification should describe the transaction creating the risk being hedged and the type of risk that the transaction creates.

> **Note.** If the hedge is not properly identified, the character of any gain or loss is determined without regard to the hedging rules; thus, any gain or loss may be capital. Because capital losses generally cannot offset ordinary income, the failure to identify a transaction as a hedge can create tax liability for the taxpayer upon audit. The IRS has the power to treat any gains as ordinary, putting the taxpayer in a "whipsaw" position.[95] If a taxpayer has both hedging and speculative transactions, it may be prudent to maintain separate brokerage accounts.

If the failure to identify a transaction as a hedge is inadvertent, the regulations may provide relief.[96] To meet the exception for "inadvertent errors," the transaction must meet the definition of a hedge, and all of the taxpayer's hedging transactions in open years must be treated as hedging transactions on original or amended returns. Otherwise, the regulations do not provide any guidance on what constitutes an inadvertent failure to identify a hedging transaction.

Failure to identify a transaction as a hedge can also trigger application of the special rules that exist for straddles[97] and the mark-to-market rules.[98] Under the straddle rules, losses are deferred on positions taken in actively traded property to the extent that built-in gain exists in an offsetting position. In addition, interest and carrying charges must be capitalized if they are allocable to personal property that is part of a straddle. The mark-to-market rules require that any capital gain or loss be treated as 60% long term and 40% short term.

> **Note.** If a straddle is composed of at least one position in an IRC §1256 contract, an election can be made on Form 6781 to exclude all positions in the mixed straddle (including §1256 contracts) from the mark-to-market rules. If the election is made, the transaction is subject to the loss deferral, wash sale, and short sale rules and the straddle is not considered a mixed straddle. Without the election, the taxpayer may elect to offset gains and losses in the mixed straddle by either separately identifying the positions of the mixed straddle or establishing a mixed straddle account.

94. Ibid.

95. IRS power rests in the anti-abuse rules. See Treas. Reg. §1.1221-2(g)(2)(iii).

96. Treas. Reg. §1.1221-2(g)(2)(ii).

97. IRC §§1092 and 263(g). Technically, a "straddle" involves the taxpayer taking offsetting positions for personal property. IRC §1092(c)(1).

98. IRC §1256.

TIMING RULE

Any income, deduction, gain, or loss from a hedging transaction is matched with the income, deduction, gain, or loss on the hedged item. Also, in some situations, the hedge timing rules apply irrespective of whether the transaction was identified as a hedge.[99]

> **Observation.** The tax rules for hedging transactions are designed to match the character and timing of a hedging transaction with the character and timing of the hedged item. The timing rule for hedges applies regardless of whether a transaction is identified as a hedge. Farmers participating in true hedging programs likely have multiple transactions for a single crop and may combine option purchases and sales to minimize the cost of these programs or to create both a ceiling and a floor for prices. Properly identifying and reporting all these transactions is a challenge for the taxpayer and tax preparer. For more information, see IRS Pub. 550, *Investment Income and Expenses*.

IRS EXAMINATION TECHNIQUES[100]

IRS guidance to its auditors specifies that hedging losses should be entered as negative amounts under "other income" on Schedule F. However, it may be common practice for farm taxpayers to deduct hedging losses as a separate item in "other expenses" or place them in either cost of sales or in expenses. Whenever gross profit on the return appears low or expenses are high in relation to sales, IRS examiners are instructed to scrutinize the accounts for losses from futures transactions.

IRS examiners are also instructed to obtain broker statements and the taxpayer's worksheets or other records whenever a hedge issue arises. Likewise, the IRS examiner should obtain the daily transaction sheets and the monthly summary statements. The taxpayer's records should show that the hedged commodity is an amount that is equal to or less than what is produced, bought, or raised for resale. Thus, it is important for the taxpayer to maintain good inventory records, purchase invoices, sales invoices, and documents that identify transactions as hedges.

IRS guidance specifies commodity transactions that do not reduce risk for farmers involve eggs, pork bellies, coffee, silver, gold, copper, and boxed beef. The IRS notes that transactions involving these commodities do not relate to the normal course of business for a farmer, cattleman, grain dealer, or feedlot operator.

ISSUE 8: FSA INCOME AUDITS — ELIGIBILITY FOR FARM PROGRAM PAYMENTS

The 2008 Farm Bill[101] and subsequent regulations established new adjusted gross income (AGI) and adjusted gross farm income (AGFI) limitations for program eligibility.[102] The new limitations are considerably lower than the previous limitation of $2.5 million and apply to more producers than did the limitation under prior law. As a result, the correct computation of AGI and AGFI is critical for ensuring that a producer remains eligible for farm program payments.

> **Note.** All producers are required to declare their AGI on U.S. Department of Agriculture Form CCC-931 (formerly Form CCC-926). The form is filed with the county office of the Farm Service Agency (FSA). In addition, upon filing Form CCC-931, a producer agrees to provide additional information to the FSA to assist in verifying income.

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99. See Rev. Rul. 2003-127, 2003-2 CB 1245.

100. *Farmers (ATG)* Chapter Nine – Grain. May 2011. [www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Farmers-ATG] Accessed on Sep. 6, 2012.

101. PL 110-234.

102. See 7 USC §1308-3a(e).

INCOME LIMITATION RULES

The new income limitations were effective beginning with the 2009 crop year. The applicable limitation on direct payments for crop years 2008–2012 for a person or entity (whether received directly or indirectly) is $40,000. The payment limit is adjusted for participation in the average crop revenue election (ACRE) program in years 2009–2012.[103] The counter-cyclical payment limit amount is $65,000 for crop years 2008–2012 and is adjusted if the recipient participates in the ACRE program in 2009–2012.[104]

For commodity and price support programs, a producer must have **nonfarm** AGI of $500,000 or less to be eligible for direct and counter-cyclical program (DCP) payments or price support benefits, and an AGFI of $750,000 or less to be eligible for direct payments under the DCP. These limits also apply to disaster assistance programs and the milk income loss compensation program. For conservation program benefits, the adjusted gross nonfarm income limit is $1 million **unless** two-thirds of AGI (both farm and nonfarm) is derived from farming, ranching, and forestry operations. This limitation can be waived on a case-by-case basis for environmentally sensitive land of special significance.[105]

The 2008 Farm Bill also expanded the definition of average AGI derived from farming, ranching, and forestry to include income and benefits from the production of all types of livestock, farm-based renewable energy, and the processing, packing, storing, shedding, and transporting of farm, ranch, and forestry commodities (including renewable energy). In addition, the bill gave the Secretary of Agriculture the discretion to include the income from any additional activity related to farming, ranching, or forestry.

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

The calculation of average AGI is computed over an applicable 3-year period. For the 2012 program year, the 3-year period includes tax years 2008–2010.

Note. Annual certifications of AGI compliance are required from each individual and legal entity that requests Commodity Credit Corporation (CCC) payments either directly or indirectly. For pass-through entities, AGI certifications are required from each member who is an individual or entity and from each embedded interest holder. For other entities, each interest holder in the entity with a direct or indirect interest must provide an annual AGI certification. The certification is made either on Form CCC-931 or by providing the FSA with an acceptable statement from a CPA or attorney. Compliance with the AGI rules is tracked through four levels of ownership in an entity. Any noncompliance within those levels results in payment being reduced by an amount that is commensurate with the ineligible share.

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103. 7 USC §1308.

104. 7 USC §7991(d).

105. 7 USC §1308-3a(b)(2)(A)(ii).

KEY DEFINITIONS

USDA regulations define AGI according to IRC §62.[106] Under IRC §62, AGI is defined as gross income minus trade and business deductions and various other deductions. In essence, AGI is a producer's net income less some "above the line" deductions on page 1 of the producer's Form 1040. It is the amount reported on line 37 of Form 1040 (2011).

The definition of AGFI is less straightforward. For tax purposes, gross farm income is the producer's gross income or gross revenue attributed to the taxpayer. However, the FSA's concept of AGFI is different. For FSA purposes, AGFI is the net income from farming and related operations. Indeed, the USDA regulation defining AGFI states that it is the "portion of the AGI of the person or legal entity that is attributable to farming, ranching. . . . "[107] Therefore, because AGI is defined as net profit in accordance with IRC §62, the portion of AGI that is AGFI must also be net profit. The instructions to FSA Form CCC-931 confirm that both AGI and AGFI are "net income" concepts.

Determining AGFI

Determining AGFI is not as simple as referring to the amount on line 18 of Form 1040 (farm income or loss). Instead, AGFI is net farm income on line 18 of Form 1040 **plus** any additional income from the sale of such items as agricultural-related land, breeding livestock, agricultural/conservation easements, and farm-related machinery.[108] These additional sources of income are generally reported on Form 8949, Form 4797, or Schedule E (for royalty income, real estate rental income, and pass-through income from an entity) and then carried over to Form 1040, lines 13, 14, and/or 17. From this total, the amount of any above-the-line deductions attributed to this income is subtracted.

Reporting AGI and AGFI to the FSA

For purposes of determining farm program eligibility, a producer must report their 3-year average AGI and AGFI to the FSA on Form CCC-931. Page two of Form CCC-931 provides guidance on determining AGI and states that "[for] . . . Form 1040 filers, specific lines on that form represent the adjusted gross income and the income from farming, ranching, or forestry operations." The instructions then tell the producer to find and compute AGI and AGFI from specified lines on Form 1040, which are net income amounts.

AGFI as a "Net" Concept. Clearly, AGFI is a net income concept — it is **not** a producer's gross farm revenue. If a producer reported gross farm income instead of net farm income, the producer could mistakenly believe that they are ineligible for program payments.

> **Example 9.** Guy Wire produces soybeans on 1,000 acres and corn on an additional 640 acres. For 2005–2007, Guy's soybean crop yielded an average of 50 bushels per acre and he received an average of $9 per bushel. Thus, Guy's gross farm income solely from the bean crop averaged $450,000 (1,000 acres × 50 bushels × $9 per bushel). Over the same timeframe, Guy's corn crop yielded an average of 225 bushels per acre and he received an average of $4 per bushel. Consequently, Guy's gross farm income solely from the corn crop averaged $576,000 (640 acres × 225 bushels × $4 per bushel), and his gross farm income from both crops averaged $1.026 million ($450,000 + $576,000). If Guy incorrectly uses his gross farm income for purposes of the CCC-931, he would be ineligible for direct payments. To properly determine his eligibility for DCP or price support payments, Guy must reduce his gross income amounts by any above-the-line deductions attributed to his farm income.

106. 7 CFR §1400.3.

107. Ibid.

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

CONSENT FORMS

Starting in 2010, the FSA and the Natural Resources Conservation Service (NRCS) provided producers with consent forms to be completed and submitted to the IRS that authorize the IRS to disclose information to the USDA. Additionally, the USDA and the IRS announced a joint program under which producers' tax data is shared for the purpose of verifying the AGI of producers receiving program payments.[109]

A single consent form (Form CCC-931) is used for individuals and for legal entities. Producers may obtain the consent form at their local USDA or NRCS offices or via the FSA website at **www.fsa.usda.gov.** Part A of Form CCC-931 is required to provide the annual AGI certification. However, in lieu of Part A, individuals or entities can submit an acceptable statement from a CPA or an attorney.

> **Note.** The completed consent form can be sent either to the producer's county FSA office or to the USDA.[110] The annual deadline to submit the form is June 15.

For purposes of AGI verification, entities include corporations, LLCs, limited partnerships, trusts, and partnerships.

The forms must be signed by the producer and submitted within 60 calendar days of the signature date. FSA power of attorney forms do not authorize others to sign the CCC-931. Thus, each individual producer must sign their own CCC-931.

Part B of Form CCC-931 authorizes the IRS to perform the average AGI calculations and disclose that information to the FSA. All program participants must complete Part B. Producers who do not voluntarily submit the consent form are notified of the requirement to submit a consent form to the IRS in order to avoid interruption of program payments. Producers who do not submit consent forms within 120 days of the signature date are ineligible for future payments and may be required to pay back all payments from the prior year.

AGI VERIFICATION

The IRS checks the AGI of each individual producer and each entity for compliance. As noted earlier, AGI calculations for 2012 are based on the 2008–2010 tax years. The IRS reports the results of their examination of a producer's or entity's data to the FSA on a regular basis.

> **Note.** The IRS, based on its examination of a program participant's tax information, reports to the FSA the number of years in the applicable 3-year period that tax data was available for the participant, and which IRS forms were used in the data comparison for each participant. This is done regardless of whether the participant appears to meet all average AGI limitations.

A producer with an AGI that appears to exceed the eligibility requirements is notified in writing of the results. Upon receipt of this notice, a producer can take one of the following actions.

1. Provide the FSA with a signed statement from a CPA or attorney demonstrating that the AGI limits have not been exceeded
2. Provide copies of the completed federal tax returns that were filed with the IRS for the applicable years
3. Provide a signed acknowledgment by the taxpayer that income exceeded the limitations if the certification form was completed in error

If the FSA determines that a producer is not in compliance with the applicable AGI limitations, the producer has the right to appeal the determination to the state FSA committee or National Appeals Division. County offices are not involved with AGI appeals.

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

110. USDA Notice PL-202 (Oct. 1, 2010).

Likely Problem Areas

Married couples filing jointly are likely to receive an adverse notice from the FSA. This is because a married couple's combined AGI may exceed the AGI limitations even though each spouse's individual AGI does not exceed the minimum limitations. Unless the IRS analyzes the various forms and schedules (e.g., Forms 1099, Schedules K-1, and Forms W-2) associated with a joint return, the IRS cannot determine how to allocate AGI between the spouses. To provide an adequate response to an FSA notice, the CPA or attorney must generate a report that allocates each item of income on the tax return to each spouse. If the CPA or attorney did not prepare the return, more information may be needed to verify the items on the return to enable the professional to adequately prepare this statement.

> **Observation.** Because of the current staffing and budget issues impacting the IRS, this level of scrutiny is very unlikely on a wide scale. However, the IRS has identified the issue and hopefully will provide guidance on how verification will be implemented.

It is possible that a very high income in one year could cause the forfeiture of FSA payments for three years because the AGI limitations are calculated using a 3-year average.

Example 10. Roger Dodger reported AGI of $3.4 million in 2008 (of which $3.3 million was nonfarm income), $50,000 in 2007, and $60,000 in 2006. All the 2007 and 2006 AGI was from farming activities. For the 2010 FSA program year, the average **nonfarm** AGI for 2006–2008 is $1.1 million ($3.3 million ÷ 3 years). The large nonfarm AGI amount is also included in the determination of eligibility for the 2011 and 2012 FSA program years. The large 2008 nonfarm income causes Roger to be ineligible for FSA program payments in 2010, 2011, and 2012.

One unusual situation can create an AGI limitation problem. If the taxpayer's average AGI is below the limit but only because of a large farming loss, the nonfarm AGI can exceed the limit.

Example 11. Larry Loser incurred a farming loss that averaged $400,000 over the applicable 3-year period under review for the FSA AGI limitation. In those same three years, Larry had nonfarm income that averaged $700,000. His average reported AGI was $300,000, which at first appears to be under the limit. However, his nonfarm income of $700,000 exceeds the limit of $500,000. Consequently, Larry is not eligible for FSA payments for the affected program year(s).

Receipt of Adverse Notice

Upon receipt of an adverse FSA notice, a producer should seek verification from a CPA or attorney. It is important for producers to realize that an adverse notice from the FSA does not automatically mean that they have exceeded AGI limitations. In many cases, the producer only needs to provide third-party verification to overcome the adverse notice. At the present time, the rules only allow a CPA or attorney to provide this written statement.

Use of Tax Information

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

ISSUE 9: CROP INSURANCE AND DISASTER PAYMENTS

OVERVIEW

The drought in significant parts of the country during 2012 has raised a number of tax-related questions for farmers and ranchers. Those questions involve the ability to defer crop insurance proceeds, the tax rules associated with sales of livestock on account of drought, and the tax treatment of damage payments paid because of the inability to fill forward grain contracts due to lack of crop. The law contains special rules for farmers in each situation. These rules can be complicated and must be followed in order to obtain any associated favorable treatment.

DEFERRAL OF CROP INSURANCE PROCEEDS

For a cash-basis taxpayer, insurance proceeds covering losses such as hail or fire damage to growing crops are includible in gross income in the year that they are actually or constructively received.[111] In essence, destruction or damage to crops and receipt of insurance proceeds are treated as a "sale" of the crop. Under a special provision, cash-basis taxpayers may elect to include crop insurance and disaster payments in income in the tax year following the crop loss year if it is the taxpayer's practice to report income from the sale of the crop in the later year.[112] The provision covers payments made because of damage to crops or the inability to plant crops. The deferral provision applies to federal payments received for drought, flood, or any other natural disaster.

Deferability and Payment Trigger Under Policy

A significant issue is whether the deferral provision also applies to new types of crop insurance such as revenue protection (RP), revenue protection with harvest price exclusion, yield protection, and group revenue protection. As mentioned earlier, in order to defer an insurance payment, it must have been made because of **damage to crops or the inability to plant crops.** Other than the statutory language that makes payments for the inability to plant crops eligible for the 1-year deferral, the IRS position is that agreements with insurance companies providing for payments without regard to the actual losses of the insured **do not** constitute insurance payments for the destruction of, or damage to, crops.[113] Thus, payments made under types of crop insurance that are not directly associated with an insured's actual loss, but are instead tied to low yields and/or low prices or replant payments, may **not** qualify for deferral. For example, payments made under multi-peril crop insurance contracts, market value protection, and revenue coverage may qualify for deferral because an insured yield loss triggers payment. Crop revenue coverage, revenue assurance, and income protection requires an insurable yield loss if the market price increases. Thus, deferral eligibility is tied to whether payment was caused by crop damage or destruction resulting in yield loss or whether payment was triggered by something other than yield loss.

If a crop insurance payment is based on both crop loss and price loss from a revenue-based insurance policy, **only** the portion intended to reimburse the farmer for crop loss can be deferred. The portion payable because of a **decline in market price cannot be deferred** and is income in the year the payment is received.

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111. For taxpayers on the accrual method, payment is taxable in the year received.

112. IRC §451(d).

113. IRS Notice 89-55, 1989-1 CB 698.

Example 12. Al Beback obtained RP insurance for his corn crop. Under the terms of the policy, the approved corn yield was set at 170 bushels per acre, and the base price for corn was set at $6.50 per bushel. At harvest, the price of corn was $5.75 per bushel. Al's insurance coverage level was set at 75%, and his yield was 100 bushels per acre. Al's final revenue guarantee under the policy is $828.75 per acre (170 bushels × $6.50 × 75%). Al's calculated revenue is his actual yield (100 bushels per acre) multiplied by the harvest price ($5.75 per bushel), which equals $575 per acre. Al's insurance proceeds are $253.75 per acre (the guaranteed amount ($828.75 per acre) less the calculated revenue ($575 per acre)). His yield loss is 70 bushels per acre (170 bushels per acre approved yield less his actual yield of 100 bushels per acre). This loss is multiplied by the harvest price of $5.75 per bushel, resulting in a physical loss of $402.50 per acre. Al's price loss is computed by taking the base price of $6.50 per bushel less the harvest price of $5.75 per bushel, or $.75 per bushel. Multiplied by the approved yield of 170 bushels per acre, the result is $127.50 per acre.

To summarize, Al has the following results.

- Total loss is $530 per acre ($1,105 anticipated income per acre – $575 actual result).
- Physical loss is $402.50 per acre (70 bushels per acre × $5.75 per bushel harvest price).
- Price loss is $127.50 (170 bushels per acre × $0.75 per bushel).
- Physical loss as percentage of total loss is 75.94% ($402.50 ÷ $530).
- Insurance payment is $253.75 per acre.
- Insurance payment attributable to physical loss (which is deferrable) is $192.70 per acre ($253.75 × 75.94%).
- Portion of insurance payment attributable to price loss that cannot be deferred is $61.05 per acre ($253.75 – $192.70).

In the following example, the harvest price **exceeds** the base price.

Example 13. Use the same facts as **Example 12,** except the harvest price of corn was $7.50 per bushel. Al's final revenue guarantee under the policy is $956.25 per acre (170 bushels per acre × $7.50 × 75%). Al's calculated revenue is his actual yield (100 bushels per acre) multiplied by the harvest price ($7.50/bushel), which equals $750 per acre. Al's insurance proceeds are $206.25 per acre ($956.25 per acre guaranteed amount – $750 calculated revenue). His yield loss is the 70 bushels per acre, which is then multiplied by the harvest price of $7.50 per bushel, for a physical loss of $525 per acre. **Al's price loss is zero because the harvest price exceeded the base price.**

To summarize, Al has the following results.

- Total loss is $525 per acre ($525 physical loss + $0.00 price loss).
- Physical loss as percentage of total loss is 100% ($525.00 ÷ $525.00).
- Insurance payment is $206.25 per acre.
- Insurance payment attributable to physical loss (which is deferrable) is $206.25 per acre ($206.25 × 100%).
- Portion of insurance payment that is not deferrable is $0 ($206.25 – $206.25).

Observation. Normally, if the price of a crop at the time of harvest **exceeds** the base price, the physical loss constitutes 100% of the total loss, and the **entire** insurance payment is deferrable. However, if insurance proceeds for physical loss to crops are collected **before** the harvest price is determined and the harvest price ultimately exceeds the base price, any additional payment attributable to the price difference may be deemed attributable to revenue loss that is not eligible for deferral.

> **Note.** For policies not based on physical loss (such as a group revenue protection), payments received cannot be deferred. The same holds true for an average crop revenue election payment because it is received after the end of the marketing year and in a year subsequent to the year the crop at issue is produced. **There is no additional ability to defer income to a later year if it is actually received in a year following the year of crop loss.**

OTHER REQUIREMENTS

The taxpayer must make an election on the tax return in order to defer crop insurance proceeds.[114] The election is made by attaching a separate, signed statement to the return for the year of damage or destruction or by filing an amended return. The following information should be included in the statement.

- The taxpayer's name, address, and a statement declaring the intention to defer crop insurance proceeds
- Identification of the specific crop(s) that were destroyed or damaged
- A statement explaining that it is the taxpayer's normal business practice to report income derived from the crops that were destroyed or damaged in the taxpayer's gross income for a tax year following the tax year of damage or destruction

> **Note.** The taxpayer must establish a history of reporting more than 50% of the crop sales in the subsequent year.[115] **If multiple crops are involved, the 50% test must be satisfied for each crop.**

- A description of the cause of the destruction or crop damage
- The date(s) on which the destruction or damage occurred
- The total payments received from insurance companies, government agencies, etc. (with each crop and payor itemized)

The ability to defer crop insurance proceeds is an important planning tool for many farmers when weather interferes with normal crop production and marketing expectations. When the requirements are satisfied, deferral allows consistency in income tax reporting of insurance proceeds (and disaster assistance payments). Even when the technical requirements cannot be satisfied, deferral can be accomplished as long as the insurance proceeds for a current year's crop are not received until the following year.

Hedging of Crop Insurance

A significant issue is whether crop insurance proceeds can be part of a hedging program. Under the regulations, a hedge is a transaction entered into in the normal course of the taxpayer's trade or business primarily to manage risk of price chances or currency fluctuations related to ordinary property that the taxpayer holds. Thus, the key determination as to whether a transaction constitutes a hedge is whether it reduces the risk of price change.

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114. The election covers the insurance proceeds attributable to all crops representing a trade or business. Treas. Reg. §1.451-6(a)(2). Also, deferral is "all or nothing." A taxpayer may not elect to defer only a portion of the insurance proceeds to the following year. Rev. Rul. 74-145, 1974-1 CB 113.

115. See *Nelson v. Comm'r,* 130 TC 70 (2008), *aff'd* 568 F.3d 662 (8th Cir. 2009).

A farmer with crop insurance is guaranteed a particular amount of revenue per acre which is a combination of actual production and insurance. The farmer's yield risk at the time of planting is associated with the difference between actual production and the insured amount. However, if the crop is a growing crop that becomes subject to a prolonged and intensifying drought, the farmer's risk becomes exclusively price risk due to crop insurance loss calculations that use a price established during October. Thus, a farmer that takes a position on the Board of Trade could eliminate the price risk and the transaction could be considered part of the farmer's overall program to reduce price risk in actual crops and those crops covered by insurance. The resulting gain or loss would be an ordinary loss under the rules governing hedges.

Tax Treatment of Court Judgments

A farmer who is found in breach of a cash forward grain contract will be ordered to pay "cover" damages. Generally, a payment made by a taxpayer pursuant to a court judgment (or settlement) is deductible as a business expense if the claim arises from acts the taxpayer performs in the ordinary course of the taxpayer's business.[116] Consequently, in cases involving breaches of forward grain contracts by farmers, cover damages are paid to compensate the buyer for the actual damage or harm that the farmer's breach caused and are deductible by the farmer.

WEATHER-RELATED SALES OF LIVESTOCK

Involuntary Conversion Treatment

Two tax provisions are available for livestock owners to use in the event that livestock must be sold due to drought or other weather-related conditions. Under the first provision, if a cash-basis farmer sells more livestock[117] (other than poultry) than the amount that would normally be sold during the time period, the sale or exchange of the excess may be treated as a nontaxable involuntary conversion.[118] The livestock sold or exchanged must be replaced with livestock similar or related in service or use within two years after the year in which proceeds were received. If it is not feasible to reinvest the proceeds in property similar or related in use, the proceeds can be reinvested in other property used for farming purposes (except real estate).

> **Note.** Under the American Jobs Creation Act of 2004, for taxable years that have a tax return due date (without regard to extensions) after December 31, 2002, the reinvestment rules for sales of livestock held for draft, dairy, or breeding purposes were expanded. Reinvestment of proceeds in "other property . . . used for farming purposes" (except for investment in real property) when it is not feasible for the taxpayer to reinvest the proceeds in property similar or related in service or use is allowed. This provision, however, applies only to 2-year reinvestment, not 4-year reinvestment, because that period for reinvestment is governed by the involuntary conversion rule, which is two years.[119]

If the replacement property is livestock, the new livestock must be held for the same purpose as the relinquished animals because of the weather-related condition.[120] In that event, the gain on the relinquished animals is not subject to tax. Instead, the gain is deferred until the replacement animals are sold or exchanged in a taxable transaction.

116. IRC §162.

117. Held for draft, dairy, or breeding purposes.

118. IRC §1033(e). The animals qualify for involuntary conversion treatment regardless of how long the taxpayer held them. There is no 12-month or 24-month test (for cattle and horses) that must be satisfied.

119. This result is reached by reading IRC §1033(a) in conjunction with IRC §1033(f) and IRC §1033(a)(2)(B)(i).

120. Treas. Reg. §1.1033(e)-1(d).

The 2-year replacement period is extended to four years in areas designated as eligible for assistance by the federal government.[121] **Once the 2-year replacement period is exceeded (if the longer period applies), the replacement property must be livestock that is similar or related in service or use to the relinquished animals.** Also, the Treasury Secretary has the authority to extend, on a regional basis, the period for replacement if the weather-related conditions continue for more than three years.

The replacement period will be extended until the end of the taxpayer's first taxable year ending after the first "drought-free year" for the applicable region. "Drought-free year" means the first 12-month period that (1) ends on August 31; (2) ends in or after the last year of the taxpayer's 4-year replacement period; and (3) does not include any weekly period for which exceptional, extreme, or severe drought is reported for any location in the applicable region. "Applicable region" is defined as the county and all contiguous counties that experienced drought conditions on account of which the livestock was sold or exchanged. Exceptional, extreme, or severe drought is determined by reference to U.S. drought monitor maps which are accessible at **http://droughtmonitor.unl.edu.** By the end of September of each year, the IRS publishes a list of counties for which extreme or severe drought was reported during the preceding 12 months.

To utilize the involuntary conversion rule, the livestock owner must attach a statement to the tax return for the year in which the animals were sold with evidence of the weather-related conditions that forced the sale. Also, the attachment must show a computation of the gain realized on the sale or exchange, and the number of livestock sold or exchanged in addition to the number of livestock of each kind that would have been sold under the usual business practice if there had not been any weather-related event.

Note. The replacement of the livestock is reported in the following years. If reinvestment does not actually occur or there is not a full reinvestment, the tax return for the year of the weather-related conditions **must be** amended to report additional income equal to the amount that was not reinvested.

One-Year Deferral Treatment. Under another provision, if a cash-method livestock owner is forced because of drought or other weather-related condition to dispose of excess livestock, the owner can elect to have the gain on sale deferred until the following taxable year.[122]

Note. The deferral provision only applies to the excess livestock sold during the tax year at issue beyond what the livestock owner would have normally sold. In addition, the area must be declared a disaster area, but the livestock need not be raised or sold in the disaster area

To be eligible for deferral, the taxpayer's principal business must be farming. However, off-farm income is permissible. For example, the IRS has stated in a private letter ruling that a rancher with $121,000 in gross income from ranching, and an additional $65,000 per year of off-farm income was still deemed to have a principal business of ranching. The rancher devoted 750 to 1,000 hours per year to the ranch and his wife contributed about 300 hours.[123]

121. There is no requirement that the area be declared a drought or disaster area if livestock is replaced within two years.

122. IRC §451(e).

123. This ruling is a strong indication that taxpayers need not spend all of their time on the farm in order to take advantage of this rule.

A separate election form must be attached to the return that must be filed on or before the due date of the return and must contain all of the following.

- A declaration that an election is being made under IRC §451(e)
- Evidence of the weather-related conditions that forced the early sale including the date the area was designated as eligible for federal assistance as a disaster area[124]
- An explanation of the relationship between the weather-related condition and the reason for the sale
- The total number of animals sold in each of the three preceding years
- That total number of animals that would have been sold under normal conditions
- The total number of animals sold during the year and the number sold because of the weather-related conditions
- The amount deferred to the following year

Deferral of income is limited to sales in excess of "usual business practices." Thus, deferral is only available for the gain attributable to the excess number of livestock sold because of the drought or weather-related condition beyond the number of livestock that the owner would normally sell during the tax year. Also, an election for 1-year deferral is valid if made during the applicable replacement period for the livestock under IRC §1033(e). Similarly, a taxpayer can only revoke a deferral election in favor of involuntary conversion treatment, but the converse is not possible because of the time limitations.

> **Note.** The deferral provision applies to all livestock held for resale (raised or feeders) as well as livestock used for draft, breeding, dairy, or sporting purposes; livestock held for less than two years (cattle and horses); and less than one year for other livestock.

ISSUE 10: AGRICULTURAL RULINGS AND CASES

FARM BANKRUPTCY TAXATION

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA)[125] made several significant changes to Chapter 12 bankruptcy.

> **Note.** For a full discussion of the BAPCPA amendments to Chapter 12 bankruptcy, see Chapter 14 of the 2008 *University of Illinois Federal Tax Workbook.* This is available online at **www.TaxSchool.illinois.edu/taxbookarchive.**

Before amendment by the BAPCPA, the deed-back of collateral to a secured creditor, as well as asset sales conducted in an attempt to downsize a farming operation, carried tax consequences to the debtor that could negatively impact the feasibility of the debtor's reorganization plan. However, under the BAPCPA, a Chapter 12 debtor can treat a "claim owed to a governmental unit" that arises as a result of a "sale, transfer, exchange, or other disposition of any farm asset used in the debtor's farming operation" as an unsecured claim that is **not entitled to priority** under §507(a) of the Bankruptcy Code, provided the debtor receives a discharge. The provision became effective April 20, 2005, the date of the BAPCPA's enactment.

124. The sale can occur before the designation is made.

125. S. 256, PL 109-31, signed into law 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:

- ***a.*** *The claim is a claim owed to a governmental unit that arises as a result of the sale, transfer, exchange, or other disposition of any farm asset used in the debtor's farming operation, in which case the claim shall be treated as an unsecured claim that is not entitled to priority under section 507, but the debt shall be treated in such manner only if the debtor receives a discharge; or*
- ***b.*** *The holder of a particular claim agrees to a different treatment of that claim . . .* [126]

Observation. The BAPCPA provision created several issues that have been addressed by numerous courts. Those issues include the procedure that the debtor is to follow in computing the amount of the claim entitled to nonpriority treatment, whether the provision applies to taxes arising from both prepetition and postpetition sale of farm assets, and what qualifies as a "farm asset."

In re Hall.[127] The debtors sold their farm **after** filing Chapter 12. The sale resulted in capital gains tax of approximately $29,000. The debtors' amended plan proposed to treat the capital gains tax liability as an unsecured claim that would be paid in full if funds were available and pro rata with other similar claims if funds were insufficient, with the remaining balance discharged. The IRS objected on the basis that a Chapter 12 bankruptcy estate is not a separate taxable entity and, as such, the resulting tax liability remains 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 USC §507 — either an administrative expense or an allowed, **prepetition** unsecured claim of a governmental unit. However, the court noted, "priority administrative expenses" are those allowed under 11 USC §503(b), which includes any tax **incurred by the bankruptcy estate.** The court held that because there is no separate taxable entity created in a Chapter 12 bankruptcy, the debtor's postpetition sale of farmland could not generate a tax incurred by a bankruptcy estate. Therefore, because the capital gains taxes were incurred postpetition and because no separate taxable entity exists in the context of Chapter 12 bankruptcy, the claim did not fall within the exception of 11 USC §1222(a)(2)(A). As such, the court noted that 11 USC §1222(a)(2)(A) only treats taxes arising from prepetition sale, transfer, or exchange of farm assets as an unsecured nonpriority claim.

The federal district court for Arizona reversed the bankruptcy court and held that 11 USC §1222(a)(2)(A) applies to taxes arising postpetition.[128] On further review, the U.S. 9th Circuit Court of Appeals reversed the district court.[129] The court noted that, by its terms, 11 USC §1222(a)(2)(A) applies only to "claims entitled to priority under section 507." Section 507 lists two categories that include taxes: §507(a)(8) (which involves prepetition taxes) and §507(a)(2) (which involves administrative expenses that are allowed under §503(b)). Therefore, to be within the scope of §503(b), the debtors' postpetition sale of land had to be "incurred by the estate." However, that was not possible, the court noted, because IRC §1399 specifies that a Chapter 12 estate cannot incur taxes. Thus, because a Chapter 12 bankruptcy estate cannot incur a tax, it cannot benefit from 11 USC §1222(a)(2)(A).

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126. 11 USC §1222(a)(2)(A).

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

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

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

In addition, the court reasoned that the fact that a bankruptcy estate can retain property does not mean that it has the ability to incur tax. The court noted that IRC §§1398 and 1399 specify that a Chapter 12 bankruptcy estate cannot incur taxes and that Congress had repeatedly indicated that it is aware that the taxable entity provisions of the Internal Revenue Code are relevant to the Bankruptcy Code. Thus, the court determined that it was clearly justified in relying on IRC §§1398 and 1399 to interpret the application of 11 USC §1222(a)(2)(A) to taxes arising postpetition in a Chapter 12 bankruptcy.

Note. The U.S. 8th and 10th Circuit Courts of Appeal reached the opposite conclusion from the 9th Circuit.[130] The U.S. Supreme Court agreed to hear the *Hall* case to clear up the disagreement between the circuit courts.[131]

On May 14, 2012, the Supreme Court affirmed the 9th Circuit in a five to four decision.[132] The Court noted that 11 USC §1222(a)(2)(A) allows nonpriority treatment for claims entitled to priority under 11 USC §507, and that 11 USC §507(a)(2) covers administrative expenses that are allowed by 11 USC §503(b)(1)(B), which includes any tax that the **bankruptcy estate** incurs. Therefore, for nonpriority treatment to apply, the bankruptcy estate must incur tax. For that to happen, there must be a bankruptcy estate in existence to incur tax that exists separately from the debtor. On that point, the court held that the statutory phrase "incurred by the estate" clearly means a tax for which the bankruptcy estate is liable. The court stated that the phrase "incurred by the estate bears a plain and natural reading." It is a tax for which the estate itself is liable.

In turn, the court noted that the Internal Revenue Code specifies that only certain types of bankruptcy estates are responsible for federal income taxes. Under those Code provisions, the responsibility for tax is allocated between the bankruptcy estate and the debtor depending on the type of bankruptcy that is at issue. In Chapter 12 and 13 cases (Chapter 12 was modeled after Chapter 13), these Code provisions specify that there is no separate taxable estate. As a result, the debtors in this case were the parties responsible for filing a tax return and are responsible for the taxes resulting from the postpetition sale of the farm.

The court also noted that it was clear that postpetition taxes fell outside the scope of 11 USC §503(b) because a proof of claim could be filed by any entity holding a claim against the debtor for taxes that become payable to a governmental unit while the case is pending. Thus, creditors holding postpetition claims could either collect the taxes inside the bankruptcy estate or from the debtor. If the debtor had no responsibility for the tax, the court reasoned that this Code provision would be superfluous. Thus, such taxes are not automatically collectible and are, therefore, not administrative expenses.

Furthermore, the court noted that 11 USC §346 (from the inception of the Bankruptcy Code) coordinates with IRC §§1398 and 1399 to specify whether a bankruptcy estate or the debtor is responsible for postpetition taxes. That relationship, the court noted, showed that from the inception of the Bankruptcy Code, Congress has specified on a chapter-by-chapter basis which bankruptcy estates are separately taxable and, hence, liable for tax. Under those coordinated provisions, **the debtor is relieved from postpetition tax liability only in a bankruptcy in which a taxable entity separate from the debtor is created. Prepetition taxes are entitled to nonpriority treatment.** In addition, the court pointed out that BAPCPA amended 11 USC §346 to align the assignment of state or local taxes with federal tax rules.

Note. To maximize the amount of prepetition taxes that receive favorable nonpriority claim treatment, the Chapter 12 bankruptcy petition should not be filed until all assets that generate taxable gains are sold.

130. *Knudsen v. IRS,* 581 F.3d 696 (8th Cir. 2009); *In re Dawes,* 652 F.3d 1236 (10th Cir. 2011).

131. *Hall v. U.S.,* 131 S. Ct. 2989 (2011).

132. *Hall v. U.S.,* 132 S. Ct. 1882 (2012).

Observation. The majority opinion of the court stated that "it is implausible to maintain that taxes are 'incurred by the estate' when 11 USC §346(b) specifically prohibits such taxes from being 'taxed to or claimed by the estate.'" The court stated that while 11 USC §1222(a)(2)(A) changed the ordinary priority classification scheme, the provision did not change which claims are entitled to priority or the division of tax liability between the bankruptcy estate and the debtor. The majority concluded its opinion with rather strong language by stating that **none** of the arguments by the petitioners or the dissent overcame the plain language of the statute or the statute's context and structure. The court further stated that there was **"no textual basis"** for reading "incurred by the estate" as including all taxes incurred postpetition. Although the court noted that there could be sound policy reasons for treating postpetition taxes as subject to nonpriority treatment under the BAPCPA provisions, the statute did not provide for it.[133]

CHARITABLE DONATIONS OF MINERALS AND WATER RIGHTS

Note. For a discussion of the various tax issues association with donating permanent conservation easements on agricultural land, see Chapter 11 of the 2005 *University of Illinois Federal Tax Workbook.* This is available online at **www.TaxSchool.illinois.edu/taxbookarchive.**

Esgar Corporation, et al. v. Comm'r.[134] This case involves the appropriate valuation of donated conservation easements with the specific issue of whether the "highest and best use" of the land subject to the easements was gravel mining or agricultural use as irrigated farmland. The petitioners, a corporation and two couples, owned land with another corporation in undivided one-fourth interests. Initially, 2,200 acres were acquired. In 1998, the owners received permission to mine gravel, rock, and sand on 1,479 acres of the property. Later that same year, 661.75 acres of the property were sold, with the sellers reserving the gravel, sand, and mineral rights. A gravel pit was operated on the portion of the property that was sold, and the sellers also operated a gravel pit on a portion of the property that they retained.

With the help of a local accounting firm, the petitioners conducted a series of like-kind exchanges impacting approximately 163 acres not zoned for gravel mining. After the transactions, each petitioner owned approximately 55 acres outright. In 2004, each petitioner donated a permanent conservation easement on their respective tract and claimed a charitable contribution deduction. Combined, the deductions totaled $2.3 million based on multiple expert valuations concluding that aggregate mining was the highest and best use of each tract.

The IRS valuation expert determined that mining was not the most productive use because there was an adequate supply of, and no additional demand for, gravel in the county for the foreseeable future. Also, the local market was already dominated by two major gravel operators, which left no room economically for another local gravel operation in the near future.

Observation. The petitioners' experts argued that gravel could be shipped by rail to another county, but the court noted that there were gravel pits closer to the other county and these closer gravel pits could supply the needs of the other county more economically. Consequently, the petitioners had overstated the demand for gravel.

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133. On May 21, 2012, the Supreme Court declined to hear a similar case from the U.S. 10th Circuit Court of Appeals involving the same issue. *In re Dawes,* No. 11-217, 2012 WL 1811021 (U.S. Sup. Ct. May 21, 2012).

134. *Esgar Corporation, et al. v. Comm'r,* TC Memo 2012-35 (Feb. 6, 2012).

The court concluded that the highest and best use of the properties was for agricultural purposes rather than mining and that the highest and best use of any land is its current use unless the taxpayer can show a compelling reason for a different use. In addition, the court determined that there were sufficient comparable sales to determine the value of the donated property before the easement restriction was in place. Although the easement restriction did reduce the value of the properties, the court determined that the difference in value of the properties before and after the easement donation was $75,000 rather than $2.3 million.

Note. Although the valuation of the easement restriction resulted in a substantial tax deficiency, the court did not apply a IRC §6662(a) valuation understatement penalty. The reasons cited included that the taxpayers' advisor was a competent professional who had sufficient expertise, the taxpayers provided necessary and accurate information to the advisor, and they relied in good faith on the advisor's judgment. The court also noted that for returns filed after August 17, 2006, the reasonable cause exception to the valuation understatement penalty has been repealed.

Chief Counsel Advice 201212009 and 201212010.[135] Generally, in order to have a deductible contribution, a taxpayer must contribute their entire interest in the property.[136] This is known as the "partial interest" rule. However, there are exceptions to the rule that allow a deduction for a charitable contribution of a partial interest in property if that interest represents one of the following listed items.

- A remainder interest donated to charity in the taxpayer's personal home or farm
- An undivided part of the taxpayer's entire interest in the property that consists of a part of every substantial interest or right the taxpayer owns in the property and lasts as long as the taxpayer's interest in the property lasts
- A partial interest that would be deductible if transferred to certain types of annuities or unitrusts
- A qualified conservation contribution[137]

In these CCAs, the taxpayer proposed to make a charitable contribution of the taxpayer's "appropriative interest" in water rights. Under applicable state law, the taxpayer's appropriative interest is treated as a separate property interest. The taxpayer took the position that the appropriative right was a separate property interest but did not argue that the contribution was of a conservation easement. The Chief Counsel's Office denied the deduction under the partial interest rule and referenced an unidentified revenue ruling, which led to the conclusion that the interest at issue was not to be treated as a property interest distinct from the taxpayer's underlying water right. The second ruling noted that the taxpayer should have argued that the contribution was of a conservation easement.

Note. The referenced revenue ruling was likely Rev. Rul. 88-37.[138] In that ruling, the IRS concluded that the donation of an overriding royalty or interest equal to 10% of the net profits from the donor's working interest in an oil and gas lease to a charity was not deductible under IRC §170(a) because the donor retained control of the property. The IRS noted that the right to exploit oil and gas resources under the land is an inherent right in the ownership of the working interest and that the owner of an overriding royalty interest or a net profits interest does not have that same right. Thus, the contributed interest violated the partial interest rule because it was less than the taxpayer's entire interest in the property, was not an undivided portion of the taxpayer's entire interest in the property, was not transferred in trust, and was not a conservation easement.

135. CCA 201212009 and 201212010 (Oct. 7, 2011).

136. IRC §170(f)(3)(A).

137. IRC §§170(f)(3)(B)(iii) and (h).

138. Rev. Rul. 88-37, 1988-1 CB 37.

HOBBY LOSSES

Agricultural cases remain prominent in the hobby loss area, with the key question being where the line is drawn between a legitimate business that produces business deductions and a hobby in which deductions are severely limited. While a "hobby" is any activity that is not engaged in primarily for profit, a presumption exists that if a taxpayer's activity has gross income in excess of deductions for three or more of the last five years, the activity is presumed to be a business. For activities consisting of breeding, training, showing, or racing horses, the presumption arises if there is a profit in any two out of the last seven years. The IRS can rebut the presumption by carrying the burden of proof and establishing a lack of profit motive.

> **Observation.** For farms and ranches operated for pleasure or recreation and not as commercial enterprises, the deduction of expenses is permitted if a profit occurs over a sufficiently long period. Alternatively, both receipts and expenses may be ignored if expenses exceed receipts and the farm is an "activity not engaged in for profit." Even for activities not engaged in for profit, deductions are allowed under the usual rules for interest, taxes, and casualty losses, and for other expenses up to the remaining amount of gross income from the activity.

If the presumption does not resolve the issue of whether a farm is being operated for pleasure or recreation and not as a commercial enterprise, a determination must be made as to whether the taxpayer was conducting the activity with the primary purpose and intention of realizing a profit. The expectation of profit need not be reasonable, but there must be an actual and honest profit objective. Whether the requisite profit motive is present is determined by the facts and circumstances of each case, with the burden of proof on the farmer or rancher attempting to deduct the losses. To assist in the determination, the IRS developed nine factors which are used to determine whether the requisite profit motive exists.[139] Of these nine factors, no single factor is controlling and other factors not listed may also be considered.[140]

The nine factors are as follows.

1. The manner in which the activity is conducted
2. The taxpayer's expertise
3. The amount of time the taxpayer puts into the activity
4. Whether there is an expectation that the assets associated with the activity will increase in value
5. Whether the taxpayer has been involved in a loss venture in the past that was turned into a profitable venture
6. The history of profit and loss from the activity
7. The amount of profits earned from the activity in relation to losses and vice versa
8. Whether the taxpayer is a high-income individual
9. Whether the taxpayer derives significant pleasure from the activity

Trupp v. Comm'r.[141] In this case, the petitioner was a lawyer who incurred nearly $72,000 in "development expenses" while attending equestrian events in which his son participated. The expenses were incurred in a purported attempt to stimulate his equine law practice. The petitioner competed in equestrian events in the 1970s and was considered for a spot on the U.S. Olympic Equestrian Team. He retired from riding before entering law school.

139. Treas. Reg. §1.183-2.

140. Treas. Reg. §1.183-2(b).

141. *Trupp v. Comm'r,* TC Memo 2012-108 (Apr. 2, 2012).

The petitioner testified that when he attended his son's riding shows he contacted potential clients and developed his equine-related client base. He did not buy any banner advertising at the shows and did not establish a table at the events, instead relying on word-of-mouth. The petitioner incurred his expenses when he agreed to pay equestrian-related expenses to those who allowed his son to ride their horses at the shows. He claimed $71,836 as "business promotion" expenses, including payments for horseshoes, boarding fees, feeding and grooming costs, transportation, housing for horses and people at various farms, supplements, riding lessons, and insurance. The petitioner did not request that his law firm reimburse his expenses.

For the year at issue, the petitioner showed only $2,000 in horse-related income with the balance of his income from nonhorse related clients or former clients. The petitioner did not file a return and the IRS prepared an IRC §6020(b) return for him. The Tax Court determined that the petitioner's horse activity and law activity could not be combined under the provisions of Treas. Reg. §1.183-1(d)(1) due to a lack of sufficient interrelationship. The court also rejected the petitioner's argument that the combined horse activity and his law practice constituted a "capital asset" that might increase in value. Also, the court determined that the petitioner lacked records, lacked a profit motive, and did not participate in any equestrian events. The result was a finding that a profit motive was not present for the equestrian activities, and the burden of proof was not shifted to the IRS.

IRC §199 (OIL AND GAS)

In accordance with IRC §199, a qualifying taxpayer can claim a domestic production activities deduction (DPAD) equal to a percentage of the lesser of the taxpayer's taxable income or qualified production activities income (QPAI). For tax years beginning after 2009, the deduction is capped at 9% for all taxpayers except those engaged in the production, refining, processing, transportation, or distribution of oil, gas, or any primary product thereof, for which the deduction is capped at 6%.[142]

> **Note.** The 9% cap for taxpayers is reduced by 3% of the lesser of: the oil-related QPAI of the taxpayer for the tax year; the QPAI of the taxpayer for the tax year; or taxable income determined without regard to IRC §199.[143]

> **Note.** The IRC §199 deduction cannot exceed 50% of the W-2 wages paid by the taxpayer for the employment of employees during the calendar year ending during the tax year.[144]

Taxpayers engaged in a construction trade or business have domestic production gross receipts (DPGR) resulting from the construction of real property in the United States.[145] However, revenue attributable to the lease, rental, license, sale, exchange, or other disposition of land does **not** give rise to DPGR.[146]

The regulations also specify that DPGR includes gross receipts from the sale, exchange, or other disposition of natural gas produced by the taxpayer in the United States.[147] The provision includes all activities involved in extracting natural gas from the ground and processing the gas into pipeline quality gas.[148] DPGR does not, however, include gross receipts derived from a nonoperating mineral interest (e.g., a royalty interest or a net profits interest).[149]

> **Note.** For a thorough discussion of the DPAD, see Chapter 12 in the 2009 *University of Illinois Federal Tax Workbook.* This is available online at **www.TaxSchool.illinois.edu/taxbookarchive.**

142. IRC §199(d)(9)(B).
143. IRC §199(d)(9)(A).
144. IRC §199(b).
145. IRC §§199(c)(4)(ii) and (iii).
146. Treas. Reg. §1.199-3(m)(6)(iii).
147. Treas. Reg. §1.199-3(a).
148. Treas. Reg. §1.199-3(l)(2).
149. Treas. Reg. §1.199-3(i)(9).

In CCA 201208029,[150] the issue presented was whether the taxpayer's gross receipts derived from the sale of "leasehold rights" were DPGR under IRC §199(c)(4)(A)(ii). The taxpayer was an independent natural gas exploration and production company that leased oil, gas, and mineral rights from an individual. The taxpayer drilled a natural gas well on the leased property consisting of a borehole, steel casing, and wellhead. The taxpayer expensed all its intangible drilling costs related to drilling the well and treated its share of gross receipts derived from the sale of the produced natural gas as DPGR. Eventually, the taxpayer sold the leasehold rights and the well to an unrelated corporation for a lump sum.

The primary findings of the CCA are as follows.

- The taxpayer's gross receipts from the sale of the well were DPGR. In this regard, the well was real property in accordance with Treas. Reg. §1.199-3(m)(3).
- The DPGR derived from the well's sale included gross receipts attributable to construction activities for purposes of IRC §199. These activities were "construction" for purposes of the North American Industry Classification System as required by Treas. Reg. §1.199-3(m)(1)(i). Construction activities include drilling, development expenditures for a mine or natural deposit, and any activities whose costs are expensed as intangible drilling and development costs.
- The leasehold rights were not part of the well because they were not part of the real estate that the taxpayer constructed. Thus, the taxpayer did not "construct" the leasehold rights, and the gross receipts from unsevered oil, natural gas, and minerals related to the leasehold rights instead of the well. That was the result even though the taxpayer had a contractual right to the unsevered natural resources. However, the IRS position was that the well provided only the "means to produce" the unsevered oil, natural gas, and minerals and did not provide the taxpayer with any ownership rights in them.
- To the extent that the taxpayer capitalizes intangible drilling costs into the basis of the leasehold rights, this amount is considered a cost related to well construction with the associated gross receipts derived from the sale allocable to the intangible drilling costs qualifying as DPGR. However, the CCA notes that the DPGR should not exceed the amount of capitalized intangible drilling costs.
- For intangible drilling costs that are not expensed, the IRS concluded that some of the taxpayer's basis in the leasehold rights may be attributable to intangible drilling costs of the constructed well. The CCA contains an example showing that if no election is made to expense intangible drilling costs, the taxpayer can charge the costs to its lease rights and recover the costs through depletion upon production of oil, gas, or minerals. Thus, the taxpayer's adjusted basis in the leasehold rights can include intangible drilling costs that the taxpayer capitalized and has not yet recovered through depletion.

A key result of the CCA is that the proceeds from the sale of oil and gas wells in the United States on which the taxpayer has performed drilling activities (construction) qualifies as DPGR. However, DPGR is limited to receipts attributable to the equipment on or in the well. DPGR does not (according to the CCA) include amounts allocable to the underlying developed mineral reserves because they are allocable to leasehold rights rather than the well. Mineral reserves, according to the CCA, are not "real property."

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150. CCA 201208029 (Dec. 1, 2011).

Observation. Treas. Reg. §1.199-3(m)(3) does not include mineral reserves in the definition of "real property," however, oil and gas wells are included. IRC §614 defines oil and gas property for purposes of IRC §199, and under that provision, underlying minerals **are** viewed as part of the definition of oil and gas property. IRS Pub. 535 also indicates that "property" (for depletion purposes) includes any interest the taxpayer owns in a mineral deposit. In addition, although there is a statutory provision excluding receipts attributable to land from DPGR, there is no comparable exclusion for mineral deposits (probably because a mineral deposit is inseparable from the well). Thus, an argument can be made that the CCA unnecessarily limits the DPAD in the context of the sale of oil and gas leasehold rights.[151]

[151]. For a similar conclusion and analysis of the entire issue addressed by the CCA, see Swiech, Robert A., and Vance, Scott, "Oil and Gas Wells and the Section 199 Deduction: Deep Subject, Shallow Ruling?," *Journal of Taxation,* June 2012.